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Commonwealth Of Kentucky

Court Of Appeals

NO. 2004-CA-001947-MR

TARGET OIL & GAS CORPORATION
AND MICHAEL SMITH — APPELLANTS

v.

APPEAL FROM FRANKLIN CIRCUIT COURT
HONORABLE ROGER CRITTENDEN, JUDGE
ACTION NO. 04-CI-00588

COMMONWEALTH OF KENTUCKY,
DEPARTMENT OF FINANCIAL INSTITUTIONS,
DIVISION OF SECURITIES — APPELLEE

OPINION
AFFIRMING

** ** ** ** **

BEFORE: KNOPF AND VANMETER JUDGES; BUCKINGHAM, SENIOR JUDGE.[1]

KNOPF, JUDGE: Target Oil and Gas Corporation and Target's president, Michael Smith, (Target) appeal from an order of the Franklin Circuit Court, entered August 10, 2004, requiring Target to comply with a subpoena *duces tecum* issued by the

[1] Senior Judge David C. Buckingham sitting as Special Judge by assignment of the Chief Justice pursuant to Section 110(5)(b) of the Kentucky Constitution and KRS 21.580.

executive director of the Commonwealth's Office of Financial Institutions. Target maintains that the subpoena exceeds the director's investigative authority and otherwise amounts to an unconstitutional invasion of its internal affairs. We disagree and affirm.

Target is a Kentucky corporation apparently headquartered in Danville that engages in the notoriously risky business of oil and gas exploration. It finances its operations, at least in part, by selling shares in its ventures to investors. The Division of Securities within the Office of Financial Institutions regulates the sale of securities in Kentucky, and in late 2003 the Division began investigating unspecified investor complaints against Target. The investigation led to the subpoena at issue in this case, pursuant to which the Division seeks financial records, records of Target's drilling practices, and, in particular, "a list of all investors [since the inception of the company in 1999] and the amount of the interest that they each hold."

In Commonwealth, ex rel. Hancock v. Pineur,[2] our Supreme Court adopted the three-part test for determining the validity of an administrative subpoena *duces tecum* first articulated by the United States Supreme Court in such cases as

[2] 533 S.W.2d 527 (Ky. 1976).

Oklahoma Press Publishing Company v. Walling[3] and United States v. Morton Salt Company.[4] Quoting from Morton Salt our Supreme Court noted the similarity between the early stages, at least, of an administrative investigation and the investigation by a grand jury and held that the administrative subpoena should be enforced if the court is satisfied that "the inquiry is within the authority of the agency, the demand is not too indefinite and the information sought is reasonably relevant."[5]

This standard appears to be satisfied in this case. With respect to the director's authority to make the inquiry, KRS 292.320 makes it unlawful

> for any person, in connection with the offer, sale, or purchase of any security, directly or indirectly:
> (a) To employ any device, scheme, or artifice to defraud;
> (b) 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
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

[3] 327 U.S. 186, 66 S.Ct. 494, 90 L.Ed. 614 (1946).

[4] 338 U.S. 632, 70 S.Ct. 357, 94 L.Ed. 401 (1950).

[5] Commonwealth v. Pineur, 533 S.W.2d at 529. *Cf.* United States v. R. Enterprises, Inc., 498 U.S. 292, 301, 111 S.Ct. 722, 112 L.Ed.2d 795 (1991) (discussing grand-jury subpoenas and holding that such a subpoena should be presumed reasonable and thus enforceable unless the resistor shows that "there is no reasonable possibility that the category of materials the Government seeks will produce information relevant to the general subject of the grand jury's investigation.").

KRS 292.460 authorizes the director to inquire concerning potential violations of KRS 292.320. That statute provides that the director may, in his or her discretion,

> (1) . . . make such public or private investigations within or outside of this state as he [or she] deems necessary to determine whether any registration should be granted, denied, or revoked, or whether any person has violated or is about to violate any provision of this chapter or any rule or order under this chapter . . .
> (2) For the purpose of any investigation or proceeding under this chapter, the executive director or any officer designated by him [or her] may administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require production of any books, papers, correspondence, memoranda, agreements, or other documents or records which the executive director deems relevant or material to the inquiry.

An inquiry into potential securities fraud is thus within the director's authority as is a subpoena to further that inquiry. The subpoena in this case should be upheld, therefore, provided that it is not too broad and that the material it seeks is reasonably relevant. Target does not challenge the Director's subpoena as too broad. The director seeks only about five years' worth of financial and operations history. That demand does not seem unduly burdensome. Those records are clearly relevant, moreover, to an inquiry into whether Target's agents have misrepresented the company's practices to investors.

Likewise, the investors themselves are relevant, for without talking to them the investigators will not be able to evaluate the alleged complaints or Target's denials of wrongdoing.[6]

At first glance, therefore, the director's subpoena appears valid. Target contends, however, that the subpoena is not within the director's authority for two reasons. First, it maintains that the director's authority has been preempted by the National Security Markets Improvement Act of 1996 (NSMIA).[7] As Target correctly notes,

> [t]he primary purpose of NSMIA was to preempt state "Blue Sky" laws which required issuers to register many securities with state authorities prior to marketing in the state. By 1996, Congress recognized the redundancy and inefficiencies inherent in such a system and passed NSMIA to preclude states from requiring issuers to register or qualify certain securities with state authorities. . . . To accomplish this objective, the NSMIA precludes states from imposing disclosure requirements on prospectuses, traditional offering documents and sales literature relating to covered securities.[8]

The federal law includes a saving clause, however, which permits the states to retain jurisdiction over fraudulent conduct:

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[6] Tom v. Schoolhouse Coins, Inc., 236 Cal.Rptr. 541 (Cal.App. 1987).

[7] Pub. L. No. 104-290, 110 Stat. 3416 (1996), codified in part at 15 U.S.C. § 77r.

[8] Zuri-Invest AG v. Natwest Finance Inc., 177 F. Supp. 2d 189, 192 (S.D.N.Y. 2001) (quoting from Lander v. Hartford Life & Annunity Ins. Co., 251 F.3d 101, 108 (2nd Cir. 2001); other citations and internal quotation marks omitted).

> Consistent with this section, the securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions.[9]

As explained by the Conference Committee,

> [t]his preservation of authority is intended to permit state securities regulators to continue to exercise their police power to prevent fraud and broker-dealer sales practice abuses, such as churning accounts or misleading customers. It does not preserve the authority of state securities regulators to regulate the securities registration and offering process through commenting on and/or imposing requirements on the contents of prospectuses or other offering documents.[10]

Thus, even if Target's securities are covered by the NSMIA and are therefore exempt from the Kentucky registration statutes, the director is not precluded from investigating claims that Target may have misled its customers.[11]

Target insists, however, that the director's anti-fraud authority is limited to fraud practiced against Kentucky investors. It asserts that it does not solicit or sell to Kentucky investors and thus that in this case even an anti-fraud

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[9] 15 U.S.C. § 77r(c)(1).

[10] Conference Report, H.R. Conf. Rep. 104-864, 104th Cong, 2d Sess., at 40 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3920, 3921.

[11] State v. Justin, 779 N.Y.S.2d 717 (N.Y.Sup.Ct. 2003); Zuri-Invest AG v. Natwest Finance Inc., *supra.*

inquiry is beyond the director's authority. Clearly, though, the director is not obliged to accept Target's denials at face value; and even if Target's assertion is true, as noted above KRS 292.320 makes it unlawful for a Kentucky securities issuer to practice fraud "upon any person," not just upon Kentucky residents. We agree with the Court of Appeals of Arizona that

> [a] state has an interest in seeing that its territory is not used as a base of operations to conduct illegal sales [of securities] in other states. Thus, the host state has an interest in protecting its reputation as not being the center for illegal or questionable securities activity.[12]

The director's investigative authority is not undermined, therefore, by Target's assertion that it deals only with out-of-state investors.

Target's defensive arsenal is not yet exhausted. If the subpoena in this case does not exceed what is authorized by statute, it does exceed, Target contends, what is authorized by the constitution. In particular, Target maintains that the subpoena amounts to an unreasonable search in violation of the Fourth Amendment to the United States Constitution and that it amounts to an arbitrary governmental act in violation of Section 2 of the Constitution of Kentucky. Target is correct to the extent that administrative investigations implicate Fourth-

[12] Arizona Corporation Commission v. Media Products, Inc., 763 P.2d 527, 533 (Ariz.App. 1988) (citation and internal quotation marks omitted).

Amendment and Due-Process protections, but its argument founders on the fact that the three-part Morton Salt standard discussed above has been held to satisfy the constitutional requirements. In Morton Salt the United States Supreme Court expressly held that an administrative subpoena satisfying the three-part test shall not be deemed unreasonable for Fourth-Amendment purposes.[13] And in Commonwealth v. Pineur,[14] the Supreme Court of Kentucky held that a judicial determination that the administrative subpoena satisfied the Morton Salt reasonableness standard was an adequate protection against unconstitutionally arbitrary administrative action.

Finally, attempting to wrap itself in the mantle of cases such as NAACP v. Alabama[15] that hold that advocacy groups have First-Amendment rights that may be infringed by investigations into their membership,[16] Target contends that its First-Amendment rights are violated by that portion of the director's subpoena requiring it to provide a list of its investors. The short answer to this contention is that "[p]roducing a customer list does not offend the First Amendment because commercial transactions do not entail the same rights of

[13] 338 U.S. at 652-53.

[14] *supra.*

[15] 357 U.S. 449, 78 S.Ct. 1163, 2 L.Ed.2d 1488 (1958).

[16] *See* Roberts v. United States Jaycees, 468 U.S. 609, 104 S.Ct. 3244, 82 L.Ed.2d 462 (1984) (discussing First-Amendment associational rights).

association as political meetings."[17] Because Target's activities are clearly and solely commercial, the director's demand for a list of Target's investors does not offend the First Amendment.

In sum, because the director's subpoena is within his statutory authority to investigate potential acts of fraud and misrepresentation in the marketing of securities and because it does not invade any of Target's constitutional rights, the trial court correctly ordered that it be enforced. Accordingly, we affirm the August 10, 2004, order of the Franklin Circuit Court.

ALL CONCUR.

BRIEFS FOR APPELLANTS:

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BRIEF FOR APPELLEE:

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[17] United States v. Bell, 414 F.3d 474, 485 (3rd Cir. 2005). *See also* IDK, Inc. v. County of Clark, 836 F.2d 1185 (9th Cir. 1988); Tom v. Schoolhouse Coins, Inc., 236 Cal.Rptr. 341 (Cal.App. 1987); In the Matter of a Witness Before the Special October 1981 Grand Jury, 722 F.2d 349 (7th Cir. 1983).