



THE BLUE SKY BUGLE

A Newsletter for Blue Sky Lawyers

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EVENTS CALENDAR

NASAA 2010 FALL CONFERENCE

The Committee and its Subcommittees will meet in conjunction with the Annual Meeting of the North American Securities Administrators Association
Marriott Baltimore Waterfront Hotel
Baltimore, MD
September 26-28, 2010

ABA BUSINESS LAW SPRING MEETING

The Committee and its Subcommittees will meet in conjunction with the 2011 Spring Meeting of the ABA Business Law Section
Westin/Marriott Copley Place Hotels
Boston, MA
April 14-16, 2011

ABA BUSINESS LAW MEETING

The Committee and its Subcommittees will meet in conjunction with the ABA Annual Meeting
Westin Harbour Castle Hotel
Toronto, Ontario, Canada
August 5-8, 2011

NASAA 2011 FALL CONFERENCE

The Committee and its Subcommittees will meet in conjunction with the Annual Meeting of the North American Securities Administrators Association
Wichita, KS
September 2011

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FROM THE CHAIR – RANDOM RANTS AND RAVES

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“All Rule 506, All the Time”

A. The Saga Continues - Rule 506 State Notice Filing Issues

I hate to belabor this point, but, as clearly evidenced by e-mails and telephone calls from our fellow Blue Skyers around the country, certain states persist in imposing idiosyncratic requirements for notice filings for offerings complying with Rule 506 (“Rule 506”) of SEC Regulation D (“Regulation D”) under the Securities Act of 1933, as amended (the “1933 Act”), as enumerated in Part A of my column in the last issue of the *Bugle*. These requirements frequently conflict with the clear preemptive language of 1933

Act § 18, oftentimes are not mandated by any applicable state law, or any rule, regulation, or order thereunder, are contrary to NASAA's efforts to create a "one-stop" filing system for these notices, and, most importantly, generally have little or nothing to do with investor protection, but rather seem intended to make the filing process as cumbersome, expensive and time-consuming as possible.

Thus, for example, some states still demand that Rule 506 issuers submit separate manually-signed Form U-2 Uniform Consents to Service of Process, despite the fact that SEC Form D now includes a built-in consent, designed to supplant Form U-2. Since it's no state secret, let's consider one state which has taken this approach – New Jersey. Pursuant to Section 49:3-60.1(b) of the New Jersey Uniform Securities Law (the "NJUSL"), the chief of the New Jersey Bureau of Securities (the "NJBOS"), "by rule or otherwise," may require a Rule 506 issuer "to file a notice on SEC Form D . . . , and a consent to service of process signed by the issuer . . . , together with the fee required to be paid pursuant to [NJUSL § 49:3-50(b)(12)]." Thus, the statute doesn't mandate the use of Form U-2 or any other particular form of consent.

In turn, the NJBOS has never promulgated any rule or order setting forth the notice filing requirements pursuant to Section 49:3-60.1 since it was added to the NJUSL effective December 24, 1997 (they've only had almost 13 years to do so!). However, on October 17, 1996, following enactment of the National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290 ("NSMIA"), and despite the absence of any statutory authority at that time requiring or authorizing notice filings for "covered securities" under 1933 Act § 18, the NJBOS issued a Statement of Policy, reprinted at 2A Blue Sky L. Rep. (CCH) ¶ 40,682, concerning filings for Rule 506 offerings, essentially modifying the procedure to perfect a private offering exemption pursuant to NJUSL § 49:3-50(b)(12) or § 49:3-60(b) [the latter statutory provision was repealed when Section 49:3-60.1 was enacted]. In this Statement of Policy, the NJBOS stated that it would accept "a copy of the Form D . . . , along with a consent to service of process, a copy of the private placement memorandum, . . . and the payment of the \$250.00 fee," within 30 days after completion of the offering. The October 17, 1996 Policy Statement was subsequently modified by a June 15, 1999 Statement of Policy, reprinted at 2A Blue Sky L. Rep. (CCH) ¶ 40,691O, so as to delete the requirement to file a

copy of the private placement memorandum. Neither of these Statements of Policy specify that a Form U-2 must be filed as the only acceptable "consent to service of process." (Also note that NJUSL § 49:3-67 only authorizes the NJBOS to make, amend and rescind "rules, forms and orders as are reasonably necessary to carry out the provisions of this act"; nowhere does it authorize issuance of "statements of policy.")

Finally, while NJBOS Rule 13:47A-7.9, which governs notice filings by investment companies pursuant to NJUSL § 49:3-60.1(a), mandates that those types of issuers file a consent to service on Form U-2 (note, however, that the Form NF notice filed by investment companies doesn't include a built-in form of consent), by contrast, NJBOS Rule 13:47A-7.1, governing consents to service of process in general, doesn't specify that any particular form of consent be used, but does provide that, in the case of registration applications by broker-dealer or issuer agents, broker-dealers, investment advisers, and investment adviser representatives, the applicant may rely on the built-in consent in Form U-4, BD, or ADV, as the case may be, in lieu of filing a Form U-2.

Accordingly, given the absence of any statute, rule or order mandating use of Form U-2 for Rule 506 notice filings, and the NJBOS's acceptance of the built-in consent forms in Forms U-4, BD and ADV, why should there be an issue in accepting the built-in consent in Form D, other than bureaucratic intransigence? By the way, New Jersey is not alone in this regard; there are several other states that persist in demanding the filing of a separate Form U-2, and I believe that a close examination will reveal in most cases that there is no statute, rule, regulation or order mandating the filing of a Form U-2 and/or, by contrast, that the built-in consents in Forms U-4, BD and ADV are routinely accepted in lieu of Form U-2.

As I've stated in the past, I believe that the states which have persisted in following these non-uniform approaches to Rule 506 notice filings have done so solely to make the filing process as unwieldy as possible, and these practices certainly counter and detract from NASAA's push for uniformity with a view towards the promised "one-stop" filing system, add additional costs to the process (which are ultimately borne by the investors), and in no way enhance investor protection.

B. Some Thoughts about Prof. Warren and State Rule 506 Notice Filings

As I noted in Part B of my column in the last issue of the *Bugle*, I believe many industry representatives and private attorneys who attended the NASAA Annual Conference in Denver last September were shocked and dismayed by the incredibly one-sided program, “NSMIA 13 Years Later: Rule 506 Transactions Demonstrate the Need for Change,” moderated by Joe Borg, the Alabama Securities Commissioner. In particular, one panelist, Prof. Manning Gilbert Warren of the Louis D. Brandeis School of Law at the University of Louisville, to the delight of the panel and the state representatives present, posited his view that there’s no statutory authority for Rule 506 and it should be invalidated on that basis. Since that meeting, Prof. Warren has published an article, “An Essay on Rule 506 of Regulation D: Its Questionable Origins, Regulatory Oblivion and Judicial Revitalization,” at 38 *Sec. Reg. L.J.* 1 (2010), in which he fleshed out his arguments against the Rule’s validity, principally on the ground that there’s no specific statutory authority in the 1933 Act for the Rule, and that certain provisions of the rule are contrary to prior judicial constructions of 1933 Act § 4(2), such as SEC v. Ralston Purina, 346 U.S. 119 (1953). His article concludes that the preemption of state laws by NSMIA with regard to Rule 506 offerings has harmed investors, and that “the best outcome would be the immediate repeal of Rule 506’s status as a covered security.”

However, even if the statutory authority for Rule 506 were subject to question at the time of its initial promulgation back in 1982 (to say nothing of Rule 146, the predecessor “safe harbor” rule to Rule 506 under 1933 Act § 4(2)), didn’t Congress specifically ratify and acknowledge the existence and *bona fides* of Rule 506 by the inclusion of securities sold in Rule 506 offerings as “covered securities” pursuant to 1933 Act § 18(b)(4)(D), knowing full well that Rule 506 was the only rule issued under Section 4(2) at that time? Further, since Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (the “Dodd-Frank Act”), requires the SEC to issue rules by July 21, 2012, “for the disqualification of offerings and sales of securities made under section 230.506 of title 17, Code of Federal Regulations,” isn’t this another clear Congressional recognition of the Rule’s validity?

In addition, if Rule 506 were truly invalid on the bases espoused by Prof. Warren, it would appear that

the same arguments would seem to require the invalidation of other long-standing “safe harbor” exemptive rules promulgated by the SEC under the 1933 Act, which issuers and others have relied on for years, specifically Rules 144 and 144A regarding exempt offerings under 1933 Act § 4(1), and Rule 147 as regards exempt offerings under 1933 Act § 3(a)(11). Prof. Warren might also call into question certain other “safe harbor” exemptive rules promulgated by the SEC under other federal securities laws, such as Rule 3a4-1, the old rule specifying the circumstances under which certain associated persons of issuers wouldn’t be deemed “brokers” within the meaning of Section 3(a)(4) of the Securities Exchange Act of 1934, as amended (the “1934 Act”). It should be noted, however, that 1933 Act § 28 and 1934 Act § 36, both added by NSMIA, granted the SEC specific authority to create exemptions from the respective Acts by rule or regulation, so the SEC could always “go back to the drawing board” and readopt any such rules, as well as Rule 506, if they were invalidated, under authority of those new provisions.

I don’t intend this portion of my column to be an attack on Prof. Warren’s scholarship. However, in the interest of a “fair and balanced” presentation, I suggest that Prof. Warren’s next article should explore the legality of rules, regulations, orders, and policy statements promulgated by state securities administrators under their respective statutes, a topic I have addressed numerous times over the years, since I believe that a number of state securities regulators have violated their own statutes in issuing (or not issuing, where necessary) certain rules, regulations, orders and policy statements. One ready example of state failures in this regard may be found in the way some states have imposed notice filings for Rule 506 offerings. While there’s no denying that 1933 Act § 18(c)(2), as added by NSMIA, clearly authorized the states to require notice filings for “covered securities,” other than those securities within the scope of 1933 Act § 18(b)(1), Section 18(c)(2) is merely a permissive provision (including, in particular, the “preservation of fees” provisions in 1933 Act § 18(c)(2)(B)), and cannot be relied on by a state securities regulator as stand-alone authority to impose notice filings, in the absence of specific authority in the applicable state law.

Before addressing what particular states have done as regards Rule 506 notice filings, I note that, on April 27, 1997, NASAA adopted model amendments to Sections 201, 202, 203, 301, 401, 403, 405, and 414

of, and adopted a new model Section 307 to, the 1956 version of the Uniform Securities Act (the “1956 USA”), and also adopted a host of new and amended model rules thereunder, all in response to NSMIA. See 1 Blue Sky L. Rep. (CCH) ¶¶ 5521.45, 5522.40, 5523.45, 5531.05, 5536.10, 5541.30, 5543.05, 5545.05, 5554.10, 5512.65, 5522.45, 5522.50, 5522.55, 5522.60, 5522.65, 5523.55, 5536.15, 5536.20, 5536.25, 5541.35, and 5542.10; and the post-NSMIA version of the 1956 USA at NASAA Reports (CCH) ¶¶ 4501-4534. Notwithstanding this convenient roadmap for amending their respective statutes to address issues raised by NSMIA, several states either failed to amend their statutes in response to NSMIA, or have neglected to promulgate rules, regulations, or orders required by their laws, despite the passage of almost 14 years since enactment of NSMIA.

Thus, for example, nowhere in the Alabama Securities Act (the “ALSA”), as reprinted at 1 Blue Sky L. Rep. (CCH) ¶¶ 7101 et seq., will one find mention of the term “covered security” or “federal covered security” (the latter is the defined term used by NASAA in its post-NSMIA model amendments to the 1956 USA) or, for that matter, any provisions in response to NSMIA. Based on the annotations in CCH, it appears that the only amendments to the ALSA since 1996 were a change to a personnel provision in 2000, and increases in filing fees and an amendment to a criminal penalty provision in 2009. Notwithstanding the absence of any statutory provision requiring, or permitting the promulgation of a rule, regulation, or order mandating, notice filings for covered securities, the Alabama Securities Commission (the “ALSC”) instead promulgated a Statement of Policy on June 6, 1998, reprinted at 1 Blue Sky L. Rep. (CCH) ¶ 7570, which purports to require Rule 506 issuers to comply with the filing requirements of ALSC Rule 830-X-6-.11, a rule promulgated *pre-NSMIA* under authority of the limited offering exemption in Section 8-6-11(a)(9) of the ALSA for offerings effected in accordance with Rule 505 or 506 of Regulation D.

However, since covered securities are not subject to state securities registration by reason of NSMIA, it is submitted that covered securities notice filings can’t be imposed under the aegis of statutes relating to registration of securities or exempt securities or exempt transactions (particularly statutes pre-dating NSMIA!), but rather can only be imposed under statutes enacted post-NSMIA and specifically relating to covered securities. This position is clearly

evidenced by NASAA’s model amendment to Section 301 of the 1956 USA, providing that securities may not be offered or sold in the state unless (i) they’re registered, (ii) the security or transaction is exempted under section 402, or (iii) the security is a federal covered security – *i.e.*, federal covered securities are to be handled in a unique manner. In turn, NASAA’s model Section 307 of the 1956 USA authorizes the securities administrator, by rule or order, to require notice filings for covered securities within the meaning of 1933 Act §§ 18(b)(2) and 18(b)(4)(D), and, by “rule or otherwise,” to require notice filings for other covered securities within the meaning of 1933 Act §§ 18(b)(3) or (4). Accordingly, it is submitted that, in the absence of any apparent statutory authority, the ALSC’s Statement of Policy purporting to impose notice filings for Rule 506 offerings is invalid.

In another example of questionable state administrative practice, no provisions were added to the Texas Securities Act (the “TXSA”), requiring or authorizing the imposition of notice filings for covered securities post-NSMIA (although, curiously, various provisions were added to the TXSA relating to “federal covered investment advisers,” the state regulation of which was also affected by NSMIA). In similar fashion to Alabama, despite the absence of any apparent specific statutory authority and without reference therein to any specific section of the TXSA as authority, the Texas State Securities Board (the “TSSB”) promulgated a series of rules, codified as Ch.114 (reprinted at 3A Blue Sky L. Rep. (CCH) ¶¶ 55,590P – 55,590S), requiring notice filings, with applicable filing fees, for all offerings of covered securities, other than those within the scope of 1933 Act § 18(b)(1). Interestingly, Sec. 114.1(a) of such rules states that the chapter “covers filings and fees required to be paid in connection with the issuance of an authorization to offer and sell federal covered securities”; of course, by reason of NSMIA, only a notice filing may be required by any state, and no “authorization” is necessary. It is also noted that Arts. 581-35 and 581-41 of the TXSA specify the fees which the TSSB may impose for various filings under the TXSA; nowhere in those statutory provisions, however, is there a fee designated for notice filings relating to “federal covered securities,” nor does there appear to be authority for the TSSB to establish such fees by rule or otherwise.

While ALSA § 8-6-23 and TXSA Art. 581-28-1 each contain general rulemaking authority (in the case of Alabama, the authority of the ALSC to “make,

amend and rescind such rules . . . as are necessary and desirable to carry out the provisions of this article”; and in the case of Texas, the authority of the TSSB to “make or adopt such rules and regulations as may be necessary to carry out and implement the provisions of this Act”), by analogy to Prof. Warren’s argument (see fn. 33 of his article) that the SEC’s similar general rulemaking authority in 1933 Act § 19(a) did not authorize promulgation of Rule 506, it is submitted that the authority in those ALSA and TXSA provisions is likewise insufficient to support the notice filings those states purport to require of Rule 506 issuers. In any event, the ALSC has attempted to impose notice filings by means of a Statement of Policy, not a rule.

The foregoing are but two examples that readily came to mind; I believe that a close examination of other state laws, rules, regulations, orders, and policy statements will readily disclose other examples of questionable notice filing requirements imposed on Rule 506 issuers.

C. The Dodd-Frank Act’s Impact on Rule 506 Offerings

1. Section 926

As most of the *Bugle*’s readers are well aware, NASAA conducted an all-out campaign to repeal 1933 Act § 18(b)(4)(D), thereby eliminating securities sold in Rule 506 offerings as “covered securities” and restoring the states’ full authority over such offerings. See, in this regard, part 2.C, “Rule 506 Offerings,” in NASAA’s “Pro-Investor Legislative Agenda for the 111th Congress” (January 2009), NASAA Reports (CCH) ¶ 19,111 at p. 18,115, as cited in S. Rep. 111-176, at 113, fn. 186 (2010). Notwithstanding NASAA’s failure to provide any meaningful statistics to support its claims that fraud was rampant in Rule 506 offerings (see, in this regard, the discussion in Part B of my column in the last issue of the *Bugle*), presumably as a result of NASAA’s cajoling, Sen. Dodd incorporated an outright repeal of 1933 Act § 18(b)(4)(D) in Section 928 of the draft “Restoring American Financial Stability Act of 2009,” which he circulated for comment back in November 2009, but never officially introduced for consideration by the Senate. When Sen. Dodd formally introduced his “Restoring American Financial Stability Act of 2010,” S. 3217, 111th Cong. (April 15, 2010), the outright repeal of 1933 Act § 18(b)(4)(D) in Section 928 of his draft

bill was omitted and replaced by Section 926, an illogical and unworkable provision whereby:

- the SEC was ordered to conduct a rulemaking within 360 days after enactment of the Act to determine whether to designate a class of securities offered in reliance on Rule 506 as non-“covered securities,” because “the offering of such securities is not of sufficient size or scope,” considering the size of the offering, the number of states in which the security was being offered, and the nature of the persons to whom the security was being offered;
- required the SEC to review any filings made under Rule 506 not later than 120 days after filing with the SEC;
- if the SEC failed to complete its review, the security would no longer be a covered security, except that the SEC could, within the same 120-day period, determine that there had been “a good faith and reasonable attempt by the issuer to comply with all applicable terms, conditions, and requirements of the filing” and that any failure to comply with the applicable terms, conditions, and requirements of the filing was insignificant to the offering as a whole; and
- required the SEC to implement procedures, within 180 days after enactment of the Act and after consultation with the states, to promptly notify the states upon completion of its review of these filings.

I’ll avoid a “let me count the ways” analysis of why that provision made no sense, since, fortunately, as a result of lobbying by so-called “angel investors” and others, more reasonable minds prevailed, and by the time of enactment of the Dodd-Frank Act, Section 926 was replaced by a totally different provision. Thus, as enacted, Section 926 requires the SEC to issue, within one year after enactment (*i.e.*, by July 21, 2011), a rule (hereinafter, the “Disqualification Rule”), which would disqualify certain offerings from use of the Rule 506 exemption (and thus from claiming “covered securities” status for purposes of Blue Sky laws).

As dictated by Congress, the Disqualification Rule would have to include provisions substantially similar to the disqualifications in 1933 Act Rule 262 (part of 1933 Act Regulation A), which apply to offerings relying on the Regulation A exemption under 1933 Act § 3(b), as well as to offerings relying on the exemption pursuant to Rule 505 of Regulation D, also promulgated under 1933 Act § 3(b), pursuant to Rule 505(b)(2)(iii). The Disqualification Rule would also have to disqualify offerings by a person “subject to a final order” of a state securities regulator, a state agency supervising or examining banks, savings associations or credit unions, a state insurance commission, an appropriate federal banking agency, or the National Credit Union Administration, if the order either: (a) bars the person from (i) association with an entity regulated by the governmental agency, (ii) engaging in the business of securities, insurance, or banking, or (iii) engaging in savings association or credit union activities; or (b) constitutes a final order “based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the 10-year period ending on the date of the filing of the offer or sale.” Finally, the Disqualification Rule is also supposed to disqualify an offering by a person “convicted of any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with” the SEC.

In analyzing Section 926, while it’s obvious that any conclusions will be subject to whatever rule the SEC comes up with in response to Congress’ dictates, the first question that arises is which “persons” will be covered, so as to trigger a disqualification under the Disqualification Rule. Thus, 1933 Act Rule 262 disqualifies offerings from use of the Regulation A exemption if the issuer, any of its predecessors or any affiliated issuer, any director, officer or general partner of the issuer, any beneficial owner of 10% or more of any class of the issuer’s equity securities, any promoter of the issuer connected with it in any capacity, any underwriter of the securities [as regards the term “underwriter,” Rule 505(b)(2)(iii)(B) of Regulation D defines that term to mean “a person that has been or will be paid directly or indirectly remuneration for solicitation of purchasers in connection with sales of securities” under the exemption], or any partner, director or officer of any such underwriter, is or has been the subject of certain civil, criminal or administrative proceedings (certain proceedings going back 5 years, and others 10 years, from the date of the exemption filing with the SEC).

Accordingly, the question is whether the Disqualification Rule will encompass the same, fewer, or more persons than Rule 262. In this regard, there may certainly be cases where an individual associated with the issuer or an “underwriter” and falling within the scope of the disqualifications may have no involvement with, nor stand to profit from, an offering under Rule 506, so perhaps the SEC should seriously consider whether it’s really necessary to include the full gamut of persons covered by Rule 262 in the Disqualification Rule (noting that the Dodd-Frank Act requires that the Disqualification Rule be “substantially similar to,” but not necessarily identical to, Rule 262, and also noting that Rule 262 hasn’t been amended since August 13, 1992, so it may be time for a fresh look at that rule, too).

Second, it is noted that the preamble to SEC Rule 262 provides that, “upon a showing of good cause and without prejudice to any other action by the Commission,” the SEC is authorized to waive any disqualification under the Rule. It is recommended that the Disqualification Rule should include a similar waiver authority.

Third, the Disqualification Rule should spell out what is meant by “a final order”; ideally, it should be one issued in a proceeding in which the respondent was given full due process rights to contest the order and appeal it through administrative and judicial channels. Ex parte orders entered with no opportunity provided to contest or appeal the order should not form the basis for disqualification. Curiously, it is noted that “final order” within the scope of Dodd-Frank Act § 926 includes only those issued in administrative proceedings; thus, a comparable order issued in a judicial proceeding (despite the fact that the particular state or federal regulator concerned may not have statutory authority to issue a “final order” of the type envisioned by Section 926) shouldn’t result in disqualification.

Fourth, in the case of disqualifications premised on a violation of a law or regulation that prohibits “fraudulent, manipulative, or deceptive conduct,” the Disqualification Rule should make clear that Dodd-Frank Act § 926 was intended to encompass serious violations of law, and not violations which are literally deemed to be “fraudulent, manipulative, or deceptive,” although the statute or regulation violated may be of a purely technical nature. Thus, for example, Section 352(1) of the New York General Business Law (part of Article 23-A of the General

Business Law, New York's Blue Sky law, popularly known as the "Martin Act"), provides that any and all violations of any section of Article 23-A "are hereby declared to be and are hereinafter referred to as a fraudulent practice or fraudulent practices." Accordingly, while there's actually no authority under the Martin Act for the New York Attorney General, who enforces the Martin Act, to issue an order of the type described in Dodd-Frank Act § 926, if such an order could be issued, an issuer could be disqualified from use of Rule 506 if it, or one of the other persons falling within the scope of the Disqualification Rule, were found to have violated some minor filing requirement (say, a placement agent's past failure to file a "Further State Notice" pursuant to Section 359-e(8) of the Martin Act for some unrelated offering), simply because the New York statute deems that violation to be "fraudulent." I wouldn't be surprised if a careful reading of other states' Blue Sky laws turned up similar language construing other non-serious violations of laws or rules (such as recordkeeping requirements) thereunder as "fraudulent, manipulative, or deceptive."

Finally, the Disqualification Rule must clarify what types of felonies or misdemeanors "in connection with the purchase or sale of any security" might form the basis for disqualification. Many Blue Sky laws provide that minor violations of the statute may be criminally prosecuted as misdemeanors (or even as felonies), so that an aggressive state securities regulator or prosecutor could theoretically pursue a target for securities fraud and a host of other violations of a Blue Sky law, yet walk away with either a conviction or plea bargain for a single misdemeanor count for a recordkeeping violation. Looking again at New York's Martin Act, Section 359-g(2) of that statute provides that, except where otherwise provided in the Act, a person who violates any provision of the Martin Act "shall be guilty of a misdemeanor, . . . punishable by a fine of not more than five hundred dollars, or imprisonment for not more than one year or both." Thus, should the Disqualification Rule bar a Rule 506 offering because a proposed placement agent had pled guilty to a single misdemeanor count of failing to file a "further state notice" for a prior offering, in satisfaction of an indictment for a variety of securities law violations, primarily because it didn't want to incur the time and expense of defending itself at trial, and the Attorney General was willing to accept that plea, realizing that the state's chances of getting a conviction on the other, more serious, counts was slim to none? It is

submitted that disqualifications for criminal convictions should be premised on serious violations of law, not trivial matters, even though those matters may be prosecutable as misdemeanors or felonies.

2. Section 413

Section 413 of the Dodd-Frank Act, included as part of Title IV, separately titled the "Private Fund Investment Advisers Registration Act of 2010" (the "PFIARA"), immediately impacted, and will prospectively impact for years to come, the SEC's standards for natural persons to qualify as "accredited investors" within the meaning of Rule 501(a) of Regulation D, as well as under 1933 Act Rule 215, a rule defining the term "accredited investor" for purposes of 1933 Act § 2(a)(15), applicable to private offerings pursuant to the relatively obscure 1933 Act § 4(6) exemption for sales of securities exclusively to "accredited investors" in offerings not exceeding \$5 million. Section 413 is also apparently the result of a long-term campaign by NASAA, which has repeatedly criticized the SEC over the years for its failure to adjust the dollar thresholds in the accredited investor standards in Regulation D since 1982 to account for inflation. *See, e.g.*, Comments by Joseph P. Borg Regarding the SEC's Proposed Definition of Qualified Purchaser; Release No. 33-8041 (File No. S7-23-01), [2003-09 Transfer Binder] NASAA Reports (CCH) ¶ 13,095, at 13,309 - 13,310 (March 4, 2002); Comments by Karen Tyler Regarding Revisions of Limited Offering Exemptions in Regulation D, [2003-09 Transfer Binder] NASAA Reports (CCH) ¶ 13,188, at 13,474 - 13,475 (Oct. 26, 2007).

While the SEC had proposed amendments to the accredited investor definitions in both Rules 501(a) and 215 back in August, 2007, whereby all of the dollar amount thresholds (including those applicable to certain entities) would be adjusted for inflation every five years, with the first adjustments effective July 1, 2012, pursuant to a formula premised on the "Personal Consumption Expenditures Chain-Type Price Index" published by the U.S. Department of Commerce (or a successor index thereto), those proposals have languished since then, and also generated a slew of adverse comment letters. *See* Part II.B.3 of SEC Rel. No. 33-8828 (Aug. 3, 2007), 72 Fed. Reg. 45116, 45126 (Aug. 10, 2007); the comment letters are available from the SEC's website at <http://www.sec.gov/comments/s7-18-07/s71807.shtml>.

Section 413(a) of the Dodd-Frank Act requires the SEC to adjust the net worth standards for natural person accredited investors in the SEC's rules under the 1933 Act, so that the minimum threshold net worth of the person, or of the person's joint net worth with spouse, would exceed \$1,000,000, excluding the value of the person's "primary residence." However, Section 413(a) goes on to provide that "during the 4-year period that begins on the date of enactment of this Act, any net worth standard shall be \$1,000,000, excluding the value of the primary residence of such natural person."

As a result of somewhat-typical poor drafting by our fine Congressional representatives, Section 413(a) engendered some debate among practitioners concerning several points. First, some persons questioned whether the quoted language above was intended to serve solely as conditioning any rule amendments effected by the SEC during the 4-year period, so that any amended rule promulgated during that time had to exclude the value of the person's primary residence, or whether Congress intended that the net worth standard in 1933 Act Rules 215(e) and 501(a)(5) be adjusted immediately upon enactment of the Dodd-Frank Act to exclude the value of the person's primary residence. The consensus was that the change was to be effective immediately, *i.e.*, as of July 21, 2010, and this interpretation was adopted by the SEC (see below). Practitioners also questioned Section 413(a)'s silence as regards the treatment of any mortgage indebtedness secured by the investor's primary residence, *i.e.*, while the value of the residence must clearly be excluded from consideration as an asset of the investor, was any appurtenant mortgage debt nevertheless required to be counted as a liability and deducted from the investor's net worth? Most practitioners believed that the mortgage indebtedness should also be excluded, since it would ordinarily be netted against the value of the residence, and the SEC staff has now adopted this view, too.

Thus, on July 23, 2010, the staff of the SEC's Division of Corporation Finance issued new (and identical) Compliance and Disclosure Interpretations ("C&DIs") 179.01 and 255.47 with regard to 1933 Act Rules 215(e) and 501(a)(5), respectively, stating that while the SEC "will issue amendments to its rules to conform them to the adjustment to the accredited investor net worth standard made by [Section 413(a) of the Dodd-Frank] Act," since "the adjustment is effective upon enactment of the Act," pending implementation of those changes to the

SEC's rules, "the related amount of indebtedness secured by the primary residence up to its fair market value may also be excluded." These C&DIs, among the others relating to 1933 Act rules, may be found at <http://sec.gov/divisions/corpfin/guidance/safinterp.htm>. (Also note that on July 22, 2010, the SEC staff withdrew its old C&DI 255.13, which previously provided that an investor may include the estimated fair market value of his or her principal residence as an asset for purposes of Rule 501(a)(5), because that Rule didn't exclude any assets from calculation of the investor's net worth.)

What is problematic, however, is the final sentence in each of these C&DIs, where the staff states that "[i]ndebtedness secured by the residence in excess of the value of the home should be considered a liability and deducted from the investor's net worth." As *Bugle* readers should be well aware, as a result of the economic downturn of the past several years and overly-aggressive, sloppy or outright fraudulent mortgage underwriting practices of some lenders and mortgage brokers, nowadays there are many instances where a homeowner's mortgage indebtedness may well exceed the current fair market value of the property secured thereby. Unfortunately, however, what the C&DIs fail to consider is that, by reason of applicable law, or possibly by reason of the terms of a mortgage note, mortgage, deed of trust or other instrument governing a mortgage loan, a mortgage lender may be prohibited from obtaining a personal deficiency judgment against a defaulting borrower should the property securing the loan prove to be worth less than the balance due on the loan in the event of foreclosure or a similar proceeding. In light of the foregoing, I've e-mailed the SEC staff, recommending that the last sentence of C&DIs 179.01 and 255.47 each be revised to read "If, however, the indebtedness secured by the residence exceeds the fair market value of the residence and the mortgagee or other lender has recourse to the investor personally for any deficiency, that excess amount should be considered a liability and deducted from the investor's net worth." I would anticipate that if the SEC fails to either revise these C&DIs or include language to the foregoing effect in its proposed revisions to 1933 Act Rules 215(e) and 501(a)(5) in response to Dodd-Frank Act § 413(a), interested persons (myself included) would no doubt raise this comment again.

By reason of its immediate effect on the accredited investor net worth standard, Dodd-Frank Act § 413(a) created problems for issuers relying on Rule

506 and conducting offerings where offering materials (including subscription agreements) had been sent out prior to July 21, whereby prospective investors were asked to represent whether they complied with the old accredited investor net worth standard (and/or some other accredited investor standard, such as the income standard in Rule 501(a)(6)). If an investor submitted an irrevocable subscription agreement prior to July 21, representing that he or she qualified as an accredited investor solely by reason of the old net worth standard, but the offering wasn't scheduled to actually close until on or after July 21, the question remained whether the issuer was obligated to go back to that investor and obtain a new representation that the investor either satisfied the revised net worth standard, or otherwise qualified as an accredited investor under Rule 501(a), or, should the investor be unable to provide such a representation, reject the subscription and return the investor's money if the issuer were unable or unwilling to accept non-accredited investors.

Some persons argued that the issuer could rely on the SEC's interpretation of when a "sale" takes place for purposes of triggering the 15 days after sale Form D filing requirement in Rule 503 (see the Instruction to Item 7 of SEC Form D and C&DI 257.02). In accordance with that interpretation, the issuer could take the position that if the subscription were irrevocable on the investor's part, its reasonable belief as to the investor's accredited investor status at the time of sale for purposes of Rule 501(a) should be determined as of the time the subscription agreement was received, and thus the issuer was under no obligation to obtain a new representation from the investor. However, since the aforesaid interpretation doesn't specifically apply to accredited investor determinations under Rule 501(a), and since the consequences of a sale to a non-accredited investor could be problematic if the offering materials employed by the issuer didn't satisfy the disclosure requirements of Rule 502(b) for an offering to non-accredited investors, the subscription agreement didn't include the requisite sophistication representations from non-accredited investors in accordance with Rule 506(b)(2)(ii), or, worse, the securities had already been sold to 35 non-accredited investors, thereby exceeding the limit under Rule 506(b)(2)(i) if this new investor were accepted, I and others believed that it was better practice to go back to the investor and obtain an updated representation (or, if need be, reject the subscription) before actually closing the offering.

Of course, in the case of any offering commencing before July 21 and continuing thereafter, it is imperative that the issuer revise its offering documents and subscription agreements to conform to the revised net worth standard.

Aside from these immediate changes to 1933 Act Rules 215(e) and 501(a)(5), Dodd-Frank Act § 413(b)(1) permits, but doesn't require, the SEC to review the definition of the term "accredited investor," solely as applied to natural persons, to determine whether to adjust or modify the definition (other than the exclusion of a primary residence from net worth as provided by Section 413(a)), "for the protection of investors, in the public interest, and in light of the economy." It's unclear when such a review may take place, since Section 413(b)(1) includes no time constraints on the SEC to take such action. However, Dodd-Frank Act § 413(b)(2) goes on to require that the SEC, not earlier than 4 years after the date of enactment (*i.e.*, not before July 21, 2014), and not less frequently than once every 4 years thereafter, undertake a review of the definition of the term "accredited investor," but solely in 1933 Act Rule 215 (or any successor rule thereto) and solely as applied to natural persons, to determine whether to adjust or modify the definition "for the protection of investors, in the public interest, and in light of the economy." While Section 413(b)(2) obviously ignores 1933 Act Rule 501(a) as regards natural person accredited investors, given that the definitions of "accredited investor" in Rule 215 (coupled with the statutory definition in 1933 Act § 2(a)(15)) and in Rule 501(a) have always been identical, it would be somewhat surprising if the SEC were to follow the Congressional edict literally, and would adjust or modify the definition in Rule 215, and not simultaneously make conforming changes to the definition in Rule 501(a).

In any event, while Dodd-Frank Act § 413 may have forced the SEC's hand, it must be remembered that the SEC has always had authority to revise the definition of "accredited investor" in Rule 215 or Rule 501(a), regardless of any Congressional compulsion. I guess we could just chalk up this exercise as a bit of a kick in the SEC's butt from the fools on the hill.

By the way, while there's certainly much to be said about the potential effect of the PFIARA provisions of the Dodd-Frank Act (particularly Section 410) on investment adviser registration or licensing under

Blue Sky laws, I'll have to save that for my next column. Since the investment adviser changes wrought by PFIARA won't be effective until July 21, 2011, we do have some time to mull them over, as we await SEC rulemaking in response thereto.

BLUE SKY BITS AND PIECES

By: *Ellen Lieberman*
Debevoise & Plimpton LLP

Dana G. Fleischman has joined Latham & Watkins as a broker-dealer partner as part of a plan to grow the firm's financial institutions practice. She had been a partner at Cleary Gottlieb Steen & Hamilton in New York, which she joined after graduating from Yale Law School.

Peter W. LaVigne has joined the New York office of Goodwin Procter LLP as a partner in their financial services group. His practice concentrates on securities and broker-dealer regulation. He serves on the Executive Committee of the New York State Bar Association Business Law Section and is a member of its Securities Regulation Committee and was the founding chair of the American Bar Association Subcommittee on FINRA Corporate Financing Rules. Previously he was special counsel at Sullivan & Cromwell, practiced at Paul Hastings and Battle Fowler (which merged with Paul Hastings in 2000), and served as an assistant attorney general in the New York State Attorney General's Office, where he was Chief of the Real Estate Syndication Section. He received his J.D. from Yale Law School and his B.A. from Cornell University.

Kathleen G. Duggan is retiring from blue sky practice at Cahill Gordon & Reindel LLP at the end of September. Kathy received her J.D. degree magna cum laude from New York Law School, and also clerked for the Honorable Cornelius Blackshear, United States Bankruptcy Court, Southern District of New York. She will be succeeded by **Mary A. Stokinger**, Senior Attorney, who received her law degree at Fordham University School of Law. Kathy will have more time for grandchildren!

Mark C. Dickinson who practices at Nyemaster Goode, M.C., has agreed to serve as our Committee's Iowa liaison. Keeping us up-to-date on developments in that state will be much appreciated.

Ellen Lieberman, the author of *Blue Sky Bits and Pieces* and former Committee chair, is delighted to report the birth of her grandson Leonardo Fedele Passeri on June 11, 2010, weighing 7 lbs., 3 ozs., to her daughter, Andrea Lieberman and Andrea's husband Vince Passeri. Leo is baby brother to big sister Paloma Sophia Passeri whose birth was announced two years ago in the *Blue Sky Bugle*.

Susan M. Cohen, formerly with Lowenstein Sandler, has joined the New York office of Bingham McCutcheon as Of Counsel, focusing on Blue Sky Law.

Susan Noble, one of our good friends and longtime paralegal colleague at Bingham McCutcheon LLP retired June 30 from that firm, and has started her own company, ParaBlue Service, to assist attorneys in providing blue sky services, working out of Quincy, Massachusetts. Susan has been a frequent contributor to the *Blue Sky Bugle* and an organizer of the paralegal forum that is held annually in conjunction with the NASAA Annual Meeting.

Leonard Sommer, perhaps the longest serving blue sky lawyer in active practice, retired this year from Milbank Tweed Hadley & McCloy.

Mark T. Lab, formerly with Simpson Thacher and Bartlett, has joined Sullivan & Cromwell as Special Counsel and will focus on Blue Sky, FINRA Corporate Finance, broker deal and investment adviser compliance and registration.

Eric R. Dinallo ran unsuccessfully in the New York Democratic primary for New York Attorney General. He was previously Superintendent of the New York State Insurance Department and, before that, Chief of the Investment Protection Bureau of the New York State Attorney General's Office under **Elliot Spitzer**. The winner of this September's Democratic primary was **Eric T. Schneiderman**, a former State Senator where he was chief sponsor of the Rockefeller Drug Law reforms. His legal backgrounds includes his stint as a partner at the law firm of Kirkpatrick and Lockhart. The opposition Republic candidate for the position of New York Attorney General is **Daniel M. Donovan Jr.**, Staten Island's District Attorney.

Andrew "Buddy" Donohue, who served for four years as director the SEC's Investment Management Division, has announced his intention to leave the SEC in November. Previously, he was Global General Counsel for Merrill Lynch Investment

Managers; Executive Vice President, General Counsel, Director, and member of the Executive Committee for OppenheimerFunds; Senior Vice President, General Counsel, and Director for First Investors Corporation; and in private practice. No successor has been named nor has he announced his own future plans.

Mark Connolly resigned as director of the New Hampshire Bureau of Securities Regulation effective May 14. Connolly, the state's top securities regulator for the past eight years, left his state employment to speak up about how, in his view, the state government mishandled the matter of Financial Resources Mortgage, Inc., a mortgage company accused of running a Ponzi scheme swindling approximately 150 investors out of at least \$80 million. The president of the mortgage company, **Scott Farah**, and the company are the targets of dozens of private law suits as well as a federal criminal charge of wire fraud. In a report issued before his resignation, Connolly chastised the New Hampshire Banking Department and asked them to make all of the company's records available for public inspection. Connolly also indicated he would testify in front of a joint state legislative committee, calling himself a whistle blower. **Joseph C. Long**, well known for many years as a blue sky author, expert witness, and former special counsel to NASAA as well as a retired law school professor, was named Interim Director of Securities Regulation for New Hampshire; he had been living in Norman, Oklahoma.

The Ohio Department of Commerce, Division of Securities, had a number of personnel changes. **Mark Heuerman** was named Registration Chief Counsel, having worked for the Ohio Securities Division since 1988. **Clyde Kahrl** was named Control Bid Attorney, having earlier worked as a Division attorney from 1980 until 1990. **Anne Followell** was named Licensing Chief, **Richard Pautsch** was named Examination Supervisor and **Steve Ballard** also re-joined the Securities Division as Deputy Attorney Inspector.

Anthony Colbert, most recently Senior Counsel with the California Department of Corporations, where he reviewed and disposed of applications for franchises and for the offer and sale of securities, has become an Administrative Law Judge. He has been a frequent speaker before the Santa Clara Bar Association, San Francisco Bar Association, and Los Angeles Bar Association on California Securities Law and

Fairness Hearings, served as an expert witness in criminal, civil and administrative hearings, and recently published an article on Fairness Hearings in the California Business Law Practitioner. He received his J.D. degree from the University of Virginia School of Law.

Rebecca Gibbs, whom many of us worked with at the Georgia Division of Securities and Business Regulation, recently retired after many years of service at the Division.

William "Bill" Beatty was named Washington Department of Financial Institutions Director of Securities effective July 16. He had worked for the Department since 1986, most recently as a Program Manager and General Counsel. Before that he was a Staff Attorney, Financial Legal Examiner and Associate Legal Counsel. Beatty was responsible for creating and implementing the Division of Securities Customer Service Unit, drafting securities-related legislation, regulations, statements of policy and interpretive opinions, supervising the registration, licensing, exemption, and opinion functions of the Division and testifying before legislative committees. He has also been an active participant in NASAA committees and project groups. Beatty is a graduate of the University of Puget Sound and the Seattle University School of Law. He replaces **Michael Stevenson** who recently retired as Director of Securities. Stevenson was also very active within NASAA's leadership having served on its Board of Directors and with various of its committees and project groups.

Allan Russ has been named the Deputy Director of the Securities Division of North Carolina. He had served most recently as Enforcement Attorney of the Securities Division.

David S. Massey, Deputy Securities Administrator of the North Carolina Securities Division, and incoming NASAA President has been selected by NASAA to represent state securities regulators as a non-voting member of the Financial Stability Oversight Council, created by the Dodd-Frank Wall Street Reform and Consumer Protection Act. He has previously served as Director and as General Counsel of the North Carolina Securities Division, as well as General Counsel for that state's Department of the Secretary of State.

It is with sadness that we report the untimely passing on June 1, 2010 of **David Earl Weaver**, General Counsel of the Texas State Securities Board for the past 20 years. David who was an active committee person within NASAA was recently working closely with our Committee in trying to bring about uniformity among the states in their handling of Rule 506 notice filings in anticipation of NASAA's one-stop filing system. He was 49 years old, grew up in Longview, Texas, and spent most of his adult years in Austin, Texas. He also served as President of the Texas General Counsel Forum, on the board of the Veterans Commission where he organized an effort to provide financial assistance to Texas Veterans, and on the board of the Downtown Austin Neighborhood Association. He was described as full of life, vitality, and charm, a music aficionado and a person whose life mirrored his favorite quote from the Wizard of Oz, "It's not how much you love, but how much you are loved by others." David is survived by his partner of seven years, Bonsack Phrasavath, and by two sisters, four brothers, their spouses and children.

We sadly report the sudden death on April 27th of **Mary Bucci** of PNC Global Investment Servicing. Mary came to PNC in 1995 with a background in the mutual fund compliance industry, and began working at what was then ClearSky Corporation and is now known as ClearSky Service. Her colleagues will miss her and remarked on the immense pride she took in her work and her wonderful sense of humor. They complimented her for helping the startup ClearSky become the industry leader in mutual fund blue sky outsourcing.

DODD-FRANK, SUITABILITY AND FIDUCIARY DUTY

By Philip A. Feigin

Rothgerber Johnson & Lyons LLP

So what's all this about a uniform fiduciary standard? In Title IX, Subtitle A, Section 913 of the Dodd Frank Act, Congress charged the Securities and Exchange Commission to conduct a study and report back by July 2011 with an evaluation of:

- (i) the effectiveness of existing legal or regulatory standards of care for broker-dealers, investment advisers and their representatives imposed by regulators; and

- (ii) whether there are legal or regulatory gaps, shortcomings or overlaps that should be addressed by rule or statute.

Congress then enumerated a total of 13 specific areas the study should encompass, empowered the Commission with the statutory authority to adopt rules as appropriate to impose new standards identified in the study, and amended Section 15 of the Securities Exchange Act of 1934 and Section 211 of the Investment Advisers Act of 1940 to accommodate a new standard. Translated to practical language, Congress authorized the Commission to jettison the "suitability" standard imposed on broker-dealers and representatives making recommendations to their clients in favor of some form of "fiduciary duty" standard akin to the standard imposed on investment advisers and their representatives.

I have dealt with the concept of "suitability" for more than 30 years, first, as a regulator enforcing it, and for the last ten years or so, representing clients subject to or protected by it. Suitability began as a broker-dealer and agent regulatory concept dealing with recommendations of securities, imported only recently in relative terms into investment advisory regulation to deal with providing investment advice.

For many years, the extent of the standard imposed on broker-dealers and their agents depended on whether one was discussing suitability as construed by the SEC, the New York Stock Exchange Rule, the NASD Rule or the rule as imposed by a particular state. Generally speaking, in recommending a security to a customer, a broker-dealer and agent are required to seek (or obtain) information about a customer's financial and tax situation and their investment objectives and needs on the basis of which they have reasonable grounds to believe the investment is suitable for that customer. Similar provisions are contained in the rules of the New York Stock Exchange and virtually all state rules under which brokerage firms and their agents are regulated, and the rules of many of the states that regulate state licensed/registered investment advisers and their investment adviser representatives.

Although suitability is a concept utilized by the SEC in its regulation of investment advisers, the SEC has not adopted a particular suitability rule for advisers, although one was proposed in 1994. Instead, suitability is a concept applied in an anti-fraud analysis under Section 206 of the Advisers Act.

Suitability has been exclusively a regulatory concept, though many private litigants have attempted to assert it as a cause of action in private litigation. There is no express statutory or implied private right of action of which I am aware for the making of an unsuitable recommendation, under the Securities Exchange Act of 1934 or any state securities law against brokers or agents, or under the Advisers Act or any state securities law against investment advisers or their representatives. It is a rule imposed and intended to be enforced by regulators and regulators alone. In the regulatory view, the suitability of a particular recommended investment or investment strategy is not measured by the success or failure of the investment that follows. Neither is it a static concept, but one that can change over time.

Nonetheless, in my experience, in private litigation between clients and their investment firms and representatives, it is quite common to see complaints and statements of claims filed in which “suitability” is asserted as a cause of action after an investment fails. This is not surprising, as the grounds necessary to establish a suitability violation may often be easier to assert than statutory fraud. The broker-dealer suitability rule is a regulatory minimum that is not particularly difficult to achieve. Literally, it is designed to protect those who do not have the minimum wealth and market awareness to make even the most basic investment decisions. Conversely, it does not take a lot to ensure that a transaction or strategy is suitable. Financial wealth coupled with a basic familiarity of investing as well as investment experience will almost certainly ensure that an investment transaction or strategy is suitable.

Consumer and investor protection groups lobbied vigorously in Congress for a higher and uniform standard of care for all those who provide recommendations to retail clients. Mercifully, Congress elected not to try to define such a standard in the statute itself, but essentially delegated the task to the SEC. There is little question that the SEC is going to adopt such a standard, and it may be accomplished before the six months time limit.

What will a fiduciary standard mean for the brokerage industry? Even under the suitability standard, those making recommendations had to conduct themselves with a certain degree of care in making them, so the idea of “putting the customer’s interests first” will not be entirely foreign to them. There has been much roiling in the media by the brokerage industry and pundits about how a broker

can put the customer’s interests first when they are agents for the brokerage firm, not the customer, when they earn a commission on a sale to the customer from the brokerage firm, and in many cases, when the brokerage firm is a principal in the transaction, *e.g.*, securities are sold from the firm’s inventory, or an IPO.

Surely, the SEC is well aware of such issues and will explain them in promulgating its rules. I am not troubled by the prospects. Literally hundreds of firms in the industry are jointly registered as broker-dealers and investment advisers, and both advise their clients for a fee and effect securities transactions that result from that advice. Literally thousands of representatives of brokerage firms operate their own or work for other investment advisers. As IAs, they advise clients how to invest, and as broker-dealer reps, they effect their transactions, often with discretion. In giving the advice, they are held to a fiduciary standard, but somehow, the world did not stop rotating when these fiduciaries then went out and sold for commission. Broker-dealers, investment advisers and the reps have been inhabiting the same space for decades. The few technical wrinkles will be ironed out, and without much difficulty.

So what’s all the fuss about? In my view, it is the prospect of private civil litigation, and more particularly, FINRA arbitration. As I stated earlier, there is no statutory private civil remedy of which I am aware against a brokerage firm or rep for making an unsuitable recommendation under FINRA or state securities law rules. While there are reported cases involving administrative and enforcement actions involving suitability, there is scant private case law, given such cases are heard in arbitration. However a suitability claim was asserted, as fraud, breach of duty, what have you, private claimants were often left to their own devices in attempting to define and prove particular recommendations were “unsuitable.”

However, if federal rules are changed to impose a fiduciary standard on them, there is a broad array of state statutory and case law regarding fiduciaries and fiduciary duty that claimants’ counsel can tap to support claims in arbitration against brokerage firms and their agents. The standard is a high one, make no mistake. Even so, I do not foresee the new standard will make much difference when all is said and done.

How it will be applied to particular broker-dealer and agent conduct remains to be seen. Best practices will not change a bit. Looking at it wryly, brokerage firms

that have “clients” more than “customers” will be made to live up to their own professed image, and their commercials, more than ever before. They will embrace it, and ought to be announcing proudly that it makes no difference as they have been acting that way for years. Lesser firms may have problems adapting.

Either way, the sales industry had best get ready, for I think it rather clear a fiduciary standard for brokerage firms and agents is coming, and it is going to be a standard with sharp regulatory and private civil teeth.

BRIEF HISTORY OF SECURITIES LAW

By James A. Klimek
Attorney at Law

There is nothing new under the sun.¹

ENGLAND

In 1285, King Edward authorized the Court of Aldermen to license brokers in the City of London, and a number of prosecutions were made under the statute before 1300. In the seventeenth century, Parliament passed “an act to restrain the number and ill practice of brokers and stock jobbers.”² The special commission which recommended the legislation explained its public policy as follows:

The pernicious Art of Stock-jobbing hath, of late, so wholly perverted the End and Design of Companies and Corporations, erected for the introducing, or carrying on, of Manufactures, to the private Profit of the first Projectors, that the Privileges granted to them have, commonly, been made no use of, by the First Procurers and Subscribers, but to sell again, with Advantage, to ignorant Men, drawn in by the Reputation, falsely raised, and artfully spread concerning the thriving State of their Stock.³

The act required brokers to be licensed and transactions to be recorded, and also limited commissions to one-half of one percent.

In 1707 Parliament was in a deregulatory phase and allowed the statute to lapse. A decade later the British government granted the South Sea Company a monopoly for trading with South America and the Pacific Islands in consideration of assumption of government debt. King George served as governor of

the South Sea Company. Shares of the company traded at £128 ½ in the first quarter of 1720 and rose to over £1,000 in the second quarter. By the fourth quarter the stock had fallen to £125 after directors of the company had sold £5 million worth of shares at the top of the market. Professor Louis Loss of Harvard Law School described the consequences:

The bursting of the South Sea Bubble ruined thousands of people in all ranks of society. A committee of secrecy of the Commons found that there had been “robbery as well as jobbery.” Reputations in the financial and political world were ruined wholesale. The national disaster was aggravated by the numerous hoaxes that were developed by imitators. In a few months about 200 joint stock schemes were started, calling in the aggregate for £300 million sterling, more than the value of all the land in Great Britain. A thousand persons are said to have paid two guineas each in one morning as a first in installment on a share in a company “for carrying out an undertaking of great importance, but nobody to know what it is.”⁴

In his classic 1776 work *The Wealth of Nations*, Adam Smith, the father of modern laissez-faire economics, identified the potential for abusive management of companies that issue publicly-traded securities:

The trade of a joint stock company is always managed by a court of directors. This court, indeed, is frequently subject, in many respects, to the control of a general court of proprietors. But the greater part of those proprietors seldom pretend to understand any thing of the business of the company, and when the spirit of faction happens not to prevail among them, give themselves no trouble about it, but receive contentedly such half yearly or yearly dividend, as the directors think proper to make them The directors of such companies, however, being the managers of other people’s money rather than their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master’s honour, and very easily give themselves a dispensation from having it. Negligence and profusion,

therefore, must always prevail, more or less, in the management of the affairs of such a company.⁵

STATE BLUE SKY LAW

Kansas adopted the first comprehensive state securities act.⁶ The policy of the act was to outlaw promoters who “would sell building lots in the blue sky in fee simple.”⁷ State securities law has been known as Blue Sky Law ever since. All fifty states and the Canadian provinces eventually adopted securities acts. Uniformity was not a feature of the original Blue Sky Laws. Attorneys complained about the difficulty of assuring that securities offerings complied with 47 statutes containing 2800 exemptions.⁸

In 1954, Professor Loss, with the input of state securities regulators, the SEC, the American Bar Association and other interested parties, led an effort to create uniform standards for Blue Sky Law. The result was the Uniform Securities Act of 1956. It was eventually adopted in many jurisdictions, albeit with variations in each. In 2002, the National Conference of Commissioners on Uniform State Laws adopted a new Uniform Securities Act of 2002, which the states have gradually been adopting. Attorneys still complain about the difficulty of assuring that securities offerings comply with 50 different state securities acts.

FEDERAL SECURITIES LAW AND THE SEC

Prior to the Great Depression, Wall Street was little regulated and provided ample opportunity for the unscrupulous. In 1924, the Yellow Cab Company, led by John Hertz, was the subject of an attempted hostile take-over. Looking for shark repellent, Hertz sought the assistance of a man with a substantial bankroll: Joseph P. Kennedy. The millionaire spent a month in an improvised war room in the Waldorf-Astoria Hotel, destabilizing the price of Yellow Cab shares by placing buy and sell orders in brokerage accounts he set up all over the country, thus scaring off the would-be raiders.⁹

Kennedy’s manipulation of the market for Yellow Cab stock impressed Wall Street traders and corporate executives, who began sharing inside information with him for their mutual benefit. Kennedy found these relationships so profitable that he said the only question about insider trading was how long it would last “before they pass a law

against it.” Indeed, one of his business partners, Matthew Brush, later said that “the Wall Street racket made Al Capone look like a piker.”¹⁰

In light of public anger at windfall profits on Wall Street during the Depression, the United States Senate Banking and Currency Committee investigated the practices of firms in the financial services industry. Under oath, representatives of the biggest banks on Wall Street admitted wrongdoing throughout the business.¹¹

That same year, United States Supreme Court Justice Harlan F. Stone spoke at the dedication of the University of Michigan Law School Quadrangle. Some of his remarks, foreshadowing the troubled economic times of the early 21st Century, described abuses in unregulated financial markets as part of the cause of the Great Depression:

I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that “a man cannot serve two masters.” More than a century ago equity gave a hospitable reception to that principle. The separation of ownership from management, the development of the corporate structure so as to vest in small groups control over the resources of great numbers of small and uninformed investors, make imperative a fresh and active devotion to that principle if the modern world of business is to perform its proper function. Yet those who serve nominally as trustees, but relieved, by clever legal devices, from the obligation to protect those whose interests they purport to represent, corporate officers and directors who award themselves huge bonuses from corporate funds without the assent or even knowledge of their stockholders, reorganization committees created to serve interests of others than those whose securities they control, financial institutions which, in the infinite variety of their operations, consider only last, if at all, the interests of those whose funds they command, suggest how far we have ignored the necessary implications of that principle. The loss and suffering inflicted on individuals, the harm done to a social order founded upon business

and dependent upon its integrity, are incalculable.¹²

The response of Congress to that era's Wall Street scandals was the Securities Exchange Act of 1934, which created the Securities and Exchange Commission and empowered it to regulate the securities markets vigilantly. President Roosevelt believed that only someone already familiar with the ways of Wall Street could regulate it effectively. Saying that it would take a thief to catch a thief, he appointed Joseph P. Kennedy as the first Chairman of the SEC.¹³

SARBANES-OXLEY

From 1981 to 1999, the New York Stock Exchange market capitalization increased from \$1.1 to \$12.3 trillion. In 2002, Professor Joel Seligman stated that favorable market conditions tend to lead to lax enforcement of the disclosure principles of securities regulation resulting in negative market consequences:

With this unprecedented success there appears to have come a lulling of institutional sensibilities. A widespread belief appears to have evolved in the United States financial community that time honored rules such as those that discourage conflicts of interest are quaint and easily circumvented. Too frequently, in recent years, sharp practitioners in business, investment banking, accounting or law appear to have challenged the fundamental tenants of "full disclosure of material information" or "fair presentation of accounting results." A deterioration in the integrity of our corporate governance and mandatory disclosure systems may well have advanced, not because of a novel strain of human cupidity, but because we have had so much success, for so long, that we began to forget why fundamental principles of full disclosure and corporate accountability were long considered essential. No recent case better illustrates this deterioration than Enron.¹⁴

Enron Corp. was a provider of natural gas, electricity and communications products and services, whose total assets grew between 1996 and 2000 from \$16 to \$66 billion. Enron carried substantial debt. It wanted to use leverage to pursue business opportunities, but without putting further pressure on its balance sheet

and investment grade credit rating. The company's certified public accountants, Arthur Anderson, structured transactions designed to accomplish this goal.

Arthur Anderson advised Enron to set up special purpose entities, managed by Enron employees, to borrow money on the company's behalf. Some of these were a limited liability company called Chewco, after the Star Wars character Chewbacca, Joint Energy Development Investment Limited Partnership ("JEDI") and LJM Cayman, L.P. ("LJM1"). In November of 2001, Enron made an SEC filing disclosing that, due to accounting errors relating to Chewco and LJM1, it intended to restate its financial statements dating back to 1997 and that the audit reports covering 1997 to 2000 should not be relied upon. The market reacted to this announcement so harshly that Enron filed for bankruptcy less than a month later.

To determine how the special purpose entities led to Enron's collapse, its Board of Directors appointed a Special Investigation Committee chaired by University of Texas Law School Dean William Powers. The Powers Committee concluded that Enron's fraud was facilitated by Arthur Anderson:

Enron's original accounting treatment of the Chewco and LJM1 transactions that led to Enron's November 2001 restatement was clearly wrong, apparently the result of mistakes either in structuring the transactions or in basic accounting. In other cases, the accounting treatment was likely wrong, notwithstanding creative efforts to circumvent accounting principles through the complex structuring of transactions that lacked fundamental economic substance. In virtually all of the transactions, Enron's accounting treatment was determined with extensive participation and structuring advice from Anderson, which Management reported to the Board. Enron's records show that Anderson billed Enron \$5.7 million for advice in connection with the LJM and Chewco transactions alone, above and beyond its regular audit fees.¹⁵

The federal legislative response to the Enron scandal, among others, was the Sarbanes-Oxley Act of 2002, "a securities regulation smorgasbord."¹⁶ One of the primary changes that Sarbanes-Oxley made to federal securities law was the creation of the Public

Company Accounting Oversight Board. The Act requires that CPA firms that prepare financial statements for public companies register with the PCAOB.

The Act also limits non-auditing services that can be provided by a CPA firm to a company at the same time as it audits the financial statements of that company. Further, it required the SEC to adopt accounting rules on disclosure of off-balance sheet transactions. The Act requires financial statements to be certified by the company's chief executive officer and chief financial officer. It also enhanced the requirements for independence of public companies' boards of directors and their audit committees.

DODD-FRANK

In 2008, the international economy was crippled by the bursting of another bubble: the inflated value of real estate in the United States, which was driven in part by the low cost of credit. Governments of industrialized countries around the world intervened in their banking systems to keep the crisis from worsening. In the United States, Congress passed the Emergency Economic Stabilization Act of 2008, which authorized the \$700 billion Troubled Asset Relief Program. TARP was meant to liquefy the frozen credit markets by injecting cash into the banks.

The TARP Congressional Oversight Panel summarized the history of the housing bubble as follows:

U.S. housing prices reached their high-point in mid-2006. At the market's peak, the average cost of a home was more than twice what it had been just six and a half years earlier, a remarkable annual growth rate of nearly 12 percent. Housing construction had likewise surged to an unsustainable annual rate of 2.15 million new privately owned units, and by 2006 unsold inventory began to pile up. Then housing prices began to ebb. The decline was initially not dramatic – prices fell by less than 3 percent over the next 12 months. But it was enough to undermine a key assumption behind the financial instruments that provided much of the support for the U.S. housing bubble – that housing prices never go down, at least not on a sustained nation-wide basis.¹⁷

As soon as home prices began to fall, borrowers in the “subprime,” that is, high-risk, mortgage market began defaulting on mortgages that became unaffordable. These mortgages had been premised on the assumption that borrowers would be able to refinance before their mortgages reset to higher rates. Many of these mortgage loans had been pooled together so that they could be sold on the secondary market. The result was a mortgage-backed security, that is, “any investment security representing an interest in, or secured by, one or more pools of mortgage loans.”¹⁸

The use of mortgage-backed securities helped provide the access to credit which inflated the real estate bubble. Investors believed these securities were safe, in part because ratings agencies gave the highest investment grade rating to securities which were interests in pools of subprime mortgages. These ratings obscured disclosure of the risks attendant to investment in subprime mortgage pools.

Professor John Coffee states that it is not only the issuers of securities who investors rely on for adequate disclosure of risk:

Debacles in the financial markets usually have their roots in the failure of one (or more) ‘gatekeepers.’ Gatekeepers are the ‘reputational intermediaries’ on whom investors depend: auditors, securities analysts, investment bankers, credit-rating agencies, and sometimes attorneys. They pledge the reputational capital that they have developed over many years and many clients so that investors will trust the statements they make about a particular client. Investor trust and confidence depend on the credibility of the gatekeepers”¹⁹

Traditionally, it was difficult for a given client to exert undue influence on ratings agencies because they rate thousands of clients; losing one would have little effect. The advent of mortgage-backed securities, among other asset-backed securities, changed the relationship between ratings agencies and their clients. “Not only was it far harder and hence more profitable to rate a securitized pool of assets, but investment banks assembled these pools and brought them to the rating agency to negotiate the rating before they were marketed.”²³ Now, half of some ratings agencies' business comes from asset-backed securities, and these fees are paid by investment banks.

Rating agencies are hesitant to downgrade securities. For example, Enron's rating was not adjusted until four days before it filed for bankruptcy. Professor Coffee observed:

A rating agency earns no additional revenues from downgrading outstanding securities, but it does risk offending powerful clients – the issuer, its investment bank, and the institutional investors who hold the rated securities in their portfolio. No one is made happier by a down-grading, and many are outraged. Thus, downgradings tend to be delayed and seem to be motivated mainly by the fear that investment grade-rated securities might imminently default. In this respect, ratings downgrades are less prophecies of the future than slightly premature obituaries for terminally ill bonds.²⁰

Indeed, the conflicts of interest involved in the rating of mortgage-backed securities have created what appears to be a double standard in ratings: In a five year period, the default rate on corporate bonds with Moody's lowest investment grade rating (Baa) was 2.2%, while the default rate on mortgage-backed securities with the same rating was 24%.²¹

Congress responded to the Great Recession with the Dodd-Frank Wall Street Reform Act of 2010. The lengthy Dodd-Frank Act provides for many reforms of the financial services industry, including more extensive regulation of credit rating agencies: The Act increases internal controls, requires greater transparency of rating procedures, provides investors with a private right of action and gives the SEC greater examination and enforcement powers.²²

The Act also created the Financial Stability Oversight Council, to serve as an early warning system identifying risks in firms and market activities, and the Office of Financial Research, which has the power to gather vast amounts of market data, which are disclosable under the Freedom of Information Act.²³

Other disclosure requirements of the Dodd-Frank Act include pay and performance disclosure, requiring companies to disclose the relationship between a company's executive compensation actually paid and its financial performance, including the value of the company's shares, dividends and distributions. It also requires the SEC to issue rules requiring companies

to disclose the median annual total compensation of all employees, except the CEO, the annual total compensation of the CEO, and the ratio of the median employee annual compensation to annual total compensation to that of the CEO.²⁴

THE FUTURE

Our capitalist free-market economy works most efficiently when investors have access to the information necessary for them to make enlightened decisions about whether to purchase an interest in a company, or take the "Wall Street Option" and sell. The amount and quality of disclosure about public companies impact the capital markets and the economy as a whole.

History suggests that failures of the regime of disclosure of all material facts relating to securities will, at some time in the future, contribute to economic adversity. Just how, of course, is difficult to predict. Professor Coffee observed that, "each financial scandal, like Tolstoy's unhappy family, is pathological in its own way."²⁵

Stay tuned.

Notes

¹ Ecclesiastes 1:9 (King James).

² Stephen Killik, *The Work of the Stock Exchange* 12 (2d ed., 1934).

³ 11 H.C.H. 595 (1696).

⁴ Louis Loss, *Securities Regulation* 5-6 (4th ed. 2006) (citations omitted).

⁵ Adam Smith, *The Wealth of Nations*, 800 (Random House 1994) (1776).

⁶ Kan L. 1911, ch (33).

⁷ Loss, *supra*, at 53 (citations omitted).

⁸ Loss, *supra*, at 61 (citations omitted).

⁹ Doris Kearns Goodwin, *The Fitzgeralds and the Kennedys* 331-35, (Simon and Schuster, 1987).

¹⁰ *Id.* at 337-38.

¹¹ *Id.* at ch 26, 445-46.

¹² Harlan F. Stone, *The Public Influence of the Bar*, 48 *Harv. L. Rev.* 1 (1934).

¹³ Goodwin, *supra*, 449.

¹⁴ Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 *Wash. U. L.Q.* 449, 451-52 (2002).

¹⁵ William C. Powers, Jr. et al., *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.* 5 (2002).

¹⁶ Harold S. Bloomenthal, *Sarbanes-Oxley in Perspective*, §1.10 (Westlaw 2009).

¹⁷ TARP Cong. Oversight Panel (Dec. 9, 2009).

¹⁸ Publisher's Editorial Staff, *Mortgage-Backed Securities*, § 1.1 (Westlaw 2010).

¹⁹ John C. Coffee, Jr., *The Mortgage Meltdown and Gatekeeper Failure*, Sept. 20, 2007 N.Y.L.J. 5.

²⁰ *Id.*

²¹ Charles Calomiris and Joseph Mason, *Reclaim Power From the Ratings Agencies*, *Financial Times*, Aug. 24, 2007, 11.

²² Davis Polk & Wardwell, LLP, *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act 75* (2010).

²³ *Id.* at 20.

²⁴ *Id.* at 86.

²⁵ Coffee, *supra*.

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EDITORIAL

By: Martin A. Hewitt
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Every so often, something happens which makes us stop, take a breath, and reassess life in general and the practice of law specifically. On a day-to-day basis we all interact in a businesslike and professional manner with practitioners and regulators alike. But there is much more about these myriad relationships than meets the eye and when something unexpected happens we come to understand that the people we interact with on a daily basis are more than just lawyers and regulators. We realize, often too late, that they are unique individuals who bring something more profound to the table than just their professional abilities.

One of those people was David Weaver, General Counsel of the Texas Securities Board. David died unexpectedly on June 1, 2010. He was a true and gifted leader who had an understanding and appreciation for the common goals of investor protection and capital formation. He understood that each of these goals is essential to a robust and balanced regulatory system. While David's many accomplishments are well known both in Texas and around the country, what made David truly special was his ability to see more than just two separate sides of an argument. He was able to work with diverse interest groups and reach well-thought-out

solutions to the complicated issues of the day. He understood the importance of humor and good will in diffusing contentious situations. While his responsibilities were many, he never took himself too seriously.

At the end of the NASAA Conference last year in Denver, there were many people relaxing at the bar. Many had already changed from suits to more casual attire. David had changed to jeans and I was still dressed in suit and tie, complete with suspenders. When David saw me, he took one look at the suspenders and yelled out across the bar "It's Gordon Gekko! Get him!!" That was typical of David, full of life, vitality, and good humor.

If there is such a thing as a regulatory legacy, David's is the understanding that the regulatory world need not be adversarial. It can be collaborative and, if not always harmonious, at least not too discordant. Harmony and discord were of particular importance to my friend who was a true musician. I considered David more than a regulator, I considered him a friend and colleague. We didn't always agree on the issues of the day, but with David, you knew your argument, your opinion, was of the utmost importance.

Photo Credit: For those of you who don't recognize our new Committee mascot on the Blue Sky Bugle masthead, it is a "blue footed booby." Alan Parness took this photo in the Galapagos Islands in May, 2010.

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