THE BLUE SKY BUGLE

A Newsletter for Blue Sky Lawyers

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EVENTS CALENDAR

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ABA BUSINESS LAW SPRING MEETING
The Committee 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 ANNUAL MEETING
The Committee will meet in conjunction with the ABA Annual Meeting
Westin Harbour Castle Hotel
Toronto, Ontario, Canada
August 5-8, 2011

NASAA 2011 ANNUAL CONFERENCE
The Committee will meet in conjunction with the Annual Conference of the North American Securities Administrators Association
Wichita, KS
September 11-13, 2011

ABA BUSINESS LAW SPRING MEETING
The Committee will meet in conjunction with the 2012 Spring Meeting of the ABA Business Law Section
Caesar's Palace
Las Vegas, NV
March 22-24, 2011

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FROM THE CHAIR – RANDOM RANTS AND RAVES

By: Alan M. Parness
Cadwalader, Wickersham & Taft LLP

A. <u>NASAA's Continuing War on Rule 506 Offerings</u>

For a number of years, the North American Securities Administrators Association (“**NASAA**”) has vigorously campaigned for the repeal of Section 18(b)(4)(D) of the Securities Act of 1933 (the

"**Securities Act**"), as amended by the National Securities Markets Improvement Act of 1996 ("**NSMIA**"). No doubt at NASAA's urging, an outright repeal provision was actually included as Section 928 of a Discussion Draft of Senator Dodd's proposed "Restoring American Financial Stability Act of 2009," circulated back in November 2009 (available at http://banking.senate.gov/public/_files/AYO09D44_xml.pdf). That provision was replaced by Section 926 of Sen. Dodd's initial draft "Restoring American Financial Stability Act of 2010," circulated on or about March 15, 2010 (available at http://banking.senate.gov/public/_files/ChairmansMark31510AYO10306_xmlFinancialReformLegislationBill.pdf), which proposed amendments to Securities Act § 18(b)(4)(D) which would require that the SEC (and, if need be, the states) conduct an unworkable and incomprehensible series of reviews to determine whether a particular Rule 506 offering should be designated as "covered securities." Sen. Dodd tinkered further with Section 926 by the time his bill was formally introduced as S. 3217 on April 15, 2010 (available at http://www.gpo.gov/fdsys/pkg/BILLS-111s3217pcs/pdf/BILLS-111s3217pcs.pdf), but the provision was still clearly impracticable (see also the discussion of Section 926 of S. 3217 in S. Rep. 111-176 (2010) at 113, available at http://www.gpo.gov/fdsys/pkg/CRPT-111srpt176/pdf/CRPT-111srpt176.pdf). While I won't belabor you with the rest of the legislative history, thankfully, due to the efforts of industry lobbyists, Section 926 was totally overhauled by the time the "Dodd-Frank Wall Street Reform and Consumer Protection Act," Pub. L. No. 111-203 (the "**DFA**"), was signed into law on July 21, 2010, so as to limit the provision to mandating the SEC to adopt rules creating "bad boy" disqualifications from use of Rule 506.

Unfortunately, not willing to concede that they lost this battle once again, NASAA persists in its war against Rule 506 offerings, despite little hard evidence to show that fraud is pervasive in the tens of thousands of offerings claiming reliance on this exemption and, in turn, "covered securities" status under Securities Act § 18(b)(4)(D). Thus, NASAA's "Pro-Investor Legislative Agenda for the 112th Congress," released on February 2, 2011 and available at http://www.nasaa.org/content/Files/2011_Legislative_Agenda.pdf, includes the following as part of "Core Principle Three: Strengthen State/Federal Collaboration":

> "**Regulation D, Rule 506 offerings**. In 2009, 26,485 Regulation D, Rule 506 offerings were filed with the SEC with an estimated offering total of $609 billion. That compares to 11,000 such offerings in 1996. As a result of the National Securities Markets Improvement Act of 1996, these private placements were largely "off the radar screen" since states are preempted from reviewing offerings under Rule 506 before they are marketed to investors and the SEC generally does not review them. These offerings also enjoy an exemption from registration under federal securities law, so they receive virtually no regulatory scrutiny. Some courts have even held that offerings made under the guise of Rule 506 are immune from scrutiny under state law, regardless of whether they actually comply with the requirements of the rule. As a result, Rule 506 offerings have become the favorite vehicle under Regulation D, and many of them are fraudulent.
>
> "Although Congress preserved the states' authority to take enforcement actions for fraud in the offer and sale of all "covered" securities, including Rule 506 offerings, this power is no substitute for a state's ability to scrutinize offerings for signs of potential abuse and to ensure that disclosure is adequate before harm is done to investors.
>
> "State securities regulators appreciate congressional action to include in Dodd-Frank a provision to strengthen investor protection from securities law violators by including the disqualifier language to prevent recidivist violators of the law from conducting securities offerings under SEC Regulation D, Rule 506.
>
> "However, in light of the growing popularity of Rule 506 offerings and the expansive reading of the exemption given by certain courts, NASAA believes the time has come for Congress to reinstate state regulatory oversight of all Rule 506 offerings by repealing Subsection 18(b)4(D) of the Securities Act of 1933."

As some of you may recall, in my column for the April 2010 issue of the *Bugle*, I analyzed all of the criminal and administrative proceedings for 2009

reported on the Texas State Securities Board's ("**SSB**") website, to determine how many of them involved a defendant or respondent who had claimed reliance on Rule 506 or had effected a Form D filing with the SEC or the SSB. Based on my review, I determined that only one of the entities referenced in the 34 criminal cases reported by the SSB had made a Form D filing with the SEC, although there was no indication that the entity was charged in, or was otherwise a target of, that proceeding. As regards the 15 cease-and-desist administrative proceedings reported by the SSB, Form D filings were made with the SEC by only two of the entities named, but neither order indicated whether a notice filing had been made with the SSB or whether the issuer had otherwise asserted state preemption by reason of Rule 506.

Now that David S. Massey, Deputy Securities Administrator of the North Carolina Securities Division (the "**NCSD**"), has assumed the mantle of President of, and principal spokesman for, NASAA, I thought it would be appropriate to analyze recent enforcement proceedings brought by the NCSD to determine whether Rule 506 offerings have been a significant problem in his state. Accordingly, I reviewed orders (both temporary and final) issued in 14 matters reported from March 3, 2009 through October 22, 2010, all available on the NCSD's website at http://www.secretary.state.nc.us/sec/actions.aspx#part. It is noted that 8 of the 14 matters reported involved temporary and final orders issued in 4 separate proceedings; accordingly, there are actually only 10 separate proceedings involved.

In analyzing these 10 proceedings, it appears that only 2 of the 10 involved alleged Rule 506 offerings. In the most recent one (File No. 08-SEC-141), an Order of Summary Suspension was issued on March 2, 2010 against Jotham Walker Pruitt, CinchPoint, Inc., d/b/a CinchPoint Financial Services, and Ramses Capital Partners, LLC. The NCSD alleged, in relevant part, that Pruitt, a registered investment adviser representative in North Carolina, and CinchPoint, a registered investment adviser in North Carolina controlled by Pruitt, offered and sold limited liability company interests in Ramses, a purported hedge fund managed by CinchPoint and Pruitt, from August 2006 through October 2008 while claiming exemptions under federal and state securities laws. Ramses allegedly filed nothing with the SEC or North Carolina until October 2008, when it made a notice filing claiming reliance on Rule 506 [according to EDGAR, a Form D was filed by Ramses on October 21, 2008, under CIK No. 0001446900]. The NCSD charged that the respondents' claim in Ramses' offering materials that the offering was exempt from federal and state securities registration for the pre-filing period "was not true or legally correct." The NCSD also charged the respondents with misrepresenting the manner in which Ramses' assets would be invested and providing inaccurate, false and misleading financial and non-financial information, thereby violating Rule 502 of Regulation D and rendering Rule 506 unavailable to Ramses. In addition, Pruitt and CinchPoint were charged with offering and selling interests in two other investment funds they managed (which funds were not separately named as respondents) by means of inaccurate, false and misleading information, essentially because the offering materials for those funds didn't include accurate information about the operation of Ramses and the activities of Pruitt and CinchPoint. Interestingly, the Order only suspended Pruitt and CinchPoint's investment adviser and investment adviser representative registrations in North Carolina, while no action was taken against Ramses. According to the December 2010 issue of the NCSD's Newsletter, available at http://www.secretary.state.nc.us/sec/newsletter.aspx, Pruitt and CinchPoint have requested a hearing on the order, so this matter may still be continuing.

In the other proceeding involving an alleged Rule 506 offering (File No. 07-011-RF), a Final Order to Cease and Desist was entered on January 6, 2010 against Mason Barnes, Bradley Kirk Turner, and Kentucky Mountain View Petroleum, Inc. According to the Temporary Cease and Desist Order issued on November 2, 2009 against the same respondents, the NCSD alleged, in relevant part, that the respondents offered interests in KMVP to a single North Carolina investor with whom they had no prior relationship via the Internet (the investor allegedly submitted a form via a "pop-up window" and received a telephone call from Barnes regarding KMVP's business). While the respondents claimed reliance on Rule 506, the NCSD alleged that they employed general solicitation or advertising, and, consequently, Rule 506 was unavailable. As reflected in the Final Order, none of the respondents filed to request a hearing, submitted pleadings, or otherwise appeared in the proceeding, so the Order was entered by default.

As was the case with the criminal and administrative proceedings reported by the SSB, it is submitted that

the fact that only 2 out of 10 administrative proceedings reported by the NCSD involved alleged Rule 506 offerings over a two-year span is not exactly convincing evidence that fraud is rampant in such offerings in North Carolina. Query also how many notice filings were made with the NCSD by issuers claiming reliance on Rule 506 during the same periods covered by these 2 proceedings?

Further, despite the lack of overwhelming evidence to support their cause, why does NASAA remain so adamant that investors are truly endangered by Rule 506 offerings, and that Securities Act § 18(b)(4)(D) must be repealed in the interest of investor protection? I hate to sound cynical, but I wonder whether the states' real interest here is imposing higher fees for registration filings in lieu of notice filings, and justifying more staff and larger budgets for state securities administrators' offices?

What would be most interesting would be an empirical study by an unbiased academic, showing to what degree: (1) prior to NSMIA, states regularly uncovered and prevented fraudulent Rule 506 offerings before sales took place, by means of the regulatory scheme in place at that time (remember, Rule 506 predated NSMIA by over 14 years, and many states required pre-offering filings by issuers during that period as a condition of relying on so-called "Uniform Limited Offering Exemptions" or similar private offering exemptions); and (2) state fraud cases against claimed Rule 506 offerings have increased dramatically since the advent of NSMIA. For my part, I believe it is doubtful that any such results would ever be shown.

B. The SEC's Rule Proposals for "Mid-sized" Investment Advisers under the DFA

As discussed at length in my column in the December 2010 issue of the *Bugle*, Title IV of the DFA added, among a host of other changes affecting the bifurcated regulation of investment advisers between the SEC and the states, a new Section 203A(a)(2) to the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"). Under DFA § 410, entitled "Treatment of Mid-sized Investment Advisers," effective July 21, 2011, unless an adviser: (a) advises a registered investment company or business development company; (b) would be required to register with 15 or more states; (c) has its principal office and place of business in a state where it isn't subject to investment adviser registration or where, if registered, it wouldn't be subject to examination as an adviser; (d) qualifies for one of the exemptions in SEC Advisers Act Rule 203A-2; or (e) obtains an exemptive order from the SEC pursuant to Advisers Act § 203A(c), which authorizes the SEC to exempt a person, upon application, from the conditions of Section 203A(a), upon a finding that "the application of subsection (a) would be unfair, a burden on interstate commerce, or otherwise inconsistent with the purposes of this section," the adviser will have to meet a higher threshold of $100 million of assets under management ("**AUM**") in order to qualify for SEC registration under the Advisers Act.

In SEC Release No. IA-3110 (Nov. 19, 2010), 75 Fed. Reg. 77052 (Dec. 10, 2010) ("**Release IA-3110**"), available at http://www.sec.gov/rules/proposed/2010/ia-3110fr.pdf, the SEC announced some of its proposed amendments to Advisers Act rules and forms in response to certain provisions of DFA Title IV. As regards DFA § 410, the SEC proposed to revise a variety of rules, as well as Form ADV and the instructions thereto, to explain how to determine whether a "mid-sized adviser" within the meaning of Advisers Act § 203A(a)(2)(B) is "required to be registered" or is "subject to examination" by the state in which it maintains its principal office and place of business, and how advisers may switch from state to SEC registration, or vice versa.

On January 31, 2011, our Committee, jointly with the Committees on Federal Regulation of Securities and Private Equity and Venture Capital of the ABA Business Law Section, submitted a comment letter to the SEC concerning Release IA-3110 (the "**ABA IA-3110 Comment Letter**"); a copy of that letter, which I trust you will find self-explanatory, is available at http://sec.gov/comments/s7-36-10/s73610-66.pdf. Our representatives to the Drafting Committee for the letter – myself, Robert Boresta, Ellen Lieberman, and Martin Miller – primarily focused on provisions in the proposals in Release IA-3110 relating to state registration and regulation of advisers.

Interestingly, as reflected in Part IV of the ABA IA-3110 Comment Letter, there was a schism among the Drafting Committee members concerning whether the proposed "regulatory assets under management" test for purposes of Advisers Act § 203A should be a total assets test (as proposed by the SEC), or a net assets test. This difference in opinion arose as a

result of concerns regarding possible inconsistencies between the ABA IA-3110 Comment Letter and comments raised by the other two Committees in a joint comment letter they submitted at the same time, concerning SEC Release No. IA-3111 (Nov. 19, 2010), 75 Fed. Reg. 77190 (Dec. 10, 2010) ("**Release IA-3111**"). In that letter, the other two Committees espoused a net assets test for purposes of calculating whether an adviser would exceed the $150 million of AUM cap in the new "private fund adviser" exemption in Advisers Act § 203(m), as added by DFA § 408, and proposed Rule 203(m)-1 thereunder. Our representatives to the Drafting Committee for the ABA IA-3110 Comment Letter, however, sought a total assets test for purposes of calculating the $25 million and $100 million of AUM thresholds in Advisers Act § 203A. While the majority view won out, the ABA IA-3110 Comment Letter acknowledges our dissenting view in footnote 3 on page 10.

It is noted that NASAA submitted a comment letter on February 10, 2011, concerning both Release IA-3110 and Release IA-3111; a copy of NASAA's letter is available at http://www.sec.gov/comments/s7-36-10/s73610-69.pdf. Of particular interest is comment 5 of NASAA's letter concerning IA-3110, where NASAA expresses its support for the SEC's proposal regarding confirmation of states' investment adviser examination practices. As indicated in Part II.C on pages 3 – 4 of the ABA IA-3110 Comment Letter, we believe that the individual states should affirm annually that they perform investment adviser examinations on a "formal cyclical" basis, and not just on a "random or ad hoc" basis.

Of course, it remains to be seen to what degree the SEC accepts any of the comments submitted; the new Advisers Act rules need not be in place until July 21, 2011, when the DFA amendments become effective.

BLUE SKY BITS AND PIECES

By: Ellen Lieberman
Debevoise & Plimpton LLP

Texas Securities Commissioner **Denise Voigt Crawford** retired at the end of February, 2011, having spent 29 years at the Texas State Securities Board, of which 17 were in the top position. She served two separate terms as President of NASAA. In her most recent term as President, she led state regulators at a time when investor interests were very much in the fore, culminating in the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Texas Securities Deputy Commissioner **John R. Morgan** also retired at the same time, having joined the Texas State Securities Board in 1983, serving 13 years in the Enforcement Division (Director of the Division for eight of those years), and 14 years as Deputy Commissioner. **Benette L. Zivley** was appointed as the successor Texas Securities Commissioner. Previously he served as Director of the Inspections & Compliance Division of the Texas Securities Board since 2003 and before that at an attorney in the Enforcement Division since 1999. He was awarded the NASAA Distinguished Service Award in 2009 for his work representing NASAA and Texas on auction rate securities cases and other regulatory issues. He graduated from Thurgood Marshall School of Law at Texas Southern University and from Sam Houston State University.

Ralph A. Lambiase retired as the Director of the Connecticut Department of Banking, Securities and Business Investments Division in February 2011. Beginning in 2003 he served a term as NASAA's President. He was the recipient in 2007 of the Distinguished Managerial Service Award for exemplary leadership in state service. He joined the Department of Banking in 1977 as Director of Securities Enforcement and Registration, and was named Division Director in 1987.

Marc B. Minor, Bureau Chief of the New Jersey Department of Law & Public Safety, Bureau of Securities since 2009, was named chief of the New York Attorney General's Investor Protection Bureau. Prior to that, he was an Ohio assistant attorney general and then assistant state public defender, he worked in the New York Investor Protection Bureau from 2002 to 2004 on Wall Street malfeasance and misconduct cases under Eliot Spitzer, he was enforcement counsel for the Philadelphia Stock Exchange and then he was senior counsel at the Financial Industry Regulatory Authority. He is a graduate of Howard University School of Law.

Michele A. Kulerman, Vice Chair of our Committee and formerly at Hogan Lovells US LLP in Washington, D.C., was named Counsel at Skadden, Arps, Slate, Meagher & Flom LLP in January, and intends to move from D.C. to New York later this year where she will work from the Skadden Arps

New York office. She is a graduate of Stanford University and Southwestern School of Law.

Peter D. Hutcheon, a member of the Somerville, New Jersey, firm of Norris McLaughlin & Marcus, P.A. and our Committee's long time liaison for New Jersey, will be practicing law from his firm's New York City office. He practices in the areas of business, securities, banking and financial services and mergers and acquisitions law and is admitted to the bars of both New York and New Jersey. He received his B.A. from Williams College, magna cum laude, and his J.D. cum laude from Harvard. For 16 years he edited the Pubogram, newsletter of the ABA's Section on Business Law, Partnerships and Unincorporated Business Organizations Committee. He received that Committee's 2005 Martin I. Lubaroff Award for service. He has also been director and chair of the New Jersey State Bar, Corporate and Business Law Section, chaired its Banking Law Section and chaired the ABA's Section of Science and Technology and served as Editor of its quarterly journal, Jurimetrics.

We welcome **Mark C. Dinkinson** of Nyemaster Good, P.C., in Des Moines, Iowa as the Committees new liaison for the State of Iowa. He is a member of the firm's Business, Finance, and Real Estate Department, and practices in the area of corporate and transactional law, including securities and corporate finance, insurance regulatory matters, mergers and acquisitions, corporate governance, and franchising. A graduate of Grinnell College, he received his law degree with distinction from the College of Law at the University of Iowa. Previously he clerked for Judge Harvey Uhlenhopp of the Iowa Supreme Court.

We are also pleased to report that **Ryan Rivchun** has become our Committee's representative Director on the ABA Business Law Section Technology Committee. He is a graduate, magna cum laude and order of the coif from Case Western School of Law in Cleveland. After several years of practice at a boutique business and real estate firm, he recently started his own practice in Ohio.

The author is delighted to announce the birth of two grandchildren born to daughter Lisa and her husband Bill Nelson. Twin girls were born on March 17 (St. Patrick's Day), Alexandra Daisy Nelson weighing 3 lbs, 5 oz, and Lily Paige Nelson weighing 3 lbs, 12-1/2 oz.

NASAA PRESIDENT'S PERSPECTIVE ON PENDING REGULATION

By: David Massey
NASAA President and North Carolina Deputy Securities Administrator

In State securities regulators throughout the United States this year are observing the centennial anniversary of the nation's first "Blue Sky" law and our role in protecting investors.

A century ago, Kansas Banking Commissioner Joseph Dolley took a stand against stock speculators running rampant in Kansas and urged state legislators to act.

In his 1910 report to state legislators, Dolley recommended lawmakers pass a law requiring "all parties who offer stocks and bonds for sale in Kansas to register with some department of state, setting forth in detail their securities, and requiring them to furnish any other information that said department may demand of them, and to submit to a full examination of their affairs if said department should deem it advisable."

The legislature responded and on March 10, 1911, what became known as the Kansas Blue Sky law was signed into law. And with that, the past century of state securities regulation was born.

I hope you can join us for a centennial celebration this September as we launch the next century of investor protection at our annual conference in Wichita, Kansas.

A lot has changed in the last century. Reforms now taking shape at the national level are giving new authority to state securities regulators to address the challenges facing 21st century investors. For example, the Dodd-Frank Act recognized the strong investor protection role of state securities regulators by raising the threshold for state-registered investment advisers to $100 million from $25 million. By the time this provision takes effect, state securities regulators will oversee 75 percent of all IA firms. NASAA members continue to work with the SEC, as well as the affected regulated community, to ensure that the switch goes as efficiently and seamlessly as possible.

As Dodd-Frank continues to work its way through the implementation phase, NASAA members and investors continue to face many challenges.

I appreciated the remarks of SEC Commissioner Luis Aguilar in his opening statement at our annual 19(d) Conference on March 28, 2011. He called for regulators to unite to defend the "fundamentals of regulation," including enforcement, against an attack "on multiple fronts," from underfunding the SEC to industry efforts to claw back or delay implementation of various Dodd-Frank Act provisions.

Commissioner Aguilar also correctly observed that "the Dodd-Frank Act provides the opportunity to address many of the problems that were evident in the financial crisis." Nevertheless, the political dynamics in D.C. have changed since the 2010 midterm elections. It is sobering to read that momentum is gaining for the "Financial Takeover Repeal Act," a Senate measure to repeal Dodd-Frank. Six additional co-sponsors have joined Sen. Jim DeMint (R-SC) and his original 18 co-sponsors, bringing the total Senate support to 25. Meanwhile, the new Republican majority in the House continues its concerted efforts to derail investor protections outlined in Dodd-Frank through multiple oversight hearings, funding roadblocks and a number of bills proposing "corrections" to the reform law.

For example, the favorable outcomes of two major studies that were released by the SEC staff in late January – the Section 913 fiduciary duty study and the Section 914 SRO study – have become intertwined with politics and have taken a turn for the worse, from NASAA's point of view.

Industry calls for delay of the Section 913 fiduciary duty rulemaking have taken hold in the House Financial Services Committee. On March 17, 2011, the Chairman of the Capital Markets Subcommittee told SEC Chairman Mary Schapiro not to proceed with a rulemaking to impose a fiduciary duty for BDs. A letter, signed by 13 of the chairman's colleagues, argued that the SEC has not identified and defined clear problems to justify a rulemaking and does not have a solid basis to move forward. A week later, a leading Democrat on the Committee asked the SEC to do a cost-benefit analysis of a rulemaking – much like the dissent by SEC Commissioners Paredes and Casey.

Chairman Schapiro has been locked in a battle with House Republicans over the SEC's funding and the agency faces an uphill battle to win approval of its $1.4 billion budget request. We remain concerned that opposition to boosting the SEC's budget improves the chances that Congress may allow the SEC to designate one or more SROs to oversee investment advisers.

Each of these issues – fiduciary duty, investment adviser regulation and appropriate SEC funding – is spotlighted in NASAA's 2011 Pro-Investor Legislative Agenda. NASAA urges Congress not to undermine the new Dodd-Frank regulatory authority, either directly through legislative repeals or indirectly through a lack of appropriate funding.

Getting the Dodd-Frank provisions that benefit investors implemented correctly is not the only focus of my NASAA presidency. When I took office in September 2010, I pledged to work toward strengthening the relationship between state securities regulators with both the SEC and FINRA, with an eye toward how our shared responsibilities can better protect investors. Collaboration between regulators is especially important so that we may leverage our investor protection resources.

The NASAA Board of Directors has approved a new Board-level SRO Liaison Committee chaired by Patty Struck of Wisconsin. Members of the group include Melanie Lubin of Maryland, Keith Woodwell of Utah, Marc Minor of New York and until recently, Ralph Lambiase of Connecticut. The group's purpose is to meet regularly with a delegation of FINRA representatives to discuss issues of common interest and to strengthen our working relationships. This committee has met twice with FINRA, and I believe it is making progress on such issues.

NASAA has also engaged in an ongoing dialogue with the SEC about the implementation of Dodd-Frank. After one hour-long discussion with Chairman Schapiro, we agreed to get NASAA section chairs together with their SEC counterparts to develop cooperative and constructive working relationships on areas of common interest. This is a productive step in the right direction.

I believe the SEC is our partner and I am committed to restoring the bonds between us. While the SEC has been criticized for past enforcement problems, under the leadership of Chairman Mary Schapiro, the agency is showing a renewed determination to return to our joint mission of protecting the public from investment fraud.

The state-federal partnership is the critical element in an effective investor protection regulatory structure. Collaboration between regulators is vitally important because we must leverage our collective resources to protect investors. We're all in this fight together.

I appreciated seeing many of you at our Public Policy Conference last month in Washington. For those of you who were not at our policy conference, I want to note that former NASAA presidents Ralph Lambiase of Connecticut and Denny Crawford of Texas were awarded NASAA's highest honor, the Blue Sky Cube, for their many contributions to NASAA and our mission to protect investors.

We also presented Outstanding Service Awards to three of our former members who also recently retired or left state service: Mike Vargon of New Mexico, Bob Terry of Georgia and Larry Burton of Tennessee. And, during the 19(d) Conference, the recently retired Jim Clarkson was presented with an Outstanding Service Award for his many years of service to the SEC and for his excellent work as liaison to state securities regulators.

Remember what I said in Baltimore: my door is open. I look forward to hearing from you throughout the year.

BLUE SKY LAWS AND THE COMMERCE CLAUSE: AN ANALYSIS OF IN RE NATIONAL CENTURY FINANCIAL ENTERPRISES, INC. INVESTMENT LITIGATION AND ITS PRECEDENTS

By: Nikita Mehta, Esq.
Barron Samson LLP

The United States Constitution provides a fine balance between state regulation of securities and the Commerce Clause. In a recent 2010 decision, the Southern District of Ohio ruled that the application of the Ohio Securities Act to the issuance of fraudulent notes from an Ohio based company, but through non-Ohio buyers and sellers, would be an extraterritorial application of Ohio securities laws that violates the Commerce Clause of the United States Constitution. In re National Century Financial Enterprises, Inc. v. Investment Litigation, No. 2:03-md-01565 (S.D. Oh. Dec. 13, 2010). The decision at first glance seemed to overturn longstanding decisions that permitted States to regulate securities with any nexus to their state. *See, e.g.* A.S. Goldmen & Company, Inc. v. New Jersey Bureau of Sec., 163 F.3d 780 (3d Cir. 1999), and its progeny. However, reviewing the analysis in National Century suggests an incongruence with Goldmen that is ill-reasoned, but fails to overturn the applicability of Blue Sky Law to out-of-state transactions.

The U.S. Constitution prohibits a state from passing legislation that improperly burdens or discriminates against interstate commerce. Discriminatory laws that are simple economic protectionism or control extraterritorial conduct are per se violations of the commerce clause. City of Philadelphia v. NJ, 437 U.S. 617 (1978), and International Dairy Foods Association v. Boggs, 622 F.3d 628 (6th Cir. 2010). Where state statutes are directed to local concerns, and only incidentally burden interstate commerce, statutes will typically be upheld unless the burden imposed on interstate commerce is excessive in relation to the State's interest in regulating the subject matter. Pike v. Bruce Church, Inc., 397 U.S. 137 (1970). However, the extraterritorial principle "precludes the application of a state statute to commerce that takes place wholly outside of the State's borders, whether or not the commerce has effects within the State." Edgar v. MITE Corp., 457 U.S. 624, 642-43 (1982). Thus, insofar as the commercial activity takes place wholly outside a state's borders, a Court need not review whether the State has an interest in regulating the subject matter.

The Court in National Century creatively constructed an opinion in which the facts of the case did not meet the test of instate commercial activity. In the case, plaintiffs sued Credit Suisse Securities, LLC under the Ohio Securities Act which imputed strict liability to a person who "participated in or aided the seller in any way in making such a sale." O.R.C. § 1707.43(A). National Century issued fraudulent notes, and entered into two contracts with Credit Suisse to (1) a contract that permitted Credit Suisse to act as agent and financial advisor in connection with the marketing of note offerings and (2) Purchase and Agency Agreements that permitted Credit Suisse to act as the initial purchaser and placement agent of the notes issued by National Century. The notes were indisputably fraudulent, claiming to be backed by health care receivables when in reality the notes were backed by worthless or non-existent receivables from health care companies in which the National Century Executives held undisclosed ownership interests.

The issuance had indisputable connection to Ohio. National Century, the note issuer, was a company

with its principal place of business in Ohio. The purchaser/underwriter of the notes was Credit Suisse Securities, LLC, a Delaware corporation with a principal place of business in New York. The closings and delivery of the notes from the National Century subsidiaries to Credit Suisse took place in New York. Credit Suisse then sold notes from its New York office to a number of purchasers, the majority of which were not from Ohio. Only one purchaser had its principal place of business in Ohio, but the offer, sale and delivery of notes occurred in Illinois.

The Court in National Century concluded that "commerce" or "conduct" reached by the Ohio Securities Act was the securities transaction and not the fraud, and thus application of the Ohio Securities Act to this case would be an impermissible extraterritorial application in violation of the commerce clause. The Court based its decision on Morrison v. National Australia Bank Ltd., 130 S.Ct. 2869 (June 24, 2010). In Morrison, the Court opined on the extraterritorial reach of the federal securities fraud statute. Foreign investors had brought suit under §10(b) of the Securities Exchange Act of 1934, as amended (the "34 Act") against foreign and American defendants. The investors had purchased securities in an Australian bank whose stock was not traded on any U.S. exchange. The plaintiffs alleged that the stock's value had decreased because the bank had purchased HomeSide, an American mortgage company that was engaging in fraud when it represented the value of its mortgage services. Plaintiffs purchased securities from National Australia Bank, with a point of purchase in Australia.

The Court instead constructed a "transactional test," determining that the focus of the Exchange Act was not upon the place where the deception originated, but upon the purchases and sales of securities in the United States. The Court conducted a textual analysis of § 10(b), and found that because Congress made no clear statement of the statute's extraterritorial effect, the statute had no extraterritorial application. Reviewing the case with these two principles in mind, the Court in Morrison held that the absence of a sale in the United States or listing on the American exchange precluded the applicability of § 10(b).

The Court in National Century was mistaken in making comparisons to the Morrison case. The National Century Court incorrectly found that the Ohio Securities Act similarly focuses on the "purchase" and "sale" of a security, and that because none of the sales of purchases occurred within the State of Ohio, the Ohio Securities Act could not be utilized to impute liability upon Credit Suisse. The Morrison case involved the purchase of company stock whose underlying asset purchase was fraudulently valued. Plaintiffs in Morrison purchased National Australia Bank's securities, not securities in HomeSide. The National Century case, in contrast, involved the purchase and resale of securities that could be considered a singular transaction when viewed with the understanding of the securities marketplace.

The Southern District of Ohio erred in its decision by compartmentalizing the stages of securities sales, and ignoring the practicalities involved in the securities market. The Court's decision in National Century focused on plaintiffs' purchasing the notes from Credit Suisse and not National Century, noting that the arrangement between National Century and Credit Suisse involved the legal passing of title to Credit Suisse. However, the Court ignores the very nature by which securities are sold, that is through standby, best-efforts, or firm-commitment underwriting, only the latter of which involves the passing of title. Regardless of the type of underwriting, the sale of such securities through an underwriter to purchasers is part of the original distribution of the securities. Moreover, this interpretation would be consistent with federal securities case law which considers an individual as a statutory seller of securities whether title has passed to the individual or the individual solely solicits on behalf of the title owner. *See*, Pinter v. Dahl, 486 U.S. 622 (1988). The original distribution should, at most, be compartmentalized from the post-offering after market, as this stage of offering creates issues in tracing back to original distributors who would have more culpability if fraud were to occur. *See, e.g.* Abbey v. Computer Memories, Inc., 634 F. Supp. 870 (N.D. Cal. 1989) (refusing to ascertain statistical probability that shares purchased in the aftermarket came from a certain offering for liability under Section 11 of the 1934 Act). In contrast, the Morrison case involved a more tenuous connection between the purchaser of securities and the fraudulent purchase. Perhaps the purchase of securities in the post-offering aftermarket and from a state other than Ohio is too tenuous a connection to permit Ohio securities laws to have effect. However, the "transactional test" should permit the applicability of the Ohio securities laws to an original distribution emanating from Ohio.

The Court's holding seems to be in opposition to another constitutional challenge to blue sky law, the case of Goldmen. In Goldmen, the Third Circuit found that a New Jersey law prohibiting an in-state broker-dealer from selling securities of a New York Company that were registered in 16 states and sold to out of state purchasers from a New Jersey office was not an excessive burden on interstate commerce. In that case, the Court found that by offering the securities from a New Jersey office, the transaction could not be said to be "wholly outside" New Jersey, and thus, New Jersey had a legitimate interest in regulating the aspects of the transaction that occurred within its boundaries.

If the Court in National Century had a better understanding of the distribution of securities through various types of underwriting, the Court may have opined in a manner consistent with Goldmen. While the Third Circuit found that a simple phone call offering a security from New Jersey created a legitimate interest for New Jersey to regulate a security without offending the commerce clause, the Southern District of Ohio found that the issuance of securities from the State of Ohio would somehow utilize an extraterritorial application of Ohio securities laws. Certainly, a state regulatory authority would have far more legitimate interest in the issuance of fraudulent securities from within its boundaries than the placing of telephone calls from within its boundaries. Instead of finding parallels to Goldmen, the Court in National Century has created a dichotomy of case law – one that permits the reach of Blue Sky Law to a transaction offered from within the State, and another that disallows the reach of Blue Sky Law to a transaction that was issued from the State.

TIMING OF INVESTMENT ADVISER REGISTRATION

By: Martin A. Hewitt
Alston & Bird LLP

On April 8, 2011, the SEC sent a letter to NASAA regarding the timeline for implementing certain sections of the Dodd-Frank Act that relate to investment adviser registration. Specifically, while the SEC will complete its rule making functions by the July 21, 2011, deadline required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "DFA"), the SEC will consider providing additional time for investment advisers affected by such provisions to come into compliance.

Those investment advisers affected by this extension are mid-sized advisers (those with assets under management between $25 million and $100 million) and advisers who had previously relied upon section 203(b)(3) of the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Section 203(b)(3) was the federal de minimis exemption for advisers with fewer than 15 clients.

The reason additional time is needed for mid-sized advisers is based on the SEC's understanding that the Investment Adviser Registration Depository system (IARD) will require re-programming to accept advisers' transitional filings. Further, it is understood between the SEC and NASAA that such re-programming will take until the end of 2011 to complete.

While there are certain exemptions from registration with the SEC for advisers to venture capital funds and advisers to private funds with less than $150 million in assets under management in the United States, the SEC understands that additional time will be needed for advisers who must register with the SEC to fully comply with such advisers' obligations under the new rules.

The extension for both mid-sized advisers required to de-register with the SEC and register with the states, and advisers previously reliant upon exemption under section 203(b)(3) of the Advisers Act (thus requiring SEC registration) will be pushed back to the first quarter of 2012.

As for the need for mid-sized advisers to register in individual states, it should be noted that some states are permitting concurrent registration. This means that, advisers can, to the extent permitted by each jurisdiction, complete as much of the registration process as possible in those jurisdictions requiring registration while maintaining registration with the SEC as the process moves forward.

EDITORIAL

By: Martin A. Hewitt
Alston & Bird LLP

I'm sitting here looking at a sheet of blank paper asking, what is there to write about for this issue of the Blue Sky Bugle? The answer is that there is too much to write about. The SEC is in the process of writing myriad rules for myriad areas of securities

laws as required by Congress under the DFA. Further, the SEC is attempting to do this by a July 21, 2011 deadline, even though they are severely underfunded and lack the resources to accomplish their work.

Meanwhile, the fifty states and four territories are waiting for either the SEC or Godot, perhaps both, before promulgating the necessary rules or regulations. This assumes that the enabling statutes don't need to be updated to conform to securities laws in the twenty-first century.

Where does all of this leave practitioners, issuers, and investors? It leaves us all pretty darned confused. How can practitioners advise clients (whether issuers, broker-dealers, investment advisers, or investors), when the law is in such a state of flux or state of confusion? (Those two states are in addition to the other fifty!) The answer is that it leaves entire industries and investor groups adrift in a windless sea, without so much as a light breeze for direction.

Of course, this also explains the dearth of articles for this edition of the Blue Sky Bugle. Who wants to author an article which will forever be available on the internet which turns out to be something less than prescient? An important task for the Blue Sky Bugle is to exchange information and ideas. When could there be a more important time than now to write for the Blue Sky Bugle, when so much is subject to change. The articles published by the Blue Sky Bugle are read by a wide variety of people. It is not beyond reason that an article written by a practitioner could be read by and have an impact upon someone drafting legislation. Conversely, it is possible that an article written by a regulator could be read and have an impact upon a practitioner advising a client on the direction of the law in one way or another.

As editor of the Bugle, I am well aware of the time constraints under which we all find ourselves; however, this newsletter belongs to our entire community and our community has an obligation ne a duty to contribute to the development and practice of securities law at all levels.

Remember that the next deadline for articles is July 4, 2011.

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.

Below is a picture of the misty waters of Mirror Lake in New Hampshire. It depicts the less than crystal clear view we have of our regulatory world. It also provides the hope that at some point the mist will lift and we will be better able to navigate the waters ahead and perhaps reach a point of clear sailing.

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