STATEMENT OF BASIS AND PURPOSE

Promulgation of Amendments to Division Rules

Colorado Division of Securities
May 19, 2017

Pursuant to the authority found in the Colorado Securities Act ("Act"), sections 11-51-101, et seq., C.R.S. (2017), including part 6 of the Act, the Securities Commissioner adopts amendments to Division Rules 51-2.2, 51-3.1, 51-3.4, 51-3.5, 51-3.9, 51-3.13, 51-3.19, 51-3.24, 51-3.30, 51-4.2, 51-4.3, 51-4.5, 51-4.6, 51-4.8, 51-4.3(IA), 51-4.4(IA), 51-4.6(IA), 51-4.7(IA), 51-4.8(IA), 51-4.9(IA), 51-6.1, 51-6.2, 51-6.3, 51-6.4, 51-6.5, 51-9.3 and proposes Division Rules 51-3.31, 51-3.32, 51-3.33, 51-4.9, 51-4.11(IA), 51-4.12(IA), 51-4.13(IA), 51-4.14(IA), 51-4.15(IA) 51-6.2.5 on March 6, 2017.

Rule 51-2.2, SEC Amendments Coordinated, contained a spelling mistake, [ective date, instead of effective date. This has been fixed.

Rule 51-3.1, Registration by Coordination, formatting has been amended to be consistent with the Rules under the Colorado Securities Act (collectively, the "Rules")(individually, "Rule"). All of the underlining has been removed from this Rule.

Rule 51-3.4, Escrow and Release of Funds under Section 11-51-302(6), C.R.S., contained a spelling mistake, transanctions, which has been changed to transactions.

The general purpose of amending Rule 51-3.5, Notice of Intention to Sell in Reliance on Investment Company Exemption under Section 11-51-307(1)(k), is to promote efficiencies and save costs. The amendment requires that the Uniform Investment Company Notice Filing Form (Form NF) and the appropriate fee be filed annually. It also removes the requirement that any amendments to Form NF be filed with the Colorado Division of Securities (the "Division"). This will save time and money for the investment company compliance officers, as well as the Division, in reducing both the amount of filing, and the amount of review required. Investors remain equally protected because Form NF is still filed on an annual basis, reflecting any changes that would have previously required an amended filing.

The general purpose of amending Rule 51-3.9, Transactional Securities Exemption for Non-Issuer Distribution of Outstanding Security, is to remove manuals which no longer exist and to add manuals from OTC Markets Group Inc. ("OTC Markets Group"). Standard and Poor's Standard Corporation Descriptions no longer exists and has been removed from the Rule. Additionally, the Rule adds OTC Markets Group (with respect to securities included in the OTCQX and OTCQB markets) to the manual exemption. The OTCQX and OTCQB markets require that companies disclose all of the information required under the Manual Exemption, and that information is publicly available for free on the OTC Markets Group website. OTCQX and OTCQB companies meet their disclosure requirements by meeting one of the following standards: 1) filing periodic reports with the SEC; 2) making required filings under the SEC's Regulation A, Tier 2: 3) reporting to their banking regulator; 4) complying with Exchange Act

Rule 12g3-2(b); or, 5) following OTCQX U.S. Disclosure Guidelines, originally developed by NASAA. In addition to this fundamental information, the website also provides real-time pricing information, a repository of each company's prior public disclosures, the company's corporate action history, independent research from third parties, and other tools and information. "OTC Markets Group monitors OTCX and OTCQB company disclosure, and companies that become delinquent in providing the required information are removed from OTCQX or OTCQB, as applicable."

The general purpose of repealing Rule 51-3.13, Transactional Securities Registration Exemptions under section 11-51-308(1)(p), C.R.S., is to comply with the federal rule regarding Regulation A. The current Rule conflicts with the federal rule and the Division is pre-empted from regulating Regulation A offerings as it currently does. This amendment repeals the old "test the waters" provision. The North American Securities Administration Association ("NASAA") has asked for public comment regarding a Proposed Model Statute, a Proposed Model Rule, and a Proposed Solicitation of Interest Form to Permit Testing the Waters in Regulation A Tier 1 Offerings. A new test the waters provision will be added after a model rule has been promulgated and the Division has a chance to evaluate what NASAA proposes.

The new Rule 51-3.13, Transactional Securities Registration Exemptions under Section 11-51-308(1)(p), requires issuers who are relying on Regulation A, Tier 2 offerings to provide notice to the Division. The notice filings are not pre-empted under federal law. The new Rule makes clear that C.R.S. §11-51-308(1)(p) only applies to Tier 1 offerings (which is all Colorado can regulate). The proposed Rule is a NASAA model rule for notice filing for issuers relying on Regulation A, Tier 2.

Rule 51-3.9 Model Accredited Investor Exemption, was changed to make the Rule's organization consistent with the rest of the rules. 3.19(E)(2)(f)(1-3) was changed to 3.19(E)(2)(f)(i-iii).

The general purpose of amending Rule 51-3.24, Crowdfunding-Additional Issuer Requirements, is to ensure that issuers relying on crowdfunding are not also relying on any other registration exemption within a twelve month period. This provision requires issuers who are relying on crowdfunding and another exemption to integrate the offerings. The amendment clarifies that whether an issue is part of the same offering is a question of fact and depends on the particular circumstances. The amendment provides factors to determine if an offering is part of the same issue and should therefore be integrated.

Rule 51-3.24, Federal Rules Applicable, adds a new rule that allows offerings made pursuant to the Colorado Crowdfunding Act to be made under Rule 147A (17 CFR 230.147A). The SEC established this new intrastate offering exemption under the Securities Act of 1933, designated Rule 147A, which will be similar to the amended Rule 147, but will have no restriction on offers and will allow issuers to be incorporated or organized outside of the state in which the intrastate offering is conducted provided certain conditions are met. The new Rule 147A is designed to facilitate capital formation, including through offerings relying upon intrastate crowdfunding provisions under state securities laws, while maintaining appropriate investor protections and

providing state securities regulators with the flexibility to add additional investor protections they deem appropriate for offerings within their state.

Rule 51-3.30, Crowdfunding – Disqualification from Relying on Crowdfunding Exemption, was amended to make stylistic changes. First, the numbers in parenthesis were changed to romanettes, reflecting the overall structure of the Rules. Second, certain statutes were unnecessarily bold and the bold was therefore removed (e.g. 15 U.S.C. 78o(b)).

Rule 51-3.31, Notice Filing Requirement for Federal Crowdfunding Offerings, requires issuers who are relying on the federal crowdfunding rule to complete a notice filing in Colorado. The notice is required if the principal place of business is Colorado or if 50% of the aggregate amount of the offering is sold to residents of Colorado. Additionally, this Rule clarifies when the notice filing must be completed and for how long the notice is effective. Finally, it defines how to renew the filing. This is NASAA's model rule.

The addition of Rule 51-3.32, Use of Electronic Offerings Documents and Electronic Signatures, defines how electronic offering documents and electronic signatures can be used. The Division is adopting this Rule to ensure that investors remain protected, as increasingly documents and signatures are completed only electronically. The Rule sets the standard for how and when an electronic document and signature can be used instead of a paper copy. The Rule incorporates the Federal E-Sign Act and the Uniform Electronic Transactions Act. One commentator proposed expanding the definition of the term "Security Breach" as contained in the proposed rule, adding a definition for the term "Confidential Personal Information", incorporating the terms "Security Breach" and "Confidential Personal Information" into the Rule, removing the phrase "or any other breach of personal information" and adding a section to the Rule regarding notice to individuals following a security breach. After considering the comments, the Commissioner determined that the definitional terms "Security Breach" and any references to the term the should be removed because similar statutory requirements already exist under the Colorado Consumer Protection Act, Breach Notification Statute, § 6-1-716(1)(a) and (2), C.R.S. This will avoid unnecessary conflict and potential confusion with the statutory provisions. The Commissioner agreed that proposed definition of the term "Confidential Personal Information" should be included in the Rules, but determined that this definition should appear under Rule 51-2.1.B, in the general definition section of the rules.

The general purpose of adding Rule 51-3.33, Licensing Exemption for Merger and Acquisition Brokers, is to provide a licensing exemption for a broker engaged in the business of effecting securities transactions solely in connection with the transfer of ownership of an eligible privately held company. The Rule excludes explicit activities, like receiving stock, and includes federally defined disqualifications. This rule is modeled after the NASAA model rule.

Rule 51-4.2, Withdrawal of a Broker-Dealer License, was amended to include a hyphen between broker and dealer. This makes this Rule consistent with the rest of the Rules use of the term "broker-dealer."

Rule 51-4.3, Application for a Sales Representative License was amended to make the organizational structure consistent with the rest of the Rules. The "K" in Rule 51.4.3(J)(2)(K) should be lowercase and the Rule has been amended to reflect this.

Rule 51-4.5, Books and Records Requirements for Licensed Broker-Dealers, was amended to accurately reflect the federal rules that they reference. Currently, the Rule cites to SEC rules 15c2-6, which is reserved for future use, and 75 CFR 240.15c2-11, which does not exist. The amendment changes 15c2-6, to all of 15g (17 CFR 240.15g-1 through 240.15g-100). 15c2-6 was originally penny stocks, which are now covered by 15g. The amendment to this Rule reflects the change in the federal rule.75 CFR 240.15c2-11 was a misprint, and has been changed to 17 CFR 15c211.

Rule 51-4.6, Financial Responsibility and Books and Records Requirements for Mortgage Broker-Dealers', organization was changed to be consistent with the organizational structure of the Rules.

Rule 51-4.7, Unfair and Dishonest Dealings organizational structure was changed to be consistent with the rest of the Rules.

The general purpose of adding Rule 51-4.8, Broker-Dealer Cybersecurity, and Rule 51-4.14(IA), Investment Adviser Cybersecurity, is to clarify what a broker-dealer and investment adviser must do in order to protect information stored electronically. The Rule provides guidance to broker-dealers and investment advisers on what factors the Division will consider when determining if the procedures by the firm are reasonably designed to ensure cybersecurity. Two commentators proposed amending Rules 51-4.8.A.6 and 51-4.14(IA)A.6 changing "used to conduct the firm's electronic security" to "that have access to Confidential Personal Information" and Rules 51-4.8.C.2 and 51-4.14(IA)C.2 to include "for email containing Confidential Personal Information." One commentator proposed amending Rules 51-4.8.C.1 and 51-4.14(IA)C.1 as follows: "An annual assessments by the firm or an agent of the firm of the potential risks and vulnerabilities to the confidentiality, integrity, and availability of Confidential Personal Information." The Commissioner determined that the three proposed changes are appropriate. The changes to Rules 51-4.8.A.6 and 51-4.14(IA)A.6 expand the requirement to establish and maintain written policies and procedures regarding all devices that contain Confidential Personal Information. The changes to 51-48.C.2 and 51-4.14(IA)C.2 limit the requirement for the use secure email only to emails containing Confidential Personal Information. The changes to Rules 51-4.8.C.1 and 51-4.14(IA)C.1 clarify the scope of the annual risk assessment to be made by broker-dealers and investment advisers.

The general purpose of amending Rule 51-4.3(IA), Application for an Investment Adviser License, is to provide guidance on who needs to be licensed as an investment adviser. The Rule makes it abundantly clear who is required to be licensed as an investment adviser or investment adviser representative. The Rule clarifies that lawyers, accountants, engineers and teachers are required to be licensed as investment advisers only if the advice given is not "solely incidental" (as defined in the Rule) to the professional's regular professional practice with respect to clients. Additionally, this Rule clarifies when a broker-dealer and broker-dealer agent, insurance agents, and others must be licensed as an investment adviser or investment adviser representative.

The general purpose of amending Rule 51-4.4(IA), Application for an Investment Adviser Representative License, is to require an investment adviser who has an unpaid arbitration award to explain the details of the award. It is not in the public interest to have former securities sales representatives who have an unpaid FINRA award against them become an investment adviser representative without further explanation. This amendment is intended to protect the public by requiring the applicant to explain the details of the unpaid arbitration award. C.R.S. §11-51-403, gives the Commissioner the power to make applicants submit "additional information that is material to an understanding of information about the applicant." Because the Commissioner considers this information material, the application will remain incomplete until the information is provided.

The general purpose of amending Rule 51-4.6(IA), Books and Records Requirements for Licensed Investment Advisers, is to clearly define what the staff at the Division looks at when determining if the investment adviser's supervisory procedures are reasonably situated to the firm. Additionally, it provides what minimum supervisory procedures a firm must have. If a firm does not have written supervisory procedures, it is deemed to have violated §11-51-410(1)(g), C.R.S.

Additionally, Rule 51-4.6(IA) was amended to make the organizational structure consistent with the rest of the Rules. Finally, the Rule refers to an investment adviser being "registered." This should be licensed and has been amended.

The amendment to Rule 51-4.7(IA), Mandatory Disclosure changes the name of the form from Part II of the investment adviser's Form ADV to Part 2. This change reflects the change in the name of the universal form. Additionally, the Rule was amended to require investment advisers and investment adviser representatives who participate in a wrap fee program to give every client, including prospective clients, a copy of the Form ADV in addition to a copy of Part 2A appendix 1 of Form ADV (the wrap fee brochure). Similarly, investment advisers and investment adviser representatives must give clients participating in a pooled investment vehicle a copy of Part 2 of the investment adviser's Form ADV. One commentator suggested that the added requirement on investment advisers to provide the Form ADV, Part 2 in addition to the wrap fee brochure is "inconsistent with the published SEC instructions and will result in redundant disclosures." After considering the comment, the Commissioner declined to change the proposed rule finding that because the Form ADV, Part 2 contains additional disclosures that are not required to be made in the wrap fee brochure, clients will receive a more complete disclosure if they receive both documents.

The amendment to Rule 51-4.8(IA), Dishonest and Unethical Conduct, also changes the name of the form from Part II of the investment adviser's Form ADV to Part 2, but, additionally, includes organizational structural changes, again for consistency.

Rule 51-4.9(IA), Payment of Cash Fees for Solicitation, was amended to make its organizational structure consistent with the rest of the Rules.

The general purpose of adding Rule 51-4.11(IA), Licensing Exemption for Investment Advisers to Private Funds is to allow investment advisers who manage funds that meet the private fund definition in the Securities and Exchange Commission ("SEC") Rule 203(m)-1, 17 C.F.R. 275.203(m)-1, to be exempt from licensing. This Rule includes a list of disqualifications (17 C.F.R. 230.506(d)(1), 17 C.F.R. 275.204-4) and requires a fee to be paid to the Division. This rule is modeled after the NASAA model rule. One commentator proposed multiple changes to the Rule that would, in essence, expand the licensing exemptions for investment advisers to private funds and retail buyer funds that qualify for exemption from registration under sections 3(c)(1), 3(c)(5), and 3(c)(7) of the Investment Company Act of 1940. The Commissioner determined that these proposed changes should not be incorporated because they are inconsistent with the equivalent NASAA model rule, and as such may interfere with the convenience, predictability and clarity that the NASAA model rules otherwise provide to investors and investment advisers. While the commentator noted that in 2016 the Arizona legislature adopted a private fund exemption that expanded the definition to include Section 3(c)(5) funds and that the California Commissioner of Corporations in 2012 adopted a similar exemption that also included Section 3(c)(5) funds, these are apparently the only two states with an expanded definition. While the California Commissioner articulated various reasons for the expanded definition, it should be noted that the California rules were adopted prior to the adaption of the NASAA model rule, and the assumption is that in adopting the NASAA model rule, the member states of NASAA took into consideration the rationale of the California Commissioner, and made the determination not to include the expanded definition. If NASAA reconsiders the model rule to expand the definition, the Commissioner will also reconsider the current rule.

The general purpose of Rule 51-4.12(IA), Business Continuity and Succession Plan is to ensure that investment advisers consider disaster scenarios. This rule helps investment advisers ensure as minimal disruption as possible to their clients. It requires "minimizing service disruptions and client harm that could result from a sudden significant business interruption." This is a NASAA model rule.

The general purpose of adding Rule 51-4.13(IA), Net Worth Requirements is to ensure that investment advisers have a positive net worth. For investment advisers with discretionary authority over client funds, they maintain, at a minimum, a $10,000 net worth requirement. Investment advisers with custody are required to have a net worth of $35,000. Additionally, the Rule requires that an investment adviser notify the Commissioner if they fail to maintain the appropriate net worth requirements. This Rule is fairly similar to NASAA's model rule, Minimum Financial Requirements for Investment Advisers, Amended September 11, 2011.

The general purpose of adding Rule 51-4.15(IA) Performance-Based Compensation Exemption for Investment Advisers is to define when and how an investment adviser may charge a fee based on performance. The Rule limits the use of the fee to "qualified clients," as defined by the SEC. For a "natural person," there is a net worth requirement of $2 million, inclusive of a spouse, but exclusive of the primary residence.

Chapter 6 Procedures for Hearings Conducted by the Colorado Securities Board has been re-organized for usability. Requirements which apply to all hearings have their own section. Additionally, the Rules now require hearings regarding denial, suspension or revocation of either

a registration statement or registration to be scheduled within 120 days. Similarly, Rule 51-6.5 has been expanded to include all of the powers listed in §11-51-410, C.R.S. This includes denying a license, or suspending, revoking, censuring, limiting, or other conditions on the securities activities of a broker-dealer, sales representative, investment adviser or investment adviser representative. The Division of Administrative Hearings has been changed to the Office of Administrative Courts throughout the chapter. Finally, rules for withdrawing as an attorney have been added to Rule 51-6.4 and Rule 51-6.5. Previously, only Rule 51-6.3 regarding cease and desist hearings mentioned how an attorney can withdraw from their representation.

The amendment to Rule 51-9.3 Registration, Reports, and Bookkeeping of the Local Government Investment Pool Trust Funds, has been updated to reflect what information the Division needs from Local Government Investment Pool Trust Funds ("LGIPs"). The amendment eliminates the requirements that LGIP's submit Form TRQ-1 (QUARTERLY REPORT TO MEMBERS) and TRQ-2 (PORTFOLIO ASSETS). The Forms no longer exist. The amendment to the Rule reflects input from the current LGIPs, and the Division is asking that the LGIPs provide the information which they are already providing to their clients.

The Securities Commissioner did not propose any changes to Rule 51-9.4. However, one commentator proposed including additional reporting requirements on each Local Government Investment Pool. The Commissioner determined that these changes should not, at this time, be incorporated into the Rule noting that the Division recently adopted substantial changes to the Rules pertaining to Local Government Investment Pool Trust Funds. The Rules became effective on December 14, 2016. Therefore, insufficient time has passed for the Division to be able to determine the shortcomings, if any, of the newly-adopted rules.

The Securities Commissioner finds that the adoption of these amendments to the Rules is necessary and appropriate in the public interest, and is consistent with the purposes and provisions of the Act. The Securities Commissioner further finds that the record demonstrates the need for the Rules; the Rules are clearly and simply stated; proper statutory authority exists for the Rules; the Rules do not conflict with any other rules or statutes governing the Division of Securities; and the Rules are coordinated with the federal acts and statutes and the rules and regulations promulgated thereunder to which references are made, to the extent coordination with them is consistent with the purposes and provisions of the Act.

This general statement of basis and purpose is incorporated by reference in the rules adopted by the Securities Commissioner on May 19, 2017. The rules become effective on July 15, 2017.

DATED this 19th day of May, 2017.

Gerald Rome
Securities Commissioner