

# SECURITIES REGULATION OF FUNDRAISING ACTIVITIES OF RELIGIOUS AND OTHER NONPROFIT ORGANIZATIONS

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There is a common misconception that religious and other nonprofit organizations are exempt from compliance with the securities laws. They are not. Nonprofit organizations that engage in fundraising activities involving the offer and sale of securities must comply with the federal securities laws. They also must comply with the securities laws of each state in which such activities are conducted. This Article provides an overview of the federal and state securities laws that govern the sale of securities by nonprofit organizations, and describes the actions required to comply with those laws. This Article also addresses the impact of the Philanthropy Protection Act of 1995<sup>1</sup> and the National Securities Markets Improvement Act of 1996<sup>2</sup> on the regulation of securities activities of nonprofit organizations.

Nonprofit organizations engage in a wide variety of fundraising activities that involve the issuance of securities. Such organizations may issue notes, bonds, and other debt instruments to raise funds for general operations or for the construction or purchase of churches, schools, hospitals, retirement homes, or other facilities. Many national religious denominations operate church extension funds that issue notes to denominational members to raise funds to make loans to new or financially troubled congregations. Nonprofit orga-

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1. Pub. L. No. 104-62, 109 Stat. 682 (codified as amended in scattered sections of 15 U.S.C.).

2. Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended at 15 U.S.C. §§ 77z-3, 78mm, 80b-3a (Supp. II 1996)).

nizations administer pooled income funds and pooled charitable trust funds. A group of nonprofit organizations also may pool their funds for common investment in a manner consistent with their shared religious or social principles or objectives. Nonprofit organizations issue charitable gift annuities and accept charitable contributions in the form of charitable remainder trusts and charitable lead trusts. All of these activities require nonprofit organizations to comply with state and federal securities laws.<sup>3</sup>

Federal and state governmental agencies generally attempt to avoid regulation of nonprofit organizations by granting them privileges and exemptions not available to others.<sup>4</sup> The securities laws follow this pattern by exempting nonprofit organizations from many securities regulatory requirements.<sup>5</sup> However, due to concerns for actual or potential investment fraud or mismanagement in conjunc-

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3. The SEC has taken the position through interpretive releases and no-action letters that each of these activities, at least in some circumstances, involves the issuance of securities under federal securities laws. In some circumstances, however, some of these activities (e.g., the acceptance of an unsolicited donation through an irrevocable charitable trust) may not involve the issuance of a "security." A discussion of what constitutes a security is beyond the scope of this Article. Under section 2(1) of the Securities Act, a "security" is defined as:

[A]ny note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

A similar definition is contained in section 3(10) of the Securities Exchange Act of 1935 and section 401(2)(e) of the 1956 Uniform Securities Act. *See generally* 2 LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION, 869-1083 (3d ed. 1989 & Supp. 1996). For a discussion of the impact of the Philanthropy Protection Act on the determination of whether a charitable income fund or a charitable trust involves the issuance of a security, see Harvey Bines & Steve Thel, *Investment Management Arrangements and the Federal Securities Laws*, 58 OHIO ST. L.J. 459, 499 (1997).

4. *See* Bazil Facchina et al., *Privileges & Exemptions Enjoyed by Nonprofit Organizations*, 28 U.S.F. L. REV. 85 (1993); Sanford J. Schlesinger, *New Legislative Protection for Charitable Giving Vehicles*, 23 EST. PLAN. 392 (1996); *see also* *Developments in the Law — Nonprofit Corporations*, 105 HARV. L. REV. 1578, 1583 (1992).

5. *See* 15 U.S.C. §§ 77c(a)(4), 78l(g)(2)(D), 80a-3(c)(10) (1994 & Supp. I 1995); *see also* UNIF. SEC. ACT §§ 301, 402(a)(g), 403, 7B U.L.A. 550, 600, 620 (1958).

tion with the sale of securities, nonprofit organizations are never exempt from the anti-fraud provisions of the federal and state securities laws. Each issuer of securities is required to make full and fair disclosure to its investors and is prohibited from engaging in manipulative, deceptive, or fraudulent conduct in connection with the sale of securities.<sup>6</sup> The federal and state securities regulatory agencies actively enforce these anti-fraud requirements and will pursue civil and criminal proceedings against nonprofit organizations that engage in fraudulent activities.

These concerns often are heightened for nonprofit religious organizations.<sup>7</sup> By their very nature, religious organizations and their members look to the hopeful side of life. There often is an expectation that "The Lord will provide." In reality, this sometimes does not happen. The leaders of a religious organization, while intending to be good stewards of their members' investments, may lack the financial acumen to realize they are heading for a difficult situation. It is easy for an organization to become seriously over-committed financially, leading to failure. In some cases, especially at the local level, individual leaders may become so messianic that there is an absence of any checks and balances or financial reporting. The leader makes all decisions and controls the funds without any accountability to the members. If the leader lacks business skills or integrity, the results can be, and have been, devastating to the organization and its members. Whether it is a case of simple financial mismanagement or an intentional scheme to defraud investors of their money, the result is the same — both the investors and the religious community are the losers, both financially and in reputation.

### FEDERAL SECURITIES LAWS

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6. See *id.* § 78j.

7. See, e.g., Barry W. Taylor, *Criminal Law: Diversion of Church Funds to Personal Use: State, Federal and Private Sanctions*, 73 J. CRIM. L. & CRIMINOLOGY 1204 (1982); Jonathan Turley, *Laying Hands on Religious Racketeers: Applying Civil RICO to Fraudulent Religious Solicitation*, 29 WM. & MARY L. REV. 441 (1988); see also JOHN HAWKS, FOR A GOOD CAUSE? HOW CHARITABLE INSTITUTIONS BECOME POWERFUL ECONOMIC BULLIES ch. 10 (1997).

The primary federal securities laws that apply to the fundraising activities of nonprofit organizations are the Securities Act of 1933 (the Securities Act),<sup>8</sup> the Securities Exchange Act of 1934 (the Exchange Act),<sup>9</sup> the Trust Indenture Act of 1939 (the Trust Indenture Act),<sup>10</sup> the Investment Company Act of 1940 (the Investment Company Act)<sup>11</sup> and the Investment Advisers Act of 1940 (the Advisers Act).<sup>12</sup>

On December 8, 1995, President Clinton signed into law the Philanthropy Protection Act of 1995 (the Philanthropy Protection Act).<sup>13</sup> The stated purpose of the Philanthropy Protection Act was "to protect and facilitate donations to entities organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes by limiting the applicability of Federal and State securities laws to the activities of such organizations in connection with the maintenance of certain pooled funds."<sup>14</sup> The Philanthropy Protection Act was intended to codify the position of the Securities and Exchange Commission,<sup>15</sup> as set forth in various interpretive releases and no-action letters previously issued to non-

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8. 15 U.S.C. § 77a-78mm (1994 & Supp. I 1995).

9. *Id.* § 78a-78mm.

10. *Id.* § 77aaa-77bbb.

11. *Id.* § 80a-1-80a-52.

12. *Id.* § 80b-1-80b-21.

13. Pub. L. No. 104-62, 109 Stat. 682 (codified as amended in scattered sections of 15 U.S.C.). On December 8, 1995, President Clinton also signed into law the Charitable Gift Annuity Antitrust Relief Act of 1995. *See* Pub. L. No. 104-63, 109 Stat. 687 (codified as amended at 15 U.S.C. §§ 1, 37, 37a (Supp. I 1995)). These laws were enacted largely in response to a class action lawsuit filed in federal district court in Texas alleging, among other things, that charitable income funds were investment companies under the Investment Company Act and seeking rescission of certain charitable donations. The lawsuit also alleged a price-fixing conspiracy to set maximum rates of return on charitable gift annuities in violation of federal antitrust laws. Following passage of the Philanthropy Protection Act, the plaintiffs abandoned their claims under the Investment Company Act, although they have continued to pursue their antitrust claims. *See* *Richie v. American Council on Gift Annuities, Inc.*, 943 F. Supp. 685 (N.D. Tex. 1996), *appeal dismissed*, *Ozee v. American Council on Gift Annuities, Inc.*, 110 F.3d 1082 (5th Cir.), *reh'g*, 116 F.3d 1479 (5th Cir.), *petition for cert. filed* (Aug. 19, 1997) (No. 97-309 and No. 97-314). On July 3, 1997, the Charitable Donation Antitrust Immunity Act of 1997, H.R. Rep. No. 105-164, was enacted with the apparent singular purpose of terminating this class-action lawsuit.

14. H.R. REP. NO. 104-333, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 619.

15. "This bill would codify the current practice of the Securities and Exchange Commission with regard to charitable income funds and . . . would retain the anti-fraud and disclosure requirements currently applicable to both investment companies and charitable organizations and trusts." *Id.* at 10.

profit organizations.<sup>16</sup> The Philanthropy Protection Act accomplished this purpose by providing nonprofit organizations with additional exclusions and exemptions from registration under the various federal securities laws and by preempting certain state securities laws registration and reporting requirements.<sup>17</sup>

The National Securities Markets Improvement Act of 1996<sup>18</sup> (the Improvement Act) is comprised of five titles: the Capital Markets Efficiency Act; the Investment Company Act Amendments; the Investment Advisers Supervision Coordinating Act; Securities and Exchange Commission Authorization; and Reducing the Cost of Saving and Investment. The Improvement Act amended the federal securities laws to provide additional federal exclusions and exemptions from registration, and to preempt certain state securities laws requirements. Although the Improvement Act significantly reformed the state and federal securities regulatory structure, it likely will have only a limited impact on nonprofit organizations due to the various exemptions and exclusions available to nonprofit organizations under federal and state securities laws,<sup>19</sup> especially after passage of the Philanthropy Protection Act.

The Securities and Exchange Commission (the SEC) administers the federal securities laws and has authority to enforce compliance and to issue regulations under the federal securities laws.

### Securities Act of 1933

The Securities Act primarily regulates the registration and initial sale of securities by an issuer. The principal purpose of the Securities Act is to provide “full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails . . . .”<sup>20</sup>

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16. See *infra* text accompanying note 163–64 for a discussion of these interpretive releases and no-action letters.

17. Pub. L. No. 104-62, 109 Stat. 682 (codified as amended in scattered sections of 15 U.S.C.).

18. Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.).

19. See 15 U.S.C. §§ 77c(a)(4), 78l(g)(2)(D), 80a-3(c)(10) (1994 & Supp. I 1995); see also UNIF. SEC. ACT §§ 301, 402(a)(9), 403, 7B U.L.A. 550, 600, 620 (1958).

20. Preamble to the Securities Act, Pub. L. No. 22, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77a–77zzz (1994)).

*Registration and Prospectus Delivery Requirements*

The Securities Act requires each issuer of securities to file a registration statement with the SEC and to provide to each potential investor a prospectus that makes full disclosure of all material facts necessary for the investor to make an informed decision concerning the investment. Section 5<sup>21</sup> of the Securities Act sets forth these registration and prospectus delivery requirements, which apply to any offer or sale of a security in interstate commerce or through the mail unless an exemption is available under either section 3<sup>22</sup> or section 4<sup>23</sup> of the Act. Section 3 provides an exemption from registration of certain types of securities. Section 4 provides an exemption from registration of certain securities transactions.

*Nonprofit Organization Exemptions*

Section 3(a)(4) of the Securities Act provides an exemption from registration for “[a]ny security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any person, private stockholder, or individual.”<sup>24</sup> To qualify for this exemption, an organization must be exclusively organized and operated for specified charitable purposes.<sup>25</sup> The SEC will not issue a no-action letter<sup>26</sup> in the absence of a ruling by the Internal Revenue Service that an issuer qualifies as a tax-exempt organization.<sup>27</sup> A tax ruling is not dispositive of the issue, however.<sup>28</sup> An organization that has

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21. 15 U.S.C. § 77e (1994).

22. 15 U.S.C. § 77c (1994 & Supp. I 1995).

23. 15 U.S.C. § 77d (1994).

24. 15 U.S.C. § 77c(a)(4) (Supp. I 1995).

25. *See id.*

26. No-action letters are issued by the staff of the SEC and are not binding on the SEC, although they do inform the recipient whether the SEC is likely to bring legal action or will take no action (hence, their name) if a given transaction occurs. The value of a particular no-action letter depends significantly on the detail of the response by the staff of the SEC. *See* LOSS & SELIGMAN, *supra* note 3, at 525 n.29.

27. American Heart Assoc., SEC No-Action Letter [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,615 (Feb. 26, 1993); Northeastern Pa. Synod of the Evangelical Lutheran Church in Am., SEC No-Action Letter, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,697 (Mar. 31, 1988).

28. The Christian Stewardship Ministry, SEC No-Action Letter, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,347 (Mar. 29, 1980).

any substantial non-charitable purpose or that is in reality organized or operated for the benefit of private purposes will not qualify for the exemption.<sup>29</sup>

The Philanthropy Protection Act amended Section 3(a)(4) in 1995 to provide an additional exemption from registration applicable to “any security of a fund that is excluded from the definition of an investment company under section 3(c)(10)(B) of the Investment Company Act of 1940.”<sup>30</sup> Thus, if a charitable income fund is excluded under section 3(c)(10)(B) of the Investment Company Act,<sup>31</sup> any security issued by the fund will be exempt from registration under the Securities Act.

Section 3(a)(4) provides only an exemption from registration of securities. It does not provide an exemption from the anti-fraud provisions of the Securities Act.

#### Exchange Act of 1934

While the Securities Act is concerned primarily with the initial offer and sale of securities by the issuer, the applicable provisions of the Exchange Act are concerned primarily with regulation of the secondary market and financial intermediaries, as well as the prevention of fraud. Of primary concern to nonprofit organizations are the Exchange Act provisions that: (i) require the registration of securities and periodic reporting by certain issuers;<sup>32</sup> (ii) require registration of brokers and dealers who engage in a securities business in interstate commerce;<sup>33</sup> and (iii) address fraud and misrepresentation in connection with the sale of a security in either initial or secondary offerings.<sup>34</sup>

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29. *See, e.g.*, *E.H.I. of Fla., Inc. v. Insurance Co. of N. Am.*, 499 F. Supp. 1053, 1062 (E.D. Pa. 1980); *SEC v. American Found. for Advanced Educ. of Ark.*, 222 F. Supp. 828, 831 (W.D. La. 1963); *SEC v. Children's Hosp.*, 214 F. Supp. 883, 889 (D. Ariz. 1963); *Omega Trust Assoc.*, SEC No-Action Letter [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,756 (Oct. 3, 1980); *Inland Counties Reg'l Ctr.*, SEC No-Action Letter, [1976–1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,620 (May 21, 1976); *Philadelphia Hungarian Club*, SEC No-Action Letter, [1976–1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,872 (Nov. 8, 1976); *see also* LOSS & SELIGMAN, *supra* note 3, at 1198–1202.

30. 15 U.S.C. § 77c(a)(4) (Supp. I 1995).

31. *See infra* text accompanying note 59.

32. *See* Exchange Act § 12, 15 U.S.C. § 78l (Supp. I 1995).

33. *See id.* § 15, 15 U.S.C. § 78o (Supp. I 1995).

34. *See id.* § 10, 15 U.S.C. § 78j (Supp. I 1995); SEC Rule 17 C.F.R. § 240.10b-5

*Securities Registration; Nonprofit Organization Exemptions*

Section 12(g) of the Exchange Act sets forth requirements for the registration of securities of issuers with total assets exceeding \$10 million and a class of equity security (other than an exempted security) held of record by 750 or more persons.<sup>35</sup> Section 12(g)(2)(D) provides an exemption from these registration requirements, however, for "any security of an issuer organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any private shareholder or individual."<sup>36</sup> This exemption is almost identical to the exemption contained in section 3(a)(4) of the Securities Act.<sup>37</sup>

The Philanthropy Protection Act amended section 12(g)(2)(D) in 1995 to provide an additional exemption from registration for "any security of a fund that is excluded from the definition of an investment company under section 3(c)(10)(B) of the Investment Company Act of 1940."<sup>38</sup> The Philanthropy Protection Act also amended the definition of "exempted security" in section 3(a)(12)(A) to include "any security issued by or any interest or participation in" a charitable income fund under Section 3(c)(10)(B) of the Investment Company Act.<sup>39</sup> Thus, if a charitable income fund is excluded under section 3(c)(10)(B) of the Investment Company Act, any security issued by the fund will be exempt from registration not only under the Securities Act, but also under the Exchange Act.

The exemption under sections 12(g) and 3(a)(12)(A) are only exemptions from registration. The anti-fraud provisions of the Exchange Act continue to apply to the purchase and sale of securities that are exempt from registration.<sup>40</sup>

*Broker-Dealer Registration; Nonprofit Organization Exemptions*

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(1997).

35. See Exchange Act Rule, 17 C.F.R. § 240.12g-1 (1997).

36. 15 U.S.C. § 78l(g)(2)(D) (Supp. I 1995).

37. See *id.* § 77c(a)(4).

38. *Id.* § 78l(g)(2)(D).

39. See Exchange Act § 3(a)(12)(A), 15 U.S.C. § 78c(a)(12)(A) (1994).

40. See *infra* text accompanying note 96.

Section 15(a) of the Exchange Act generally requires any broker or dealer to register with the SEC.<sup>41</sup> A “broker” is “any person engaged in the business of effecting transactions in securities for the account of others.”<sup>42</sup> A “dealer” is “any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise.”<sup>43</sup> The Exchange Act also requires the registration of municipal and government securities brokers and dealers.<sup>44</sup>

The Philanthropy Protection Act amended the Exchange Act in 1995 to provide nonprofit organizations and their personnel an exclusion from the definition of “broker,” “dealer,” “municipal securities broker,” “municipal securities dealer,” “government securities broker,” and “government securities dealer.”<sup>45</sup>

This exclusion applies to any charitable organization, as defined in section 3(c)(10)(D) of the Investment Company Act,<sup>46</sup> or any trustee, director, officer, employee, or volunteer of such a charitable organization, that buys, sells, or trades in securities for its own account in its capacity as trustee or administrator of, or otherwise on behalf of or for the account of: (a) a charitable organization; (b) a charitable income fund; (c) a trust or other donative instrument for which the assets are permitted in a charitable income fund; or (d) the settlors (or potential settlors) or beneficiaries of any such charitable trusts or donative instrument.<sup>47</sup> This exclusion is broad enough to cover most securities sales activities of nonprofit organizations.<sup>48</sup>

This exclusion is not available, however, unless every person that solicits donations on behalf of the charitable organization from any donor to a charitable income fund is a volunteer or is engaged in the overall fund raising activities of the charitable organization and receives no commission or other special compensation based on the number or the value of donations collected for the fund.<sup>49</sup> Accordingly, a nonprofit organization and its trustees, directors, officers, employees, and volunteers will not be entitled to rely on the exclu-

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41. See 15 U.S.C. § 78o(a) (1994).

42. Exchange Act § 3(a)(4), 15 U.S.C. § 78(c)(4) (1994).

43. *Id.* § 3(a)(5), 15 U.S.C. § 78c(a)(5) (1994).

44. *Id.* §§ 15B–15C, 15 U.S.C. § 78o(4)–(5) (1994).

45. See *id.* § 3(e), 15 U.S.C. § 78c(e)(1) (Supp. I 1995).

46. See *infra* note 57 for the definition of “charitable organization.”

47. See Exchange Act § 3(e)(1), 15 U.S.C. § 78c(e)(1) (Supp. I 1995).

48. See *infra* text accompanying notes 152–55.

49. See Exchange Act § 3(e)(2), 15 U.S.C. § 78c(e)(2) (Supp. I 1995).

sion under section 3(e)(2) if the nonprofit organization: (i) retains an outside organization or person or hires an employee solely to solicit donations to a charitable income fund and not to participate in other fundraising activities of the organization; or (ii) pays impermissible compensation to any person for soliciting donations to the charitable income fund.

#### Trust Indenture Act of 1939

The Trust Indenture Act generally requires the appointment of an independent trustee and the use of a trust indenture to provide a mechanism for repayment of indebtedness and to provide protection for debt holders in a public offering of debt securities.<sup>50</sup> The Trust Indenture Act also prescribes eligibility and disqualification requirements for indenture trustees and establishes procedures for collection in the event of default under the debt securities.<sup>51</sup>

The Trust Indenture Act does not apply to any security that is exempt from registration pursuant to section 3 of the Securities Act.<sup>52</sup> Accordingly, if a nonprofit organization is exempt from registration under section 3(a)(4) of the Securities Act, the organization will not be subject to the requirements of the Trust Indenture Act.

#### Investment Company Act of 1940

##### *Registration Requirements*

The Investment Company Act regulates investment companies and requires each investment company to register with the SEC.<sup>53</sup> An "investment company" is defined generally as an issuer of securities primarily engaged in the business of investing in, holding, or trading securities.<sup>54</sup> Although the most common form of investment company is a "mutual fund" that continuously issues redeemable shares to the public, the SEC has deemed a great variety of investment vehicles to be investment companies that are subject to the requirements of the Investment Company Act. For example, the SEC has taken the position that an investment company has been

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50. See Trust Indenture Act §§ 305–307, 15 U.S.C. §§ 77eee–ggg (1994).

51. See *id.* §§ 310–311, 15 U.S.C. §§ 77jjj–kkk (1994).

52. See *id.* § 304(a)(4), 15 U.S.C. § 77ddd(a)(4) (1994).

53. See Investment Company Act § 8, 15 U.S.C. § 80a-8 (1994).

54. See *id.* § 3(a), 15 U.S.C. § 80a-3(a) (1994).

formed when a company that is not itself an investment company (e.g., a charitable organization) creates a pool of assets segregated from other company assets, issues interests or participations in the pool, and pays a return to each participant based upon the returns of the pool.<sup>55</sup>

### *Nonprofit Organization Exemptions*

Section 3(c)(10)(A)(i) of the Investment Company Act provides that the definition of an “investment company” shall not include “any company organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes — no part of the net earnings of which inures to the benefit of any private shareholder or individual.”<sup>56</sup>

The Philanthropy Protection Act amended section 3(c)(10) in 1995 to provide an additional exclusion from the definition of an investment company. The additional exclusion in section 3(c)(10)(A)(ii) and (B) applies to “any company organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes . . . which is or maintains . . . a pooled income fund, collective trust fund, collective investment fund, or similar fund maintained by a charitable organization<sup>57</sup> exclusively for the collective investment and reinvestment” of certain permissible assets.<sup>58</sup> Funds meeting the requirements of section 3(c)(10)(B) are referred to in this article as “charitable income funds.”<sup>59</sup>

55. Robert C. Hacker & Ronald D. Rotunda, *The SEC's Ectoplasmic Theory of an Issuer as Applied to Educational and Charitable Institutions, Bank Trustees, and Other Exempt Issuers*, 65 CAL. L. REV. 1181 (1977).

56. 15 U.S.C. § 80a-3(c)(10)(A)(i) (Supp. I 1995). This exemption is almost identical to the exemptions contained in the Securities Act and the Exchange Act. *See supra* text accompanying notes 24 and 36.

57. The term “charitable organization” means an organization described in paragraphs (1) through (5) of section 170(c) or section 501(c)(3) of the Internal Revenue Code of 1986. *See* Investment Company Act § 3(c)(10)(D)(iii), 15 U.S.C. § 80a-3(c)(10)(D)(iii) (Supp. I 1995).

58. 15 U.S.C. § 80a-3(c)(10)(A)–(B) (Supp. I 1995). A trust or fund is maintained by a charitable organization if the organization serves as a trustee or administrator of the trust or fund or has the power to remove the trustees or administrators of the trust or fund and to designate new trustees or administrators. *See* Investment Company Act § 3(c)(10)(D)(i), 15 U.S.C. § 80a-3(c)(10)(D)(i) (Supp. I 1995).

59. In congressional testimony, remarks, and reports in connection with consideration of passage of the Philanthropy Protection Act, funds meeting the requirements of section 3(c)(10)(B) commonly were referred to as “charitable income funds.” *See Philan-*

The only permissible assets<sup>60</sup> for charitable income funds are: (1) assets of the general endowment fund or other funds of one or more charitable organizations; (2) assets of a pooled income fund;<sup>61</sup> (3) assets contributed to a charitable organization in exchange for the issuance of charitable gift annuities;<sup>62</sup> (4) assets of a charitable remainder trust<sup>63</sup> or of any other trust, the remainder interests of which are irrevocably dedicated to any charitable organization; (5) assets of a charitable lead trust;<sup>64</sup> and (6) such assets as the SEC may prescribe by rule, regulation, or order.<sup>65</sup>

A charitable income fund is prohibited from containing assets of a revocable trust, subject to two exceptions: a limited revocability exception and a grandfather exception.<sup>66</sup> Under the limited revocability exception,<sup>67</sup> assets of revocable trusts are permitted in a charitable income fund if the remainder interests are revocably dedicated to or for the benefit of one or more charitable organizations and the ability to revoke the dedication is limited to circumstances involving: (i) an adverse change in the financial circumstances of a

*thropy Protection Act of 1995: Hearings on H.R. 2519 Before the Subcomm. on Telecomm. and Fin.*, 104th Cong. 5-9 (1995) (statement of Barry P. Barbash, Director, Division of Investment Management, SEC); H.R. REP. NO. 104-333, *supra* note 14, at 4. The Authors continue this practice. The term "charitable income fund" should not be confused with a "pooled income fund," which is just one type of charitable income fund described in section 3(c)(10)(B) of the Investment Company Act. *See* 15 U.S.C. § 80a-3(c)(10)(B) (Supp. I 1995).

60. *See* Investment Company Act § 3(c)(10)(B)(i)-(v), (viii), 15 U.S.C. § 80a-3(c)(10)(B)(i)-(v), (viii) (Supp. I 1995).

61. The term "pooled income fund" has the same meaning as in section 642(c)(5) of the Internal Revenue Code of 1986. *See* Investment Company Act § 3(c)(10)(D)(ii), 15 U.S.C. § 80a-3(c)(10)(D)(ii) (Supp. I 1995); I.R.C. § 642(c)(5) (1994).

62. The term "charitable gift annuity" means an annuity issued by a charitable organization that is described in section 501(m)(5) of the Internal Revenue Code of 1986. *See* Investment Company Act § 3(c)(10)(D)(vi), 15 U.S.C. § 80a-3(c)(10)(D)(vi) (Supp. I 1995); I.R.C. § 501(m)(5) (1994).

63. The term "charitable remainder trust" means a charitable remainder annuity trust or a charitable remainder unitrust, as those terms are defined in section 664(d) of the Internal Revenue Code of 1986. *See* Investment Company Act § 3(c)(10)(D)(v), 15 U.S.C. § 80a-3(c)(10)(D)(v) (Supp. I 1995); I.R.C. § 664(d) (1994).

64. The term "charitable lead trust" means a trust described in section 170(f)(2)(B), 2055(e)(2)(B), or 2522(c)(2)(B) of the Internal Revenue Code of 1986. *See* Investment Company Act § 3(c)(10)(D)(iv), 15 U.S.C. § 80a-3(c)(10)(D)(iv) (Supp. I 1995); I.R.C. §§ 170(f)(2)(B), 2055(e)(2)(B), 2522(c)(2)(B) (1994).

65. To date, the SEC has not promulgated any such rules, regulations, or orders.

66. *See* Investment Company Act § 3(c)(10)(C), 15 U.S.C. § 80a-3(c)(10)(C) (Supp. I 1995).

67. *See id.* § 3(c)(10)(B)(vi), 15 U.S.C. § 80a-3(c)(10)(B)(vi) (Supp. I 1995).

settlor or an income beneficiary of the trust; (ii) a change in the identity of the charitable organization or organizations having the remainder interest, provided that the new beneficiary is also a charitable organization; or (iii) both the changes described in (i) and (ii).<sup>68</sup> Under the grandfather exception,<sup>69</sup> assets of revocable remainder trusts are permitted in a charitable income fund for a period of three years after the date of enactment of the Philanthropy Protection Act (i.e., until December 8, 1998), but only if (i) such assets were contributed before the date that was sixty days before such enactment (i.e., before February 6, 1996); and (ii) such assets are commingled in the fund with the other permissible assets of charitable income funds.<sup>70</sup>

The Improvement Act amended section 3(c) in 1996 to provide an additional exclusion for privately offered investment companies whose investors, termed "qualified purchasers," are all highly sophisticated.<sup>71</sup> This exclusion applies to any issuer whose securities are owned exclusively by qualified purchasers and which is not making and does not propose to make a public offering of such securities.<sup>72</sup> Included in the definition of "qualified purchaser" is

any company that owns not less than \$5 million in investments and that is owned by two or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons."<sup>73</sup>

The SEC has adopted final rules under the Investment Company Act to implement these provisions of the Improvement Act.<sup>74</sup> This exclusion will benefit the small number of private foundations and

68. *See id.*

69. *See id.* § 3(c)(10)(B)(vii), 15 U.S.C. § 80a-3(c)(10)(B)(vii) (Supp. I 1995).

70. *See id.* § 3 (c)(10)(C), 15 U.S.C. § 80a-3 (c)(10)(C) (Supp. I 1995).

71. *Id.* § 2 (a)(51)(A), 15 U.S.C. § 80a-2(a)(51)(A) (Supp. I 1995).

72. *See* Investment Company Act § 3(c)(7)(A), 15 U.S.C. § 80a-3(c)(7)(A) (Supp. I 1995).

73. *Id.* § 2(a)(51)(A)(ii), 15 U.S.C. § 80a-2(a)(51)(A)(ii) (1994).

74. *See Privately Offered Investment Companies*, Investment Company Act Release No. 22,579 [Current] Fed. Sec. L. Rep. (CCH) ¶ 85,929 (April 3, 1997) (effective June 9, 1997).

charities referenced in the definition of "qualified purchaser."<sup>75</sup>

### *Disclosure Requirements*

Although the Philanthropy Protection Act provided a new exclusion for charitable income funds, the Philanthropy Protection Act also amended the Investment Company Act to impose new disclosure requirements applicable only to charitable income funds. Section 7(e) of the Investment Company Act requires each charitable income fund to provide to each donor to the fund, at the time of donation, written information describing the material terms of the operation of the fund.<sup>76</sup> To meet this requirement, nonprofit organizations must prepare an offering circular or other disclosure document that contains all material information with respect to the fund and provide it to each donor or participant at or before the time of donation.<sup>77</sup>

The disclosure requirements under section 7(e) are not waivable.<sup>78</sup> A contract purporting to waive any requirement of the Investment Company Act is void by statute.<sup>79</sup> In addition, a contract that is made in violation of the Investment Company Act or whose performance involves a violation of the Investment Company Act is unenforceable and may be rescinded by either party to the contract.<sup>80</sup> Accordingly, any contributor to a charitable income fund who does not receive the disclosures required by section 7(e) would have the right to rescind the contract and to receive a full refund of the amounts contributed, with interest.

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75. These private foundations and charities also will benefit from new state law preemptions made available by the Improvement Act. *See* Pub. L. No. 104-290 (1996) (codified as amended at 15 U.S.C. §§ 77z-3, 78mm, 80b-3a (Supp. II 1996)). Under new sections 18(a) and 18(b)(3) of the Securities Act, the offer and sale of securities to a qualified purchaser is automatically exempt from registration or qualification under state securities laws. *See id.* § 77r(a), (b)(3). The only state provisions that are preempted, however, are those requiring the registration or qualification of securities. Preemption does not apply to any other state securities laws, including anti-fraud laws or laws requiring the registration of brokers, dealers, investment advisers, agents, or representatives. Unlike the Philanthropy Protection Act, states do not have the ability to opt out of federal preemption under the Improvement Act.

76. *See* Investment Company Act § 7(e), 15 U.S.C. § 80a-7(e) (Supp. I 1995).

77. *See id.*

78. *See id.*

79. *See id.* § 46(a), 15 U.S.C. § 80a-46(a) (1994).

80. *See id.* § 46(b), 15 U.S.C. § 80a-46(b) (1994).

Significantly, compliance with the disclosure requirements under section 7(e) is not a condition to the section 3(c)(10)(B) exclusion. A charitable income fund that fails to provide the required disclosures will thereby not become subject to the registration and other requirements of the Investment Company Act applicable to investment companies.<sup>81</sup> The nonprofit organization and the individuals involved also will not lose the benefit of the state and federal exemptions from registration as brokers, dealers, agents, or investment advisers in connection with their activities involving charitable trusts.<sup>82</sup> If, however, a charitable income fund fails to provide the disclosures required by section 7(e), the charitable income fund, the nonprofit organization that administers or maintains the fund, and the officers, directors, and controlling persons of the fund and the organization will be subject to potential liability for violation of the anti-fraud requirements of state and federal securities laws.<sup>83</sup>

#### Investment Advisers Act of 1940

##### *Registration Requirements*

The Advisers Act regulates and requires the registration of investment advisers.<sup>84</sup> An “investment adviser” is defined generally as any person who, for compensation, engages in the business of advising others as to the value of securities or the advisability of investing in, purchasing, or selling securities, or of publishing analyses or reports concerning securities.<sup>85</sup> The courts and the SEC have interpreted the definition of investment adviser broadly.<sup>86</sup>

##### *Nonprofit Organization Exemptions*

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81. *See id.*

82. *See supra* note 44 and accompanying text; *infra* notes 86, 157 and accompanying text.

83. *See infra* notes 93–114, 130–35 and accompanying text.

84. *See* Investment Advisers Act § 203, 15 U.S.C. § 80b-3 (1994).

85. *See id.* § 202, 15 U.S.C. § 80b-2(a)(11) (1994).

86. *See, e.g.*, Investment Advisers Act Release No. 1092 (Oct. 8, 1987). This release was adopted jointly by the SEC and the North American Securities Administrators Association and addresses the applicability of the Advisers Act to financial planners. *See also* THOMAS P. LEMKE & GERALD T. LINS, REGULATION OF INVESTMENT ADVISERS § 1.02[1] (1996).

Unlike the Securities Act, the Exchange Act, and the Investment Company Act, the Advisers Act did not contain an exemption or exclusion applicable to nonprofit organizations prior to 1995. Accordingly, if a nonprofit organization was acting as an "investment adviser," as defined in the Advisers Act, the organization was required to comply with the registration and other requirements applicable to investment advisers under the Advisers Act.<sup>87</sup>

The Philanthropy Protection Act amended the Advisers Act in 1995 to provide a new exemption from registration as an investment adviser.<sup>88</sup> This exemption applies to any charitable organization, as defined in section 3(c)(10)(D) of the Investment Company Act,<sup>89</sup> and any trustee, director, officer, employee, or volunteer of such a charitable organization acting within the scope of such person's employment or duties with such organization.<sup>90</sup> To qualify for this exemption, the investment advice, analyses, and reports of such persons must be provided only to one or more of the following: (a) a charitable organization; (b) a charitable income fund; (c) a trust or other donative instrument the assets of which are permitted in a charitable income fund; or (d) the settlors (or potential settlors) or beneficiaries of any such trusts or donative instruments.<sup>91</sup>

A nonprofit organization that is engaged in investment advisory activities that do not qualify for this exemption still must register as an investment adviser and comply with the other requirements under the Advisers Act.<sup>92</sup>

### Anti-Fraud Provisions

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87. See United Methodist Found. of the Baltimore Annual Conference, Inc., SEC No-Action Letter, 1988 WL 235247 (S.E.C.), at \*3 (Nov. 29, 1988). "In our view, the Foundation comes within this definition and, there being no exemption available to it, must register under the act." *Id.*; see also The Christian Stewardship Ministry, SEC No-Action Letter, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,347 at 76,461 (Mar. 29, 1980).

88. See 15 U.S.C. § 806.3(b) (Supp. I 1995).

89. See *supra* note 57 for the definition of "charitable organization."

90. See 15 U.S.C. § 806.3(b)(4) (Supp. I 1995).

91. See *id.*

92. See *id.*

*Securities Act and Exchange Act*

The anti-fraud provisions of the Securities Act are contained in section 11,<sup>93</sup> section 12,<sup>94</sup> and section 17.<sup>95</sup> The primary anti-fraud provisions of the Exchange Act are contained in section 10,<sup>96</sup> pursuant to which the SEC has promulgated Rule 10b-5.<sup>97</sup> These provisions prohibit the use of any scheme to obtain money by means of an untrue statement or omission to state a material fact or of any manipulative or deceptive device in connection with the purchase or sale of any security.<sup>98</sup> Anti-fraud provisions can provide for civil liability and a private cause of action for damages by a purchaser against a seller who fails to disclose all material information to the purchaser or who otherwise engages in fraudulent or deceptive activities in connection with the sale of securities.<sup>99</sup>

The most significant anti-fraud provisions apply to both registered and exempt offerings. Accordingly, these anti-fraud requirements apply to offerings by nonprofit organizations, even though they may be exempt from registration under section 3(a)(4) of the Securities Act or section 12(g)(2)(D) of the Exchange Act.<sup>100</sup>

*Investment Company Act*

A charitable income fund that fails to provide the disclosures required by section 7(e) of the Investment Company Act<sup>101</sup> will be subject to those enforcement and penalty provisions of the Investment Company Act that apply not just to registered investment companies

93. 15 U.S.C. § 77k (1994). This section applies only to offerings registered with the SEC.

94. *Id.* § 77l (1994).

95. *Id.* § 77q (1994).

96. *Id.* § 78j (1994). Other anti-fraud provisions are contained at 15 U.S.C. §§ 78i, 78s (1994).

97. 17 C.F.R. § 240.10b-5 (1997).

98. For a discussion of whether a donative transfer is a "sale" under Rule 10b-5, see Carol J. Sulcoski, *Looking a Gift of Stock in the Mouth: Donative Transfers and Rule 10b-5*, 88 MICH. L. REV. 604 (1989); see also LOSS & SELIGMAN, *supra* note 3, at 1088-1089.

99. See generally LOSS & SELIGMAN, *supra* note 3, at 3403-3448.

100. See, e.g., SEC v. World Radio Mission, Inc., 544 F.2d 535 (1st Cir. 1976), *rev'd on other grounds*, Aaron v. SEC, 446 U.S. 680 (1980); SEC v. Bennett, 899 F. Supp. 804 (E.D. Pa. 1995); SEC v. American Found. for Advanced Educ. of Ark., 222 F. Supp. 828 (W.D. La. 1963); SEC v. Children's Hosp., 214 F. Supp. 883 (D. Ariz. 1963).

101. See *supra* text accompanying note 76.

but to any violation of the Investment Company Act. Among other sanctions, the SEC may assess civil money penalties for each violation of the Investment Company Act.<sup>102</sup> In addition, the SEC can issue cease and desist orders applicable to past, present, or future violations of the Investment Company Act and can require an accounting and disgorgement, including reasonable interest.<sup>103</sup> Any person convicted of willfully violating any provision of the Investment Company Act may be fined not more than \$10,000 or imprisoned for not more than five years, or both.<sup>104</sup> These enforcement and penalty provisions apply not only to the nonprofit organization itself, but also to each trustee, director, or other person who controls the organization.<sup>105</sup> These persons also would be subject to potential liability under the anti-fraud provisions of the Securities Act, the Exchange Act, and the Advisers Act, as well as under state securities laws.<sup>106</sup>

#### *Investment Advisers Act*

Section 206 of the Advisers Act makes it unlawful for an investment adviser to employ any device, scheme, or artifice to defraud clients, to operate a fraud or deceit upon any client or prospective client, or to engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative.<sup>107</sup> Section 206 is broader in scope than the anti-fraud provisions of SEC Rule 10b-5, since section 206 is not limited to transactions involving the purchase or sale of securities and may not require a showing of scienter (i.e., recklessness or intent) to find a violation of section 206.<sup>108</sup>

Section 206 applies to all investment advisers, whether or not they are exempt from registration under the Advisers Act.<sup>109</sup> Al-

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102. See Investment Company Act § 41(e)(1), 15 U.S.C. § 80a-41(e)(i) (1994).

103. See *id.* § 9(f)(1), (2), (5), 15 U.S.C. § 80a-9(f)(1), (2), (5) (1994). The SEC's authority to enter temporary restraining orders under section 9(f)(3) and (4) generally would not apply to nonprofit organizations due to the exemptions and exclusions provided by the Philanthropy Protection Act. See *id.* § 9(f)(3)(B), 15 U.S.C. § 80a-9(f)(3)(B) (1994).

104. See Investment Company Act § 48, 15 U.S.C. § 80a-48 (1994).

105. See *id.*

106. See 15 U.S.C. §§ 77k, 78t, 80b-9 (Supp. I 1995).

107. See Investment Advisers Act § 206, 15 U.S.C. § 80b-6 (1994).

108. See LEMKE & LINS, *supra* note 84, § 2.02[4][a].

109. See Investment Advisers Act § 206, 15 U.S.C. § 80b-6 (1994).

though section 3(c)(10)(D) provides nonprofit organizations an exemption from registration under the Advisers Act, nonprofit organizations are not excluded from the definition of an investment adviser in section 202.<sup>110</sup> Accordingly, the anti-fraud requirements in section 206 apply to any nonprofit organization that engages in investment advisory activities, even though the organization may be exempt from registration under section 3(c)(10)(D).

The SEC has authority to enforce compliance with the Advisers Act, including the anti-fraud requirements of section 206, by censuring, suspending, or revoking the registration of an investment adviser,<sup>111</sup> assessing civil money penalties,<sup>112</sup> and issuing cease and desist orders.<sup>113</sup> Willful violations are punishable by up to five years imprisonment or a \$10,000 fine, or both.<sup>114</sup>

### STATE SECURITIES LAWS

Each state in the United States has a securities agency that regulates the sale of securities from and within its boundaries. The regulatory entity may be designated as a commission, a bureau, a department, a division of the Attorney General's office, an agency, or other title. The authority is roughly comparable regardless of the form of organization, although the control and reporting structure may be more or less complex depending upon the bureaucratic layering and decisionmaking processes.

All states belong to a national organization, the North American Securities Administrators Association (NASAA).<sup>115</sup> While NASAA lacks the authority to enforce laws, it does create and recommend for adoption by its membership various policies, including two policies that apply to nonprofit religious organizations.<sup>116</sup> These policies

110. *See supra* text accompanying note 45. Compare Investment Advisers Act § 202, 15 U.S.C. § 80b-2(a)(11) (1994), with Exchange Act § 3, 15 U.S.C. § 78c(e)(1) (Supp. I 1995) (excluding nonprofit organizations and their personnel from the definition of “broker,” “dealer,” “municipal securities broker,” “municipal securities dealer,” “government securities broker,” and “government securities dealer.”).

111. *See* Investment Advisers Act § 203(e), 15 U.S.C. § 80b-3(e) (1994).

112. *See id.* § 203(i), 15 U.S.C. § 80b-3(i) (1994).

113. *See id.* § 203(k), 15 U.S.C. § 80b-3(k) (1994).

114. *See id.* § 217, 15 U.S.C. § 80b-17 (1994).

115. *See* THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 8.1 (2d ed. 1990 & Supp. 1994).

116. *See id.*

are discussed in detail below and are published in the CCH NASAA Reporter.

Most state securities laws are based in substantial part on the Uniform Securities Act of 1956, as drafted and approved by the National Conference of Commissioners on Uniform State Laws (Uniform Act).<sup>117</sup> However, some states have not adopted the Uniform Act, and all states adopting the Uniform Act have enacted substantial variations so that the term "uniform" must be taken with a grain of salt.<sup>118</sup> Further, the Uniform Act is broadly written, so that enabling rules can vary substantially from state to state. While NASAA has adopted uniform guidelines,<sup>119</sup> some states will follow them precisely, some ignore them, and most provide their own interpretation.<sup>120</sup> Indeed, the guidelines themselves are so characterized for the purpose of emphasizing the need for flexibility depending upon the facts of the individual offering.<sup>121</sup> In addition, some states have guidelines that originated from the state and not from NASAA.<sup>122</sup>

While one must look to the securities laws and rules of each state to determine the applicable requirements, there is a general pattern that holds true for most states. Using the Uniform Act as the point of reference, the following sections summarize the state securities laws.

### Securities Registration

Section 301 of the Uniform Act requires that all securities offered and sold in the state be registered or exempt.<sup>123</sup> Section 402(a)(9)<sup>124</sup> provides an exemption for nonprofit organizations that

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117. See LOSS & SELIGMAN, *supra* note 3, at 9–10 (1995); HAZEN, *supra* note 115, § 8.1 n.3.

118. See HAZEN, *supra* note 115, § 8.1.

119. See LOSS & SELIGMAN, *supra* note 3, at 10.

120. See UNIF. SEC. ACT, 7B U.L.A. 509–14 (1985).

121. See *id.*

122. See *id.*

123. Section 301 provides that "[i]t is unlawful for any person to offer or sell any security in this state unless (1) it is registered under this act or (2) the security or transaction is exempt under section 402." UNIF. SEC. ACT § 301, 7B U.L.A. 550 (1985).

124. Section 402(a)(9) provides an exemption from registration for "any security issued by any person organized and operated not for private profit but exclusively for religious, educational, benevolent, charitable, fraternal, social, athletic, or reformatory purposes . . ." *Id.* § 402(a)(9), 7B U.L.A. 600 (1985). The exemption is thus somewhat

generally parallels that found in section 3(a)(4) of the Securities Act before enactment of the Philanthropy Protection Act. However, eighteen states have limited this exemption by adding a requirement for a filing of certain documents. Some eleven states require a registration of nonprofit offerings, and six states require broker-dealer or issuer-dealer registration.<sup>125</sup>

For states that require either registration or an exemption order to permit the sale of securities in their jurisdiction, the procedures involve generally the preparation and filing of a draft of an offering circular meeting the guideline appropriate for the type of offering.<sup>126</sup> The filing is made either using a prescribed form, or, alternatively, simply sending a letter with the required attachments.<sup>127</sup> Usually the issuer sends: its articles of incorporation and amendments; the bylaws; the most recent nonprofit corporation annual report of its state of domicile; a copy of the debt instrument or other certificate evidencing the security;<sup>128</sup> any form of agreement with a broker-dealer; a copy of advertising material; a copy of the trust indenture, if one is required; an opinion of counsel; a consent of the auditors; and an authorizing resolution for the sale of the securities by the issuer's governing body.<sup>129</sup> Some jurisdictions charge a filing fee and some require a consent to service of process.

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broader in scope than section 3(a)(4) of the Securities Act. *See* JOSEPH C. LONG, *BLUE SKY LAW* § 4.10[1] (Securities Law Series 1997).

125. The following states require examination of documents (although the offering is exempt from registration): Alabama; Alaska; Arkansas; Connecticut; Idaho; Iowa; Kentucky; Maryland; Michigan; Missouri; Montana; Nevada; New York; North Carolina; Oklahoma; South Carolina; Tennessee; Virginia; and Wisconsin (Wisconsin corporations only).

126. The following states require registration of the securities: California (registration by permit required for nonprofit debt securities); Colorado (if seasoned issuer exemption is not met); Georgia; Indiana; Louisiana; Minnesota; Ohio; Oregon; Pennsylvania; and Wisconsin (except Wisconsin corporations, which are exempt).

The following states require registration of a broker-dealer and review documents: Florida; Hawaii; Nebraska; New Jersey; North Dakota; Vermont (but waiver is available often).

In addition, the following states require some form of notification of the offering: Arizona; Maine (Forms U-2 and U-2A); Massachusetts (Forms U-2 and U-2A); New Hampshire (Forms U-2 and U-2A); and Washington.

127. *See* UNIF. SEC. ACT § 403, 7B U.L.A. 620.

128. The copy of the debt instrument or other certificate evidencing the security should be marked to show that it is a specimen only.

129. *See* UNIF. SEC. ACT § 403, 7B U.L.A. 620.

### Anti-Fraud Provisions

Even if registration or exemption filing is not required in a state, both the federal and state securities laws prohibit fraud in the sale of securities. Securities fraud is defined more broadly than common-law fraud.<sup>130</sup> Usually the state anti-fraud provision is found in section 101<sup>131</sup> of the Uniform Act or its equivalent.

The NASAA Church Bond Guidelines<sup>132</sup> state that

[I]t may, in fact, be deemed by an Administrator to be a fraudulent transaction per se, if an Issuer either (i) offers Church Bonds without the use of an Offering Circular substantially conforming to the disclosures contained in the following Guidelines, or (ii) offers Church bonds which the Issuer cannot adequately demonstrate an ability to repay."<sup>133</sup>

The Uniform Act anti-fraud language is the same as that found in Rule 10b-5 under the Exchange Act.<sup>134</sup> Both federal and state securities regulators have a history of proceedings against those persons who fraudulently sell securities while hiding behind religious or other purportedly charitable objectives to achieve nefarious ends.<sup>135</sup> Since both the federal and state securities laws provide that violation of their respective provisions can constitute criminal conduct, in severe cases wrongdoers can contemplate facing criminal as well as civil or administrative proceedings by government agencies.

### Broker-Dealer and Agent Registration

130. See UNIF. SEC. ACT § 401(d), 7B U.L.A. 578.

131. Section 101 provides that

It is unlawful for any person, in connection with the offer, sale, or purchase of any security, directly or indirectly

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

UNIF. SEC. ACT § 101, 7B U.L.A. 516 (1985).

132. Church Bonds, NASAA (CCH) ¶ 1001, at 701 (Apr. 29, 1981).

133. *Id.* at 702.

134. Compare UNIF. SEC. ACT § 101, 7B U.L.A. 516 (1985), with 17 C.F.R. § 240.10b-5 (1997).

135. See generally LONG, *supra* note 124, § 4.10[2][a].

In addition to the requirement that an issuer either register its securities or find an exemption, the individuals or entities who sell securities on behalf of the issuer must likewise either register as agents of the issuer or find an exemption. Section 201(a) of the Uniform Act provides that "it is unlawful for any person to transact business in this state as a broker-dealer or agent unless he is registered under this act . . . ."<sup>136</sup> If sales are made through a broker-dealer rather than by personnel employed or controlled by the issuer, then the broker-dealer should arrange compliance with state laws.<sup>137</sup> While such broker-dealer participation is not customary, it does occur, especially for the sale of bonds for schools and hospitals built on behalf of nonprofit organizations. The issuer should verify that the broker-dealer and its agents who will be selling are registered in the state or states in which the securities will be sold. This can be done by requesting a copy of the broker-dealer's current Form BD.<sup>138</sup>

Individuals who sell on behalf of a religious organization or entity face a variety of requirements depending upon the states in which the offers or sales will be made. Some states have no registration requirements for persons selling exempt securities, as long as the individual selling on behalf of the issuer is not paid a commission. Any compensation that is based on the results of sales will be deemed a commission. The test is not how the compensation is characterized, but rather whether it is a reward for selling. A pre-designated salary is not regarded as a commission for state law purposes, even if the individual works entirely or primarily on the task of selling the issuer's securities.

Some states have more extensive requirements. States may require that an individual complete a registration application, usu-

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136. State law usually requires a registered broker-dealer to "maintain detailed records of his business activities, file certain periodic financial reports with the state authority and be subject to examination by it." 1 SECURITIES LAW TECHNIQUES § 4.04[1] (A.A. Sommer, Jr., ed., 1993).

137. See UNIF. SEC. ACT § 201(b), 7B U.L.A. 528.

138. See LONG, *supra* note 124, § 6.01[1]. Form BD is the national form used to register a broker-dealer with the SEC, the states, and the securities exchanges. This form lists all states in which the firm is registered. The registration of individuals is usually verified by a representation from the broker-dealer in a selling agreement that its sales are in compliance with the securities laws. Such a representation is usually delivered at each closing of the offering.

ally Form U-4.<sup>139</sup> A few states require successful completion of examinations administered through the NASD.<sup>140</sup> Two types of examinations may be required. The first is the Series 63 examination, which tests the knowledge of state securities laws. The second type of examination, often an additional requirement, is the Series 7 examination, which is the entry level examination for those entering the securities business professionally. These examinations are ill-suited to the purpose of ensuring competence or understanding of the functions of those required to take them. It would make far more sense if such individuals were required to understand the offering circular that was prepared for the issuer they represent, and were restricted to providing information set forth in that document or any authorized sales literature. Agents of issuers who have complied with state filing and review requirements rarely are a source of regulatory problems.

Organizations should be wary of the so-called “consultants” who provide an offering package to churches and other nonprofit religious organizations. The package generally includes an offering circular, forms, and training. The prices charged by these consultants may be exorbitant; the quality of the documents may not meet regulatory standards; and the training on sales may be of limited value or improper. These consultants seek to avoid registration as a broker-dealer by not directly being involved in any sales of securities. Only Michigan requires that such consultants register as broker-dealers.<sup>141</sup>

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139. See LONG, *supra* note 124, § 6.01[1]. Form U-4 is the national form used for registering individuals associated with broker-dealers with the National Association of Securities Dealers, Inc. (NASD) and with the individual states. Copies of the current form can be obtained from any state securities regulator. The principal purpose of the form, other than identification of the individual, is to receive answers to a series of questions regarding prior criminal, civil, or administration sanctions against the agent.

140. Examinations are required in Alabama (Series 63 and 7); Arkansas (Series 63 and 7); Delaware (Series 63); District of Columbia (Series 63); Florida (Series 63); Hawaii (Series 63 and 7); Illinois (Series 63); Indiana (Series 63); Iowa (Series 63 and one of a variety of other NASDR examinations); Kansas (Series 63 and 7); Maine (Series 63); Maryland (Series 63); Michigan (Series 63, unless an agent exclusion order is issued); Nebraska (Series 63 and another NASD examination); Nevada (Series 63); New Hampshire (Series 63); New Jersey (Series 63 and another NASD examination); Pennsylvania (Series 63); Utah (Series 63); Virginia (Series 63); West Virginia (Series 63); and Wyoming (Series 63 — which may be waived if no commissions are paid).

141. See MICH. ADMIN. CODE r. 451.803.3 (1989 & Supp. 1997); CYRIL MOSCOW & HUGH H. MAKENS, MICHIGAN SECURITIES REGULATION § 5.02(A)(8) (2d ed. 1994).

### Investment Adviser Registration

The state definition of investment adviser found in the Uniform Act tracks its federal counterpart. Generally, investment advisers with less than \$25 million under management must register with each of the states in which they conduct business or otherwise provide investment advice. The larger investment advisers must register only with the SEC.<sup>142</sup> This split of state and federal responsibilities occurred with the passage of the Improvement Act.<sup>143</sup> The states generally have not required religious organizations that operate church extension funds or that sell bonds for individual building construction to register as investment advisers in connection with these activities. Many of the charitable income funds were offered without compliance with state securities laws, so the issue has been infrequently raised in that context.

### Philanthropy Protection Act Preemption

In addition to providing new exemptions and exclusions under the federal securities laws, as discussed above, the Philanthropy Protection Act also preempted certain registration and qualification requirements under the securities laws of any state.<sup>144</sup>

Section 6(a) of the Philanthropy Protection Act preempts any state securities statute or regulation that requires the registration or qualification of a security<sup>145</sup> issued by, or any interest or partici-

142. See UNIF. SEC. ACT § 201(c), 7B U.L.A. 528 (Supp. 1996).

143. See National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended at 15 U.S.C. §§ 77z-3, 78mm, 80b-3a (Supp. II 1996)). After passage of this Act, the SEC adopted rules under the Investment Act of 1940 to implement new provisions that apply to privately-offered investment companies. See *id.* Some of these rules define certain terms for purposes of the new exclusion from regulation under the Investment Company Act for privately-offered companies whose investors are all highly sophisticated investors, termed “qualified purchasers.” *Id.* These rules went into effect on June 9, 1997.

144. The Improvement Act also preempted state securities laws for “qualified purchasers” owned by certain private foundations and charities. See *supra* note 75. In addition, the Act also preempted state securities laws for church employee benefit plans. See *infra* text accompanying note 286.

145. For purposes of preemption of state securities laws, the term “security” has the same meaning as in section 3 of the Exchange Act. See Philanthropy Protection Act § 6(d)(2), 15 U.S.C. § 80(d)(2) (1994).

pation in, any charitable income fund, or the offer or sale thereof.<sup>146</sup> Accordingly, charitable income funds that qualify for the federal exemption from registration also will avoid securities registration or qualification requirements under state securities laws because of federal preemption.<sup>147</sup>

Similarly, section 6(b) of the Philanthropy Protection Act preempts any state securities laws that regulate or require the registration of brokers, dealers, agents, or investment advisers.<sup>148</sup> This preemption applies to any charitable organization,<sup>149</sup> and any trustee, director, officer, employee, or volunteer of the charitable organization acting within the scope of such person's employment or duties, who buys, sells, or trades in securities for its own account in its capacity as trustee or administrator of, or otherwise on behalf of or for the account of: (i) a charitable organization; (ii) a charitable income fund; (iii) a trust or other donative instrument the assets of which are permitted in a charitable income fund; or (iv) the settlors (or potential settlors) or beneficiaries of any such charitable trust or donative instrument.<sup>150</sup>

Although the Philanthropy Protection Act primarily addresses charitable income funds, the preemption provided by section 6(b) is not limited exclusively to the activities of nonprofit organizations in connection with charitable income funds. Rather, the section 6(b) preemption also applies to the purchase, sale, or trading in any securities for the account of or otherwise on behalf of the charitable organization.<sup>151</sup> This preemption is broad enough to cover many securities activities of nonprofit organizations, including sales of notes, church bonds and denominational debt securities, and offerings by church extension funds.<sup>152</sup> The section 6(b) preemption al

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146. *See* Philanthropy Protection Act of 1995 § 6(a), 15 U.S.C. § 80a-51 (Supp. I 1995).

147. *See id.* For purposes of preemption of state securities laws, the term "state" means each of the several states of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Samoa, and the Commonwealth of the North Mariana Islands. *See id.* § 6(d)(3), 15 U.S.C. § 80a-3a(d)(3) (Supp. I 1995).

148. *See id.* § 6(b), 15 U.S.C. § 80a-3a(b) (Supp. I 1995).

149. The term "charitable organization" means an organization described in paragraphs (1) through (5) of section 170(c) or section 501(c)(3) of the Internal Revenue Code of 1986. *See id.* § 6(d)(1), 15 U.S.C. § 80a-3a(d)(1) (Supp. I 1995).

150. *See id.* § 6(b), 15 U.S.C. § 80a-3a(b) (Supp. I 1995).

151. *See id.*

152. *See* Philanthropy Protection Act of 1995 § 6(b), 15 U.S.C. § 80a-3a(b) (Supp. I

so applies to the purchase, sale, or trading in any securities for the account of or otherwise on behalf of a trust or other donative instrument, the assets of which are permitted in a charitable income fund, or the settlors (or potential settlors) or beneficiaries of any such trusts or donative instruments.<sup>153</sup> This preemption covers most remaining securities activities of nonprofit organizations, including the solicitation of contributions through charitable gift annuities, charitable remainder trusts, and charitable lead trusts. Accordingly, except in those states that opt out of preemption, a nonprofit organization may now engage in most securities activities without complying with state securities laws provisions that regulate or require the registration of the organization or its trustees, directors, officers, employees, or volunteers as brokers, dealers, agents, or investment advisers.<sup>154</sup> The organization still must comply, however, with any state anti-fraud requirements applicable to such activities.

Although these state securities laws are automatically preempted by the Philanthropy Protection Act, states have the ability to “opt-out” of preemption.<sup>155</sup> To opt-out, a state must enact a statute that specifically refers to section 6 of the Philanthropy Protection Act and that provides prospectively that section 6 shall not preempt the laws of that state.<sup>156</sup> The ability of states to opt-out of preemption expires November 7, 1998.<sup>157</sup> As of August 1, 1997, only Maryland and Arkansas had opted out of federal preemption.<sup>158</sup>

Regardless of whether a state opts out of federal preemption, the Philanthropy Protection Act does not preempt the anti-fraud requirements of the securities laws of any state.<sup>159</sup> States retain authority to investigate and prosecute violations of the state securi-

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153. *See id.*

154. Similarly, the exclusion provided under section 3(e) of the Exchange Act is not limited exclusively to the activities of nonprofit organizations in connection with charitable income funds, and also would provide a federal exclusion available for most securities sales activities of nonprofit organizations. *See* Philanthropy Protection Act of 1995 § 6, 15 U.S.C. § 80a-3a (Supp. I 1995).

155. *See id.* at § 6(c), 15 U.S.C. § 80a-3a(c) (Supp. I 1995).

156. *See id.*

157. *See id.* (providing a three-year limitation for states to opt out of preemption by the Philanthropy Protection Act).

158. *See* ARK. CODE ANN. § 23-42-503 (Michie 1997); MD. CODE ANN. [Corporations and Associations] § 11-103 (1997).

159. *See* Philanthropy Protection Act of 1995 § 6(c), 15 U.S.C. § 80a-3a(c) (Supp. I 1995).

ties laws that require the disclosure of material information to investors in securities or that otherwise prohibit manipulative, deceptive, or fraudulent conduct in connection with the sale of securities.<sup>160</sup>

### CHARITABLE INCOME FUNDS

As discussed above, the Philanthropy Protection Act amended the various federal securities laws, and also preempted most state securities laws requirements, thereby providing exclusions or exemptions from the requirements to register charitable income funds under state and federal securities laws.<sup>161</sup> Charitable income funds remain subject to the state and federal anti-fraud requirements and the disclosure requirements under section 7(e) of the Investment Company Act.<sup>162</sup>

Before enactment of the Philanthropy Protection Act in 1995, the SEC had issued a series of no-action letters<sup>163</sup> and releases in which the SEC interpreted the various federal charitable organization exemptions in the context of different types of charitable income funds.<sup>164</sup> Since the Philanthropy Protection Act was intended merely to codify the position of the SEC at the time of enactment of the Philanthropy Protection Act, these letters and releases provide additional guidance for interpreting the new exemptions and exclusions provided by the Philanthropy Protection Act. These letters and releases likely will be referred to and cited by the courts, the SEC and the state securities authorities in litigation and regulatory proceedings involving charitable income funds under the Philanthropy Protection Act. The following is a summary of key SEC no-action letters and interpretive releases applicable to the various types of charitable income funds.

### Collective Investment Funds

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160. See *supra* note 99 and accompanying text.

161. See *supra* notes 30, 38, 58–59, 144 and accompanying text.

162. See Investment Company Act § 7(e), 15 U.S.C. § 80a-7(e) (1994).

163. See *supra* note 26.

164. See, e.g., The Christian Stewardship Ministry, SEC No-Action Letter, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,347 (Mar. 29, 1980).

Not uncommonly, a group of affiliated or unaffiliated nonprofit organizations will agree to pool their funds collectively for the purpose of common investment. By increasing the amount of assets under common investment, the organizations reduce transaction and investment management expenses and also can ensure investment in accordance with common religious or social principles. Such collective investment funds are expressly included in the list of charitable income funds entitled to the exclusions and exemptions provided by the Philanthropy Protection Act.<sup>165</sup>

Before enactment of the Philanthropy Protection Act, the SEC issued no-action letters in which it interpreted the various federal charitable organization exemptions in the context of collective investment funds of charitable organizations.<sup>166</sup> Each letter requested a determination by the SEC that it would not recommend enforcement action if the collective investment fund were not registered as an investment company under the Investment Company Act or as a security under the Securities Act.<sup>167</sup> Some letters also sought a determination by the SEC that it would not recommend enforcement action if the charitable organization that organized and administered the fund did not register as a broker-dealer or transfer agent under the Exchange Act or as an investment adviser under the Advisers Act.<sup>168</sup>

In these no-action letters, the SEC stated that it would not recommend any enforcement action for the failure to register a collective investment fund under the Investment Company Act when the collective investment fund was structured as follows:

- (1) The fund was organized and operated, at all times, exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and no part of the fund's net earnings would inure to the benefit of a private shareholder or individual;
- (2) Each participant in the fund would, at all times, be exempt from taxation under section 501(c)(3) of the Internal Revenue Code;

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165. *See supra* note 49 and accompanying text.

166. *See generally* National Assoc. of Congregational Christian Churches, SEC No-Action Letter [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,111 (Aug. 11, 1995); Catholic United Income Trust, SEC No-Action Letter [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,615 (May 6, 1994).

167. *See, e.g.*, American Heart Assoc., SEC No-Action Letter [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,615 (Feb. 26, 1993).

168. *See id.*

(3) Each participant in the fund would invest only funds over which it had immediate, unrestricted, and exclusive use, benefit, and enjoyment;

(4) No participant would assign, encumber, or otherwise transfer any part of its interest in the fund;

(5) No funds that a participant contributed would be attributable to a retirement plan that provided for employee contributions or variable benefits;

(6) All financial benefits (i.e., income and right of a participant to redeem all or any portion of its interest in the fund, net of fees and expenses) would be distributed exclusively to the participants and would be used solely for such participants' tax exempt purposes; and

(7) An offering memorandum would be distributed to each participant stating that neither the charitable organization that organized the fund, nor the fund itself, was registered as an investment company under the Investment Company Act.<sup>169</sup>

The SEC also stated that it would not recommend enforcement action if the charitable organization that organized and administered the collective investment fund was not registered as an investment adviser under the Advisers Act, under facts where, in addition to the seven factors above:

(8) The charitable organization would not make any recommendations to its affiliates or to potential participants as to whether they should invest in the fund;

(9) The charitable organization provided each participant an offering memorandum stating that the charitable organization was not registered as an investment adviser under the Advisers Act; and,

(10) Expenses of the fund were paid directly from the assets of the fund.<sup>170</sup>

The SEC refused to issue a no-action letter where a charitable organization would receive significant expense reimbursement in connection with its investment advisory activities in a collective investment fund program. In *Northeastern Pennsylvania Synod of the Evangelical Lutheran Church in America*,<sup>171</sup> the Synod re

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169. *See id.* at 77,620.

170. *See id.* at 77,618.

171. *Northeastern Pa. Synod of the Evangelical Lutheran Church in Am.* [1987-1988

ceived reimbursement for travel and meal expenses of committee members when they attended meetings.<sup>172</sup> The Synod also was reimbursed for expenses paid to third parties for goods or services rendered to the participating congregations.<sup>173</sup> It also received reimbursement for its own expenses, such as portions of salaries of employees who spent a significant amount of time in connection with the collective investment fund program, the cost of supplies used in connection with the collective investment fund program, and expenses associated with the Synod's office costs, computer hardware and software, and other similar expenses to the extent that they were directly identifiable to the collective investment fund program.<sup>174</sup> The SEC stated, "[W]e are unable to conclude that none of these reimbursements will constitute an economic benefit and, hence, 'compensation' to the Synod."<sup>175</sup> Accordingly, the SEC could not assure the Synod that it would not recommend any enforcement action if the Synod implemented the program without registering as an investment adviser under the Advisers Act.

If a collective investment fund operated by a charitable organization met each of these requirements, the SEC also concluded that it would not recommend enforcement action if the charitable organization was not registered as a broker, dealer, or transfer agent under the Exchange Act or if the interests in the collective investment fund were not registered as a security under the Securities Act or the Exchange Act.<sup>176</sup>

### Pooled Income Funds

A pooled income fund is one of the methods created under the 1969 Tax Reform Act by which a taxpayer may make a tax deductible remainder gift to a charitable organization.<sup>177</sup> The charitable organization establishes the pooled income fund to receive irrevocable gifts from at least two individual donors. The fund pays current income to the individual beneficiaries for life, but at the termination

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Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,697 (May 2, 1988).

172. *See id.* at 77,971.

173. *See id.*

174. *See id.*

175. *Id.* at 77,974.

176. *See id.* at 77,975.

177. *See* I.R.C. §§ 170(f)(2)(A), 2522(c)(2)(A), 2955(e)(2)(A).

of each income interest, the allocable principal must revert permanently to the charitable organization.<sup>178</sup> Pooled income funds are expressly included in the list of charitable income funds entitled to the exclusions and exemptions provided by the Philanthropy Protection Act.<sup>179</sup>

On January 10, 1980, the SEC issued Release No. 33-6175 ("Release 6175"), summarizing and restating the SEC's position, as previously enunciated in no-action letters,<sup>180</sup> that pooled income funds did not qualify for the charitable organization exemptions under the federal securities laws. Release 6175 stated as follows:

To satisfy the requirements of the charitable organization exception . . . (1) an issuer must be organized and operated exclusively for "religious, educational, benevolent, fraternal, charitable, or reformatory purposes," and (2) no part of its net earnings may inure to the benefit of any private shareholder or individual. It is questionable whether a pooled income fund could be deemed to be organized and operated exclusively for charitable purposes, since it is organized and operated to produce a regular income which must be currently distributed to beneficiaries who are for the most part private individuals. In any event, the second part of the test would seem not to be met by a pooled income fund because of the distribution of its income to beneficiaries.<sup>181</sup>

Nevertheless, the SEC stated in Release 6175 that it would not recommend any enforcement action if a charity established and maintained a pooled income fund without registration under: (1) the Investment Company Act of the fund, the charity, or a trustee of the fund; (2) the Securities Act or the Exchange Act of interests in the fund; or (3) the Exchange Act of persons soliciting gifts by means of the fund, if the following three requirements were met:

(1) The fund qualified as a recipient of tax-deductible contributions under section 642(c)(5) of the Code;

(2) Each prospective donor was furnished written disclosures that fully and fairly described the operation of the fund; and

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178. *See id.* § 642(c)(5).

179. *See supra* note 57 and accompanying text.

180. *See* Robert C. Hacker & Ronald D. Rotunda, *The SEC's Ectoplasmic Theory of an Issuer as Applied to Educational and Charitable Institutions, Bank Trustees, and Other Exempt Issuers*, 10 SEC. L. REV. 69, 98 (1978).

181. *See* 17 C.F.R. § 271.11016 (1997).

(3) Any person soliciting contributions to the fund was either a volunteer, or a person who was employed in the charity's overall fund-raising activities and who was not compensated on the basis of the amount of gifts transferred to the pooled income fund.<sup>182</sup>

The SEC explicitly based its no-action position in Release 6175 and the previous no-action letters on the assumption that the primary purpose of persons who transfer property to a pooled income fund is to make a gift to a charity of their choice and the belief that this donative intent and the application of Internal Revenue Code restrictions and Treasury regulations made registration under the federal securities laws unnecessary.<sup>183</sup> Release 6175 made it clear, however, that the SEC would continue to apply the anti-fraud provisions of the federal securities laws to sales of interests in pooled income funds.

#### Charitable Remainder Trust Funds

Before enactment of the Philanthropy Protection Act, the SEC stated in no-action letters that, if the requirements of SEC Release 6175 were met, the SEC would not recommend enforcement action against a charitable organization that pooled the assets of charitable remainder trusts for which it served as trustee, without registration of the pooled fund, the interests in the pooled fund, or any person or entity participating in the organization, administration, or promotion of the pooled fund, under the Securities Act, the Exchange Act, or the Investment Company Act.<sup>184</sup> In 1986, the SEC concluded that “[h]aving stated our views regarding the commingling of the assets of charitable remainder trusts under the circumstances, we will no longer respond to no-action requests in this area unless they raise novel or unique questions.”<sup>185</sup>

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182. In one subsequent no-action letter, the SEC stated that it was unable to conclude that the proposed pooled fund was the type of pooled income fund that Release 6175 contemplated to be entitled to a no-action position, in part because contributions to the fund would be solicited by a registered broker-dealer and it appeared that the contributor's primary intent would not be donative. See *Gustavus Adolphus College Pooled-Life Income Fund*, SEC No-Action Letter, available in WESTLAW, FSEC-NAL database, 1987 WL 108542 (SEC) at \*16 (1987).

183. See 17 C.F.R. § 271.11016 (1996).

184. See *President and Fellows of Middlebury College*, SEC No-Action Letter, [1986-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,347 (July 24, 1986).

185. *Id.* at 77,109.

One condition imposed by the SEC for charitable remainder trust funds, in addition to the requirements under Release 6175, was that each of the charitable remainder trusts be irrevocable.<sup>186</sup> The SEC refused to grant a no-action position in a situation where the charitable organization intended to pool together irrevocable and revocable trusts and invest those assets collectively.<sup>187</sup> The SEC stated, “[W]e are unconvinced that the donors of the revocable trusts evidence a true charitable donative intent and not the intention of investor.”<sup>188</sup>

### GIFT ANNUITIES AND CHARITABLE TRUSTS

#### Charitable Gift Annuities

A charitable gift annuity is a contract between a charitable organization and a donor by which the donor makes a charitable contribution to the organization and the organization agrees to pay a specified amount each year to one or more individuals for life.<sup>189</sup> The charitable organization has a general obligation to make annuity payments from its revenues and assets, in accordance with the terms of its gift annuity contract with the donor.<sup>190</sup> A charitable deduction is allowed for the excess of the amount paid over the value of the annuity contract at the time of purchase.<sup>191</sup>

#### Split-Interest Charitable Trusts

A charitable remainder trust is a type of trust in which one or more noncharitable beneficiaries receive an income interest, with the remainder passing to charity.<sup>192</sup> There are two types of charitable remainder trusts: the charitable remainder unitrust and the

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186. See Society for the Propagation of the Faith, SEC No-Action Letter, [1984–1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,809 (Aug. 23, 1984).

187. See *id.* at 79,138.

188. *Id.*

189. See *supra* note 62; see also Pam H. Schneider & Lloyd Leva Plaine, *Planning for the Generation-Skipping Transfer Tax*, SB72 A.L.I.-A.B.A. 75 (1997) (defining charitable gift annuities).

190. See Schneider & Plaine, *supra* note 189, at 75.

191. See I.R.C. § 170 (1994).

192. See generally Paul N. Frimmer, *Charitable Alternatives*, SB72 A.L.I.-A.B.A. 207 (1997).

charitable remainder annuity trust.<sup>193</sup> Every charitable remainder trust must name one or more charitable organizations as the remainder beneficiaries and must provide for specific annual payments to one or more individuals for the life or lives of the individuals or for a specified period of years.<sup>194</sup> If a charitable remainder trust meets numerous and complex requirements, the present value of the charitable remainder can be immediately deducted as a charitable contribution for income, estate, and gift tax purposes.<sup>195</sup> The trust itself is exempt from paying income taxes unless it has unrelated business income.<sup>196</sup>

A charitable lead trust provides an income (or lead) interest to be paid to one or more charitable beneficiaries for a specified time, with the principal of the trust either reverting to the settlor or paid over to one or more noncharitable remainderman upon the expiration of the trust term.<sup>197</sup> Payments of a guaranteed annuity or a unitrust amount must be made at least annually only to charitable beneficiaries during the term of the trust.<sup>198</sup> Income tax consequences vary based on trust structure.<sup>199</sup> The present value of a qualified charitable income interest is deductible for federal estate and gift tax purposes.<sup>200</sup>

Whether a charitable organization may act as a trustee of a split-interest charitable trust is determined under state law.<sup>201</sup> The payment obligation of the trustee of a split-interest charitable trust is limited, in any event, to the trust corpus.<sup>202</sup>

### Philanthropy Protection Act Exemptions

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193. *See supra* note 63.

194. *See* I.R.C. § 664(d)(1), (2) (1994).

195. *See id.* §§ 170(f)(2)(A), 2055(e)(2)(A), 2522(c)(2)(A).

196. *See id.* § 664(c).

197. *See generally* Frimmer, *supra* note 192, at 289 (outlining general rules for lead trusts).

198. *See id.*

199. *See* I.R.C. § 170(f)(2)(B) (1994).

200. *See id.* §§ 2055(e)(2)(B), 2522(c)(2)(B).

201. *See, e.g.,* Pamela R. Champine, *Paying Administration Expenses Out of Income Attributable to Marital and Charitable Residency Bequests: Double Dipping or Appropriate Accounting?* 14 VA. TAX REV. 507 (1995).

202. *See generally* Frimmer, *supra* note 192.

The legislative history indicates that the federal exemptions and state securities law preemptions provided by the Philanthropy Protection Act were intended to apply to charitable gift annuities and charitable trusts.<sup>203</sup>

Barry P. Barbash, Director of the SEC's Division of Investment Management, stated in testimony before Congress:

If enacted, the Act would confirm what the Commission believes was Congress' intent all along — that the federal securities laws should apply to investments in our capital markets, not to gift giving. *The Act would expressly permit charitable organizations and their agents to solicit donations and make income or annuity payments to donors without being subject to the full array of regulations contained in the federal securities laws.* In recognition of the social desirability of charitable organizations and the important functions they provide, the Act would establish a streamlined regulatory structure for those organizations. The Commission believes that this approach strikes an appropriate balance between protecting investors and facilitating a charitable organization's ability to manage its donations.<sup>204</sup>

Congressional approval was based on the understanding that the Philanthropy Protection Act would provide securities registration exemptions or state registration preemption for charitable trusts and charitable gift annuities.

Charitable gift annuities and charitable trusts make it possible for donors to make a gift to a charity — while receiving some of the investment income produced by that gift . . . . The Philanthropy

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203. Other commentators have stated or implied, typically without detailed analysis, that gift annuities and charitable trusts are entitled to the exemptions provided by the Philanthropy Protection Act. See Sanford J. Schlesinger, *New Legislative Protection for Charitable Giving Vehicles*, 23 EST. PLAN. 392 (1996) (“The statutes afford protection to charitable gift annuities and other charitable vehicles”); Jacques T. Schlenger et al., *New Statutes Exempt Charitable Gift Annuities from Antitrust and Securities Laws*, 23 EST. PLAN. 135 (1996); Dennis I. Belcher, *Charitable Gift Annuity Legislation*, Q250 A.L.I.-A.B.A. 17, 21 (March 28, 1996) (“The Act exempts from the Investment Company Act of 1940 the following funds ‘maintained’ by a charitable organization: (a) general endowment funds, (b) pooled income funds, (c) charitable gift annuities, (d) charitable remainder trusts, and (e) charitable lead trusts”).

204. See *Philanthropy Protection Act of 1995, Hearings on HR 2519 Before the Subcomm. on Communications and Finance*, 104th Cong. (1995) (statement of Barry P. Barbash, Director, Division of Investment Management, United States SEC).

Protection Act of 1995 will amend the Federal securities laws to clarify that the provisions of those laws are meant to apply to investment in our capital markets, not to gift-giving.<sup>205</sup>

The Philanthropy Protection Act and the Charitable Gift Annuity Antitrust Relief Act are necessary steps toward restoring the interpretation of the purpose of charitable gifts. Without these two pieces of legislation, the foundation of donating charitable gifts and trusts will be eliminated . . . . *The two acts . . . will establish charitable gift annuities as an exemption from Federal antitrust and securities laws* that require interest return at market rates. This will enable charitable organizations to continue to accept planned giving donations from individuals, pay out reasonable annual returns to the donor and provide the excess interest to benevolent activities.<sup>206</sup>

The donors who enter into charitable gift annuities do not act to make a profitable return on an investment. Rather, they are acting because they support the mission of the charity, and donate their money to that end . . . . This legislation, supported by the Securities and Exchange Commission, will protect charities from securities and antitrust-based lawsuits, and allow them to raise funds in the years to come.<sup>207</sup>

Enactment of these bills was urgently needed to put a stop to unwarranted litigation and ensure that charities can continue to accept gift annuities from generous donors across the country. For these reasons it was important for me to clear the way to immediate passage of the bills.<sup>208</sup>

Notwithstanding this legislative history, the actual text of the Philanthropy Protection Act does not provide clear and unequivocal federal exemptions from the registration of charitable gift annuities or charitable trusts under state or federal securities laws.

The federal securities registration exemptions provided by the Philanthropy Protection Act are available only for: (i) charitable income funds, under section 3(c)(10)(B) of the Investment Company

205. House Cong. Rec. E2,006 (October 24, 1995) (Statement of Rep. Fields).

206. Mr. Thornberry, *Charitable Gift Annuity Antitrust Relief Act of 1995* (visited Sept. 13, 1997) <<http://thomas.loc.gov/cgi-bin/query/d?r104:./temp/r104MKpd:e16734:>>.

207. Hon. Richard A. Gephardt, *In Support of Charitable Gift Annuity Relief Act* (visited Sept. 13, 1997) <[http://frwebgatel.access.goo.bor/cgi-bin/ . . . cID=9945827321 is O0&WAIaction=retrieve](http://frwebgatel.access.goo.bor/cgi-bin/. . . cID=9945827321 is O0&WAIaction=retrieve)>.

208. Mr. Dole, *Charitable Gift Annuity Legislation* (visited Sept. 13, 1997) <<http://rs9.loc.gov/cgi-bin/query/Z7.r104:SO4DES-6Z:>>.

Act; (ii) securities of charitable income funds, under section 3(a)(4) of the Securities Act; and (iii) securities issued by, or interests or participations in, charitable income funds, under section 3(a)(12)(A)(v) of the Exchange Act.<sup>209</sup> Similarly, the state securities registration preemption provided by section 6(a) of the Philanthropy Protection Act is available only to funds excluded from the definition of investment company under section (3)(c)(10) of the Investment Act of 1940.<sup>210</sup>

Gift annuities and charitable trusts generally are not considered to be charitable income funds or securities issued by a charitable income fund. In addition, they are not typically considered to be an interest or participation in a charitable income fund, since neither the annuitant nor the trust beneficiary has a direct investment interest in the fund.<sup>211</sup> Under this analysis, the Philanthropy Protection Act does not provide federal exemption or state preemption from registration of gift annuities or charitable trusts.<sup>212</sup>

In light of the legislative history, however, it is arguable that charitable gift annuities and charitable trusts should be entitled to the state and federal securities registration exemptions provided by the Philanthropy Protection Act.

For charitable organizations that pool their gift annuity or charitable trust assets in a charitable income fund, it could be argued that each gift annuity or charitable trust is exempt because it is a "participation" in the fund, even though neither the annuitant nor the trust beneficiary has a direct investment interest in the fund. The Philanthropy Protection Act expressly provides exemptions for "participations" in a charitable income fund, in addition to the exemptions for "securities issued by" and "interests in" a charitable

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209. See *supra* notes 30, 38, 40, 58 and accompanying text.

210. See Philanthropy Protection Act of 1995 § 6(a), 15 U.S.C. § 80a-3a(c) (Supp. I 1995).

211. A possible exception is the unusual situation where the annuity contract or trust instrument specifically requires the donated funds to be pooled with other assets of the organization exclusively for collective investment and reinvestment through a charitable income fund.

212. Indeed, the stated purpose of the Philanthropy Act is to limit the applicability of federal and state securities laws "in connection with the maintenance of certain pooled funds." H.R. REP. NO. 104-333 at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 619. The stated purpose does not include limiting the applicability of the securities laws to deferred giving instruments such as charitable gifts annuities and charitable trusts, the assets of which are permitted to be pooled in a charitable income fund. See *id.*

income fund.<sup>213</sup>

The case also can be made that each charitable trust should be considered to be a charitable income fund. Under the Philanthropy Protection Act, the definition of when a fund is “maintained” by a charitable organization expressly includes acting in the capacity of trustee,<sup>214</sup> and charitable trust assets are listed among the permissible assets for a charitable income fund.<sup>215</sup> Moreover, the charitable organization acting as trustee has a fiduciary duty to invest and otherwise manage the corpus of the trust for the benefit of the trust's beneficiaries.<sup>216</sup> Accordingly, each charitable trust could be considered to be a fund maintained by a charitable organization exclusively for the investment and reinvestment of the assets in the trust. Each trust beneficiary could be considered to have an interest or participation in this charitable income fund, since the trustee's obligation to make payments to the beneficiary would be limited to the trust's corpus. Under this analysis, each charitable trust would be a charitable income fund that is exempt from federal registration, and the interests of the trust's beneficiaries would be exempt from federal registration and would be preempted from state registration.

The case for charitable gift annuities is more difficult. With a gift annuity, the charitable organization has a general obligation to make annuity payments from its revenues and assets. There is no corpus of assets that is managed by the organization as trustee and in which the annuitant has a participation or interest. The organization may use the funds received from the gift annuity for any purpose, including spending them to meet general expenses. Many charities, however, treat their gift annuities essentially as trusts. The gift annuity assets are segregated from the general endowment of the organization and are managed, invested, and separately accounted for during the life of the donor. For these charities, the case

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213. See Philanthropy Protection Act of 1995 § 5, 15 U.S.C. § 80a-3a(b) (Supp. I 1995).

214. See *supra* text accompanying note 58.

215. See *supra* notes 63–64.

216. See UNIF. PRUDENT INVESTOR ACT (1994), 7B U.L.A. 16 (Supp. 1995), Prefatory Note, *Implications for Charitable and Pension Trusts*. The Act states that “the prudent investor rule also bears on charitable” trusts. *Id.* (citing RESTATEMENT OF TRUSTS § 389 (1959)). Furthermore, “in making investments of trust funds the trustee of a charitable trust is under duty similar to that of the trustee of a private trust.” RESTATEMENT OF TRUSTS § 389; see also John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 654–55 (1996).

could be made that a gift annuity should be accorded the same treatments as a charitable trust. To do otherwise would elevate form over substance. Arguably, such gift annuities should be entitled to the same exemptions from registration as charitable trusts under the Philanthropy Protection Act.

#### Other Nonprofit Exemptions

Even if the Philanthropy Protection Act does not provide applicable exemptions, most gift annuities still would be exempt from federal securities registration requirements. Before enactment of the Philanthropy Protection Act, section 3(a)(4) of the Securities Act exempted “any security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any person, private stockholder, or individual.”<sup>217</sup> Section 12(g)(2)(D) of the Exchange Act provided an almost identical exemption.<sup>218</sup> These nonprofit exemptions are still available. The SEC has interpreted these nonprofit exemptions to apply to gift annuity programs.<sup>219</sup> Gift annuities would remain subject to any state securities registration requirements.

The SEC may conclude, however, that these nonprofit exemptions do not apply to charitable trusts. According to the SEC, a charitable remainder trust that is established as a pooled income fund does not qualify for these nonprofit exemptions because it is organized and operated to produce a regular income that must be currently distributed to beneficiaries who are for the most part private individuals.<sup>220</sup> This reasoning would seem to apply not only to pooled income funds, but also to the other types of charitable trusts.

Nevertheless, the SEC has determined not to take action against a pooled income fund that does not register under the federal securities laws, provided the fund meets the requirements of Release 6175. The SEC based its no-action position in Release 6175 on the assumption that the primary purpose of persons who transfer property to a pooled income fund is to make a gift to a charity of

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217. See *supra* text accompanying note 24.

218. See *supra* text accompanying note 37.

219. See *infra* text accompanying notes 224–36.

220. See *supra* text accompanying notes 181–83.

their choice, and the belief that this donative intent and the application of Internal Revenue Code restrictions and Treasury regulations make registration under the federal securities laws unnecessary.<sup>221</sup> This reasoning would apply equally to other types of charitable trusts. Although Release 6175 by its terms applies only to pooled income funds, the SEC has issued no-action letters extending its applicability to pooled funds containing the assets of irrevocable charitable remainder trusts.<sup>222</sup> Accordingly, although not entirely free from doubt, the SEC should agree not to take action against a nonprofit organization that accepts contributions through any form of irrevocable charitable trust that meets the requirements of Release 6175. These charitable trusts would remain subject to any state securities registration requirements.

As discussed above, the Philanthropy Protection Act provides nonprofit organizations with broad federal exemptions, and broadly preempts state requirements, with respect to registration as a broker, dealer, agent, or investment adviser.<sup>223</sup> These federal exemptions and the state law preemption will continue to be available to nonprofit organizations and the individuals involved in the solicitation of donations, regardless of whether the donative instrument (e.g., a charitable trust or a gift annuity) is itself exempt from registration as a security under federal or state securities laws. Accordingly, if appropriately structured, charitable trust and gift annuity programs will be exempt from federal requirements and the requirements of most states with respect to registration as brokers, dealers, agents, or investment advisers. Each state has until November 7, 1998, to opt out of federal preemption of the state's registration requirements.

#### SEC No-Action Letters

Before enactment of the Philanthropy Protection Act, the SEC had issued two no-action letters in the context of gift annuity programs.

In *Christ Church of Washington*,<sup>224</sup> the Church proposed to issue

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221. See *supra* text accompanying notes 181–83.

222. See *supra* text accompanying notes 184–88.

223. See *supra* text accompanying notes 45 & 144.

224. *Christ Church of Wash.*, SEC No-Action Letter, 1974 WL 9979 (SEC), at \*1 (June 17, 1974).

gift annuity contracts to members of the congregation without registration under the Securities Act.<sup>225</sup> The gift annuity contract would involve a gift of a remainder interest in property to the Church and a guarantee of life income to the donor.<sup>226</sup> The donor-annuitant would receive a guaranteed annuity payable for life. The rate of return to the annuitant would be computed by reference to the annuity tables published by the Committee on Gift Annuities.<sup>227</sup> The proceeds of the gifted remainder interest would be used for general religious purposes and under no circumstances would the proceeds of such a donation be used for the benefit of any private individual.<sup>228</sup> The distribution of gift annuity contracts would be handled primarily through personal contact by a representative of the Church.<sup>229</sup> Publicity of the gift annuity program would be made through advertising in periodicals and on the radio.<sup>230</sup> The SEC stated that it would not recommend any enforcement action if the gift annuity contracts were issued without registration under the Securities Act.<sup>231</sup>

In *University of Minnesota Foundation*,<sup>232</sup> the Foundation represented to the SEC that it would operate its gift annuity program in compliance with the requirements of SEC Release 6175 and requested the SEC to treat its gift annuity program in a manner similar to a pooled income fund.<sup>233</sup> The Foundation stated:

[W]e recognize . . . that it is the position of the SEC that the anti-fraud provisions of the federal securities laws are applicable to interests such as charitable gift annuities and that each prospective participant in the gift annuity program must receive written disclosures which fully and fairly describe the gift annuity program."<sup>234</sup>

The University of Minnesota Foundation also made the follow-

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225. *See id.*

226. *See id.*

227. *See id.*

228. *See id.* at \*2.

229. *See id.* at \*1.

230. *See Christ Church of Wash.*, 1974 WL 9979 (SEC), at \*1.

231. *See id.*

232. University of Minn. Found., SEC No-Action Letter, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,792 at 77,206 (Dec. 24, 1980).

233. *See id.* at 77,207.

234. *Id.* at 77,208.

ing representations:

(1) The sole purpose of the Foundation was to acquire and invest contributions in order to make expenditures for the benefit of a state-chartered university;

(2) The Internal Revenue Service had determined that the Foundation was exempt from taxation under Section 501(c)(3) of the Internal Revenue Code; and

(3) Donors contributing under the gift annuity program would convey assets to the Foundation itself which, in turn, would make fixed annual payments to the annuitants from its general assets.<sup>235</sup>

Based upon these representations, the SEC stated that it would not recommend any enforcement action if the Foundation established and maintained the gift annuity program without registration: (1) under the Investment Company Act of the Foundation; (2) under the Securities Act or the Exchange Act of the gift annuities to be issued by the Foundation; or (3) under the Exchange Act of persons soliciting gifts by means of the gift annuity program.<sup>236</sup>

#### State Registration Requirements

Each nonprofit organization that accepts contributions in the form of gift annuities or charitable trusts must comply with the state securities laws applicable to such activities, unless the Philanthropy Protection Act has preempted these laws. As discussed above, it is unclear whether the federal exemptions and state preemptions under the Philanthropy Protection Act apply to gift annuities or charitable trusts.<sup>237</sup> Until this issue is resolved by court decision, legislative action, or other regulatory interpretation, the conservative approach would be to assume that the Philanthropy Act does not preempt state securities laws with respect to gift annuities or charitable trusts, and that nonprofit organizations must comply with the securities laws of the state of residence of each donor and the state of domicile of the nonprofit organization. In any event, nonprofit organizations must comply with the securities laws of any state that opts out of preemption under the Philanthropy Protection

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235. *Id.* at 77,207.

236. *See id.*

237. *See supra* notes 209–16 and accompanying text.

Act.

State laws vary widely in the treatment of charitable gift annuities and charitable trusts. In some states, charitable gift annuities and charitable trusts are expressly subject to the securities laws, although exemptions from registration may be available. For example, Washington expressly includes charitable gift annuities in the definition of a "security," but provides an exemption from registration of charitable gift annuities of certain universities, state colleges, insurers, and other institutions.<sup>238</sup> Charitable trusts are excluded from the definition of a security in Washington.<sup>239</sup> In Ohio, gift annuities and charitable trusts are securities, but certain qualified charities are exempt from registration.<sup>240</sup> Kansas exempts charitable gift annuities of charitable organizations that have been in existence for more than five years, are licensed by the Secretary of Social and Rehabilitative Services, and have fund balances exceeding \$1 million.<sup>241</sup> Iowa exempts charitable gift annuities of certain nonprofit organizations that have been in existence for at least ten years, but requires a notice filing with the Iowa Securities Bureau.<sup>242</sup> Since annuity payments are required for the life of the annuitant, charitable gift annuities are subject to the insurance laws of some states and, accordingly, may be exempt from the state's securities laws.<sup>243</sup> In other states, such as Wisconsin, charitable gift annuities may be regulated under both the state securities laws and the state insurance laws.<sup>244</sup> A nonprofit organization that accepts contributions in the form of gift annuities or charitable trusts must ensure compliance with the securities and insurance laws of each state in which such contributions are accepted.

### *SECURITIES OFFERINGS OF RELIGIOUS ORGANIZATIONS*

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238. See WASH. REV. CODE §§ 21.20.005(12), 21.20.310(12), (13) (1996).

239. See WASH. ADMIN. CODE § 460-52A-020(4) (1996).

240. See OHIO ADMIN. CODE § 1301: 6-3-03(A)(11) (1997).

241. See KAN. STAT. ANN. § 17-1261(o) (1996).

242. See IOWA ADMIN. CODE r. 191-50.14(502) (1997).

243. See 70 PA. CONS. STAT. ANN. § 1-102(t)(iii) (1997); Release No. 95-CF-1, Division of Corporate Finance, Pennsylvania Securities Commission (Jan. 4, 1995), 2A Blue Sky L. Rep. (CCH) ¶ 48,684O (1995).

244. See WIS. STAT. § 615.03 (1995-96); Monthly Bulletin, Jan. 1981, Wisconsin Office of the Commissioner of Securities, 3 CCH Blue Sky L. Rep. ¶ 64,886, at 56657 (1981). The bulletin states that "any solicitation of the general public regarding the gift annuity/deferred gift arrangement could be made only upon registration." *Id.*

As discussed above, the Philanthropy Protection Act preempts state registration and qualification requirements for charitable income funds.<sup>245</sup> The Philanthropy Protection Act does not, however, preempt state securities registration and qualification requirements for other types of nonprofit securities offerings. This includes church bond offerings and national religious denomination offerings of notes or other debt securities. Although church bond offerings and denominational note offerings generally are exempt from registration under federal securities laws,<sup>246</sup> each offering must comply with the registration or qualification requirements under applicable state securities laws.

#### Church Bond Offerings

NASAA's Church Bonds Guidelines were adopted in 1981.<sup>247</sup> While not formally adopted in all states, these guidelines are generally followed. Some states have their own rules or procedures for church bonds, so inquiry should be made of each relevant state when a church bond offering is contemplated.<sup>248</sup>

The Church Bonds Guidelines both describe the nature of the information that should be included in the offering circular and set certain standards for the offering. Among the key considerations in preparing for a church bond offering are the following:

- The church should offer no more bonds than it can reasonably expect to repay. The burden of proving the ability to repay is placed on the church. As a rule of thumb, the states believe that total debt upon completion of the offering should not exceed four times the last twelve months' revenues, excluding nonrecurring bequests and other extraordinary forms of revenues. The aggregate amount of the offering should not exceed 75% of the appraised value of the completed properties pledged as collateral.
- The offering often will be required to be secured by a trust indenture, pledging the properties acquired to secure the bonds. The bonds must have a first lien upon the pledged properties. The trust indenture must provide for an independent trustee

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245. *See supra* notes 144–60 and accompanying text.

246. *See supra* notes 24, 36 and accompanying text.

247. Church Bonds, NASAA (CCH) ¶ 1001, at 701 (Apr. 29, 1981).

248. *See id.*

and a paying agent and must include bond holder protections similar to those found in commercial mortgages, such as provisions for maintenance, insurance, prohibition against further encumbrances, and rights to information and accountability. The indenture also must require regular payments sufficient to cover debt service on the bonds annually. The trust indenture must require that the paying agent report to the trustee each failure to cure a non-payment after thirty days from the due date and that the trustee contact the state administrator if the payment is over sixty days late.

- Balloon payments or other graduated payments are prohibited.
- The issuer should obtain a fixed price contract, completion bond, or other assurance of performance within the amounts contemplated by the bond offering.
- The offering circular must contain three years of financial statements, with at least the most recent year audited. If the financial statements are over 120 days old, stub financial statements are required.<sup>249</sup>
- Bonds offered to refinance obligations of a church, which are in default without immediate refinancing, are prohibited unless the aggregate of all indebtedness outstanding after the new offering meets guideline requirements.
- The proceeds of the offering may not be commingled with general church funds.<sup>250</sup>

In reality, there is often a great deal of flexibility provided by the state securities administrator if the church can convince the administrator of the overall soundness and safety of the offering. Financial requirements can be modified, the trust indenture waived, and other restrictions modified to deal with the special problems often faced by churches.

The offering circular must meet the disclosure requirements set forth in the Church Bonds Guidelines.<sup>251</sup> The disclosure requirements are similar in many respects to those imposed on businesses.

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249. Stub financial statements are interim unaudited financial statements prepared for a portion of the new fiscal year following the annual audit. These statements must be submitted with an affirmation of accuracy by a senior church official. *See* Church Bonds, NASAA (CCH) ¶ 1005, at 711.

250. *See id.* at 705.

251. *See id.* at 701.

Basic organizational and operational information is required.<sup>252</sup> The state legends must be included in the front of the offering circular.<sup>253</sup> The church must identify the important risk factors of the investment, including: the principal sources of revenues and any potential fluctuations in these sources; assumptions about membership growth; additional financing that may be required; restrictions on sale or transfer of the bonds; construction risks; refinancing explanation; description of material pending litigation or contingent liabilities; and a statement that the church property may not, upon completion, be worth the amount paid for it, given the special and limited use for such buildings.<sup>254</sup>

The offering circular also should have a detailed explanation of the use of proceeds from the offering. It is important that the church adhere to these plans, and not depart in any material way. The other disclosure requirements in the guidelines are generally routine. Indeed, preparation of a church bond offering circular is not especially difficult if the church has good records, has done a competent job of preparing for the construction of its facilities, has experienced accountants and internal staff, is not in financial difficulty, and has avoided schisms and litigation.

The church may be required to escrow funds received until the minimum amount necessary to complete construction has been raised. This prevents the church from starting construction prior to the time that it has sufficient funds to assure completion. Construction of more than one church facility has begun, only to grind to a halt when all funds could not be raised.

When the offering circular is filed with the state, the initial review process can take from two to six weeks, depending upon the state. After initial comments are received from the state, the offering circular is amended to address the concerns raised through comment, additional background information is provided, and the offering circular is then finalized. The offering circular need not be in any special format, and can be reproduced by copying and stapling rather than through a commercial printer. Copies must be distributed to every purchaser prior to the church's receipt of funds or a subscription document, if one is used.

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252. *See id.* at 707.

253. *See id.* at 708.

254. *See id.* at 709.

Once sales commence, the church has an obligation to update its offering circular during the offering in the event that material changes occur. After necessary funds have been raised and deposited with a local bank as escrow, the church can either independently obtain release of those funds, or, alternatively, may be required in some states to seek an order from the state securities administration permitting release. If the offering is a "part or none" offering, where a designated portion of the offering is raised, and, upon meeting that level, the offering may continue without an escrow, the offering circular will be amended or supplemented to reflect the breaking of escrow and continuation of the offering.

Normally the state will authorize an offering only for a period of one year. If the offering is to continue thereafter, most states will require a new filing with updated information. An amendment or supplement is required to report material adverse events that occur during the year. At the completion of the offering, the church may be required to file a report summarizing the results of its sales activity.

#### Denominational Debt Securities Offerings

The NASAA Guidelines for General Obligation Financing by Religious Denominations<sup>255</sup> (the Denominational Guidelines) were adopted in 1994. These guidelines were designed to set the standards for offering debt securities in the form of general obligation financing (referred to as "notes" in the Denominational Guidelines) issued by a religious denomination or a national or regional unit thereof or other entity affiliated or associated with the denomination.<sup>256</sup> Each of these affiliated or associated entities is referred to in practice, and in the Denominational Guidelines, as a Church Extension Fund (CEF).<sup>257</sup>

Denominational offerings are intended for multiple projects and the notes are usually sold for various terms and at varying interest rates depending upon the term of the note.<sup>258</sup> Series of notes run traditionally from one to five years, but may be longer. The proceeds are usually used to provide ongoing financing for the purpose of constructing new churches, renovating older churches and construct-

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255. NASAA (CCH) ¶ 1951, at 1141 (Apr. 17, 1994).

256. *See id.*

257. *See id.*

258. *See id.*

ing or improving other church properties. The emphasis for most denominations is on the development of new or mission churches rather than providing substantial funding for existing churches or affiliated organizations. Such funding is often done with an issuance of securities for that specific purpose, to the extent that funds are not available from donations and endowments.

Sales efforts for the denominations are often very limited. National bulletins, newsletters, or magazines will announce the availability of an offering circular describing the sale of the notes and generally will explain the purpose of the offering. Once or twice a year, church bulletin inserts or language for inclusion in the bulletin will be provided to member churches. Some CEFs also use regional representatives who make periodic presentations during religious services to discuss the availability of the notes and the intended use of proceeds from sales of the notes. Customarily, investors will write or call the CEF for an offering circular, and mail in their funds, with little or no discussion with individuals representing the CEF.

The experience of the denominations is that a substantial portion of investors renew their notes at maturity by rolling them over into new notes on the terms and at the rates in effect at the time of renewal. CEFs are often incorporated and operated separately from the national denominational organization, although it is not unusual for the CEF and the national organizations to share officers and to have an identical board of directors or board of trustees.

CEFs generally offer notes that pay interest at rates below the commercial market rates for debt instruments of similar maturities since a primary motivating factor in the investment is to provide assistance to the denomination. Interest on notes may be retained and compounded at the CEF, rather than paid on a regular basis.

The history of CEF note programs has reflected an absence of defaults or financial problems, although some of the programs are thinly capitalized. Investors have been very loyal, regardless of the performance of the economy. The continuous nature of the offering of notes on an annual basis makes a traditional trust indenture inappropriate. Accordingly, the states generally do not require a sinking fund or trust indenture for repayment of the notes. The principal problem experienced by CEFs is the partial default of the start-up church that does not develop as fast as expected. It is rare that foreclosure is necessary, although partial forgiveness of indebtedness may occur.

The denominations have formed an association called Denomination Investment & Loan Administrators (DILA), which was the moving force behind development of the Denominational Guidelines. This group meets annually to discuss the problems and issues faced by CEF programs. Securities issues generally represent only a minor portion of their agenda. DILA has no offices or staff. Rather, the individual members provide the necessary support during their terms as officers. Almost all national denominational CEF organizations are members of DILA.

The Denominational Guidelines establish a series of requirements for denominational offerings, including the following:

- The notes must be exempt from registration under the Securities Act pursuant to Section 3(a)(4).
- No fees or commissions can be paid in direct or indirect compensation for the sale of the notes.
- Each CEF must comply with the agent and broker-dealer registration requirements in each state in which securities are sold. These requirements are the same as those described above for sales of church bonds.<sup>259</sup>
- Notes may only be sold to a limited class of investors. These generally include members of, contributors to, or participants in the denomination. This generally is not a hardship since most organizations made CEF investments available only to their members even before the adoption of the Denominational Guidelines.
- Advertising must meet certain requirements, including standard legends, limitation on distribution to the authorized class of investors, and a requirement that the advertising be consistent with the offering circular. Some states require review of the advertising prior to use. Modifications to the advertising may also require prior state review.
- Issuers should offer and sell no more notes than they can reasonably expect to repay, when due, in the ordinary course of business. This poses a dilemma for the denomination since it must predict demand for its notes and at the same time not understate the total amount of permitted sales for the year, since that could result in a regulatory violation. To complicate

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259. See Church Bonds, NASAA (CCH) ¶ 1001, at 705.

matters even further, some states want to know the amount that will be offered and sold in their specific jurisdiction and may base filing fees upon the amount authorized for sale for that year. Accordingly, CEFs must exercise great care in fixing the amount of securities to be sold so as to avoid regulatory violations, yet not to overstate the amount so they are compelled to pay excessive fees or violate the Denominational Guideline's mandate of not overstating the amount to be sold.<sup>260</sup>

The Denominational Guidelines impose operational and structural standards as well. The CEF must be a section 501(c)(3) organization.<sup>261</sup> The notes must be general obligation notes, and not specifically secured by particular loans to specific borrowing entities.<sup>262</sup> The proceeds must be deposited in the general fund of the CEF.<sup>263</sup> Appropriate disclosure must be made of the expenses incurred to operate the CEF.<sup>264</sup> A separate accounting must be provided for CEF operations, and the CEF cannot use the financial statements of the denomination unless there is a guarantee from that body.<sup>265</sup>

Some of the CEFs have been thinly capitalized, at least during their start up years. The boards of such organizations are dedicated to attempting to maximize the use of funds for the mission of the CEF, and there is often a reticence to build up a reserve that regulators deem adequate. Since this is the one issue that is likely to stop a denominational offering in some states, the governing body usually faces the issue and increases its reserves in order to more effectively serve its members.

Financial standards are the crux of NASAA's protection for investors in denominational offerings. Under the Denominational Guidelines, each CEF must have a positive net worth equal to at least three percent of its total assets.<sup>266</sup> The CEF must also have liquid assets in the form of cash, cash equivalents, and readily marketable assets with a market value of at least five percent of the

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260. *See* Guidelines for General Obligation Financing by Religious Denominations, NASAA (CCH) ¶ 1952, at 1143–45 (Apr. 17, 1994).

261. *See id.* ¶ 1953, at 1143–45.

262. *See id.*

263. *See id.*

264. *See id.*

265. *See id.*

266. *See* Guidelines for General Obligation Financing by Religious Denominations, NASAA (CCH) ¶ 1954, at 1147.

principal balance of its total outstanding notes.<sup>267</sup> If the CEF does not have this amount, it is permitted to supplement its net worth with a line of credit or other source of credit from a financial institution.<sup>268</sup> In reviewing the offering circular, states will expect that the CEF's net income, exclusive of non-recurring or extraordinary items, will be positive in at least three of its past five years.<sup>269</sup>

The CEF must provide information establishing that for its three most recent fiscal years, and on an estimated basis for its two succeeding years,<sup>270</sup> the coverage ratio of available cash as compared to cash redemptions, exclusive of denominational accounts,<sup>271</sup> shall be at least 1:1. The Denominational Guidelines set standards for determining acceptable liquid assets and cash sources. The practical concern is that loan maturation may not match the cash flow from operations, so that there could be a theoretical "run on the bank" because of the inability to repay given the timing of loan maturations compared to mortgage payments. Offering circulars generally contain tables reflecting these maturities, so the matching process is straight forward. The other concern is that the CEF may have mortgage funding obligations that can exceed its cash flow at a given time.

Regulators are concerned about a high level of loan delinquencies.<sup>272</sup> Without specifying a specific level of concern, the Denominational Guidelines require that delinquencies not be excessive and that the CEF continue to maintain the net worth, liquidity, and cash flow standards established in the Denominational Guidelines.<sup>273</sup> A high level of delinquencies may be reflective of an inadequate loan policy, failure to monitor and control loans, lack of communication

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267. *See id.*

268. *See id.*

269. *See id.* at 1147.

270. The estimates may be based on the historical experience for the prior five years. *See id.*

271. Defined in the Denominational Guidelines as demand and short-term obligations and accounts issued by the CEF and held by national, regional, or other affiliated units, institutions and organizations of the denomination, exclusive of those notes purchased based on the offering circulars pursuant to the registration, exemption, or qualification process. *See id.* ¶ 1951, at 1142.

272. Defined in the Denominational Guidelines as borrower's loan balances on which the payments of principal or interest are delinquent ninety days or more whether in default or not. *See Guidelines for General Obligation Financing by Religious Denominations, NASAA (CCH) ¶ 1951, at 1142.*

273. *See id.* ¶ 1954, at 1146.

with congregations or leaders, or poor decisions on location of new churches, among other things. A problem loan portfolio will receive extensive discussion in the offering circular.

The Denominational Guidelines create a concept of the “seasoned issuer.”<sup>274</sup> A seasoned issuer is deemed to meet all of the financial standards if it has fulfilled the requirements for at least three of the last five fiscal years, if it has an average for the five most recent fiscal years that reflects compliance, or if the information provided to the regulator establishes that it can repay the notes and other debt obligations when due in the ordinary course of business.<sup>275</sup>

When the maturity date for a note approaches, the investor must receive a written notification of maturity and any offer of extension at least thirty days prior to maturity.<sup>276</sup> The investor must also receive a current copy of the offering circular, if one has not been provided earlier.<sup>277</sup> The notice must state that if the investor notifies the CEF in writing on or prior to the maturity date that the investor does not want to renew the note, payment of principal and interest will be promptly made.<sup>278</sup> Failure to reply will result in automatic renewal, except in the State of California, which requires an affirmative decision to remain an investor.

The procedure for preparation and review of the offering circular is substantially equivalent to that described above for church bond offerings. The states have been very consistent in application of the Denominational Guidelines. The states have permitted the use of a national offering circular, rather than preparation of individual state models, which they generally required in the years prior to the Denominational Guidelines.<sup>279</sup>

The Denominational Guidelines caution that statements to the effect that little or no risk is involved in purchasing notes are prohibited, and that such statements will be regarded as a material misrepresentation.<sup>280</sup> This problem rarely occurs in an offering circu-

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274. *Id.* at 1147.

275. *See id.*

276. *See id.*

277. *See id.*

278. *See* Guidelines for General Obligation Financing by Religious Denominations, NASAA (CCH) ¶ 1954, at 1147.

279. *See id.* ¶ 1957 cmt., at 1148.

280. *See id.* at 1149.

lar, but individuals preparing advertising materials or speaking directly with potential investors may be less mindful of legal requirements and the problem can become a greater concern.

Among the unique features of disclosure for a CEF is the information relating to the denomination, the nature and extent of the offering of notes on a national basis, the unsecured nature of the general obligations of the CEF, the priority of its notes, circumstances under which early redemption will be permitted, historical information on the notes, and the underlying investments of proceeds — both for loans to churches and for use of reserve funds, summaries of outstanding receivables, lending activities and policies, selected financial data describing key financial information, and information about the management of the CEF.<sup>281</sup>

The offering circular must contain audited financial statements consisting of two years of audited balance sheets, three years of audited statements of cash flows, and three years of audited income statements or aggregation of fund balances.<sup>282</sup> A description of any change in accounting policies also is required.<sup>283</sup>

### Church Employee Pension Plans

Most major religious denominations in the United States have established retirement programs for their clergy and layworkers.<sup>284</sup> Historically, church employee pension plans were not exempted from registration under the federal securities laws, although exemptions were available for private sector and government retirement plans. Although the SEC indicated that it did not regard church employee pension plans to be the type of entity that should be subject to registration under the Investment Company Act, there was no express statutory exemption for these plans.<sup>285</sup>

In 1996, as part of the Improvement Act, Congress put church pension plans in the same category as private sector and govern-

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281. *See id.* at 1149–51.

282. *See id.* at 1152.

283. *See id.*

284. *See* S. REP. NO. 104-293, at n.12 (1996) (testimony of Barbara A. Boigegrain, General Board of Pension and Health Benefits of the United Methodist Church and Dr. Paul W. Powell, Annuity Board of the Southern Baptist Convention, on behalf of the Church Alliance, before the Committee on Banking, Housing, and Urban Affairs).

285. *See* S. REP. NO. 104-293 (1996); Hacker & Rotunda, *supra* note 55, at 98.

ment plans by exempting church plans from most federal and state securities regulation and registration requirements.<sup>286</sup> To protect plan participants and beneficiaries, Congress opted to tailor very specific exemptions from existing law. To qualify for exemption, substantially all of the activities of an exempt company or account must relate to the church plan or its administration.<sup>287</sup> In addition, church plans must meet eligibility requirements under section 414(e) of the Internal Revenue Code and must be administered for the exclusive benefit of participants and beneficiaries.<sup>288</sup> The anti-fraud laws continue to apply to the plan and to those individuals who perform certain functions for the plan (who would otherwise have had to register as an investment advisor or broker-dealer), notwithstanding the exemption.<sup>289</sup>

If these requirements are met, the church plan will be excluded from the definition of an investment company under the Investment Company Act<sup>290</sup> and any security issued by or any interest or participation in the church plan will be exempt from registration under the Securities Act,<sup>291</sup> the Exchange Act,<sup>292</sup> and the Trust Indenture Act.<sup>293</sup> Church plans are required to notify plan participants that the plan is not subject to, and the participant is not covered by, state

286. See National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290 (1996) (codified in scattered sections of the U.S.C.).

287. See *id.*

288. See *id.*

289. See S. REP. NO. 104-293 (1996).

290. The exclusion applies to:

Any church plan described in Section 414(e) of the Internal Revenue Code of 1986, if, under any such plan, no part of the assets may be used for, or diverted to, purposes other than the exclusive benefit of plan participants or beneficiaries, or any company account that is—

(A) Established by a person that is eligible to establish and maintain such a plan under Section 414(e) of the Internal Revenue Code of 1986; and

(B) Substantially all of the activities of which consist of—

(i) Managing or holding assets contributed to such church plans or other assets which are permitted to be commingled with the assets of church plans under the Internal Revenue Code of 1986; or

(ii) Administering or providing benefits pursuant to church plans.

Investment Company Act § 3(c)(14), 15 U.S.C. § 80a-3(c)(14) (Supp. II 1996).

291. Securities Act § 3(a)(13), 15 U.S.C. § 77c(a)(13) (Supp. II 1996).

292. Exchange Act § 3(a)(12)(A)(vi), 15 U.S.C. § 78c(a)(12)(A)(vi) (Supp. II 1996).

293. Trust Indenture Act of 1939 § 304(a)(4)(A); 15 U.S.C. § 77ddd(a)(4)(A) (1994).

and federal securities laws.<sup>294</sup> The SEC is authorized to monitor compliance with the new exemptions and to issue rules requiring exempt church plans to file a notice with the SEC.<sup>295</sup>

In addition, the church plan, any person or entity eligible to establish and maintain a church plan, and any trustee, director, officer, or employee of or volunteer for such church plan, company, account, person, or entity, will be exempt from registration under the Exchange Act as a broker, dealer, municipal securities broker, municipal securities dealer, government securities broker, government securities dealer, clearing agency, or transfer agent.<sup>296</sup> To qualify for this exemption from registration under the Exchange Act, no such person or entity is permitted to receive a commission or other transaction-related sales compensation in connection with any activities conducted in reliance on the exemption.<sup>297</sup> Each such entity or person also is exempt from registration as an investment adviser under the Advisers Act, if such person or entity provides investment advice exclusively to, or with respect to, the church plan.<sup>298</sup>

In addition to providing these exclusions and exemptions from registration under the federal securities laws, the Improvement Act also preempted any state registration requirements for church plans. Any security issued by or any interest or participation in any church plan, company, or account that is excluded from the definition of an investment company under section 3(c)(14) of the Investment Company Act, and any offer, sale, or purchase thereof, is exempt from any law of a state that requires registration or qualification of securities.<sup>299</sup> In addition, any church plan, person, or entity eligible to establish and maintain a church plan, and any trustee, director, officer, or employee of or volunteer for any such plan, person, or entity is exempt from any state regulation of, or requirements to qualify or register as, an investment company, broker, dealer, investment adviser, or agent.<sup>300</sup> To qualify for this state law preemption, there is no restriction on the manner of compensation of

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294. See Investment Company Act § 29(g), 15 U.S.C. § 80a-29(i) (Supp. II 1996).

295. See Exchange Act § 3(g), 15 U.S.C. § 78c(g) (Supp. II 1996).

296. See *id.*

297. See *id.*

298. See *id.*

299. See *id.*

300. See *id.*

such persons or entities.<sup>301</sup>

### CONCLUSION

Nonprofit organizations have always received favorable treatment under the federal and state securities laws and have been entitled to a variety of exemptions not available to other organizations. These nonprofit exemptions have been clarified and expanded with the recent enactment of the Philanthropy Protection Act in 1995 and, to a lesser extent, the National Securities Markets Improvement Act in 1996.

The securities laws are complex, however, and it is easy for a nonprofit organization to inadvertently fail to qualify for one or more potential exemptions from registration. For example, if an organization were to include the assets of a single impermissible revocable trust in an otherwise appropriately structured charitable income fund, the fund would lose most of its federal exemptions from registration, as well as its preemption from state securities registration. Similarly, if an organization were to pay a commission or other form of sales-based compensation to a single person in connection with the solicitation of donations to a charitable income fund, most of the otherwise available federal and state exemptions from broker-dealer and agent registration would be unavailable not only for that person, but also for the organization and its trustees, directors, officers, employees, and volunteers. Accordingly, it is essential for each nonprofit organization to structure its fundraising programs carefully to ensure that the securities either qualify for an exemption or are appropriately registered under federal and state securities laws.

Many nonprofit organizations mistakenly believe that they will be exempt from all requirements under the securities laws if they structure their fundraising programs to qualify for an exemption from registration. In reality, however, a particular securities sales program may qualify for an exemption from registration under the Securities Act, while still being subject to registration of the organization or the individuals as broker-dealers or investment advisers under the Exchange Act or the Advisers Act. In addition, a federal

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301. *Cf.* Securities Exchange Act § 3(g), 15 U.S.C. § 78(c)(g) (prohibiting receiving a commission or other transaction-related sales compensation to qualify for the federal exemption).

exemption from registration does not guarantee an exemption in all states in which the program is offered.

Most importantly, even if the program is exempt from all registration requirements, nonprofit organizations are never exempt from the anti-fraud provisions of the federal or state securities laws. If a nonprofit organization is involved in the sale of securities, it must prepare and distribute to each participant an offering circular or other disclosure document that provides full and fair disclosure of all material information with respect to the fundraising program. Failure to provide these disclosures constitutes fraud under the securities laws.

Failure to comply with the registration and anti-fraud requirements of the securities laws can have serious consequences. The organization and its trustees, directors, officers, employees, and volunteers may face civil lawsuits, administrative enforcement actions and, if the violations are serious, even criminal sanctions. The adverse publicity can be devastating, even if there was no intent to mislead or deceive and no participant was harmed by the innocent violation. In light of the many exemptions available, especially after the recent enactment of the Philanthropy Protection Act, nonprofit organizations would be well-advised to review their various fundraising programs to ensure that they are in compliance.

As a wise man once said, “[T]he time to repair the roof is when the sun is still shining.”<sup>302</sup>

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302. John F. Kennedy, State of the Union Message, Jan. 11, 1962, PUBLIC PAPERS OF THE PRESIDENTS (Jan. 11, 1962).