

THE STATE OF SOUTH CAROLINA
In The Supreme Court

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APPEAL FROM THE ADMINISTRATIVE LAW COURT

S.C. Supreme Court

Ralph K. Anderson III, Administrative Law Judge

Opinion No. 5274 (S.C. Ct. App. filed October 8, 2014)

Appellate Case No. 2014-002736

Duke Energy Corporation.....Petitioner,

v.

South Carolina Department of Revenue.....Respondent.

**AMENDED AMICUS CURIAE BRIEF ON BEHALF OF THE SOUTH CAROLINA
MANUFACTURERS ALLIANCE**

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INTRODUCTION

The South Carolina Manufacturers Alliance (the “SCMA”), as *amicus curiae* of the Court, respectfully offers this brief in support of Petitioner, Duke Energy Corporation (“Duke Energy”). The case presents the issue of whether the South Carolina Department of Revenue (“Department”) can alter the plain meaning of a statute by alleging that the statute does not clearly reflect the taxpayer’s income and would otherwise produce an absurd result. Only last year, this court ruled that the South Carolina Department of Revenue must *prove* that the standard statutory income tax apportionment method does not clearly reflect a taxpayer’s business activity within the state *before* it can advance a reasonable alternative.

This case involves the proper computation of the South Carolina sales factor of the apportionment formula used by South Carolina taxpayers with multistate/multinational operations. This issue turns on whether “total sales” – as the term is used in the South Carolina sales factor statute - include all receipts from sales or less than all receipts from sales (“net sales”). The Department determined that “total sales” excluded a portion of the taxpayer’s receipts from sales of securities based on its view that including all receipts from sales of securities in the definition “total sales” produced less tax and would therefore not clearly reflect Duke Energy’s income and would produce an absurd result. However, as the record in this case shows, the Department never offered any proof that including all sales of securities in “total sales” did not reasonably reflect Duke Energy’s income or would produce an absurd result. Instead, the Department simply claimed that Duke Energy’s application of the standard apportionment formula resulted in less tax to the State. This cannot be the proper result under South Carolina law and is of concern to all taxpayers doing business in this state.

STATEMENTS OF IDENTITY AND INTEREST OF AMICUS CURIAE

The SCMA is a non-profit, bipartisan organization that has been in existence for 109 years. It serves as the manufacturing industry's trade organization and government liaison in South Carolina. The goal of the organization is to be the voice of manufacturers to the State's legislative and regulatory branches of government, as well as preserving and promoting South Carolina's widely respected business climate. It also provides a variety of educational forums.

The SCMA strives to preserve and promote the economic health of manufacturing industries in the state by seeking positive action in state government, as well as to educate public officials and the general public on issues of importance to manufacturing industries. SCMA emphasizes that maintaining strong manufacturing industries in the State will foster and promote the strength of South Carolina's economy. In 2009, the manufacturing sector accounted for approximately 12% of the State's total employment.¹

Manufacturing employment (while down from historical figures) still constitutes 13% of total state employment in South Carolina,² and manufacturers pay 20.9% of all state wages. Manufacturers pay average annual wages of \$47,073 versus the South Carolina state average of \$37,752. Manufacturing wages range from \$135,148 in aircraft manufacturing, \$83,980 in nuclear power generation to \$37,336 in textiles.³ By contrast, retail trade pays an average wage of \$23,862, with food services paying \$14,357 and grocery stores \$21,001.⁴ Manufacturing directly creates and supports 256,000 jobs in South Carolina and indirectly another 328,000.⁵

¹ S.C. Comptroller General's Office, "Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2009" at 8.

² Miley, Gallo & Associates, LLC, *The Economic Impact of Manufacturing in South Carolina 3* (Dec. 2009), http://myscma.com/public_docs/ManufacturingReport_Final.pdf

³ *Id.* at 9, tbl. 7.

⁴ *Id.* at 9, tbl. 7.

⁵ *Id.* at 13.

Manufacturers also pay some 25% of all property taxes in South Carolina (including both traditional property taxes as well as fee-in-lieu).⁶ In some counties manufacturers constitute more than 50% of the property tax base. A recent study indicates that South Carolina's economy ranks 11th in the nation in being dependent on the manufacturing sector.⁷

The SCMA's interest in this matter arises from the miscalculation of Duke Energy's sales factor by the Department and the courts below in that the sales factor statute mandates the inclusion of "total sales," and yet less than the total sales of securities were included in the computation of Duke Energy sales factor. As a result, the courts below approved the Department's deviation from the statutorily prescribed apportionment formula even though the Department had neither asserted the application of an alternative apportionment formula nor met its burden of proof as required by this Court in *CarMax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Rev.*, 411 S.C. 79, 767 S.E.2d 195 (2014). This issue is significant to all businesses that do business in the state.

QUESTION PRESENTED

Did the Court of Appeals err in narrowing the definition of "receipts" for South Carolina corporate income tax purposes and in holding that securities sold in Duke Energy's ordinary course of its business are not "receipts" for South Carolina corporate income tax purposes even though South Carolina statutes require that taxpayers include their "total gross receipts" or "total sales" in apportioning their income to South Carolina?

During the periods at issue, Duke Energy Corporation ("Duke Energy") like most, if not all SCMA members, had a treasury department that, as part of managing the company's cash and working capital needs for its operations, purchased and sold municipal bonds, U.S. Treasury

⁶ *Id.* at 11, tbl. 8.

⁷ G. Scott Thomas, *Indiana Leans More on Manufacturing than any Other State*, Charlotte Business Journal (July 18, 2011, 1:00 AM), <http://www.bizjournals.com/bizjournals/on-numbers/scott-thomas/2011/07/indiana-leans-heavily-on-manufacturing.html>.

securities, commercial paper, agency securities, and loan repurchase agreements (collectively “securities”). These treasury function transactions were performed outside of South Carolina using company-approved investment guidelines that defined the “type, term, and ratings of permitted investment securities.” (App’x. at 3012:19-3016:14 (Love Dep.).)

This case involves the narrow issue of whether Duke Energy must include its total or less than total (“net”) receipts from sales of securities in the denominator of its sales apportionment factor when apportioning its South Carolina income.

During the tax years 1978 through 2001 (“Tax Years at Issue”), multistate taxpayers engaged in manufacturing were required to apportion their income using a statutory formula based on their sales, property, and payroll in South Carolina relative to their sales, property, and payroll everywhere. S.C. Code Ann. § 12-6-2280 (for tax years after 1995); former S.C. Code Ann. § 12-7-1170 (for tax years prior to prior to 1996). The sales factor was based on the ratio of “*total sales*” in South Carolina to the “*total sales*” made by a taxpayer everywhere. *Id.* “Sales” included all receipts from sales of tangible property, intangible property, and services. § 12-6-2280(c)

The Department agreed that the income from Duke Energy’s sales of securities was business income for purposes of applying the South Carolina corporate income tax. Therefore, Duke Energy included all receipts from its sales of securities in the calculation of its “total sales” in accordance with the plain language of the South Carolina income tax apportionment factor.

Following its audit of Duke Energy, the Department rejected the inclusion of all receipts from Duke Energy’s sales of securities explaining that “to do so lessens the South Carolina income subject to tax.” (App. p. 5554.)

The Court of Appeals upheld the Department's determination holding that Duke Energy should only include the "net receipts" in the denominator of its sales factor. The court gave two reasons for its decision. First, the court stated that receipts from sales of securities, other than net receipts, were not "receipts" for purposes of computing Duke Energy's sales factor because they were "not money [Duke Energy] received from its products or services." Second, the court held that including all of Duke Energy's receipts from its sales of securities in the sales factor, as required under the standard apportionment formula, "would not reasonably represent the proportion of the trade or business carried on within this State." *Duke Energy Corp. v. S.C. Dep't of Revenue*, 410 S.C. 415, 425, 764 S.E.2d 712, 718 (2014) (App. p. 8443).

ARGUMENTS

I. Does the term "Total Sales" mean "Net Sales" when that raises more tax revenue for the State of South Carolina?

During the tax years at issue, the sales factor of the standard apportionment formula consisted of "[t]he ratio of total sales made by such taxpayer during the income year which are attributable to this State to the **total sales** made by such taxpayer everywhere during the income year" S.C. Code Ann. § 12-6-2280 (for tax years after 1995); former S.C. Code Ann. § 12-7-1170 (for tax years prior to 1996). (Emp. added.)

As the Department accurately describes it in its Brief of Respondent to the Supreme Court (pg. 2) (hereinafter "Department Brief"): "For 1978-1995, the sales factor was defined as '[t]he ratio of sales made by such taxpayer during the income year which is attributable to this State to the *total* sales made by such taxpayer everywhere during the income year . . . ' S.C. Code Ann. § 12-7-1170 (years before 1996). For 1996 through 2001, the sales factor was similarly defined as 'a fraction in which the numerator is the *total* sales of the taxpayer in this State during the taxable year and the denominator is the *total* sales of the taxpayer everywhere

during the taxable year. S.C. Code Ann. § 12-6-2280(A) (years after 1995).” (Emp. added.) This case turns on the meaning of the term “total sales.” The Department – and the courts below – concluded that under the plain language of the apportionment statute, “total sales” means what it states – i.e., total/all sales – but only when it raises more tax revenue for the state of South Carolina. However, because in this case the plain meaning of the term decreases the amount of tax owed by Duke Energy to South Carolina, the Department argues that “total” means less than total and it only includes “net sales.” (As stated below, there is a statutory mechanism which the Department can apply where under relatively unique facts “total sales” results in distortion for either the taxpayer or the Department. The Department did not assert this statutory mechanism in this case.)

Prior to this case, “total sales” had always meant “total sales.” And such an interpretation is fully supported by the term’s standard dictionary definitions:

Definitions of “Total” or “In total”

Cambridge American English Dictionary

(<http://dictionary.cambridge.org/us/dictionary/american-english/total>)

Total (n): the whole amount

In total (n): including everything added together

Total (v): to have as a whole amount

Oxford Dictionary

(http://www.oxforddictionaries.com/us/definition/american_english/total)

Total (adj.): comprising of the whole number

Total (n): the whole number or amount of something

Merriam – Webster

(<http://www.merriam-webster.com/dictionary/total>)

Total (adj.): complete or absolute

Total (adj.): after everything or everyone is counted

Total: comprising or constituting a whole

Dictionary.com

(<http://dictionary.reference.com/browse/total?s-t>)

Total (n): the total amount; sum; aggregate

Total (adj.): involving all aspects, elements, participants, resources, etc.; unqualified; all-out

Black's Law Dictionary (10th ed. 2014)

“[T]otal ... 1. Whole; not divided; full; complete. 2. Utter; absolute.”

II. The General Assembly knew the definition of “Total Sales.”

As detailed below, the statutory definition of “total sales” (which is similar in many states) has on occasion resulted in distortion for certain multi-state taxpayers. States have remedied that distortion in appropriate cases in two ways: (1) by amending their statute (on a prospective basis as it resulted in a substantial change in the law);⁸ and (2) by invoking the state’s equitable apportionment statute (which is discussed at length below).

Following the lead of several other states, the South Carolina General Assembly amended the definition of “total sales” in 2006. The Legislature enacted a *new* statutory provision that, effective for tax years after 2006, expressly defines the terms “sales” (for purposes of the three-factor formula) and “gross receipts” (for purposes of the single-factor formula). 2007 S.C. Laws Act 110 § 51.A (enacted as S.C. Code Ann. § 12-6-2295(B)). As the Department’s Legislative Update for 2007 states: “Code section 12-6-2295 was *added* to provide examples of items that the terms ‘sales’ and ‘gross receipts’ do and do not include.” See SC Information Letter No. 07-16, p. 6 (emphasis added).

⁸ After the Oregon Supreme Court’s decision in *Sherwin-Williams Co. v. Dep’t of Revenue*, 996 P.2d 250 (Or. 2000), the Oregon Legislature changed its law to exclude gross receipts, Or. Rev. Stat. § 314.665(6)(a). After the District Court Ruling in *Western Elec. Co. v. Norberg*, 89-131 (1983), *cert. denied*, 461 A.2d 679 (R.I. 1983) Rhode Island similarly amended its statute, R.I. Gen. Laws § 44-11-14(a)(2)(v). Wisconsin did the same.

Section 12-6-2295 came into the Code in two separate Acts: Act 116 and Act 110. Both Acts contain the same title: “By adding section 12-6-2252 and 12-6-2295 so as to further provide for allocation and apportionment of business income for state income tax purposes by basing the determination only on a sales factor and to define the terms ‘sales’ and ‘gross receipts’ consistently and specifically for the purpose.”

The Legislature’s amendment in 2006 included ten new categories of receipts to be excluded from “sales” and “gross receipts.”⁹ For example, the new statutory section – section 12-6-2295 – provides, in part, that “sale” for manufacturer and “gross receipts” for service providers do not include:

- (1) Damages and other amounts received as a result of litigation;
- (2) Income from forgiveness of indebtedness;¹⁰
- (3) Pension Reversions;¹¹ and
- (4) tax refunds.¹²

The first three exclusions are new as no Department policy document had ever allowed the exclusion of such receipts from the sales factor; and all three are directly contrary to federal income tax law. South Carolina annually conforms to federal income tax law, section 12-6-40, and thus the General Assembly was required to pass legislation to decouple from federal law in order to exempt these items. Tax refunds (or rather the interest earned on such refunds) were previously taxable. *See* S.C. Rev. Rul. 91-15.

Perhaps because of the pending Duke Energy refund claims, the Department’s technical correction bill also excluded from the definition of sales and gross receipts “redemption of the

⁹ Under S.C. Code Ann. § 12-6-2295, the definition of “sales” is identical to the definition of “gross receipts.”

¹⁰ At the federal level discharge of indebtedness is in many cases taxable under 26 U.S.C. § 108.

¹¹ Pension reversions are taxable under the Internal Revenue Code. *See* § 26 U.S.C. § 4980

¹² Tax refunds were previously taxable in South Carolina. *See* S.C. Rev. Rul. # 91-15

principal of a loan, bond, . . . certificate of deposit or similar marketable instrument” as well as the “principal amount received under a repurchase agreement.” The Department Brief (pg. 26) claims that “the General Assembly... expressly ratified the Department’s [unwritten] policy through the enactment of § 12-6-2295(B).” In fact, Act 116 contains 71 Sections (70 substantive provisions and one effective date provision in Section 71). The relevant Act section is section 56. Section 56B plainly states: “B. This section takes effect upon approval by the Governor and *applies for taxable years beginning after 2006.*” (Emp. added.)

Twenty-seven of the 70 substantive sections in Act 116 contain specific effective date provisions, *e.g.*, section 16, “B. This section takes effect upon approval by the Governor and applies to tax years beginning after December 31, 2005.” Forty-three do not. Section 71 contains the general effective date provision and its states:

This act takes effect ‘upon the approval by the Governor, and *is applicable for tax years beginning after 2007*’, except for Section 5, relating to Section 12-6-3415(A), which is applicable for tax years beginning after 2006, and Section 6, relating to Sections 12-20-105, which is applicable for tax years beginning after 2003. (Emp. added.)

Act 110 also contained the new § 12-6-2295 in section 51. Section 51B plainly states: “This section takes effect upon approval of this Act by the Governor and *applies for taxable years beginning after 2006.*” Section 61 contains the general effective date provision: “*Except as otherwise provided elsewhere in this act*, this act takes effect upon approval by the Governor.” (Emp added). Twenty-seven of the sixty substantive sections of Act 110 have their own effective date provision, *e.g.*, Section 10, “this section takes effect upon approval by the Governor and applies to tax years beginning after December 31, 2005.” Thirty-three do not.

If the Legislature was expressly ratifying the Department's secret policy why did the General Assembly in *four different sections* of Acts 110 and 116 take pains to note that the change was effective "for taxable years beginning after 2006?"

The General Assembly undoubtedly added the specific prospective effective date provision because this change in law was substantive. The 2006 law change added a new section to the statute which excluded ten new categories of receipts from the definitions of "sales" and "gross receipts." For example, income from discharge or cancellation of indebtedness was previously taxable in South Carolina if it was taxable under federal law. Under the new Act these new exclusions were not subject to state income taxes even if taxable under federal law. When the Legislature amends a statute to include a *material* change, there is a *presumption* that the Legislature intended to change the existing law rather than to clarify its original intent. *Key Corporate Capital, Inc. v. Cnty. of Beaufort*, 373 S.C. 55, 60-61, 644 S.E.2d 675, 678 (2007). Obviously the General Assembly paid attention to when it wanted the Code sections contained in Acts 110 and 116 to take effect.

In 2007, this Court held in *Key Corporate Capital, Inc. v. Cnty. Of Beaufort*:

[p]urchasers of properties at tax sale were limited to refund of purchase price without interest as remedy when the sale was voided, under statute in effect at time of the transaction, providing for a refund of 'the amount paid' to the successful bidder where a tax sale was voided; court would apply *presumption that Legislature's subsequent amendment of the statute to include interest was intended to change the existing law*, and equitable remedy was not warranted because the statute provided an adequate remedy at law.

373 S.C. 55, 644 S.E.2d 675 (2007) (emphasis added). In doing so, the Court acknowledged the longstanding precedent for such a presumption. *See Vernon v. Harleysville Mut. Cas. Co.*, 244 S.C. 152, 155, 135 S.E.2d 841, 844 (1964); *see also North River Ins. Co. v. Gibson*, 244 S.C. 393, 137 S.E.2d 264, 266 (1964) (where the Court recognized "the rule of construction that the

adoption of an amendment which materially changes the terminology of a statute ... raises a presumption that a departure from the original law was intended”); *Hyde v. S.C. Dep’t of Mental Health*, 314 S.C. 207, 210, 442 S.E.2d 582, 583 (1994) (Toal, J., dissenting) (“Where a statute has been amended, there is a presumption that the legislature intended to change the law.”). Therefore, in *Key Corporate*, the Court found that the Legislature’s material amendment of the statute in question was meant to change the law.

Similarly, in *Cannon v. S. Carolina Dep’t of Prob., Parole & Pardon Servs.*, 371 S.C. 581, 641 S.E.2d 429 (2007), a parolee sought a declaratory judgment that DNA Identification Record Database Act, which required submission of DNA samples by parolees convicted of enumerated crimes, did not apply to him. The Court stated, “We find the Act is inapplicable to petitioner because the Legislature’s act of amending the statute in 2000 shows that a departure from the original law was intended.” *Id.* at 584.

In *Edwards v. State Law Enforcement Div.*, 395 S.C. 571, 720 S.E.2d 462 (2011) a sex offender, who had received a pardon on his two “Peeping Tom” convictions, filed a petition requesting issuance of an order mandating that he was no longer required to register as a sex offender. The State relied on *Stuckey v. State Budget and Control Bd.*, 339 S.C. 397, 529 S.E.2d 706 (2000), in support of its position that the General Assembly’s amendments clarified the legislature’s original intent that, with only limited exceptions, even those with pardons should be required to register.

In *Stuckey*, the appellant began employment as a public school teacher in August 1972 and was enrolled in the state retirement plan until she terminated her employment in June 1973. appellant attended law school full-time from August 1973 to May 1976, and in October 1976 she began employment with the State Department of Education. In May 1995, she filed a request

with the South Carolina Retirement Systems (Agency) for two years retroactive educational leave pursuant to section 9-1-1140 of the South Carolina Code, which at the time provided, “[A] member who leaves employment to attend graduate school and returns directly to employment may establish up to two years’ retirement credit by paying the actuarial cost as determined by the [State Budget and Control] Board.” S.C. Code Ann. § 9-1-1140 (1986).

The Retirement System denied appellant's request because she had not returned directly to covered employment. The Retirement System interpreted “directly” to mean “immediately” but allowed for a grace period of ninety days in order to accommodate teachers who had an annual three month lapse in employment. *Stuckey*, 339 S.C. at 400-01, 529 S.E.2d at 707. This Court found that the General Assembly’s amendment to section 9-1-1140 shed light on the legislature's intent. *Id.* at 401, 529 S.E.2d at 708. After appellant filed her claim, the General Assembly amended the statute to provide, “[A] member who leaves covered employment to attend undergraduate or graduate school and returns to covered employment within ninety days after the member's last date of enrollment may establish up to two years’ retirement credit by paying the actuarial costs as determined by the board.” *Id.* (quoting S.C. Code Ann. § 9-1-1140 (Supp.1997)) (emphasis added). This Court found the subsequent statutory amendment clarified the original legislative intent. *Id.* at 401, 529 S.E.2d at 708.

By contrast, the Court in *Edwards* rejected the holding in *Stuckey*, stating “However, the statute creating the sex offender registry did not speak to the issue of pardons, and thus, *there was no language for the subsequent amendments to clarify*. Thus, the facts and analysis of *Stuckey* are inapplicable to the amendments of section 23-3-430 of the South Carolina Code.” *Id.* at 577-78. (Emp. added.)

In our case there were no definitions of “sales” or “gross receipts” regarding certificates of deposit, bonds and repurchase agreement to clarify. In addition, the new Code section as stated above also provides in part that “sale” for manufacturer and “gross receipts” for service providers do not include: (1) damages and other amounts received as a result of litigation; (2) income from forgiveness of indebtedness; or (3) Pension Reversions. These three exclusions were not only brand new but were directly contrary to federal law. Since South Carolina annually adopts federal tax conformity, they reversed the former treatment of these tax items. In addition, the Act reversed state law regarding the taxation of refund claims.

III. Are receipts included in “total receipts” only when they are risky investments?

Virtually every one of the SCMA member companies has a treasury function that invests excess cash to manage the company’s daily working capital and cash needs. This function was described in the Court of Appeals’ decision as follows:

To understand whether Duke Energy’s gross receipts from sales of short-term investments should be included in the formula, it is helpful to examine the investment transactions at issue. According to Sherwood L. Love, Duke Energy’s Assistant Treasurer and General Manager of Long Term Investments, Duke Energy maintained a Cash management Group within its treasury department that “provide[d] required liquidity support for Duke[’s] commercial paper programs . . . for the short-term funding of additional electric generation, transmission and distribution facilities[.]” The Cash Management Group carried out this objective by “invest[ing] Duke[’s] excess operating cash in various short-term marketable securities.” These securities included municipal bonds, loan repurchase agreements, commercial paper, U.S. Treasury securities and agency securities.

410 S.C. 415, 427, 764 S.E.2d 712, 719.

The Department’s Brief (pg. 7) similarly describes Duke Energy’s treasury function as follows: “During the periods at issue, Duke Energy invested excess cash from operations in municipal bonds, U.S. Treasury securities, commercial paper, agency securities, and loan

repurchase agreements.” The Department’s Brief (pg. 7) argues that “total receipts” means net receipts because “the transactions were not risky.” Such a claim is not only factually incorrect, but it is also unwarranted.

A securities broker-dealer or an issuer who advertised to potential clients that municipal bonds, commercial paper, or loan repurchase agreements are “not risky” would be subject to enforcement action by the National Association of Securities Dealers (NASD), now called FINRA, the Securities Division of the Attorney General’s Office, or the SEC. See *Sec. & Exch. Comm’n Release Notice*, Litigation Release No. 16458 (2000) (issuers of commercial notes indicted in part for claiming notes were “risk-free” investments); *Sec. & Exch. Comm’n*, Litigation Release No. 15139 (1996) (permanent injunction issued against issuer of investments claiming to be “riskless”).

Simply put, as explained in the attached Investor Alert (Ex. A) issued by the Securities and Exchange Commission, Financial Industry Regulatory Authority (“FINRA”) and NASAA, “no investment is risk free.” The Investor Alert states that “Investors should exercise caution before investing in these type of products.” Two of the products discussed were Certificate of Deposits and Bonds, and one of the Enforcement Actions cited in the Alert was a broker who represented that “investments had little or no risk and were as safe as bank deposits.” The FINRA issued the attached Notice (Ex. B), “The Reality of Investment Risk” which states: “When it comes to risk, here’s a reality check: All investments carry some degree of risk. Stock, bonds, mutual funds and exchange-traded funds can lose value, even all their value, if market conditions sour.”

Duke Energy invested in municipal bonds. FINRA’s brochure, *Understanding Bond Risk* (Ex. C), states that “[l]ike other investments, when you invest in bonds . . . you face the risk that

you might lose your money.” FINRA cites Interest Rate Risk, Call Risk, Duration Risk, Refunding Risk, Default and Credit Risk, Inflation and Liquidity Risk, and Event Risk. The pamphlet notes that “most bonds face a possibility of default.” Puerto Rico is not the first, and surely not the last, but merely the latest governmental entity whose bonds were once considered “risk-free,” but now are subject to default.¹³

Does “total sales” in South Carolina only include receipts derived from churning, high pressure sales seminars, pump and dump, or Equity Indexed Certificates of Deposits (see SEC/FINRA/NASAA Investor Alert)?

IV. Are Duke’s receipts a “return of principal”?

The Department’s position in this case centers almost entirely on the notion that Duke’s “total sales” consisted of “recovered principal.” For example, page 3 of the Department Brief states “the Department determined that including recovered principal in the apportionment formula was contrary to the Department’s long-standing administrative policy . . . (recovery of principal issue).” Page 25 states: “The Department had a long-standing policy . . . to exclude recovered investment principal from the standard apportionment formula.” Pages 25 and 26 make repeated references to recovery of “investment principal.” Page 5 summarizes the Department’s position in this case as follows:

Like many companies, Duke Energy repeatedly invests excess working capital in short-term investments and then, after a few days or weeks, recovers its invested principal plus a proportionately small amount of interest or gain. *This repeatedly*

¹³ See Aaron Kuriloff, “Puerto Rico Defaults on Most of \$58 Million Debt Payment,” *Wall St. J.*, Aug. 3, 2015 (available at <http://www.wsj.com/articles/puerto-rico-misses-most-of-58-million-debt-payment-1438633822?mod=djemalertNEWS>) and Michael Corkery, “Pain of Puerto Rico’s Debt Crisis Is Weighing on the Little Guy, Too,” *N.Y. Times*, Aug. 9, 2015 (available at <http://www.nytimes.com/2015/08/09/business/dealbook/pain-of-puerto-ricos-debt-crisis-is-weighing-on-the-little-guy-too.html>) (“They told me this was safe . . . that the legal protections to repay the bonds were strong. . . . They told me this was the best place to put my money, and I trusted them.”)

invested and recovered principal is nothing more than the company's own money – no different than an amount loaned and subsequently returned with interest or an amount deposited and later withdrawn from an interest-bearing bank account. (Emp. added.)

One can only imagine the reaction of the SEC, the U.S. Attorney General's Office or FINRA (the successor organization to the National Association of Securities Dealers) to an issuer or broker-dealer who advertised the sale of municipal bonds, commercial paper, or repos by stating: "Buy this investment – it has no more risk – and a higher return – than an 'interest bearing bank account'!" Or an issuer or broker-dealer who claimed "invest in this security – your principal investment is always your 'own money' and you will always get your principal back!" In fact, the Department's "recovered principal" argument is so absurd there is no accounting, economic or financial treatise to refute it.

Except as stated below, there is no reference in Title 12, the tax code, the State's Securities Act, or any Department income tax publication which references "recovered principal." The term "principal" was added to Title 12 in 2006 in the new statutory section 12-6-2295, presumably because of the pending Duke Energy refund claims.¹⁴ Tax, financial, and accounting statutes and treatises refer to a taxpayer's "basis" in an investment (amount invested less costs of purchase). There are no references to "principal" much less recovered principal.

Indeed, diligent research reveals only one reference to "recovery of principal" in any Department document. In S.C. Private Letter Ruling # 04-6 ("PLR"), the Department considered the property taxation of personal property (computers) leased to the federal government. The

¹⁴ As the Court of Appeals noted in the *Duke* decision:

In December 2002, Duke Energy filed amended tax returns for each of these years. ... In February 2003, the department denied the requests. In March 2003, Duke Energy appealed this decision to the department's Office of Appeals. The department did not act on the appeal until February 2010 – almost seven years – when it issued a "determination" denying the appeal.

410 S.C. 415, 418-19, 764 S.E.2d 712, 714.

taxpayer leased computers to the federal government under a lease to own plan, wherein legal title was held by the lessor for security purposes, although similar to any capital lease, the federal government was treated as the income tax owner. The PLR notes that “[t]he lease payments are reported as interest income and return of principal by the Lessor.”

The thrust of the Department’s “recovery of principal” argument is based upon the promise that its receipts (or “total sales”) “is nothing more than the company’s own money.” (Department Brief, pg. 5) The Department emphasizes this point by stating that sales of municipal bonds or CDs is “no different than . . . an amount deposited and later withdrawn from an interest-bearing bank account.” The Court of Appeals in *Duke* emphasizes this same factual and legal error: “When Duke Energy invests the proceeds of its business in a short-term financial instrument and sells the investment for a profit, the profit generated may be considered a receipt. However, the principal of the investment is its own money – not money it received for its products or services. Thus, the return of the principal is not a receipt.” 410 SC at 429, 764 S.E.2d at 720.

First, Duke (or any other depositor) does not “own” the money deposited in a bank account – and it certainly does not “own” the amount invested in municipal bonds or CDs. (Obviously it has legal rights to the cash deposited in a bank account or invested in a bond or CD.) Again, this statement is so erroneous it is difficult to find scholarly refutations, but regarding the ownership of money in a bank account, Wikipedia under “Deposit Account” states:

Subject to restrictions imposed by the terms and conditions of the account, the account holder (customer) retains the right to have their money repaid on demand. The customer may or may not be able to pay money into or out of the account by cheque, internet banking, EFTPOS or other channels, depending on those terms and conditions.

The banking terms “deposit” and “withdrawal” mean a customer paying money into, and taking money out of, the account. From a

legal and financial accounting standpoint, the term “deposit” is used by the banking industry in financial statements to describe the liability owed by the bank to its depositor, and not the funds that the bank holds as a result of the deposit, which are shown as assets of the bank.

For example, a depositor opening a checking account at a bank in the United States with \$100 in cash surrenders legal title to the \$100 in cash, which becomes an asset of the bank. On the bank’s books, the bank debits its currency and coin on hand account for the \$100 in cash, and credits a liability account (called a demand deposit account, checking account, etc.) for an equal amount. (See double-entry bookkeeping system.)

In the audited financial statements of the bank, the \$100 in currency would be shown on the balance sheet as an asset of the bank on the left side, and the deposit account would be shown as a liability owed by the bank to its customer, on the right side of the balance sheet. The bank’s financial statement reflects the economic substance of the transaction—which is that the bank has borrowed \$100 from its depositor and has contractually obliged itself to repay the customer according to the terms of the agreement. To offset this deposit liability, the bank now owns the funds deposited (either in notes and coin or more usually as a debt owed by another bank) and the bank shows those funds as an asset of the bank. These “physical” reserve funds may be held as deposits at the relevant central bank and will receive the interest as per monetary policy.

The “ownership,” risk, and tax treatment of funds in Duke’s investments may be summarized as follows:

Ownership of Funds

1. Bank Account – the bank owns the funds (and depositor has a legal right to the funds).
2. Commercial Paper – once purchased, the issuer of the commercial paper owns the invested funds (and the purchaser owns the commercial paper).
3. Municipal Bonds – once purchased, the issuer of the municipal bond owns the invested funds (and the purchaser owns the municipal bond).

Risks

1. Bank Account – in the event a bank fails, the depositor can collect up to \$250,000 from the FDIC.

2. Commercial Paper – a person who purchases commercial paper is not a secured creditor; in the event of default or the bankruptcy of the issuer, the purchaser would share in any assets remaining after the secured creditors were paid.

3. Municipal bonds – a person who purchases municipal bonds is typically not a secured creditor. In the event of a default or bankruptcy, the holder would be in line to share in any unsecured assets of the municipality.

Sales Proceeds

In the event the purchaser sells his investment he does not recover “his principal.” (No securities or investment handbook ever refers to the “recovery of principal” when such a sale occurs.)

1. Bank Account – The depositor receives his deposited amount together with accrued interest.

2. Commercial Paper – If the purchaser sells prior to maturity he receives the market value less commissions. This can be a gain or loss. If he holds until maturity he receives the face value of the commercial paper plus any accumulated interest.

3. Municipal Bond – If the purchaser sells prior to maturity he receives the market value of the bond less commission. This can be a gain or loss. If he holds to maturity he receives the face value of the bond plus accumulated interest less commission.

Taxation

The taxation of proceeds from withdrawing funds from a bank account differ from the sale of commercial paper or bonds.

1. Bank Account – The depositor is taxed as ordinary income of any interest earned. There is no taxation on withdrawal of the deposited funds.

2. Commercial Paper – The purchaser is taxed on the gain or loss. The gain or loss is calculated on the sales price less the investor's basis in the paper. The gain can be taxed as ordinary income, long or short term capital gain depending upon a variety of factors.

3. Municipal Bonds - The purchaser is taxed on the gain or loss. The gain or loss is calculated on the sales price less the investor's basis in the bond. The gain can be taxed as ordinary income, long or short term capital gain depending upon a variety of factors.

The above principles are discussed at length in one of the cases cited by the Department in its brief, *General Motors Corp. v. Franchise Tax Board*, 39 Cal. 4th, 773, 139 P.3d 1183 (Cal. 2006). The California Supreme Court held in that case that gross receipts from the sales of marketable securities went into the denominator but that only interest earned from repo transactions should be included in the denominator as a repo has “the characteristics of a [secured] loan not the sale of a commodity.” The decision provides considerable detail why sales of Duke's other securities (municipal bonds, U.S. Treasury Securities, and commercial paper) *are* included in gross receipts.

The Department cites *Genentech, Inc. v. Comm'r of Revenue*, 2014 WL 6609681 (Mass. 2014) in support of its claim; however, that case is distinguishable from the present case. The issue in that case was whether Genentech was a manufacturer and was thus required to use the Massachusetts manufacturing apportionment statute. (Genentech argued it was not a

manufacturer.) Genentech's treasury function was handled by Mellon Bank in 11 money market funds. The Court described the funds as follows:

Money market funds are pooled investment vehicles that differ from other types of investment funds in that they aim to maintain a consistent net asset value ("NAV") of \$1 per share.

Unlike the facts in *Genentech*, there is no evidence in the record that Duke Energy's treasury function transactions were pooled investment vehicles.

The Department also cites *Walgreen Arizona Drug Co. v. Arizona Dep't of Revenue*, 97 P.3d 896 (Ariz. App. 2004). As the Court of Appeals pointed out in that case the statutory definition of "'sales' consists of 'all gross receipts of the taxpayer not allocated under this article' except as 'the context otherwise requires.'" *Id.* at 898 (emphasis added). The Court noted that "the taxpayer's arguments would require us to ignore the caveat 'unless the context otherwise requires' preceding the definition of 'sales.'" *Id.* The South Carolina statute contained no such caveat.

The Department also cites *AT&T v. Director, Division of Taxation*, 476 A.2d 800 (1984). The Court in that case draws the same legal and factual errors as the Department in this case:

To include such receipts in the fraction would be comparable to measuring business activity by the 'amount of money that a taxpayer repeatedly deposited and withdrew from its own bank account. The bulk of funds flowing back to AT&T from investment paper was simply its own money.

Simply put, has any person in the history of the Bankruptcy Code ever successfully filed a motion in the Bankruptcy Court arguing for the return of "its own funds" where the issuer of commercial paper filed bankruptcy? The purchaser shares in the assets along with all the other unsecured creditors.

V. The Court of Appeals erred in concluding that Duke Energy's receipts from sales of securities were not "receipts" because they were not "money the business receives for its products or services."

The Court of Appeals incorrectly found that Duke Energy's receipts from sales of securities other than the net receipts were not "receipts" because they were not money "for what [Duke Energy] ... does in its business," and "not money it received for its products or services." *Duke Energy*, 410 S.C. at 429, 764 S.E.2d at 719-20. The Court of Appeals adopted *Webster's* definition of the term "receipt" as "something received" and reasoned that "[i]n the business context, 'receipt' means money the business receives from its products or services – for what it does in its business." (App. p. 8446.) However, the Department conceded that Duke Energy's receipts from sales of securities were business income. If the Court of Appeals' interpretation of the term "receipt" were left unchanged, it would lead to significantly change the way in which any taxpayer reports its income to South Carolina.

An army of tax lawyers and accountants – many operating on a contingency fee basis – will read the Court of Appeals' decision with great interest.¹⁵ Armed with a decision that "total" means "net," throngs of "tax consultants" undoubtedly will descend on South Carolina in search of refund opportunities for South Carolina taxpayers.¹⁶

¹⁵ See, e.g., on the property tax side, J.L. Entrikin, *Tax Ferrets Tax Consultants Bounty Hunters, and Hired Guns: The Property Tax Netherworld Fueled by Contingency Fees and Champertous Agreements*, 89 Chicago-Kent Law Review 289 (2014).

¹⁶ Ryan is one of the largest accounting and legal firms. Its website states: "We commit every day to sifting through, drilling down, and peeling back the intricacies of federal, state, local and international tax to discovery truly *significant recovery opportunities*." (Emp. added.) Another website states "LEVERAGE SALT, LLC specializes in transforming the complexity of multistate taxation into practical solutions to a client's unique planning, compliance and controversy situations. *The firm continually monitors* state and local tax news and developments, drafting documents that analyze tax developments, such as recent legislation, regulations and *rulings to identify areas of risk mitigation, compliance simplification, and refund opportunities*. (Emp. added.)

This case involves the denominator of the equation used to calculate income for multi-state taxpayers. Because the Department did not invoke the alternative apportionment statute and instead unilaterally – and without any basis in the law – limited the type of receipts includable in the denominator, taxpayers can (and will) use the same rationale – supported by the Court of Appeals’ decision - to modify and reduce the sales factor numerator, thereby ultimately reducing the amount of tax due to South Carolina.

For simplicity purposes, take for example the apportionment statute currently used for service providers. As the Department states in South Carolina Tax Incentives for Economic Development (2014) (pg. 11): “the taxpayer shall apportion its remaining net income using a fraction in which the numerator is gross receipts from within this state during the taxable year and the denominator is total gross receipts from everywhere during the taxable year.”

Note that the definition of numerator and denominator are exactly the same – “gross receipts.” Increasing the numerator increases the amount of taxes owed to South Carolina. Decreasing the numerator decreases the taxes owed. The Court of Appeals’ decision can – and will – be used by accountants to reduce the numerator. Any transaction which arguably involves a “return of principal” will surely not go into the numerator. Any transaction involving the return of the taxpayer’s “own money” (which will be very broadly defined) will not go into the numerator. And any transaction which involves a receipt which is not from the sale of the services customarily sold by the taxpayer will not go into the numerator.

Take the simplest example. A multi-state architect-engineering firm or hospital based in South Carolina invests its excess cash in an interest-bearing bank account in a New York bank, and earns \$250,000 a year. (Interest rates are currently so low that does not happen today, but

interest rates will rise.) Prior to the *Duke* decision, the architect or hospital included those interest earnings in its numerator and paid taxes on it.

Simply put, the accounting firms are going to advise taxpayers not to include interest in the numerator. The interest income earned is not what the architect-engineering or hospital “receives from its product or services – for what it does in its business.” It’s a relatively safe investment and the interest is earned on “its own money.” Both the Department and the Court of Appeals have determined it is not part of a total sale or gross receipt. So it does not go into the numerator and no tax is paid on it.

Take another simple example. A for-profit hospital system based in South Carolina has hospital subsidiaries in North Carolina and Georgia. The South Carolina parent hospital will enter into \$10 million loans with an 18% interest rate with the subsidiaries. (The loan will be “papered” with a 60-page form loan document but no money will change hands, just accounting entries.) The North Carolina and Georgia hospitals will annually pay \$1.8 million to the South Carolina parent and take an interest deduction in that amount thus reducing the taxes owed in their home state. Will the parent hospital include the \$1.8 million in the numerator and pay state income taxes on it? Certainly not, or at least not until it recovered its full \$10 million. It is a return of principal – the parent’s own money – and it is not a receipt from hospital services. Since the interest is earned in North Carolina and Georgia it would “distort” the taxpayer’s numerator in South Carolina to include it. And the accounting firm which structures the transaction will shop this tax saving device to all its clients.

The South Carolina Code itself contains 85 uses of “gross” for tax purposes, including gross receipts, gross income, gross wages, gross estate, and gross proceeds. (App. pp. 411-12, 678-727.). Prior to the *Duke* decision, these statutes uniformly have been interpreted by the

Department and taxpayers to mean “gross” and not “net.”¹⁷ Accounting firms will pore over all 85 statutes to determine, using the Department’s position and Court of Appeals’ decision, when the taxpayer can use net (and not gross) proceeds, or exclude items altogether where a sale involves the return of the taxpayer’s “own money.”

VI. The Court of Appeals erred in allowing the Department to fail to follow the state alternative apportionment statute.

As stated above, courts in other states have determined that the inclusion of total sales has led to unfair representation or distortion of a taxpayer’s business activity in a state. But they have not done so by limiting, without any basis in the law, the meaning of “total sales” to net sales (when it results in higher tax collection). Instead, they have done so by authorizing the state’s revenue department (or a taxpayer) to invoke the alternative/equitable apportionment statute. And the Department chooses this route to prevent from being whipsawed as discussed above. Prof. Hellerstein in *State Taxation* (3d Ed.) states in ¶ 9.20:

The state statutes prescribing the division of the tax base have long authorized or directed that tax administrator to vary the allocation or apportionment methods set forth in the statute if they do not fairly reflect the extent of the taxpayer’s business activity within the state. The UDITPA “**equitable apportionment**” provision, as such provisions are known

The UDITPA equitable apportionment statute, section 18, is virtually identical to the South Carolina statute. *See Carmax auto Superstores West Coast, Inc. v. S.C. Dep’t of Rev.*, 411 S.C. 79, 767 S.E. 2d 195 (2014). South Carolina law provides that the Department or the taxpayer may use a reasonable alternative apportionment method if the standard statutory

¹⁷ For example, S.C. Code Ann. § 12-36-90 imposes the sales tax on “[g]ross proceeds of sales.” S.C. Code Ann. § 12-37-930 imposes a special depreciation rule for certain “gross cost of assets” located in this state. “Gross wages” means all wages, and not the net amount an employee receives after deductions. *See also Duke Power Co.*, 292 S.C. at 66, 354 S.E.2d at 903 (1987) (“gross receipts” means all receipts from a sales transaction).

apportionment formula does not fairly represent a taxpayer's business activity in South Carolina, S.C. Code Ann. § 12-6-2320.

Hellerstein discussed the application of the UDITPA "relief provision" to the gross vs. net issue as follows:

The California courts have considered the appropriate standard for invoking the relief provision in a number of cases. Most of these cases arise out of the California court's determination that the "gross receipts" from the sale or redemption of securities and other intangibles must be included in the sales factor under UDITPA's standard provisions. Once this determination has been made, the question becomes whether the tax administrator (in this case the California Franchise Tax Board (TDB) is entitled to invoke UDITPA's **equitable apportionment** provision either to include only the "net" receipts from such sales or redemptions or to exclude the receipts altogether from the sales factor. Although these particular issues were ultimately resolved by regulations and legislation excluding such receipts from the sales factor, the cases retain their importance in providing guidance as to the proper standard for applying UDITPA's relief provisions.

The Department failed to invoke equitable apportionment in this case, perhaps because it would carry the burden of proof as directed by this Court in *Carmax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Rev.*, 411 S.C. 79, 767 S.E.2d 195 (2014). In addition, the Department may have been reluctant to set a benchmark for distortion, which taxpayers would pursue in their own petitions for equitable apportionment.

As Hellerstein, *State Taxation* supra, states in ¶ 9-20:

In *General Mills v. Franchise Tax Board*, after holding that amounts received in connection with commodity futures sales that are made to hedge against price fluctuations constituted "gross receipts" for sales factor purposes, the California Court of Appeal turned to the FTB's contention that the receipts should be excluded or included on a net basis *only under the equitable apportionment provision*. (Emp added.)

VII. The Department's long-standing agency policy

The Department has repeatedly claimed that the ALC and Court of Appeals' decisions correctly affirmed "the Department's long-standing administrative policy" that total receipts means net receipts. Department Brief, pg. 3 ("Department's long-standing administrative policy"); pg. 6 ("the Court of Appeals Decision is entirely consistent with the Department's long-standing policy"); and pg. 25 ("the department had a long-standing policy").

Not once – NOT ONCE – has the Department cited or quoted a regulation, Policy Document (Revenue Ruling, PLR , or other Policy Document), Publication (the Department has many), or instruction in its tax forms which contains such long-standing Administrative Policy! NOT ONCE!

Specifically, the Department Brief does not cite a single Regulation, Policy Document, Publication or Instruction in its tax form which states it is the Department's position that "total sales" means "total sales" only where it results in more tax revenue to the State – and otherwise means "net receipts."

To the extent the Department contends it is relying on its own unwritten, unpublished, and unpublicized guidance, such "long-standing policy" does not have the force of law and should not be entitled to deference. "Policy or guidance issued by an agency other than in a regulation does not have the force or effect of law." *DIRECTV, Inc. & Subsidiaries v. Dep't of Rev.*, Docket No. 14-ALJ-17-0158-CC (Admin. Law Court, filed June 12, 2015) (citing S.C. Code Ann. § 1-23-10(4) (2005); *Kirven v. Cent. States Health & Life Co., of Omaha*, 409 S.C. 30, 727 S.E.2d 794, 802 (2014) ("[A]n agency guideline does not have the force of law, and in any event, can never trump a regulation.... Policy or guidance issued by an agency other than in a regulation does not have the force or effect of law") (quoting *Doe v. S.C. Dep't of Health & Human Servs.*, 398 S.C. 62, 68 n.7, 727 S.E.2d 605, 608 n.7 (2011))). Moreover, policy that is

“once apparently written down [but is] no longer written anywhere and apparently has not been for some time . . . is insufficient as a basis for deference” for purposes of relying on a so-called longstanding policy. *See id.*

Finally, a number of lower courts have agreed that these “secret” rules asserted by agency staff which have not been promulgated in regulations or binding policy documents are entitled to little, if any, deference. *See* S.C. Tax Comm’n Dec. 93-78 (rejecting taxpayer’s use of longstanding agency interpretation stating that, “we do not believe there are any generally accepted consolidation rules which exist *if they are not codified*,” (emphasis added); S.C. Tax Comm’n Dec. 94-90 (likewise rejecting the taxpayer’s “longstanding administrative policy,” argument, stating “it is important to note that there are no Commission decisions or Department approved policy documents which support that [Department] decision”); *Seigfried v. S.C. Dep’t of Rev.*, 2003 WL 24004736 (S.C. Admin. Law Judge Div. 2003); *S.C. Dep’t of Motor Vehicles v. Lajuenesse*, 2008 WL 1740063 (S.C. Admin. Law Judge Div. 2008); *Coastal Conservation League v. S.C. Dep’t of Health & Envtl. Control*, 363 S.C. 67, 610 S.E. 2d 482 (2005); and *Clarendon Cnty. Mem. Hosp. v. S.C. Dep’t of Health & Envtl. Control*, 2006 WL 1430090 (S.C. Admin. Law Judge Div. 2006).

CONCLUSION

In order to affirm that Court of Appeals’ decision, this Court will have to ignore the plain and unambiguous language of the South Carolina apportionment statutes and find that “total sales” (and “gross receipts”) are in fact “net” sales (and “net” receipts), i.e., less than “total” (or “gross”). The Court will further have to ignore the General Assembly’s admonition in the 2006 law change’s effective date provisions – and there are four of them – that the 2006 legislation,

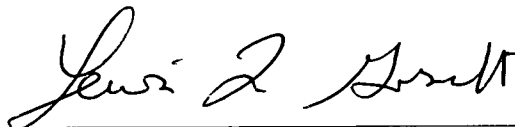
which the Department claims affirms their actions in this case, is effective for tax years *after* 2006, even though this case involves tax years well *prior* to that time.

And the Court will have to consider the impact of an affirmation of the lower court's decision on the computation of the sales factor numerator and ultimately, the amount of tax due to South Carolina. Because the numerator is defined in the exact same terms as the denominator, an army of accountants and lawyers will apply the exact reasoning advanced by the Court of Appeals to reduce a taxpayer's sales factor numerator and therefore its South Carolina tax liability. Because the Department failed to invoke the equitable apportionment provisions which would have confined the Court's decisions to the denominator, the numerator is now wide open to net gaming, elimination of inclusion of the "taxpayer's own money," and receipts which are not part of the goods and services normally sold by the taxpayer.

Finally, and perhaps more importantly, if the lower court's decision remains unchanged, the Department will have carte blanche to do exactly what this Court ruled was impermissible in *Carmax*, i.e., apply an alternative apportionment method without satisfying the dual burden the Court ruled must be met before the Department (or a taxpayer) is permitted to deviate from the standard apportionment formula.

For all of the above reasons, the SCMA respectfully requests that the decision of the Court of Appeals be reversed.

RESPECTFULLY SUBMITTED,

A handwritten signature in black ink, appearing to read "Lewis Gossett", written over a horizontal line.

Lewis Gossett, Esquire
President of South Carolina Manufacturers
Alliance

October 2nd, 2015
Columbia, South Carolina

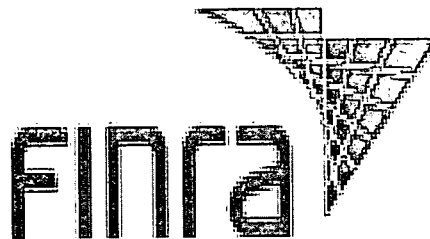
EXHIBIT A

Investor Alert

Investment Products and Sales Practices Commonly Used to Defraud Seniors: Stories from the Front Line

In recent years, senior citizens have increasingly become targets of financial abuse and fraud. Approximately 5 million senior citizens become victims of financial abuse and fraud each year. This trend is related to the high amount of wealth held by older investors as nearly one-third of all U.S. investors are between 50 and 64 years of age. It is particularly devastating when older investors are defrauded because they are generally beyond or near the end of their earning years and as a result, have little or no ability to rebuild their retirement funds.

The Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), and the North American Securities Administrators Association (NASAA), which represents state securities regulators, are seeing a number of investment products and sales practices recurring in schemes to defraud older investors. The following are examples of products and practices that have triggered SEC, FINRA, and/or state securities regulator investigations in recent months. Investors should exercise caution before investing in these types of products.



Charitable Gift Annuities

When investing in charitable annuities, investors should ensure that the firm or individual is representing a legitimate charitable organization and that the organization is fully aware of the salesperson's activities. In an increasing number of cases, a solicitor will pose as an employee of a charitable organization and offer customers the opportunity to invest money that will purportedly provide monthly annuity payments to both the investor and the charity. Unbeknownst to the investor, a significant portion of the funds are never invested for charitable purposes, but instead are directly deposited in the solicitor's personal account. The following are examples of such schemes that have triggered SEC and state securities regulator investigations in recent months.

- The SEC sued Robert Dillie for defrauding senior investors of at least \$52.9 million through the sale of charitable gift annuities. He represented to investors that their funds would go into stocks, bonds and money market accounts, but \$19.2 million of the monies raised were diverted to a hidden account that afforded him a luxurious lifestyle. When the plan collapsed, he told investors that the company had "disbanded due to inadequate assets." [See *Securities and Exchange Commission v. Robert R. Dillie et al.* (Civil Action No. CV-01-2493-PHX-JAT)].
- Arizona state securities regulators obtained a \$4.3 million final judgment against two insurance agents who fraudulently sold charitable gift annuities to seniors, telling them that their money would be invested in secure accounts. Instead the funds were placed in high-risk, speculative investments with the potential for a complete loss of those funds, and the insurance agents helped themselves to \$1.3 million in commissions. [See *Arizona Corporation Commission v. One Vision Children's Foundation, Inc., et al.* (State of Arizona, Maricopa County Superior Court, No. CV2002-020878)].

"High Return" or "Risk-Free" Investments

Investors should be wary of opportunities that promise spectacular profits or "guaranteed" returns. As the adage goes, if the deal sounds too good to be true, then it probably is. Commonly, an individual will claim that unrealistic returns can be realized from "Low-Risk Investment Opportunities." But no investment is risk-free. And sometimes the investment products touted do not even exist – they're merely scams. The following are examples of such schemes that have triggered SEC and state securities regulator investigations in recent months.

- The SEC obtained a \$112 million judgment against investment advisers who induced at least 803 seniors to invest in notes that purportedly paid a "guaranteed" return of 5.5% to 8% per year. The fraudsters claimed that investor funds would be used to make secured loans to businesses and that investors would be repaid their principal at maturity, but these representations were false. [See *SEC v. D.W. Heath & Associates, Inc., et al.*, No. CV 04-02949JFW (Ex) (C.D. Cal.)].

- Florida regulators sued two insurance agents who convinced clients to liquidate annuity investments and invest in a bogus real estate company by promising returns of up to 9%. Thomas A. Masciarelli and Steven Petrarca were convicted of aggravated white collar crime and making fraudulent investment transactions following an investigation by the Florida Department of Financial Services, Division of Insurance Fraud, and the Office of Financial Regulation. Detectives arrested Masciarelli a second time in 2005 and charged him with stealing \$300,000 from three investors – a 58-year-old woman supporting a disabled adult daughter, an 82-year-old woman with no family, and an 80-year-old man suffering from Parkinson's disease. All three cases were nearly identical: Masciarelli sold them fixed annuities and then later advised them to cash out the annuities and buy investments purportedly offered through his own company. However, detectives said Masciarelli did not invest the funds but instead used the money for personal and other expenses. [See <http://myfloridacfo.com/pressoffice/ViewMediaRelease.asp?ID=2354>].
- Florida regulators sued three individuals who conspired to obtain money from investors by fraudulently representing that the viatical contracts they were selling were risk-free. Many of the victims were senior citizens who had invested their life savings in these policies. [See <http://myfloridacfo.com/pressoffice/ViewMediaRelease.asp?ID=2042>].

Investment Adviser Services

An “investment adviser” is an individual or firm responsible for making investments on behalf of, and providing advice to, investors. An investment adviser has a duty to act in the best interest of their clients. Sometimes, however, investment advisers will take advantage of their positions of trust and use unauthorized and deceptive methods to misappropriate money directly from their clients. Investors should be careful to review their monthly account statements and to conduct annual reviews of their investment plans with their investment adviser. Investors should be vigilant for abnormal changes in their monthly account statements. The following are examples of investment adviser services that have triggered SEC and state securities regulator investigations in recent months.

- Wisconsin state securities regulators issued an order of prohibition against a Duane C. Boechler, a former investment adviser who took over \$7 million from at least 27 senior investors. The investors were mostly clients from his investment advisory business. The investors were told that their investments, either promissory notes or limited liability company interests in various businesses that Boechler had formed, were going to be used to improve these allegedly successful businesses. Instead the money was used to finance Boechler's lifestyle including his luxury apartment in Panama City and to repay earlier investors. Boechler is now also facing criminal charges in two Wisconsin counties. See *In the Matter of Duane C. Boechler*, File No. S-07034 (April 13, 2007)

- The SEC brought an action against an investment adviser who misappropriated over \$5.4 million from the accounts of four profit-sharing plans that were owned by clients of her employer. As part of the scheme, the investment adviser placed unauthorized orders to sell securities in these accounts and forged documents that transferred the proceeds from those sales to the accounts of two elderly women who were also advisory clients. The adviser then forged the signatures of these women on checks that she made payable to herself, her creditors, and her relatives. [See *SEC v. Susana P. Longo*, Case No. 1:05-CV-0164 (N.D. Ga.)].
- The Oregon Department of Consumer and Business Services and the SEC charged an investment adviser with misleading investors and misappropriating their funds. The adviser raised millions of dollars from investors, including many seniors, by representing that he would invest their money in stocks and bonds. Instead, the adviser used the money to buy himself vintage cars and sports memorabilia. [See *SEC v. C. Wesley Rhodes, Jr., et al.*, Civil Action No. CV06-1353-MO (D. Or.); *In the Matter of Rhodes Econometrics, Inc. and Charles Wesley Rhodes Jr.* No. S-06-0036 (A)].

Certificates of Deposit or Bonds

Investors searching for relatively low-risk investments that can easily be converted into cash often turn to certificates of deposit (CDs). A CD is a special type of deposit account with a bank or thrift institution that typically offers a higher rate of interest than a regular savings account. Unlike other investments, CDs feature federal deposit insurance of up to \$100,000. Investors should be skeptical of promises of above-market returns and be careful to confirm the legitimacy of the CD with the named issuing bank or thrift institution. The following are examples of CD sales that have triggered SEC and state securities regulator investigations in recent months.

- The SEC filed a complaint against individuals who raised more than \$3.9 million from at least 50 investors by selling CDs that did not exist. The fraudsters lured investors, many of whom were seniors, with promises of above market rates on FDIC-insured CDs purportedly issued by an entity called the "Liberty Certificate of Deposit Trust Fund." Rather than purchasing the CDs as agreed, the perpetrators used the invested money to make payments to prior investors and for their own personal uses. [See *SEC v. Reinhard et al.*, Civil Action No. 06-997-CMR (E.D. Pa.)].
- The SEC and the Florida Office of Financial Regulation filed an Emergency action and secured injunctions and asset freezes against financial services firm AmeriFirst Funding and its principals for defrauding investors of approximately \$55 million in a fraudulent offer and sale of so-called Secured Debt Obligations (SDOs). AmeriFirst sales agents lured older investors and those saving for retirement, with advertisements for relatively high-yielding FDIC-insured certificates of deposit, then convinced the investors to purchase the SDOs instead. Defendants falsely asserted that the investment had little or no risk because accounts were guaranteed by a commercial bank, protected by many layers of

insurance coverage and fully secured by collateral. [See *SEC v. Amerifirst Funding, Inc., et al.* Civil Action No. 3:07-CV-1188-D (N.D. Tex.); *State of Florida vs. AmeriFirst Funding Inc. et al.*].

Promissory Notes

A promissory note is a form of debt – similar to a loan– that a company may issue to raise money. Typically, an investor agrees to loan money to a company for a set period of time. In exchange, the company promises to pay the investor a fixed return on his or her investment, generally principal plus annual interest. While promissory notes can be legitimate investments, those that are marketed broadly to individual investors often turn out to be scams. Investors should carefully investigate the legitimacy of all promissory notes. The following are examples of such schemes that have triggered SEC and state securities regulator investigations in recent months.

- The SEC sued a number of individuals who used mailing lists to target seniors for investments in "guaranteed" and fully-collateralized promissory notes. The individuals distributed literature stating that the lengthy, complicated, and expensive Texas probate process could be overcome by employing their company's planning services. Investors were urged to liquidate their legitimate, safe investments; to withdraw funds from their IRAs; and to invest in high-risk investments. Investors were told their investments would be used to fund business ventures, none of which existed. Instead, investor funds were misappropriated to inappropriate uses as the construction of a lake home and the payment of personal credit card debts. [See *SEC v. Gary Landon Davenport, et al.*, Case No. 7:99-CV-185-R (N.D. Tex.)].
- Georgia securities regulators brought charges against four individuals who had purportedly sold phony promissory notes to senior investors. The investors lost approximately \$305,000. The investors had been told the investments were safe, guaranteed, and would earn a 2 to 3 % return each month. [See <http://sos.georgia.gov/pressrel/021006.htm>].

Sale and Leaseback Contracts

In an attempt to avoid the investor protections of securities laws, some investments are structured to resemble the sale of a piece of equipment such as a payphone, ATM machine or Internet booth. Commonly, the equipment is located in a location where the investor cannot service or maintain the equipment and must enter into a servicing agreement. To make the deal more attractive, investors are told that after a given period the equipment can be sold back to the seller at the investor's original purchase price. The investor is also promised a specific rate of return. In a variant of this scheme, a real estate interest such as a long-term lease in a resort community is sold instead of physical equipment. Frequently the equipment or property does not exist, and the seller lacks the financial capacity to keep the promise of repurchase. Investors should be skeptical of such leaseback contracts.

The following are examples of sale and leaseback contracts that have triggered SEC and state securities regulator investigations in recent months.

- The SEC obtained a judgment against individuals who offered and sold unregistered investment contracts in a scheme involving pay telephone leasebacks. The scheme raised more than \$74 million from more than 2,000 investors most of whom were seniors. [See *SEC v. Phoenix Telecom, L.L.C., et al.*, Civil Action File No. 1:00-CV-1970-JTC (N.D. Ga.)].
- In Texas, state securities regulators sued an individual who had deceived a senior into investing in a timeshare sale and leaseback arrangement involving hotels located in Branson, Missouri. In addition to a prison term, the individual was ordered to pay restitution of \$35,000 to the investor. [See http://www.ssb.state.tx.us/Enforcement/2006_Civil_and_Criminal_Actions.php].

Unsuitable Investment Recommendations

Some unscrupulous investment advisers convince clients to purchase investment products that don't meet the objectives of an investor. Unsuitable recommendations can occur when a broker sells speculative investments such as options, futures, or penny stocks to a senior with a low risk tolerance. Investors should be careful to review the risk profile of each investment recommendation. The following are examples of actions that have triggered SEC, FINRA, and state securities regulator investigations in recent months.

- In Texas, three individuals were convicted of violations of the registration requirements of the Texas Securities Act in connection with a scheme that offered investments in high-risk foreign currency markets to senior citizens. [See http://www.ssb.state.tx.us/Enforcement/2006_Civil_and_Criminal_Actions.php].
- The SEC brought an enforcement action against two brokers who induced their clients to invest in unsuitably high-risk securities. To persuade seniors to invest large amounts of their savings and retirement funds in the high-risk securities, the brokers falsely represented that the investments had little or no risk and were as safe as bank deposits. [See *SEC v. William Edward Sears and Patricia Jean Sears Million*, Case No. CV-05-1473 CO (D. Ore.)].
- The Oregon Department of Consumer and Business Services revoked the securities license of a stockbroker and fined him \$100,000 after finding that, instead of recommending investments appropriate for seniors, the stockbroker advised more than a dozen of his clients to become "general partners" in risky oil and gas ventures. In one instance, the stockbroker accompanied an 89-year-old man suffering from dementia to a bank branch, and instructed the visibly confused client to withdraw funds for investment purposes. [See *In the Matter of Jack Kleck*, Oregon Department of Consumer and Business Services No. S-07-0001].

- FINRA sanctioned a financial services firm for abusive sales practices and inadequate supervisory procedures because the company recommended inappropriately high-risk investments to its clients, a number of whom were retired or approaching retirement. The company was censured, fined \$500,000, and ordered to make restitution totaling more than \$2.8 million. [See http://www.nasd.com/PressRoom/NewsReleases/2003NewsReleases/NASDW_002809].
- FINRA expelled a brokerage firm from its membership after it engaged in fraudulent and illegal sales activities. The firm used misleading and incomplete information to induce seniors into making highly risky private investments, leading to losses of over \$10 million. [See http://www.nasd.com/PressRoom/NewsReleases/2004NewsReleases/NASDW_010886].
- FINRA barred Travis Wakeley, a registered representative, from association with any FINRA member firm in any capacity after he made an investment recommendation to a senior that was not suitable for the customer based on her age, risk tolerance, investment objective, investment experience and net worth. [See FINRA Case #2005001267501].
- The New York Stock Exchange (NYSE) took action against a registered representative who engaged in a pattern of unsuitable trading in the accounts of nine customers, seven of whom were seniors. Over a three-year period, the customers saw a total realized loss of approximately \$1,321,988 and the registered representative earned approximately \$585,274 in commissions from these accounts. [See *Kenneth Edward Stephens*, Decision 06-216 NYSE Hearing Board (December 13, 2006)].

Churning

“Churning” refers to when securities professionals making unnecessary and excessive trades in customer accounts for the sole purpose of generating commissions. Most churning occurs where a broker has discretion to trade the account without prior approval from the client. Investors should be careful to review their monthly account statements and investigate any abnormally high trading activity. The following are examples of churning activities that have triggered FINRA and state securities regulator investigations in recent months.

- In Massachusetts, Secretary of the Commonwealth William F. Galvin fined a brokerage \$1 million for the theft, churning, and unauthorized trading perpetrated by one of its agents. In addition to the \$987,500 that it had already been ordered to pay to settle the senior investor’s claim, the brokerage was ordered to pay \$135,000 in restitution. [See *In the Matter of Oppenheimer & Co., Inc., & Stephen J. Toussaint*].

- FINRA sanctioned a broker who churned the accounts of two senior citizens. A default decision was entered against the broker, and he was barred from trading and ordered to pay \$278,072.59 in restitution. [See FINRA Case #ELI200400810].
- The Attorney General of New York reached a settlement agreement with a brokerage after it failed to supervise one of its brokers who defrauded 15 customers, many of whom were seniors, out of over \$740,000. The broker mismanaged customer accounts by engaging in excessive, unauthorized, and unsuitable trading, signing wire transfers and new account documents without customer authorization, and failing to inform her clients of the risks of trading on margin. [See http://www.oag.state.ny.us/press/2006/oct/oct17a_06.html].

Equity Indexed Certificates of Deposit

Equity indexed CDs are hybrid securities products that offer an interest coupon payment that is based on a stock market index. Returns are not FDIC insured and are dependent on the performance of the stock market. As a result, these products may not be suitable for seniors who need liquid funds for retirement living.

High Pressure Sales Seminars

Investment advisers commonly invite investors to attend sales seminars. These seminars are sometimes held at upscale hotels and restaurants and offer a free meal. At these seminars, advisers often use high pressure sales tactics to pitch unsuitable products. Investors should avoid making rushed decisions at sales seminars and should seek objective third party advice before committing their funds. The following are examples of high pressure sales seminars that have triggered SEC and state securities regulator investigations in recent months.

- The SEC filed a complaint against an investment adviser who fraudulently solicited over \$22 million from investors. The adviser invited investors to free dinner seminars for the sake of retirement planning and told the investors that he would invest their funds in real estate transactions that would provide returns as high as 24%. The adviser failed to purchase real estate, misrepresented to investors that their investments would be secured by real property, and failed to disclose that he used new investor money to pay returns to prior investors. [See *SEC v. Jon W. James*, No. 06 Civ. 4966 (C.D. Cal. Aug. 24, 2006)].
- The Nevada Securities Division filed a complaint against an individual who defrauded over 42 investors out of \$2.7 million. The individual held seminars at several Las Vegas hotels and casinos, soliciting seniors to participate in various investment opportunities. Instead of investing the money as promised, the individual funneled investor funds into her personal accounts. She was charged with 23 felony violations for, amongst other things, the sale of unregistered securities and securities fraud. [See <http://sos.state.nv.us/information/news/press/2007/20070525.asp>].
- A brokerage firm consented to an order entered by the Utah Division of Securities to pay a \$50,000 fine after two of its agents were found offering free lunch seminars to seniors and misrepresenting the credentials of one of the agents. At the seminars, inaccurate and misleading information was presented in an attempt to persuade the seniors to transfer their investment accounts to one of the agents. [See *In the Matter of Andrew J. Moleff, John F. Hoschouer and World Group Securities, Inc.*].
- The Colorado Securities Commission sued an individual who fraudulently solicited over \$600,000 from at least 25 investors who were induced into investing during free lunch seminars held at their retirement and senior centers.

The perpetrator failed to invest the funds he raised and, instead, used the funds to pay his personal living expenses. [See http://co.jefferson.co.us/news/news_item_T3_R354.htm].

Prime Bank Schemes

Investors should be particularly wary of investment opportunities that promise spectacular profits when the investment product is from outside of the U.S. securities markets. In prime bank schemes, individuals persuade investors to purchase and trade "prime bank" financial instruments on clandestine overseas markets. Neither these instruments, nor the markets on which they are allegedly traded exist. To provide the appearance of legitimacy, documents are distributed which appear to be, complex, sophisticated, and official. Investors are commonly told that they have special access to programs that otherwise would be reserved for top financiers on Wall Street. Investors are also told that profits of 100% or more are possible with little risk. The following is an example of a prime bank scheme that triggered a recent SEC investigation:

- The SEC sued several individuals involved in a massive nationwide prime bank scheme which targeted, amongst others, seniors. The perpetrators raised \$45 million from 300 investors by selling "prime bank" securities. The perpetrators told investors that their funds would be deposited in a London bank, secured by a bank guarantee, and used as collateral to trade financial instruments with "top 50" European banks for annual returns of 24% to 60%. The prime bank program did not exist, no funds were sent to Europe, and the funds were left unsecured by any sort of guarantee. The investment funds had been misappropriated for personal and other unauthorized uses. [See *SEC v. Benjamin Franklin Cook*, No. 99 Civ. 571 (N.D. Tex. Mar. 17, 1999); *SEC v. Resource Development International, LLC*, No. 97 Civ. 1018Y, (N.D. Tex. filed Mar. 2002); *United States v. William Whelan*, No. 05 Crim. 00226OWW (E.D. Ca. Nov. 28, 2005)].

Pump and Dump Schemes

In a "pump and dump" scheme, individuals drive up the price of a company's stock (typically a microcap or penny stock) by issuing false and misleading statements. After the price is driven up, the individuals sell their own shares. Typically, at whatever point the individuals stop touting the stock, the price plummets and leaves legitimate investors with worthless or significantly devalued stock. Investors should remain particularly skeptical of any security that is priced below \$5 or that does not trade on a registered securities exchange. Investors also should be suspicious of all "too good to be true" stories coming from salespersons who are neither registered brokers nor investment advisers. The following are examples of pump and dump schemes that have triggered SEC and FINRA investigations in recent months.

- The SEC sued a number of individuals who used telemarketers that employed high-pressure sales tactics and made false representations to investors in order to sell shares of a certain penny stock. As a result of the fraud, investors, many of whom were seniors, lost over \$6.8 million. [See *SEC v. U.S. Gas & Elec., Inc., et al.* (S.D. FL 2006)].

- FINRA brought a successful disciplinary action against brokers in Brooklyn who used high-pressure sales tactics, fraudulent misrepresentations, baseless price predictions, and omissions of material facts to persuade investors – many of whom were seniors – to purchase shares of three highly speculative securities. The brokers were ordered to pay 10 customers more than \$3.8 million in restitution, plus interest and costs. [See <http://www.finra.org/PressRoom/NewsReleases/2005NewsReleases/P012997>].
- FINRA sanctioned two investment firms for using fraudulent tactics to sell highly speculative securities to seniors and other investors. The firms manipulated the market and the price of stocks by permitting a broker to buy and sell shares in his personal accounts in order to give the appearance of market interest in the stock. [See http://www.nasd.com/PressRoom/NewsReleases/2004NewsReleases/NASDW_002833].

Variable Annuities

Variable annuities are insurance products that allow investors to enjoy tax-deferred growth in mutual funds, while retaining the security of an insurance policy. While these products are legitimate investments, commissions for those who sell variable annuities are very high, and create incentives for sellers to promote products that are inappropriate for older investors. Variable annuities are generally not appropriate for most seniors or individuals near retirement because of their steep penalties incurred for early withdrawals. Investors should be skeptical of any broker who suggests purchasing a variable annuity to hold in a 401(k) or IRA because these accounts already provide tax-deferred growth, and the variable annuity simply adds a layer of cost with no additional tax benefits. The following are examples of actions that have triggered investigations in recent months.

- The Missouri State Commissioner of Securities sanctioned an investment adviser for recommending inappropriate variable annuity products to seniors. Eight Missouri residents between the ages of 72 and 87 invested approximately \$1.2 million with the adviser, resulting in commissions of approximately \$98,000. These investment products were not suitable for the clients. In fact, one annuity's producers had a policy against the sale of the product to individuals over the age of 75. The adviser's registration was suspended for four months, she was fined \$25,000, and she was prohibited from selling variable annuities or handling accounts for individuals over the age of 65 for five years. [See <http://www.sos.mo.gov/securities/orders/AP-06-47.asp>].
- FINRA suspended an investment adviser for six months and levied a fine of \$28,000 against the adviser when the adviser sold unsuitable variable annuities to seniors. [See http://www.nasd.com/PressRoom/NewsReleases/2004NewsReleases/NASDW_002828].

- FINRA barred an investment adviser from association with any FINRA-regulated securities firm and ordered the adviser to pay more than \$1.5 million in restitution to seniors and other customers for unsuitable sales of variable annuities and mutual funds totaling over \$6 million. [See http://www.nasd.com/PressRoom/NewsReleases/2004NewsReleases/NASDW_002860].
- FINRA fined a financial services firm, \$2.75 million for failing to maintain an adequate supervisory system to oversee the variable annuity sales activities of over 1,000 branch managers working in offices throughout the United States. In a related action, FINRA permanently barred one of those branch managers because the manager recommended unsuitable variable annuity products to seniors and made misleading statements to customers in correspondence. [See http://www.nasd.com/PressRoom/NewsReleases/2007NewsReleases/NASDW_018681].
- FINRA fined an investment services firm, \$850,000 for supervisory, recordkeeping, telemarketing, and other violations. The firm had failed to implement proper procedures for selling variable annuities to seniors. [See http://www.nasd.com/PressRoom/NewsReleases/2006NewsReleases/NASDW_017657].
- NYSE fined a firm \$550,000 for making unsuitable sales of variable annuities. The \$550,000 penalty included a \$175,000 fine and \$375,000 to be used to compensate injured customers. [See *David A. Noyes & Co., Inc.*, Decision 05-98 (NYSE Hearing Panel November 9, 2005)].
- NYSE disciplined a registered representative for sales practice violations involving the sale of unsuitable variable annuities to seniors. [See *Steven Allen Koch*, Decision 05-104 (NYSE April 12, 2007)].

Early Retirement

Commonly, individuals provide misleading advice to seniors about early retirement schemes. The individuals mislead seniors into cashing in their company retirement savings and reinvesting the money, promising that the seniors will be able to live comfortably off the proceeds for the rest of their lives. People who have built up sizeable retirement savings have been misled and harmed by flawed and fraudulent early-retirement investment schemes. The following are examples of situations that have triggered investigations in recent months.

- FINRA brought a claim against a brokerage when the brokerage failed to supervise a broker who lured long-term employees of Exxon Corporation into retiring prematurely. The broker made unreasonable and exaggerated promises of high returns from reinvested funds from their company retirement plans. FINRA fined the brokerage \$2.5 million for failure to supervise and required it to pay \$13.8 million in restitution to 32 former Exxon employees. [See <http://www.nasd.org/PressRoom/NewsReleases/2006NewsReleases/P017386>].

- FINRA fined a brokerage \$3 million and ordered it to pay \$12.2 million in restitution to more than 200 former BellSouth employees. The brokerage failed to supervise a team of brokers who used misleading sales materials during dozens of retirement seminars and meetings for hundreds of employees of BellSouth Corporation. FINRA found that the brokers' sales materials and presentations did not disclose that the recommended investments exposed the employees to greater market risk than their fixed annuity pension payments from BellSouth. As a result of these omissions and misrepresentations, BellSouth employees believed they could afford to retire early by relying upon monthly withdrawals from their retirement savings. Relying on the brokers' representations, many of the customers cashed out their nearly risk-free BellSouth pensions, their 401(k) accounts and other retirement assets and invested the proceeds with the brokers. [See <http://www.finra.org/PressRoom/NewsReleases/2007NewsReleases/P019240>].
- NYSE fined an investment firm \$900,000 for its failure to supervise a branch office manager who made unsuitable trades in customer accounts. The manager held seminars in which he encouraged long-term factory workers to retire, sell their stock in the profit sharing plan, and invest the derived funds through him. He then employed a trading strategy that included the purchase of unsuitable stocks. In some instances, the manager executed unauthorized trades and exercised discretionary trading authority without the customers' prior written authorization. [See *A. G. Edwards*, Decision 06-133 (NYSE Hearing Board July 10, 2006)].
- NYSE fined a registered representative for various sales practice violations. The representative gave investment seminars to employees of an oil refinery who were offered lump-sum retirement payments in lieu of pensions. He recommended that retired or soon-to-be-retired customers should invest in technology-sector stocks that were unsuitable for the customers' investment experience, financial resources, and investment objectives. [See *Henry William Kalweit*, Decision 06-62 (NYSE October 4, 2006)].

EXHIBIT B



The Reality of Investment Risk

When it comes to risk, here's a reality check: All investments carry some degree of risk. Stocks, bonds, mutual funds and exchange-traded funds can lose value, even all their value, if market conditions sour. Even conservative, insured investments, such as certificates of deposit (CDs) issued by a bank or credit union, come with inflation risk. They may not earn enough over time to keep pace with the increasing cost of living.

What Is Risk?

When you invest, you make choices about what to do with your financial assets. Risk is any uncertainty with respect to your investments that has the potential to negatively affect your financial welfare.

For example, your investment value might rise or fall because of market conditions (market risk). Corporate decisions, such as whether to expand into a new area of business or merge with another company, can affect the value of your investments (business risk). If you own an international investment, events within that country can affect your investment (political risk and currency risk, to name two).

There are other types of risk. How easy or hard it is to cash out of an investment when you need to is called liquidity risk. Another risk factor is tied to how many or how few investments you hold. Generally speaking, the more financial eggs you have in one basket, say all your money in a single stock, the greater risk you take (concentration risk).

In short, risk is the possibility that a negative financial outcome that matters to you might occur.

There are several key concepts you should understand when it comes to investment risk.

Risk and Reward. The level of risk associated with a particular investment or asset class typically correlates with the level of return the investment might achieve. The rationale behind this relationship is that investors willing to take on risky investments and potentially lose money should be rewarded for their risk.

In the context of investing, reward is the possibility of higher returns. Historically, stocks have enjoyed the most robust average annual returns over the long term (just over 10 percent per year), followed by corporate bonds (around 6 percent annually), Treasury bonds (5.5 percent per year) and cash/cash equivalents such as short-term Treasury bills (3.5 percent per year). The tradeoff is that with this higher return comes greater risk: as an asset class, stocks are riskier than corporate bonds, and corporate bonds are riskier than Treasury bonds or bank savings products.

Exceptions Abound

Although stocks have historically provided a higher return than bonds and cash investments (albeit, at a higher level of risk), it is not always the case that stocks outperform bonds or that bonds are lower risk than stocks. Both stocks and bonds involve risk, and their returns and risk levels can vary depending on the prevailing market and economic conditions and the manner in which they are used. So, even though target

-date funds are generally designed to become more conservative as the target date approaches, investment risk exists throughout the lifespan of the fund.

Averages and Volatility. While historic averages over long periods can guide decision-making about risk, it can be difficult to predict (and impossible to know) whether, given your specific circumstances and with your particular goals and needs, the historical averages will play in your favor. Even if you hold a broad, diversified portfolio of stocks such as the S&P 500 for an extended period of time, there is no guarantee that they will earn a rate of return equal to the long-term historical average.

The timing of both the purchase and sale of an investment are key determinants of your investment return (along with fees). But while we have all heard the adage, “buy low and sell high,” the reality is that many investors do just the opposite. If you buy a stock or stock mutual fund when the market is hot and prices are high, you will have greater losses if the price drops for any reason compared with an investor who bought at a lower price. That means your average annualized returns will be less than theirs, and it will take you longer to recover.

Investors should also understand that holding a portfolio of stocks even for an extended period of time can result in negative returns. For example, on March 10, 2000, the NASDAQ composite closed at all-time high of 5,048.62. It has only been recently that the closing price has approached this record level, and for well over a decade the NASDAQ Composite was well off its historic high. In short, if you bought at or near the market's peak, you may still not be seeing a positive return on your investment. Investors holding individual stocks for an extended period of time also face the risk that the company they are invested in could enter a state of permanent decline or go bankrupt.

Time Can Be Your Friend or Foe

Based on historical data, holding a broad portfolio of stocks over an extended period of time (for instance a large-cap portfolio like the S&P 500 over a 20-year period) significantly reduces your chances of losing your principal. However, the historical data should not mislead investors into thinking that there is no risk in investing in stocks over a long period of time.

For example, suppose an investor invests \$10,000 in a broadly diversified stock portfolio and 19 years later sees that portfolio grow to \$20,000. The following year, the investor's portfolio loses 20 percent of its value, or \$4,000, during a market downturn. As a result, at the end of the 20-year period, the investor ends up with a \$16,000 portfolio, rather than the \$20,000 portfolio she held after 19 years. Money was made—but not as much as if shares were sold the previous year. That's why stocks are always risky investments, even over the long-term. They don't get safer the longer you hold them.

This is not a hypothetical risk. If you had planned to retire in the 2008 to 2009 timeframe—when stock prices dropped by 57 percent—and had the bulk of your retirement savings in stocks or stock mutual funds, you might have had to reconsider your retirement plan.

Investors should also consider how realistic it will be for them to ride out the ups and downs of the market over the long-term. Will you have to sell stocks during an economic downturn to fill the gap caused by a job loss? Will you sell investments to pay for medical care or a child's college education? Predictable and unpredictable life events might make it difficult for some investors to stay invested in stocks over an extended period of time.

Managing Risk

You cannot eliminate investment risk. But two basic investment strategies can help manage both systemic risk (risk affecting the economy as a whole) and non-systemic risk (risks that affect a small part of the economy, or even a single company).

- **Asset Allocation.** By including different asset classes in your portfolio (for example stocks, bonds, real estate and cash), you increase the probability that some of your investments will provide satisfactory returns even if others are flat or losing value. Put another way, you're reducing the risk of major losses that can result from over-emphasizing a single asset class, however resilient you might expect that class to be.
- **Diversification.** When you diversify, you divide the money you've allocated to a particular asset class, such as stocks, among various categories of investments that belong to that asset class. Diversification, with its emphasis on variety, allows you to spread your assets around. In short, you don't put all your investment eggs in one basket.

Hedging (buying a security to offset a potential loss on another investment) and insurance can provide additional ways to manage risk. However, both strategies typically add (often significantly) to the costs of your investment, which eats away any returns. In addition, hedging typically involves speculative, higher risk activity such as short selling (buying or selling securities you do not own) or investing in illiquid securities.

The bottom line is all investments carry some degree of risk. By better understanding the nature of risk, and taking steps to manage those risks, you put yourself in a better position to meet your financial goals.

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EXHIBIT C



Understanding Bond Risk

Like other investments, when you invest in bonds and bond funds, you face investment the risk that you might lose money. In addition, the following risks, which can happen if the price falls and you sell for less than you paid. Just because you take investment risks doesn't mean you can't exert some control over what happens to the money you invest. apply specifically to bonds:

Interest Rate Risk

Remember the cardinal rule of bonds: When interest rates fall, bond prices rise, and when interest rates rise, bond prices fall. Interest rate risk is the risk that changes in interest rates (in the U.S. or other world markets) may reduce (or increase) the market value of a bond you hold. Interest rate risk—also referred to as **market risk**—increases the longer you hold a bond.

Let's look at the risks inherent in rising interest rates.

Say you bought a 10-year, \$1,000 bond today at a coupon rate of 4 percent, and interest rates rise to 6 percent.

If you need to sell your 4 percent bond prior to maturity you must compete with newer bonds carrying higher coupon rates. These higher coupon rate bonds decrease the appetite for older bonds that pay lower interest. This decreased demand depresses the price of older bonds in the secondary market, which would translate into you receiving a lower price for your bond if you need to sell it. In fact, you may have to sell your bond for less than you paid for it. This is why interest rate risk is also referred to as **market risk**.

Rising interest rates also make new bonds more attractive (because they earn a higher coupon rate). This results in what's known as opportunity risk—the risk that a better opportunity will come around that you may be unable to act upon. The longer the term of your bond, the greater the chance that a more attractive investment opportunity will become available, or that any number of other factors may occur that negatively impact your investment. This also is referred to as **holding-period risk**—the risk that not only a better opportunity might be missed, but that something may happen during the time you hold a bond to negatively affect your investment.

Bond fund managers face the same risks as individual bondholders. When interest rates rise—especially when they go up sharply in a short period of time—the value of the fund's existing bonds drops, which can put a drag on overall fund performance.

Call Risk

Similar to when a homeowner seeks to refinance a mortgage at a lower rate to save money when loan rates decline, a bond issuer often calls a bond when interest rates drop, allowing the issuer to sell new bonds paying lower interest rates—thus saving the issuer money. For this reason, a bond is often called following interest rate declines. The bond's principal is repaid early, but the investor is left unable to find a similar bond with as attractive a yield. This is known as **call risk**.

With a callable bond, you might not receive the bond's original coupon rate for the entire term of the bond, and it might be difficult or impossible to find an equivalent investment paying rates as high as the original rate. This is known as **reinvestment risk**. Additionally, once the call date has been reached, the stream of a callable bond's interest payments is uncertain, and any appreciation in the market value of the bond may not rise above the call price.

Duration Risk

If you own bonds or have money in a bond fund, there is a number you should know. It is called duration. Although stated in years, duration is not simply a measure of time. Instead, duration signals how much the price of your bond investment is likely to fluctuate when there is an up or down movement in interest rates. The higher the duration number, the more sensitive your bond investment will be to changes in interest rates.

Duration risk is the name economists give to the risk associated with the sensitivity of a bond's price to a one percent change in interest rates.

For more information, see FINRA's alert, *Duration—What an Interest Rate Hike Could Do to Your Bond Portfolio*.

Refunding Risk and Sinking Funds Provisions

A sinking fund provision, which often is a feature included in bonds issued by industrial and utility companies, requires a bond issuer to retire a certain number of bonds periodically. This can be accomplished in a variety of ways, including through purchases in the secondary market or forced purchases directly from bondholders at a predetermined price, referred to as **refunding risk**.

Holders of bonds subject to sinking funds should understand that they risk having their bonds retired prior to maturity, which raises reinvestment risk.

Default and Credit Risk

If you have ever loaned money to someone, chances are you gave some thought to the likelihood of being repaid. Some loans are riskier than others. The same is true when you invest in bonds. You are taking a risk that the issuer's promise to repay principal and pay interest on the agreed upon dates and terms will be upheld.

While U.S. Treasury securities are generally deemed to be free of **default risk**, most bonds face a possibility of default. This means that the bond obligor will either be late paying creditors (including you, as a bondholder), pay a negotiated reduced amount or, in worst-case scenarios, be unable to pay at all.

Using Ratings Agencies to Assess Default & Credit Risk

The Securities and Exchange Commission (SEC) has designated 10 rating agencies as Nationally Recognized Statistical Rating Organizations (NRSROs).

These organizations review information about selected issuers, especially financial information, such as the issuer's financial statements, and assign a rating to an issuer's bonds—from AAA (or Aaa) to D (or no rating).

Each NRSRO uses its own ratings definitions and employs its own criteria for rating a given security. It is entirely possible for the same bond to receive a rating that differs, sometimes substantially, from one NRSRO to the next. While it is a good idea to compare a bond's rating across the various NRSROs, not all bonds are

rated by every agency, and some bonds are not rated at all. In such cases, you may find it difficult to assess the overall creditworthiness of the issuer of the bond.

Slow Down When You See "High Yield"

Generally, bonds are lumped into two broad categories—investment grade and non-investment grade. Bonds that are rated BBB, bbb, Baa or higher are generally considered investment grade. Bonds that are rated BB, bb, Ba or lower are non-investment grade. Non-investment grade bonds are also referred to as high-yield or junk bonds. Junk bonds typically offer a higher yield than investment-grade bonds, but the higher yield comes with increased risk—specifically, the risk that the bond's issuer may default.

Don't Reach

Investors who decide which bonds to buy based solely on a bond's yield are "reaching for yield," one of the most common mistakes bond investors make. See FINRA's Investor Alert *The Grass Isn't Always Greener—Chasing Return in a Challenging Investment Environment*.

Inflation and Liquidity Risk

Inflation risk is the risk that the yield on a bond will not keep pace with purchasing power (in fact, another name for inflation risk is **purchasing power risk**). For instance, if you buy a five-year bond in which you can realize a coupon rate of 5 percent, but the rate of inflation is 8 percent, the purchasing power of your bond interest has declined. All bonds but those that adjust for inflation, such as TIPS, expose you to some degree of inflation risk.

Liquidity risk is the risk that you will not be easily able to find a buyer for a bond you need to sell. A sign of liquidity, or lack of it, is the general level of trading activity: A bond that is traded frequently in a given trading day is considerably more liquid than one which only shows trading activity a few times a week.

Some bonds, like U.S. Treasury securities, are quite easy to sell because there are many people interested in buying and selling such securities at any given time. These securities are liquid. Others trade much less frequently. Some even turn out to be "no bid" bonds, with no buying interest at all. These securities are illiquid.

Investors can check corporate bond trading activity—and thus liquidity—by using FINRA's Market Data Center. For insight into municipal bond liquidity, investors can use trade data found on the Municipal Securities Rulemaking Board's website.

Event Risk

Mergers, acquisitions, leveraged buyouts and major corporate restructurings are all events that put corporate bonds at risk, thus the name event risk.

Other events can also trigger changes in a company's financial health and prospects, which may trigger a change in a bond's rating. These include a federal investigation of possible wrongdoing, the sudden death of a company's chief executive officer or other key manager, or a product recall. Energy prices, foreign investor demand and world events also are triggers for event risk. Event risk is extremely hard to anticipate and may have a dramatic and negative impact on bondholders.

THE STATE OF SOUTH CAROLINA
in The Supreme Court

APPEAL FROM THE ADMINISTRATIVE LAW COURT

Ralph K. Anderson III, Administrative Law Judge

RECEIVED

OCT - 2 2015

Opinion No. 5274 (S.C. Ct. App. Filed October 8, 2014)

Appellate Case No. 2014-002736

S.C. Supreme Court

Duke Energy Corporation.....Petitioner,

v.

South Carolina Department of Revenue.....Respondent.

PROOF OF SERVICE

I certify that I have served Amended Amicus Brief on Behalf of the South Carolina Manufacturers Alliance on counsel of record for the South Carolina Department of Revenue and to the Clerk of the Court of Appeals by depositing a copy of it in the United States Mail, postage prepaid, on October 2nd, 2015, addressed to:

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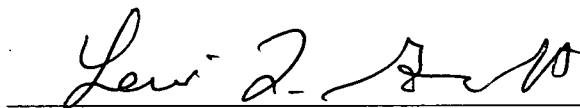
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A handwritten signature in black ink, appearing to read "Lewis Gossett", written over a horizontal line.

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