



# THE BLUE SKY BUGLE

A Newsletter for Blue Sky Lawyers

Published by the ABA Committee on State Regulation of Securities

Volume 2011, Number 3, December 2011

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## EVENTS CALENDAR

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### **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, 2012

### **ABA BUSINESS LAW MEETING**

The Committee and its Subcommittees will meet In Conjunction with the ABA Business Law Section's 2012 Annual Meeting  
Chicago, IL  
August 3-6, 2012

### **NASAA 2012 ANNUAL CONFERENCE**

The Committee will meet in conjunction with the Annual Conference of the North American Securities Administrators Association  
San Diego, CA  
Hotel Del Coronado  
September 9-11, 2012

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## **INSPIRATION, ASPIRATION, PERSPIRATION**

*By: Shane B. Hansen – Committee Chair*  
Warner Norcross & Judd LLP

Virtually every good idea requires inspiration, aspiration, and perspiration to be achieved. Not only must the idea be inspired and aspired, most often it only becomes a reality with persistence, dedication, and hard work. An efficient and cost-effective system of state securities regulation that preserves

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and enhances investor protection has long been the inspired and aspired objective of regulators, industry, and their legal counsel alike, even though it may not always feel like a mutually shared objective. Several recent NASAA developments represent significant milestones on the path to this achievement, but there is much work to be done and there are some landmines along the way.

Implementation of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) during the first quarter of 2012 significantly retools the regulatory system applicable to investment advisers. Rules adopted under Title IV by the Securities and Exchange Commission (“SEC”) in June 2011<sup>1</sup> switch an estimated 3,200 SEC-registered investment advisers (sometimes referred to as “mid-sized advisers”) to state registration and regulation.<sup>2</sup> When the dust settles by June 28, 2012,<sup>3</sup> the states are expecting to regulate approximately 75 percent of all then-registered investment advisers.<sup>4</sup>

Even while the states and mid-sized advisers are collectively investing thousands of dollars and tens of thousands of man-hours to make this Congressionally-mandated switch go smoothly, draft legislation under consideration by U.S. House Financial Services Committee Chair Spencer Bachus (R-Ala) could re-engineer our bifurcated SEC-state regulatory system for investment advisers by prescribing the formation of a self-regulatory organization (“SRO”) for SEC-registered advisers<sup>5</sup>—likely including these soon to be state-registered mid-

sized advisers. Leaving aside our Congress’s dubious ability to pass significant legislation in an election year, and the wasted resources resulting from a Congressional “mulligan” for mid-sized advisers, this draft legislation should rivet attention on at least one critical policy-making consideration: how efficient and cost-effective will multi-state regulation be for mid-sized advisers? In the political process of assessing the comparative merits of a hybrid SEC-SRO system versus the existing SEC-state level system, significant attention will likely be paid to their comparative costs to taxpayers (both federal and state) and to the regulated advisers, as well as their effectiveness in protecting investors. Finding an appropriate balance among these and other considerations will be challenging given the widely divergent viewpoints.

A significant number of mid-sized advisers conduct business in multiple states and will soon be regulated in a multi-state environment.<sup>6</sup> How states handle the registration and regulation of these new registrants will vigorously test their ability to efficiently and cost-effectively apply the existing system of state-level regulation to larger and more sophisticated multi-state advisers. Those test results will assuredly factor into this policy debate. Whether or not those state-registered mid-sized advisers are swept along with SEC-registered advisers into a new SRO’s jurisdiction will be affected by the politically expressed views of those advisers. On grass-roots issues such as this, Members of Congress may be influenced by the views and voices of their many local constituents, perhaps even more than the influence of PACs and political payola. Kudos and compliments are seldom seen or heard in the political arena, but a loud political hue and cry is easily fomented from adversely impacted constituents.

In recent years the states have been highly effective in protecting investors, demonstrably recovering significant amounts of money for a large number of smaller investors.<sup>7</sup> However, the successes of

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<sup>1</sup> SEC Release No. IA-3221, *Rules Implementing Amendments to the Investment Advisers Act of 1940*, 2011 SEC LEXIS 2149 (June 22, 2011) (the “SEC Implementation Rules”).

<sup>2</sup> The SEC Implementation Rules describe mid-sized advisers as those having between \$25 million and \$100 million of regulatory assets under management.

<sup>3</sup> See the SEC’s Implementation Rules and NASAA’s IA Switch FAQ available at <http://www.nasaa.org/industry-resources/investment-advisers/ia-switch-faq/>.

<sup>4</sup> Testimony of Steven D. Irwin, Pennsylvania Securities Commissioner and Chairman, Federal Legislation Committee, North American Securities Administrators Association (“NASAA”) before the House Subcommittee on Capital Markets and Government Sponsored Enterprises, September 13, 2011, available at <http://www.nasaa.org/5587/ensuring-appropriate-regulatory-oversight-of-broker-dealers-and-legislative-proposals-to-improve-investment-adviser-oversight/>

<sup>5</sup> Section 914 of the Dodd-Frank Act required, and the SEC produced, a *Study on Enhancing Investment Adviser Examinations*, January 2011, addressing the need for enhanced examination and enforcement resources for investment advisers. The SEC’s recommendations did not address the role of state securities regulation.

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<sup>6</sup> The national *de minimis* exemption in Section 222, *State Regulation of Investment Advisers*, of the Investment Advisers Act of 1940, as amended (“Advisers Act”), allows an adviser to have up to five clients in a state before state registration is required. Amended SEC Rule 203A-2(d) permits SEC registration by advisers who are required to register with 15 or more states.

<sup>7</sup> See the Written Testimony of Heath Abshire, Arkansas Securities Commissioner and Chairman of NASAA’s Corporation Finance Section Committee, before the U.S. House Subcommittee on Capital Markets and Government Sponsored

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individual states, or groups of states coordinated through NASAA, to bring enforcement actions under state antifraud powers does not necessarily correlate with their ability to efficiently and cost-effectively regulate the vast supermajority of law-abiding investment advisers. State antifraud enforcement authority has always been preserved, even while Congress preempted and disenfranchised state regulatory authority in response to political pressure arising from inconsistent and uncoordinated administration of securities laws by the states.<sup>8</sup>

There is, however, good reason to hope that state-level regulation can be more consistently administered. Through strong leadership and state cooperation<sup>9</sup> NASAA's Investment Adviser Section has achieved several milestones on the path towards a more cost-efficient system of state-level regulation. These are remarkable achievements considering there are 49 states regulating investment advisers<sup>10</sup> through a variety of state governmental structures.<sup>11</sup>

On November 7, 2011, NASAA launched the Coordinated Review Program for SEC-registered advisers switching to registration in four or more states.<sup>12</sup> The Program provides a structure for the

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Enterprises, September 21, 2011, available at <http://www.nasaa.org/5941/legislative-proposals-to-facilitate-small-business-capital-formation-and-job-creation/> and NASAA's reported enforcement statistics at <http://www.nasaa.org/regulatory-activity/enforcement-legal-activity/enforcement-statistics/>. See also the SEC's 2011 Annual Performance and Accountability Report available at <http://www.sec.gov/about/secpar2011.shtml> and the reports by the SEC's Office of Inspector General available at <http://www.sec-oig.gov/>.

<sup>8</sup> See, for example, Section 203A(b)(2) of the Investment Advisers Act of 1940 and Section 18(c) of the Securities Exchange Act of 1934.

<sup>9</sup> Cooperation is, of course, the stated public policy in federal and most state securities laws. See Section 203A(d) of the Investment Advisers Act of 1940; Section 19(d) of the Securities Act of 1933, and Section 15(b)(7) of the Securities Exchange Act of 1934; Section 608 of the Uniform Securities Act (2002); and Sections 203, 412, and 420 of the Uniform Securities Act (1956).

<sup>10</sup> Wyoming's Uniform Securities Act, Wyo. Stat. Ann §§ 17-4-101 through 17-4-132, does not regulate investment advisers.

<sup>11</sup> As summarized in recent Congressional testimony given by NASAA President Jack Herstein, ten state administrators work under their respective secretaries of state, five work under their attorney general, some are appointed by their state governors and cabinet officials, some are employed by state government departments or state agencies, and others work for independent commissions or boards.

<sup>12</sup> More information about the Coordinated Review Program is available on NASAA's website at <http://www.nasaa.org/7425/investment-adviser-coordinated-review-program-frequently-asked-questions/>.

coordinated multi-state review and discussion of the registration applications and related submissions through a NASAA program coordinator. Each state will still communicate its own comment letter to an applicant, but only after those comments are discussed among the participating states' registration examiners. This discussion among examiners is intended to identify, coordinate, and resolve inconsistent requirements among states, thus reducing the burden on applicants and shortening the overall application processing time. Hopefully, this internal discussion will prompt examiners to consider whether their comments enhance investor protection or are merely personal preferences. While this program is designed to expire on March 30, 2012, if its administration and operation are viewed as successes by the states and participating applicants, it might serve as a template for other multi-state coordination and cooperation.

There is no better example of the necessity for coordinated reviews than the new Form ADV, Parts 2A and 2B.<sup>13</sup> Designed to be a free-writing document, wide latitude is explicitly given to advisers in addressing the prescribed items of content in the adviser's own words. These firm brochures and brochure supplements are to be written in plain English,<sup>14</sup> further widening the range of ways in which a particular adviser may describe its business, services, fees, practices, and conflicts. The initial experience of some advisers registering in multiple states has been decidedly mixed. Some registration examiners have insisted on writing the brochures their way, the only way. Managing multiple state versions of a brochure or any number of brochure supplements, or frequently republishing those documents, is an administrative nightmare, costly, and risky from a disclosure point of view. Since the application processes for multi-state registrations are about to kick into high gear, we hope that examiners will carefully consider whether their comments materially enhance investor protection or merely reflect personal preferences in the contents of these brochures.

In 2011, NASAA's Investment Adviser Section launched a detailed internal member survey of state investment adviser registration and regulatory

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<sup>13</sup> See SEC Release No. IA-3060; File No. S7-10-00, *Amendments to Form ADV* (Jul. 28, 2010).

<sup>14</sup> See the SEC's *A Plain English Handbook: How to create clear SEC disclosure documents*, available at <http://www.sec.gov/pdf/handbook.pdf>.

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practices. At last report, the Section had received responses from 47 of 49 states who regulate investment advisers and it is compiling those results for publication to members and, hopefully soon after, to the public. Several objectives can be achieved from this painstaking and time-consuming effort. First, the survey should identify the material differences among the states, which is the first step in assessing whether those differences enhance investor protection or merely add to the complexity and cost of multi-state regulation. Once known, material differences may be harmonized and immaterial differences may be eliminated. Second, when publicly disseminated, the survey's results should enhance transparency for advisers and their legal counsel. The results should mitigate the "desk drawer" policies and practices that are not easily found in a state's published rules, orders, interpretations, or website. For example, registrants can most efficiently address differences when they are known before application documents are prepared and submitted to a state. Third, the survey's results may serve as reference material for NASAA's examiner training programs.

The survey results may also be helpful in NASAA's implementation of the Memorandum of Understanding for the Sharing of Resources among the states.<sup>15</sup> Sharing examination resources is most efficient and cost-effective when examiners understand the similarities and differences in the administration of each state's laws and rules. The consistency of administration should also be enhanced through the roll-out of NASAA's Electronic Examination Modules database project, known as "NEMO." Not only should NEMO result in more consistent examination results, but the system will enable states to share access to completed examination reports. This sharing should allow an adviser's home state's examination report to be viewed by examiners in another state that may be considering or conducting a branch office examination. This may allow the other state to conduct an off-site desk audit, rather than a time-consuming and costly on-site examination. Clearly, NEMO has the potential for enhancing more efficient and cost-effective regulation, as well as enhancing investor protection.

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<sup>15</sup> See the Testimony of Steven D. Irwin, referenced in footnote 4 above.

Finally, during 2011 NASAA proposed and adopted a number of model investment adviser rules.<sup>16</sup> The formulation of these model rules have taken into consideration state variations, as well as the content of comparable SEC rules. Harmonizing state and SEC rules on the same subject matter is critical to mid-sized advisers so as to avoid unnecessarily retooling their compliance policies and procedures. The wide-spread adoption of these model rules is critical to improving the consistency and uniformity of professional standards of conduct and related regulatory oversight. Consistent rules enable states to more efficiently train and share examiners, and enable advisers to more efficiently and compliantly operate in a multi-state environment—both of these outcomes enhance investor protection.

NASAA's successes in establishing the Coordinate Review Program, the nearly 100 percent participation in its member survey, and its promulgation of updated model investment adviser rules all lay the groundwork for a more efficient and cost-effective state-level system of investment adviser regulation. A high degree of state participation and cooperation in utilizing these new tools is critical to maximizing the benefits of these initial successes. If these objectives are achieved, then in at least some camps the call for an SRO for mid-sized advisers may be muted.

With the restful holidays behind us, its time for everyone to roll-up their shirt sleeves—it's going to be a "sweaty" year ahead. Best wishes for a successful, prosperous and compliant new year!

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## **THE CURMUDGEON'S CORNER – SOME FURTHER THOUGHTS ON RULE 506 OFFERINGS**

*By: Alan M. Parness*

Cadwalader, Wickersham & Taft LLP

With the passing of the mantle of Committee chair to Shane Hansen, I thought it was time for a clever new alliterative title for what has become my regular column for *The Blue Sky Bugle*. Taking a cue from the late and great Andy Rooney, and in keeping with what, in my dotage, has become my reputation as a

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<sup>16</sup> NASAA's model rules are available at <http://www.nasaa.org/1325/adopted-model-rules/> and its model rulemaking proposals are available at <http://www.nasaa.org/regulatory-activity/nasaa-proposals/>.

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professional kvetch, I've decided to go with "The Curmudgeon's Corner." Since I know that many of our members can't get enough of this topic, this issue's column is devoted exclusively to Rule 506 issues.

A. Waiting for the "NASAA EFD"

*"It's simply great, mate, waitin' on the levee, waitin' for the NASAA EFD!"<sup>17</sup>*

In any event, as discussed in several of my past columns in the *Bugle* (most recently, in the September 2011 issue), representatives of the North American Securities Administrators Association ("NASAA") have been repeatedly promising, seemingly for ages, that NASAA's "one-stop filing system" (which has been assigned the acronym "EFD," for "Electronic Filing of Form D") for notice filings of offerings complying with Rule 506 ("**Rule 506**") of Regulation D ("**Regulation D**") promulgated by the U.S. Securities and Exchange Commission (the "**SEC**") under the Securities Act of 1933, as amended (the "**Securities Act**"), would be up and running in the near future. As another indication of how long the EFD project has been kicking around, I note that NASAA entered into a Memorandum of Understanding with the SEC back on *April 5, 2010* (the "**EFD MOU**") concerning the creation and operation of the EFD (*see*, [http://www.nasaa.org/wp-content/uploads/2011/08/EDF\\_MOU.pdf](http://www.nasaa.org/wp-content/uploads/2011/08/EDF_MOU.pdf); also reprinted at NASAA Reports (CCH) ¶¶ 3851 – 3852).

At the last NASAA Annual Conference in Topeka, Kansas in September, Willie Neumann, NASAA's outside consultant on the EFD project, aside from indicating his displeasure with my comments in the *Bugle* about the pace with which the EFD was being implemented, promised that the EFD would be up and running for "Beta testing" by mid-January 2012. Needless to say, I've seen no notice from NASAA about "Beta," "Gamma," "Delta" or any other testing program for the EFD, and, unless I missed it, a search

of NASAA's newly-configured website turned up no mention of the EFD, other than a copy of the EFD MOU. Further, an attempt (on December 29, 2011) to access the website "efd.nasaa.org," as referenced in paragraph 8.1 of the EFD MOU, turned up a blank page.

As I've said numerous times before, I fail to understand why the EFD system is still languishing, and I remind *Bugle* readers that the states have now been on notice for four and one-half years, since the issuance of SEC Release No. 33-8814 (June 29, 2007), reprinted at 72 Fed. Reg. 37376 (July 9, 2007), that the SEC would be switching to an electronic filing system for Form Ds and that the states should or would set up their own "one-stop" filing system. The repeated delays in implementing a functional EFD are inexplicable and inexcusable, and it's time for NASAA to get its act together (in this regard, how many states would look the other way if an issuer made a Rule 506 notice filing 4-1/2 years late?).

By the way, for those of you who didn't attend the NASAA Annual Conference, according to my notes, Mr. Neumann stated that Form D notice filers would be charged a flat fee of \$150 for the life of an offering to effect filings via the EFD, in addition to any state filing fees, and noted that imposition of that fee might make certain issuers' use of the EFD uneconomical. Thus, he said that states would be encouraged to make EFD filings optional, and not mandatory. That said, I note that the Texas State Securities Board amended its Rule 114.4(b)(1)(C), reprinted at 3A Blue Sky L. Rep. (CCH) ¶ 55,590S, effective June 21, 2011, to provide, with regard to notice filings for Rule 506 offerings:

"The filing of Form D and the payment of the filing fee *shall* be made electronically through the EFD System, when such system becomes available."

While I obviously support the concept of the EFD system, a small business issuer effecting a Rule 506 offering in one or two states shouldn't be forced to file via the EFD and pay out an additional \$150 fee on top of state filing fees (all of which fees, of course, reduce the offering proceeds and ultimately come out of investors' pockets). In certain states, the EFD fee will equal or exceed the state's own filing fee (*e.g.*, Colorado charges \$75, Connecticut charges \$150, Delaware has no filing fee, and a \$100,000

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<sup>17</sup> The parodied lyric above is with apologies to Lewis F. Muir (Music) and L. Wolfe Gilbert (Lyrics), who wrote "Waiting for the Robert E. Lee" back in 1913. The song became a hit for Al Jolson (*see*, <http://www.youtube.com/watch?v=PLqGNI5Jak> to listen to the 78 RPM recording), and was also featured in the 1941 movie musical, "Babes on Broadway," starring Mickey Rooney and Judy Garland, in which the song served as the musical's finale, performed in non-politically correct (at least nowadays) "minstrel style."

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offering in Texas would be subject to a \$100 filing fee). Thus, states should make EFD filings optional, and leave it up to issuers to decide whether use of the system makes economic sense to them.

#### B. SEC Rules Affecting Rule 506 Offerings

As our Committee members should know by now, the SEC was supposed to adopt, by July 21, 2011, amendments to Rules 501(a)(5) and 506 of Regulation D, as mandated by Sections 413(a) and 926 of the “Dodd-Frank Wall Street Reform and Consumer Protection Act,” Pub. L. No. 111-203. These provisions required the SEC to: (a) adjust the over \$1,000,000 minimum net worth standard for natural person accredited investors in any SEC rules under the Securities Act (such standard also appears in Rule 215(e) under the Securities Act), so that the value of the primary residence of such an investor would have to be excluded from the investor’s net worth; and (b) create certain “bad actor” disqualifications from use of Rule 506.

The SEC has finally adopted amendments to Rules 215(e) and 501(a)(5), revising the accredited investor net worth standard, as proposed in Release No. 33-9177 (Jan. 25, 2011), reprinted at 76 Fed. Reg. 5307 (Jan. 31, 2011), and finalized in Release No. 33-9287 (Dec. 21, 2011). The amendments will be effective 60 days after Release No. 33-9287 is reprinted in the *Federal Register*; a copy of that Release is available at <http://www.sec.gov/rules/final/2011/33-9287.pdf>. While the SEC proposed amendments to Rule 506, adding a “bad actor” disqualification, in Release No. 33-9211 (May 25, 2011), reprinted at 76 Fed. Reg. 31518 (June 1, 2011), that proposal was still pending as of December 29, 2011, and engendered a host of comment letters, including one which our Committee submitted jointly with other ABA committees. See, <http://www.sec.gov/comments/s7-21-11/s72111.shtml>.

It is my understanding that the SEC staff is working through the comment letters they received in response to Release No. 33-9211 and is preparing recommendations for the Commission; one of the major issues to be resolved involves the retroactive application of the “bad actor” disqualification provisions.

#### C. H.R. 2940, “Access to Capital for Job Creators Act”

H.R. 2940 (*see*, <http://thomas.loc.gov/cgi-bin/query/z?c112:H.R.2940:>) was passed overwhelmingly by the House of Representatives (413 Ayes, 11 Nays, 9 Present/Not Voting) on November 3, 2011. A companion identical Senate bill, S. 1831 (*see*, <http://thomas.loc.gov/cgi-bin/query/z?c112:S.1831:>) with the same Act name was introduced by Sen. John Thune (R-S.D.) on November 9, 2011 and assigned to the Senate Committee on Banking, Housing, and Urban Affairs; a hearing on S. 1831 was held by that Committee on December 1, 2011 (for convenience purposes, all references in this section to the bill shall be to H.R. 2940, as passed by the House). H.R. 2940 would simply: (1) add the following language to the end of Section 4(2) of the Securities Act: “, whether or not such transactions involve general solicitation or general advertising”; and (2) require the SEC to revise Rule 506, within 90 days after enactment, so as to (a) make the prohibition on general solicitation or general advertising inapplicable to Rule 506 offerings if all purchasers are “accredited investors,” and (b) set forth methods whereby an issuer may verify that purchasers are accredited.

According to H.R. Rep. 112-263, at 1 (Oct. 31, 2011):

“The legislation would allow companies greater access to accredited investors and to new sources of capital to grow and create jobs, without putting less sophisticated investors at risk. To ensure that only accredited investors purchase the securities, H.R. 2940 requires the SEC to write rules on how an issuer would verify that the purchasers of securities are accredited investors.”

Of course, by removing the general solicitation/general advertising constraints on Rule 506 offerings, H.R. 2940 would overturn years of precedent as to how the term “public offering” should be construed for purposes of the Section 4(2) exemption. *See*, for example, SEC Release No. 33-285 (Jan. 24, 1935), reprinted at 1 Fed. Sec. L. Rep. (CCH) ¶ 2740, generally discussing the exemption under then-Section 4(1) of the Securities Act, including that the exemption should be “. . . largely limited to those cases wherein the issuer desires to

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consummate a few transactions with particular persons.” Interestingly, while the SEC never codified this concept into the “limitation on manner of offering” in Rule 502(c) of Regulation D, the SEC staff has taken the position for years that there must be a “pre-existing relationship” between the offeror and the offerees in order for an issuer to avail itself of the Section 4(2) exemption. Thus, as set forth in Question 256.18 of the SEC Division of Corporation Finance’s Compliance and Disclosure Interpretations (“C&DIs”), it was the staff’s view that a proposed offering exclusively to accredited investors wouldn’t mean that the offering is in compliance with Rule 502(c), since that rule “relates to the nature of the offering, not the nature of the offerees.” See, <http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm>.

However, does it make sense that an issuer effecting a Rule 506 offering shouldn’t be able to “cold-call” or send offering materials directly to strangers who are clearly accredited (e.g., the chief executive officers of the *Fortune* 100 companies or persons on *Forbes’* list of billionaires), without running afoul of Rule 502(c)? Is it really necessary for an issuer to pre-establish a relationship with all prospective investors, so long as the issuer weeds out inappropriate investors before any securities are actually sold to them? If Rule 506 presumes that accredited investors are capable of protecting their interests, and places no limit on the number of accredited investors in a Rule 506 offering, why should it be critical to restrict the manner of offering if all purchasers in a particular offering must be accredited?

When the House was considering H.R. 2940 (and two other bills which I’m not discussing in this article), Heath Abshure, the Arkansas Securities Commissioner, testified as NASAA’s representative before the House Subcommittee on Capital Markets and Government Sponsored Enterprises on September 21, 2011 (a copy of his testimony (the “**Abshure Testimony**”) is available at <http://www.nasaa.org/5941/legislative-proposals-to-facilitate-small-business-capital-formation-and-job-creation/>, and reprinted at NASAA Reports (CCH) ¶ 17,084). Mr. Abshure stated, with regard to H.R. 2940:

“ . . . it is going to be impossible to limit the sale to only accredited investors when they advertise to everyone. Indeed, there will be

no reason to believe that any investor, seduced by the public advertising, will hesitate to be dishonest when completing the investor suitability questionnaire.”

Mr. Abshure then went on to recommend that the Subcommittee consider NASAA’s “Model Accredited Investor Exemption” (“MAIE”), <http://www.nasaa.org/wp-content/uploads/2011/07/24-Model-Accredited-Investor-Exemption.pdf>, reprinted at NASAA Reports (CCH) ¶ 361, as an alternative to the H.R. 2940 proposal. The MAIE (which I believe is little-used, certainly as contrasted to Rule 506) provides an exemption from state securities registration for an offering sold exclusively to accredited investors, subject to certain other conditions which differ from Rule 506 as it presently exists, such as a “bad actor” disqualification and the issuer’s ability to publish a limited form of “general announcement” concerning the offering (without constraints as to the persons who might see or receive such an announcement).

I note, however, that paragraph (A) of the MAIE provides “Sales of securities shall be made only to persons who are or the issuer *reasonably believes* are accredited investors.” Further, according to paragraph (F)(2) of the MAIE, the issuer may provide information (in addition to the “general announcement”) to prospective purchasers whom it “reasonably believes” are accredited, while, under paragraph (G) of the MAIE, the issuer may also make telephone solicitations to prospective purchasers whom it “reasonably believes” are accredited. Compare this language in the MAIE to the preamble of Rule 501(a) of Regulation D, which defines the term “accredited investor”:

“*Accredited investor* shall mean any person who comes within any of the following categories, or who the issuer *reasonably believes* comes within any of the following categories, at the time of the sale of the securities to that person.”

In addition, Rule 506(b)(2)(i) provides that:

“There are no more than or the issuer *reasonably believes* that there are no more than 35 purchasers of securities from the issuer in any offering under this section.”

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In turn, Rule 501(e)(1)(iv) of Regulation D provides that any accredited investor will be excluded from the 35-purchaser limit in Rule 506(b).

Thus, I fail to see any distinction between the “reasonable belief” tests throughout the MAIE and Regulation D. Furthermore, once the SEC’s “bad actor” disqualification rule is effective for Rule 506 offerings, if H.R. 2940 is enacted into law and the SEC adopts a rule thereunder placing appropriate conditions on the manner in which issuers are to verify that all purchasers are accredited, I don’t believe that there is any real substantive difference between the MAIE and what’s contemplated by H.R. 2940, except that H.R. 2940 would appear to permit the issuer to use broader means of advertising the offering than the “general announcements” permitted under paragraph (E) of the MAIE, and, unlike the post-sale state notice filings authorized by Section 18(c)(2)(A) of the Securities Act, the post-sale notice filings mandated by paragraph (I) of the MAIE require the issuer to file a copy of the issuer’s “general announcement” with the state.

I am also flabbergasted (there’s a good curmudgeonly word!) by Mr. Abshure’s assertion that an offeree in a Rule 506 offering in which public solicitation is permitted would be more likely to be “seduced by the public advertising” and thus “be dishonest” about his or her accredited status, while implicitly an offeree in an MAIE offering who finds out about the offering by means of a permitted “general announcement” wouldn’t be so “seduced.” First of all, it is submitted that a private offering memorandum and related offering materials distributed in a Rule 506 offering under the current constraints on general solicitation may be just as “seductive” to a prospective investor as the public advertising permitted by H.R. 2940, while the “general announcement,” as well as the additional information and telephone solicitations permitted for accredited investors (or persons reasonably believed to be accredited), authorized under the MAIE may be equally “seductive” as H.R. 2940-authorized public advertising.

Second, while I won’t deny the possibility that some investors exaggerate (or outright lie about) their financial wherewithal in order to invest in an attractive Rule 506 offering (or, for that matter, a public offering registered with the SEC and/or the states where investors must satisfy some financial suitability standard), why should the issuer be blamed for an investor’s dishonesty, absent some clear and

compelling evidence that the issuer knew, or should have known, that the investor didn’t satisfy the applicable standard claimed by the investor?

No issuer that I’m aware of insists that prospective investors submit audited balance sheets or certified appraisals to prove that they satisfy the net worth test of Rule 501(a)(5) of Regulation D, or copies of their past two years’ income tax returns and current year’s W-2 Forms to prove that they satisfy the income test of Rule 501(a)(6) of Regulation D. While, at first glance, it probably wouldn’t be “reasonable” for an issuer to believe that a prospective investor living in a trailer park in a rundown “single-wide” qualifies as an accredited investor, that particular investor might turn out to be an eccentric millionaire qualifying several times over, either on the basis of income or net worth. Conversely, while at first glance it would appear “reasonable” for an issuer to believe that an investor residing in an expensive home or condominium apartment does qualify as an accredited investor, if it turns out that the investor’s debts far exceed his or her assets, that his or her income is barely sufficient to cover his expenses, and that the investor plans on taking out a second mortgage to finance the investment, that person might not qualify despite the issuer’s initial impression. Likewise, there may be honest misunderstandings as to how Rule 501(a) of Regulation D is to be interpreted in the case of certain entities (for example, certain special types of trusts which don’t qualify as accredited investors under Rule 501(a)(7) may instead qualify under Rule 501(a)(8), as per Question 255.21 of the C&DIs).

In sum, I don’t believe it’s fair for NASAA to generalize that Rule 506 issuers somehow “seduce” investors into lying about their status as accredited investors, and that use of public advertising would somehow exacerbate that “problem.” Unfortunately, the states have gotten into the habit of allowing investors to accept no personal responsibility for their own foibles, and instead blame issuers and others involved in a securities offering when an investor complains, irrespective of any showing of fraud. Again, absent compelling evidence to the contrary, it should be reasonable for an issuer to believe an investor’s representations as to accredited investor status, without need for the issuer to (i) insist on receipt of a truckload of supporting documentation from the investor, (ii) hire a private detective to do a background check on the investor, or (iii) waterboard the investor to determine the truth of his or her status.

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Issuers shouldn't have to pay the price for an investor's failure to be forthright in the course of subscribing for an investment.

#### D. The NASAA 2010 Enforcement Report

In past columns, I questioned whether NASAA, in its never-ending campaign to undo the preemption of state securities laws with regard to Rule 506 offerings, had greatly exaggerated problems encountered by the states in connection with such offerings. Most recently, according to NASAA's 2010 Enforcement Report (Oct. 2011), a copy of which is available at <http://www.nasaa.org/wp-content/uploads/2011/10/2010-Enforcement-Report.pdf>, and which report is based on a survey of NASAA members conducted in the spring of 2011 (to which 45 U.S. NASAA members responded), "States brought more than 250 actions involving Rule 506 or Reg D offerings . . .," and such offerings are listed as the most common products triggering enforcement actions. *Id.* at 7.

As I've said repeatedly in the past, I certainly won't deny that some Rule 506 offerings have been fraudulent (as have been certain registered offerings, offerings claiming reliance on other exemptions under the federal and state securities laws, and offerings in which federal and state securities laws were simply ignored), while some issuers claimed reliance on Rule 506 while negligently or deliberately violating one or more terms of the Rule, such as engaging in general advertising or general solicitation. I have no problem with subjecting those issuers and the other persons selling those offerings to appropriate civil, administrative or criminal sanctions by the SEC and applicable states, and to rescission actions by aggrieved investors where authorized by law.

However, since the NASAA report fails to disclose exactly what kind of allegations were involved in these 250 enforcement actions, I decided to check the Arkansas Securities Department's well-organized and user-friendly website, which conveniently summarizes, and provides links to copies of, all administrative orders issued by the Department each year, going back to 1998 (*see* <http://www.securities.arkansas.gov/legal/orders/>), to see what sort of enforcement actions the Department took against Rule 506 issuers in 2010. In reviewing the Department's orders for 2010, I found 12 orders specifically relating to Rule 506 offerings; *however,*

*each such order alleges that the issuer failed to make its Form D notice filing in a timely fashion, not that the issuer engaged in fraudulent practices or otherwise failed to comply with a term of Rule 506 and therefore wrongfully claimed "covered security" status.*

If the orders issued by the Arkansas Securities Department are indicative of what it and other states reported as "enforcement actions" against issuers claiming reliance on Rule 506, I believe there are serious questions as to whether NASAA has once again exaggerated the scope of the alleged "problems" with these offerings. Rule 506 and Questions 257.07 and 257.08 of the C&DIs are clear that filing a Form D in a timely fashion with the SEC is not a condition of Rule 506, nor does it affect the "covered security" status of the offering. In turn, a literal reading of Section 18(c)(3) of the Securities Act leads to the conclusion that the sole remedy available to a state for an issuer's failure to file a Form D and pay a requisite fee in a timely fashion is a suspension of the offer or sale of the securities in the state until the filing is effected. Accordingly, a stop order is the sole remedy recognized by Section 302(d) of the Uniform Securities Act (2002), as endorsed by NASAA, for an issuer's failure to comply with the notice or fee requirement of the covered security notice filing requirements of Section 302; Section 302(d) also provides: "If the deficiency is corrected, the stop order is void as of the time of its issuance and no penalty may be imposed by the administrator."

Thus, if a significant number of these state "enforcement actions" were, in fact, premised solely on an issuer's deliberate or negligent failure to file a Form D with, and pay a fee to, the state in a timely fashion (and I'd be willing to bet that most of such failures were negligent), then there is little evidence that fraud or noncompliance with the basic requirements of Rule 506 is rampant in these offerings, so as to justify reinstatement of full state jurisdiction over these offerings, as sought by NASAA. Further, considering that, according to page 6 of the Abshire Testimony: "Each year, more than 20,000 private offerings are filed with the SEC," even if each of the 250 proceedings reported to NASAA actually did involve fraud or noncompliance with a basic requirement of Rule 506, that would represent less than 1.25% of the 20,000+ offerings filed annually with the SEC, not exactly a significant percentage.

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In conclusion, I think NASAA and its member states should be a little more forthright with their statistics as to what these “enforcement actions” actually entailed, and what percentage of total Form D filings in each state resulted in such actions.

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## BLUE SKY BITS AND PIECES

By: *Ellen Lieberman*  
Debevoise & Plimpton LLP

**Jack E. Herstein**, Assistant Director of the Nebraska Department of Banking and Finance Bureau of Securities since 1986, began a one-year term as president of NASAA on September 13, 2011. He previously served NASAA as a member of its Board of Directors and Treasurer, and was chair of its Corporation Finance Section. He began at the Nebraska Bureau of Securities in 1977 as a securities examiner and in 2005 was named an official observer of the Securities & Exchange Commission’s Advisory Committee on Smaller Public Companies.

Commissioner for the California Department of Corporations **Preston DuFauchard** was named NASAA’s President-Elect in September. Subsequent to that honor, however, he determined to leave his position as Commissioner at the end of 2011. For that reason, he submitted his resignation as President-Elect of NASAA effective December 31, 2011. DuFauchard was initially appointed to the position of California Commissioner in June 2006 and confirmed the following year by the California State Senate. He has also served as Co-Chair of the California Governor’s 2006 Task Force on Military Financial Protection, a member of the California Industrial Development Finance Advisory Committee and a Director for the American Association of Residential Mortgage Regulators. As California Corporations Commissioner, he has testified regularly at hearings held by the Banking and Financial Institutions Committees of the California State Senate and Assembly. A graduate of Boalt Hall School of Law and Stanford University, he practiced civil litigation and trial work in San Francisco at Brobeck, Phleger & Harrison where he became a partner, as a partner at Landels, Ripley & Diamond and then in house at Bank of America Corporation where he was Assistant General Counsel and then the bank’s San Francisco Office Manager.

**Jan Owen** has been selected by California’s Governor Jerry Brown to become the new

Commissioner for the California Department of Corporations effective in 2012. Her service in the past has included Chief Committee Consultant for the California Senate, the Executive Director of the California Department of Insurance and Acting Commissioner of the California Department of Financial Institutions and, in the private sector, with Apple, Inc. and Washington Mutual. Subsequent to assuming office as Commissioner for the California Department of Corporations, her appointment will need to be confirmed by the California Senate within 365 days.

Also named to NASAA’s Board of Directors were **Steven D. Irwin**, the Pennsylvania Securities Commissioner, **Andrea L. Seidt**, the Commissioner for the Ohio Division of Securities, **Patricia D. Struck**, the Wisconsin Securities Administrator, and **Franklin L. Widmann**, the Florida Securities Division Director. NASAA’s Board of Directors will select an interim acting President-Elect to succeed Preston DuFauchard shortly, and the membership of NASAA will then vote for a President-Elect in May 2012.

Pennsylvania Securities Commissioner since 2006, **Steven Irwin** recently presented NASAA’s position to the House Capital Markets Subcommittee in opposition to the creation of any self-regulatory organization for state-regulated investment advisors, and he stressed the need to address various issues before creation of an SRO for SEC-registered investment advisors. He is a partner and member of the management committee of the Pittsburgh law firm Leech Tishman Fuscaldo & Lampl, LLC and was a legislative assistant to U. S. Senator Arlen Specter and a law clerk to Judge Joseph F. Weis, Jr., of the U.S. Third Circuit Court of Appeals. He received degrees from Harvard and from Georgetown University Law Center and served as an adjunct professor at the University of Pittsburgh, as chairman of the Pittsburgh Parking Authority, as Pittsburgh representative to the Southwestern Pennsylvania Commission, as chairman of the Pittsburgh Council of the Anti-Defamation League, as president and board member of Big Brothers Big Sisters of Greater Pittsburgh and as a trustee of the United Jewish Federation. He is a person of varied interests and talents, also playing accordion with an all-lawyer music group The Surreal McCoys, and competing as a masters oarsman at national and international levels.

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**Andrea Seidt** was appointed Commissioner of the Ohio Division of Securities in 2008. Previously she was Deputy Chief Counsel for the Office of the Ohio Attorney General working on investor and consumer protection litigation including as lead counsel for Ohio's subprime lending investigation. She worked as a Research Assistant at the Federal Judicial Center in Washington, D.C., for the second edition of the Reference Manual on Scientific Evidence, graduated from Ohio State University College of Law with honors, and practiced as an associate in the Columbus Ohio office of Jones Day

**Patricia Struck** has served as the Division of Securities Administrator with the Wisconsin Department of Financial Institutions for 15 years and is a former President of NASAA serving in 2005-2006 and also chaired its CRD Steering Committee and Investment Adviser Section. She received her bachelor's degree from Mount Holyoke College in Massachusetts (junior year abroad in Paris, and still speaks fluent French and Italian), and her J.D. from University of Wisconsin Law School and then worked at a large regional bank, Marine Bank (which over the years became Chase). She was unanimously selected as chairperson of the State Bar of Wisconsin's Board of Governors for fiscal year 2012 and received that organization's 2011 Presidential Award.

**Franklin Widmann**, who served as the Florida Securities Division Director, is a past President of NASAA 2004-2005. He previously served as New Jersey Deputy Attorney General, Chief of the New Jersey Bureau of Securities, and as its Chief Securities Regulatory Officer. He has also served as co-chair of the NASAA Analyst Conflicts of Interest Task Force Steering Committee, on the NASAA CRD Steering Committee and with the NASAA Corporation Finance Section. He was recognized with Outstanding Service Awards from NASAA in October, 2002 and September, 2003. He received his J.D. and A.B. degrees from Rutgers University. Subsequent to appointment to the NASAA Board, his retirement from the Florida Securities Division for health reasons was announced as of December 16, 2011. **Pamela P. Epting** has been appointed as Interim Florida Securities Division Director, while also remaining Florida's Registration Bureau Chief.

**Luis Aguilar** was sworn in for a second term on the Securities and Exchange Commission. **Daniel M. Gallagher**, the second Republican on the SEC, was

nominated by President Obama for a term expiring June 5, 2016, and replaces outgoing Commissioner **Kathleen Casey**. Thus the SEC again has a full roster of five Commissioners.

**Daniel Gallagher** previously served as deputy director, then co-acting director of the SEC's Trading and Markets Division, and before that as a counsel to SEC Commissioner Paul S. Atkins and as a counsel to SEC Chairman Christopher Cox. Most recently he was a partner at Wilmer Cutler Pickering Hale and Dorr LLP in Washington, and before his SEC service General Counsel and Senior Vice President of Fiserv Securities, Inc., where he managed their legal and regulatory matters, and in private practice advising on broker-dealer regulatory issues, and representing clients in SEC and SRO enforcement proceedings. Gallagher received his JD, magna cum laude, from the Catholic University of America where he was a member of the law review and his BA from Georgetown University. Gallagher has said he will focus on risk management and on coordinating Dodd-Frank implementation domestically and internationally

On September 20, 2011, **Eric J. Wilder** was appointed by Connecticut Banking Commissioner Howard Pitkin to serve as Director of the Connecticut Securities and Business Investments Division. Wilder has worked at the Securities and Business Investments Division for more than thirty years, as Assistant Director and before that a Principal Examiner. He has a Bachelor of Arts in Accounting from Western New England College.

**Peter O. Jamison, III** has left his position as Deputy Attorney General of the Delaware Department of Justice in which position he served as Delaware's Securities Commissioner. He previously served as Project Group chair on Attorney/Investigator Training for NASAA's Enforcement Section.

New Mexico has named **Daniel S. Tanaka** to replace **Bruce R. Kohl** as Securities Division Director. Tanaka had served the New Mexico Securities Division as a Senior Special Agent.

**Kenneth L. Hojnacki** retired at the end of June 2011 as Director of the Bureau of Professional Regulation and Compliance of the Wisconsin DFI Division of Securities.

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**Benette L. Zivley** resigned in November 2011 as Texas Securities Commissioner. His successor will be **John Morgan** who previously served as Deputy Commissioner for 14 years before retiring from state employment in February 2011. Morgan in total had worked at the Agency for 27 ½ years, with 13 years in the Enforcement Division, eight of them as Director of Enforcement. Morgan, who will be the seventh Securities Commission since creation of the Agency in 1957, is a graduate of the University of Kansas and received his law degree from the Texas Tech University School of Law.

**Martin A. Hewitt** who has been actively engaged on behalf of this Committee as Editor of the Blue Sky Bugle for several years, and Vice Chair of the American Bar Association Committee on State Regulation of Securities, has left his position as Counsel at Alston & Bird and is conducting a private law practice in New Jersey. He previously practiced law at Lowenstein Sandler PC, Cadwalader, Wickersham & Taft LLP and Simpson Thacher & Bartlett LLP, in areas of corporate finance including FINRA compliance and mortgage-backed securities. Mr. Hewitt currently serves as co-chair the ABA Task Force on Private Placement Broker Dealers, and also serves as chair of the CLE & Publications Subcommittee of the American Bar Association (ABA) Section of Business Law Committee on State Regulation and Securities and is the editor of The Blue Sky Bugle, published by the ABA. He received his J.D. from Seton Hall University School of Law.

**Suzanne E. Rothwell** retired as Counsel from the Washington, DC office of Skadden, Arps, Slate, Meagher & Flom LLP, and has her own law practice in nearby Virginia. She was for 20 years at FINRA and its predecessor the NASD, where she served as Assistant Director of the Corporate Financing Department, Associate General Counsel, and Chief Counsel for Corporate Financing, and was Special Counsel to NASDAQ on the PORTAL market. She also served as Chair of the FINRA Corporate Financing Rules Subcommittee of the ABA Business Law Section Committee on Federal Regulation of Securities. She also serves as an Editor of TheCorporateCounsel.net. She received a J.D., an MBA and a BBA from the George Washington University.

**Peter T. McKeon**, previously Blue Sky Department Coordinator with Skadden, Arps, Slate, Meagher & Flom LLP and before that Blue Sky Specialist at

Sullivan & Cromwell, has joined Lowenstein Sandler LLP in New York as Counsel to the firm's Specialty Finance Group.

**David N. Jonson**, the Committee's North Carolina liaison, is now practicing at Wyrick Robbins Yates & Ponton LLP in Raleigh, North Carolina. Previously with K&L Gates LLP, he also previously served as South Carolina Deputy Attorney General in charge of the Securities Division, as a member of NASAA's Board of Directors, on the Board of Directors of the North Carolina Securities Industry Association, and as the Committee's Liaison on Arbitration.

Please let us help you spread the word. We would happily announce for Committee members and regulators their new jobs, new honors, new children and grandchildren, new publications, etc. Send the update to [elieberman@debevoise.com](mailto:elieberman@debevoise.com).

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#### **A MESSAGE FROM THE NEW NASAA PRESIDENT**

*By: Jack E. Herstein*

NASAA President and Assistant Director of the Nebraska Department of Banking & Finance, Bureau of Securities

I have been serving as NASAA's president for three months now and I'd like to reinforce a point I made when I addressed the NASAA membership and some of you in September at our annual conference in Kansas.

Collaboration between regulators and industry is vital. We have a strong and positive relationship and I look forward to hearing from you throughout my term to learn how we can make our relationship even stronger.

For the past 100 years, state securities regulators have delivered effective protection for investors and efficient regulation for industry. I am proud to have been a part of this history for the past 34 years, after joining the Nebraska Bureau of Securities in 1977 as a securities examiner.

I'd like to take this opportunity to outline three topics of interest to NASAA as the year draws to a close: the upcoming IA switch, the future of investment adviser regulation and the steps state securities regulators are taking to help small businesses raise capital.

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Dodd-Frank recognized NASAA's leadership and record of accountability when it gave state securities regulators new authority to address the challenges facing 21st century investors.

By mid-2012, states will see an increase of approximately 25 percent in the number of investment advisers subject to state regulation. This presents states with a unique regulatory challenge. Fortunately, states and NASAA have been preparing to meet this challenge for more than a year and are ready for the switch. These preparations enable state regulators to implement intelligent, efficient and responsive regulation.

Throughout the United States, more than 400 experienced state employees are dedicated to licensing and examination, including field examiners, auditors, accountants and attorneys.

Even a highly skilled workforce cannot succeed without adequate resources. The need for additional resources is a natural consequence of increased responsibility. NASAA members are developing ways to maximize available resources. For example, each state has agreed to work together and share resources as needed to regulate the expanded state investment adviser population.

A new NASAA initiative enables regulators to review the applications of advisers required to register in four or more states in a coordinated manner as they switch from federal to state regulation. This initiative helps advisers by encouraging states to coordinate potential problems with applicants and avoid inconsistent deficiencies.

NASAA also is investing in new tools that will enable states to leverage their resources in the examination of investment advisers. We have developed uniform examination procedures to promote a consistent and high standard of examination at the state level and advanced risk-analysis software to allow states to rapidly review and rank their investment adviser registrants.

Against this backdrop, some in Congress are pushing to overhaul the current regulatory structure of investment adviser oversight to include self-regulation.

It is no secret that NASAA does not support the creation of a self-regulatory organization for state-

regulated investment advisers. For that matter, we have significant and longstanding concerns regarding any effort to establish a self-regulatory organization for investment advisers.

NASAA continues to believe that investment adviser regulation should continue to be the responsibility of state and federal governments, and that these regulators must be adequately funded to carry out their responsibilities. We see little benefit in constructing a new layer of bureaucracy, with its high incumbent expense.

Of course, reasonable people can and often do disagree. While the investment adviser industry favors paying user fees to the SEC for examinations, other organizations representing the broker community and the industry's self-regulator, FINRA, support an SRO concept outlined in September by House Financial Services Chairman Spencer Bachus.

In his "discussion draft" of legislation to create an SRO for investment advisers, Chairman Bachus offered an initial look at how an IA SRO might be constructed and what its oversight role might be.

This initial approach appears to be an over-reaching solution to inadequate SEC funding. It also appears to be based on a misguided concept that the regulation of investment advisers is enhanced by allowing industry to police itself.

Our primary concerns are conflicts of interest and a lack of accountability, transparency and independence inherent to the SRO model of regulation. As we testified in September, expanding industry self-regulation to investment advisers without first correcting the flaws of the SRO model will do nothing but prolong these structural failures.

Until these flaws are corrected, state securities regulators will continue to oppose efforts to expand the outsourcing of governmental regulatory responsibilities to industry membership organizations.

NASAA also believes that Congress should refrain from considering an expansion of the SRO model to investment advisers until FINRA correctly interprets the "state actor" issue, or until the issue is adequately addressed by legislation.

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FINRA's sensitivity to being labeled a state-actor has in some instances led FINRA to claim it is precluded from engaging in basic and vital types of regulatory coordination and information-sharing with state regulators.

Settling the question of whether or not FINRA or any other SRO is a "state-actor" is of vital importance to effective regulation. Until this question is resolved, we will continue to hold that state securities regulators are best positioned to be the primary regulator for small and mid-size investment advisers.

While much of NASAA's focus has been, and will continue to be, on matters affecting IA regulation, several bills to promote capital formation among small and entrepreneurial businesses that sped through the House of Representatives this fall demanded our attention.

Two bills in particular, H.R. 2930 and S. 1971, raised the specter of NSMIA with their provisions to prevent state securities regulators from reviewing investment opportunities made on "crowdfunding" websites before they are offered for sale to the public.

Preempting state authority is a very serious step and should never be done without a thorough examination of all available alternatives.

While decreasing federal regulation over small business capital formation may be appropriate, several proposals under consideration by Congress would needlessly preempt state law. Instead, Congress should give states greater flexibility to create innovative regulations that allow small businesses to use modern methods of attracting investors and provide appropriate disclosures.

States are uniquely qualified to provide an efficient regulatory framework to enable new and small businesses to raise investment capital and provide safeguards for investors.

Because we realize that small businesses are vital to job growth and improving the nation's economy, state securities regulators have no interest in throwing up needless roadblocks for small businesses.

Instead of preempting states, as both H.R. 2930 and S. 1791 would do, Congress should allow the states to take a leading role in implementing an appropriate regulatory framework for crowdfunding.

Balancing the needs of small businesses and investors requires a degree of regulatory flexibility and creativity. If regulatory authority for the states is preserved, NASAA will continue to pursue the development of an innovative model exemption for crowdfunding that would allow "one-stop filing" in the state of the issuer's principal place of businesses. Congress also should direct the SEC to work with the states to develop a federal exemption in tandem with the state model rule.

This streamlined approach can be achieved without preempting state securities regulators and is consistent with the goals of both Congress and the Obama Administration to help small businesses access the capital they need in order to promote economic recovery and job growth.

Small business investment has the potential to be a very positive economic force and major driver of wealth and jobs when done in the right way. But when done incorrectly and without appropriate oversight, these investments have the potential to become costly failures.

If the fall of 2011 has been any indication, the winter and spring of 2012 promise to be full of interesting and challenging times. I look forward to working with you in the coming year and I hope you can join us in Washington in May at our 2012 Public Policy Conference.

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## **OUTSIDE BUSINESS ACTIVITY: PART ONE – WHERE THE RULES NOW STAND**

*This first of a series of three articles is reprinted from Practical Compliance & Risk Management for the Securities Industry, November/December 2011.*

*By: Paul B. Uhlenhop, John S. Monical and Mitchell B. Goldberg*

*Lawrence, Kamin, Saunders, & Uhlenhop, L.L.C.*

### **I. Introduction**

The Financial Industry Regulatory Authority ("FINRA")<sup>18</sup> has adopted and proposed important

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<sup>18</sup> In 2007, the NASD changed its name to FINRA and assumed responsibility of certain regulatory functions of the New York Stock Exchange ("NYSE"). At the present time, FINRA is combining the former NASD rulebook with the NYSE rules with a goal of having a consolidated rulebook, which project should be completed in the next several years. At this time, there are some NYSE rules that have been integrated, consolidated, updated or changed with former NASD rules and are referred to herein as

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changes to the current regulatory scheme and obligations relating to notice and supervision of outside business activities and private securities transactions. For a number of years, the National Association of Securities Dealers, Inc. (“NASD”) rules 3030, 3040 and 3050 were the principal rules of the NASD with respect to outside business activities, personal securities transactions and personal transactions by account executives and associated persons.

NASD rule 3030 entitled “Outside Business Activity of Registered Persons” has been replaced by FINRA rule 3270.<sup>19</sup> FINRA has proposed that NASD rule 3050 be replaced by FINRA rule 3210,<sup>20</sup> but the rule has not been filed with the Securities and Exchange Commission (“SEC”). The authors expect that FINRA will re-propose the rule with some changes. FINRA has proposed that NASD rule 3040 be replaced by FINRA rule 3110(b)(3).<sup>21</sup> FINRA omitted these changes in a recent rule filing with the SEC with respect to FINRA rule 3110. FINRA intends to re-propose the substance of this withdrawn rule change as a separate rule.<sup>22</sup> Until these proposed FINRA rules are approved by the SEC, FINRA rule 3270 and NASD rules 3040 and 3050<sup>23</sup> govern outside business activity and selling away.

This article represents the first of a three-part series on outside business activities, with a particular focus on selling away issues. This Part 1 discusses the language and interpretations of new FINRA rule 3270, describes the effect of recent proposed changes to NASD rules 3040 and 3050, and sets out considerations for registered representatives dually registered as investment advisors. In Part 2, we will provide an overview of how and when mandatory arbitration applies to selling away cases and explain the legal theories which may impose civil or regulatory liability against a firm for outside business

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FINRA Rules. In other cases, NASD rules remain in effect and there are proposed amendments to them and they will continue in effect until they are approved by the SEC and are included in the consolidated rulebook. In this article NASD rules will be referred to as NASD rules if they remain effective or are proposed to be revised. Former NASD Notices to Members will be referred to as NTMs and FINRA Regulatory Notices will be referred to as RNs.

<sup>19</sup> RN 10-49 (Oct. 2010); effective December 15, 2010.

<sup>20</sup> See RN 09-22 (April 2009).

<sup>21</sup> RN 08-24 (May 2008).

<sup>22</sup> 76 F.R. 38245 (June 29, 2011).

<sup>23</sup> These rules have been interpreted by NTM 94-44 (1994), NTM 96-33 (May 1996), NTM 01-79 (December 2001), and NTM 03-79 (December 2003).

activity. Finally, in Part 3 we will set forth some suggested compliance and supervisory procedures that firms should consider adopting as part of a reasonable system for supervision of outside activity.<sup>24</sup>

## **II. FINRA’s Current Outside Business Activity Rules**

### **A. FINRA Rule 3270**

FINRA rule 3270, entitled “Outside Business Activities of Registered Persons,” and its supplementary material provide long-awaited clarification and changes. Rule 3270 reads as follows:

No registered person may be an employee, independent contractor, sole proprietor, officer, director or partner of another person, or be compensated, or have the reasonable expectation of compensation, from any other person as a result of any business activity outside the scope of the relationship with his or her member firm, unless he or she has provided prior written notice to the member, in such form as specified by the member. Passive investments and activities subject to the requirements of NASD Rule 3040 shall be exempted from this requirement. (Emphasis added.)

Like NASD Rule 3030, FINRA Rule 3270 can apply not only to business activity involving securities, but to any business activity of a registered associated person. Rule 3270 also requires that the registered person give written notice to the person’s registered firm.<sup>25</sup> However, unlike Rule 3030, Rule 3270 requires “prior” as opposed to “prompt” written notice of the activity. Rule 3270 also applies to registered associated persons who have various described positions or relationships with another person or are “compensated” or have a reasonable expectation of compensation from the outside business activity. This is broader than the prior rule. A careful reading of the revised rule makes it clear

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<sup>24</sup> We encourage firms reviewing their supervisory procedures to also review Chapter 5 “Supervision of Registered Representative’s Outside Business Activities,” *Broker-Dealer Regulation*, Practising Law Institute, Corporate and Securities Law Library, which gives additional details, citations, history and in-sights that are very valuable to any supervisory program in this area.

<sup>25</sup> Cf. NYSE Rule 346(b), requiring prior written consent.

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that a registered person who falls within any of the described relationships with another person whether or not compensated is included within the scope of the rule. As quoted above, there is an “or” between “be compensated” and also an “or” before “have the reasonable expectation” as emphasized.

The Supplementary Material in IM rule 3270 provides additional clarification by imposing specific obligations on the member receiving notice from a registered person pursuant to rule 3270. The Supplementary Material in IM rule 3270 states:

.01 Obligations of Member Receiving Notice. Upon receipt of a written notice under Rule 3270, a member shall consider whether the proposed activity will: (1) interfere with or otherwise compromise the registered person’s responsibilities to the member and/or the member’s customers or (2) be viewed by customers or the public as part of the member’s business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered. Based on the member’s review of such factors, the member must evaluate the advisability of imposing specific conditions or limitations on a registered person’s outside business activity, including where circumstances warrant, prohibiting the activity. A member also must evaluate the proposed activity to determine whether the activity properly is characterized as an outside business activity or whether it should be treated as an outside securities activity subject to the requirements of NASD Rule 3040. A member must keep a record of its compliance with these obligations with respect to each written notice received and must preserve this record for the period of time and accessibility specified in SEA Rule 17a-4(e)(1).<sup>26</sup> (emphasis added)

Although a retail firm generally will require prior consent as a part of its supervisory procedures to carry out its obligations under IM 3270, consent by the member is not a requirement of Rule 3270 or IM 3270 and, for certain types of broker-dealers, prior written consent may not be a necessary part of a reasonable system of supervision.

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<sup>26</sup> IM Rule 3270; RN 10-49 (Oct. 2010).

Under IM 3270, a member must perform an analysis of the proposed outside activities in two respects stated above and the analysis must include evaluating the possibility of imposing specific conditions or limitation on the registered person’s outside business activity and/or prohibiting the activity, depending on the evaluation by the member of the criteria set forth above. Specific records must be maintained with respect to notices, the evaluation and the conditions. As discussed later in Sections II.B and C, if the activities involve securities or investment banking, transactions also should be effected through the firm and reflected on the firm’s books and records.<sup>27</sup>

The rule does not define outside business activity. Because of the lack of definition, certain activities, such as volunteer activities associated with a corporate non-profit organization, could be found to be business activities included within the rule. As discussed later in this article, firms may wish to clarify the scope of outside business activities in their written supervisory and compliance procedures to encourage reporting of such activities. Many volunteer activities for non-profits (such as fundraising for the non-profit, voting on investment advisors or managers, and managing investments) could create conflicts of interest with a firm’s other activities or other regulatory concerns.

#### B. NASD Rule 3040

NASD rule 3040, “Private Securities Transactions of an Associated Person,” is complex and too lengthy to be quoted in its entirety. FINRA proposed to replace NASD rule 3040 with FINRA rule 3110(b)(3), but deleted the proposed change in connection with the filing of proposed changes to rule 3110 with the SEC. FINRA stated that it will re-propose the substance of proposed rule 3110(b)(3) as a separate rule.<sup>28</sup> See Section II.C. Rule 3040 complements rule 3270 and provides that no person associated with a member shall participate in any manner in a private securities transaction as defined, except in accordance with the rule. Subsection (b) of rule 3040 states:

Prior to participating in any private securities transaction, an associated person shall provide written notice to the member with which he is associated describing in

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<sup>27</sup> 75 F.R. 53362 (Aug. 31, 2010); see also 76 F.R. 38245 (June 29, 2011).

<sup>28</sup> RN 08-24 (May 2008).

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detail the proposed transaction and the person's proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction; provided however that, in the case of a series of related transactions in which no selling compensation has been or will be received, an associated person may provide a single written notice.

Rule 3040 is more limited than rule 3270 in that it only applies to "private securities transactions" (as opposed to any business activity). However, it is broader than 3270 in that it applies to all associated persons, not just registered associated persons. Although an "associated person" under rule 3040 includes unregistered individuals, it does not extend to every employee of the firm. Specifically, it does not include persons performing solely ministerial or clerical activities.<sup>29</sup>

Subsection (c) of rule 3040 deals with private securities transactions for compensation – what is traditionally thought of as "selling away." "Private securities transactions" is very broadly defined in subsection (e)(1) as follows:

(1) "Private securities transaction" shall mean any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission, provided however that transactions subject to the notification requirements of Rule 3050, transactions among immediate family members (as defined in Rule 2790), for which no associated person receives any selling compensation, and personal transactions in investment company and variable annuity securities shall be excluded (emphasis added).

"Selling compensation" is also very broadly defined in subsection (e)(2). "Selling compensation" as defined includes any compensation direct or indirect in connection with or as a result of a purchase or sale of a security no matter what the source. It includes things such as commissions, finder fees, securities, options, profit participations, dissolution proceeds, tax benefits, expense reimbursement, gifts, lavish

entertainment<sup>30</sup> and a host of other things that are connected to the private securities transaction.

A member who has received notice of a private securities transaction pursuant to subsection (b) of the rule is required to advise the associated person in writing whether the member approves the proposed participation or disapproves of the participation. If the member approves the participation, the transaction is to be treated as any other transaction for the member and recorded on the member's books and records with all of the attendant supervision requirements of the person's participation in the transaction as if the transaction was executed on behalf of the member. See Section II.C and D for further discussion. If the member disapproves the participation, the associated person may not participate in the transaction in any manner, directly or indirectly.

Rule 3040(d) provides a different set of rules for transactions that do not involve compensation. In transactions for which the associated person will not receive any "selling compensation" as defined, the member who has received notice shall provide the associated person with a written acknowledgement of the notice and may, at the discretion of the member, require the person to conform to certain specified conditions in connection with the participation in the transaction. The rule does not specifically say that the member may disapprove the transaction, but the new FINRA rule 3270 IM interpretation arguably provides support for a firm's right not only to prohibit or to impose conditions upon outside business activities, but also to evaluate proposed private securities transactions and prohibit or approve them with or without conditions. Most members also require approval of non-security transactions without selling compensation. Rule 3040 does not specifically require the member to record the non-compensation security transactions on its books or supervise them. However, if adopted, proposed rule 3110(b)(3) would have required all securities or investment banking activities to be carried on the firm's books and records and subject to supervision. As a practical matter, however, most members prohibit such a securities transaction without selling compensation and/or treat the transaction the same way as a transaction for compensation.

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<sup>29</sup> NASD rule 1011(b).

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<sup>30</sup> See also FINRA Rule 3220.

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Outside business activities of an associated person of a broker-dealer that involve securities purchases and sales not on the books and records of his or her employer broker-dealer would require, in many cases, the associated person to register as a separate broker-dealer under Section 15 of the Securities Exchange Act<sup>31</sup> (“Exchange Act”) and applicable SEC staff interpretations and under certain state laws.

### III. FINRA’s Proposed Rule 3110(b)(3)

In RN 08-24 (May 2008), FINRA proposed to delete rule 3040, simplify it and somewhat change it, and move it into rule 3110(b)(3) subtitled “Supervision of Outside Securities Activities.” However, the proposed FINRA rule 3110(b)(3) was not included in the recent rule filing of FINRA rule 3110 with the SEC. FINRA stated that the provisions set forth in proposed rule 3110(b)(3) will be the subject of a separate rule to be noticed by FINRA in the not-too-distant future. The proposed rule 3110(b)(3) replacement is expected to include many of the provisions of proposed rule 3110(b)(3). The proposed rule change was designed to clarify the obligations of member firm supervisors of outside securities activities. The proposed rule provision, which was omitted, would have read as follows:

#### (3) Supervision of Outside Securities Activities

(A) Unless a member provides prior written approval, no associated person may conduct any investment banking or securities business outside the scope of the member’s business. If the member gives such written approval, such activity is within the scope of the member’s business and shall be supervised in accordance with this Rule, subject to the exceptions set forth in subparagraph (B).

#### (B) Dual Employees

(i) The supervision required by subparagraph (A) shall not be required with respect to the bank-related securities activities of dual employees when such activities are included within any of the statutory

or regulatory exemptions from registration as a broker or dealer, provided that the member receives written notice of, and approves, such activities.

(ii) A member shall not approve the activities of dual employees pursuant to subparagraph (i) unless the member has written assurance that the bank or a supervised bank affiliate will:

- a. have a comprehensive view of the dual employee’s securities activities;
- b. employ policies and procedures reasonably designed to achieve compliance with the anti-fraud provisions of the federal securities laws; and
- c. give prompt notice to the member of any dual employee’s violation of such policies and procedures.

(iii) A member may rely upon the written representation of any enumerated entity in subparagraph (ii) that it is employing the policies and procedures required in subparagraph b. provided the member supplies access and information, in compliance with SEC Regulation S-P, as is necessary for the execution of such policies and procedures. Upon receiving notice of a dual employee’s violation of the policies and procedures required in subparagraph b., the member shall assure itself that the policies and procedures of the enumerated entity in subparagraph (ii) are reasonably designed to achieve compliance with the anti-fraud provisions of the federal securities laws or have been amended to achieve such compliance. In the event a member cannot reach such

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<sup>31</sup> 15 U.S.C. §78(o).

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assurance, the member must revoke its approval of the dual employee's bank-related securities activities.

(iv) For purposes of this subparagraph (B), the term "dual employee" means a natural person who has prior written approval from the member to perform as both an associated person of a member and a bank employee.

(v) For purposes of this subparagraph (B), the term "supervised bank affiliate" means a bank affiliate that is subject to consolidated supervision by the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, or the Director of the Office of Thrift Supervision. (emphasis added.)

The proposed rule would have made two principal changes. First, the rule 3110(b)(3) proposal would have required that all securities and investment banking transactions previously outside the scope of the member's business be treated as if they were part of the firm's business. The proposed rule would have eliminated the distinction between private securities transactions for which compensation is and is not received. Similarly, the proposed rule also would have eliminated the exemption for personal transactions in investment companies and variable annuity securities. Because the proposed rule would have placed all outside business activities involving the investment banking or securities business under the member's business, the rule would have required the firm to record the transactions on its books and records and to supervise them as any other transaction.

The second major change would have applied to "dual employees." Subsection (b) of the proposed rule was entitled "Dual Employees" and attempted to clarify an area of some confusion with respect to bank-related securities activities of dual employees when their activities are within the statutory or regulatory exemptions for banks from registration as a broker-dealer. Subsection (b)(2) sets forth a number of conditions on the approval of activities of

"Dual Employees." A member would not need to supervise the exempt bank's securities activities of the associated person if the member meets certain requirements as follows:

1. A member must receive written notice of any such activities and approve the activities.
2. A member must receive written assurance that the bank or supervised affiliate of the bank will have a comprehensive view of the Dual Employee's securities activities, employ procedures reasonably designed to achieve compliance with the anti-fraud provision of the federal securities laws and give prompt notice to the member of any Dual Employee's violation of such policies and procedures.

A member would have been able to rely on a representation of a bank or its supervised affiliates with respect to (b)(2). But, if a member received notice of a violation of the policies and procedures of a bank or its affiliates by the Dual Employee, the member would have been required to assure itself that the bank or its affiliate's policies and procedures were reasonably designed to achieve compliance with the anti-fraud provisions of the federal securities laws or had been subsequently amended to achieve such compliance. In the event the member could not obtain such assurance, the member would have to revoke its approval of the Dual Employee's relationship. The Dual Employee provision would have put a new burden on broker-dealers to monitor the activities of Dual Employees that work in exempt securities activities of a bank or its affiliate as defined, such as trust services, custodial services and other securities activities of banks that are exempt from broker-dealer registration under the Exchange Act.

The proposed rule change did not deal with other conflicts arising from dual registration requirements such as conflicts between a registered representative who is also an individual registered investment advisor or affiliated with an investment advisor that is not affiliated with the associated person's broker-dealer employer. It also did not deal with potential conflicts of a broker-dealer registered under §15b-11 of the Exchange Act that engages in futures activities as an FCM but is a notice-registered broker-dealer (to

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be able to transact certain types of single stock futures and/or narrow securities index futures). Hopefully, FINRA will provide appropriate guidance in its new rule which is expected in the near future.

#### **IV. Considerations for Registered Representatives with Dual Registration as an Investment Adviser**

NASD NTM 96-33 (May 1996) and NTM 94-44 (May 1994) are particularly important when an associated person registered representative (“RR”) is also a registered investment adviser or associated with an investment adviser (“IA”). In these Notices, the NASD gives particular attention to the supervision of securities transactions conducted by a dual RR/IA. In NTM 94-44, the NASD warned that rule 3040 conduct is triggered whenever a dual RR/IA participates in the execution of a security transaction to the extent that his or her actions go beyond a mere recommendation. Implementing any sort of recommendation by phone calls or placing orders would be included within the definition of execution of a private securities transaction, triggering the recordkeeping and supervision requirements of FINRA for the transaction by the RR’s member firm even though the transaction is not executed through the RR’s member firm.

The interplay between NASD rule 3040 and the investment adviser’s Codes of Ethics<sup>32</sup> that are required for IAs presents another interesting issue for a dual registrant. The ethics code of the IA may be more encompassing or less encompassing than the supervision required by rule 3040. The supervision of an affiliated IA where there is a dually registered representative should be carefully coordinated so that nothing is overlooked under the Investment Advisers Act<sup>33</sup> and its rules as well as the requirements for broker-dealers and applicable rules. There also may be the same type of differences between the broker-dealer’s system of supervision and the ethics code of a state-registered broker-dealer.

The NASD specified in NTM 94-44 that an associated person is required to provide written notice to the member with which he or she is associated of any proposed employment or outside business activity involving securities from which he or she will or may receive compensation from others.

New proposed FINRA rule 3110(b)(3) would have required written notice of any outside business activity involving any security or investment banking and required that the activity be carried on the firm’s books and records and supervised. If a member has approved a dual RR/IA’s participation in private securities transactions for execution of transactions of the IA for which the RR will receive compensation, the member must develop and maintain a recordkeeping system that among other things captures the “outside” transactions executed by the RR in its books and records sufficiently to exercise supervision over that activity. Recording the transactions is not enough. The member must have a recordkeeping system and procedures that, for example, enable the member to collect sufficient information to supervise the individual transactions of the RR/IA. NTM 96-33 specifies the following books and records as possible requirements:

- dated notifications from the RR/IA detailing the services to be performed by the RR/IA and the identity of each RR/IA customer serviced at another firm in a private securities transaction;
- dated responses from the NASD member to the RR/IA acknowledging and approving or disapproving the RR/IA’s intended activities;
- a list of RRs who also are IAs;
- a list of RR/IAs approved to engage in private securities transactions;
- a list of RR/IA customers, including those that are customers of both the member firm and the RR/IA, with a cross reference to the RR/IA;
- copies of customer account opening cards to determine, among other things, suitability;
- copies of discretionary account agreements;
- duplicate confirmation statements;
- duplicate customer account statements;
- a correspondence file for RR/IA customers;

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<sup>32</sup> 17 CFR 275.204A-1.

<sup>33</sup> 15 USC §80b.

- investment advisory agreements between the RR/IA and each advisory client;
- advertising materials and sales literature used by the RR/IA to promote investment advisory services wherein the RR/IA holds himself or herself out as a broker/dealer, complemented by a process that shows whether proper filings have been made at the NASD and whether the RR/IA is using any electronic means, such as the Internet, to advertise services or correspond with customers;
- exception reports, where feasible, based on various occurrences or patterns of specified activity, such as frequency of trading, high compensation arrangements, large numbers of trade corrections, and cancelled trades; and
- supervisory procedures fully responsive to Article III, Section 27 requirements and designed to address Section 40 compliance. The procedures may include such items as the identity of persons responsible for Section 40 compliance, the recordkeeping system to be used and followed, and memoranda or compliance manuals that notify RR/IAs of the member's procedural requirements for Section 40 compliance.

The Questions and Answers of NTM 96-33 provide a wealth of additional detail that should be reviewed in any case by a FINRA member involving dual RR/IAs and the supervisory procedures should be adjusted accordingly. In the answers to Frequently Asked Questions which is part of NTM 96-33, the NASD clarified that a RR/IA does not need to give prior notice of each transaction for which investment advisory services will be provided. Rather, the RR/IA must receive approval to conduct investment advisory activities for a fee on behalf of his advisory clients. The notice specifies what must be included in the notice and members have the right to approve or disapprove. If it is approved, "the employer member must thereafter record subsequent transactions on its books and records and supervise activity in the affected accounts as if it were his own."<sup>34</sup>

<sup>34</sup> NTM 96-33, p. 2 (May 1996).

Under the proposed rule 3110(b)(3), all securities business or investment banking business would be included within the area of supervision and there would be no provision for non-compensated transactions. This seems to indicate that any transactions by an associated person affiliated with an independent IA would have to be supervised and carried on the books and records of the member employer of the RR.

## **V. NTM 01-79 – NASD Reminds Members of Their Selling Away Responsibilities**

In December 2001, the NASD issued NTM 01-79 (December 2001) to remind associated persons and firms of their responsibilities relating to NASD rules 3030 and 3040. The NASD stated that in the time period leading up to NTM 01-79, it had noticed an increase in selling away activity and had brought significant enforcement actions relating to outside business activity. NTM 01-79 warned associated persons of their responsibilities to report such activity to their member firms, reminded member firms of their supervisory responsibilities, and suggested actions firms could take to review and improve on their supervisory procedures and to educate associated persons. Notwithstanding NTM 01-79, selling away claims appear to have continued to increase, many of them in connection with note schemes, prime bank schemes, phony hedge funds and various types of property sold with management contracts which are later found to be investment securities for purposes of the state and federal securities laws. NTM 01-79 emphasized and explained to members the many pitfalls that associated persons encounter when they engage in outside business activity and warned against relying upon a lawyer's opinion that an investment is not a security.

## **VI. Other Considerations**

### **A. NASD Rule 3050**

NASD rule 3050, entitled "Transactions For or By Associated Persons," in a sense, also deals with outside business activities. It should be noted that rule 3050 is proposed to be changed by new FINRA rule 3210 as stated in RN 09-22 (April 2009). Nevertheless, NASD rule 3050 remains the controlling rule until such time as FINRA and the SEC approve new rule 3210. An associated person

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who opens an account or places an order for a securities transaction at another financial institution, including a broker-dealer, a notice-registered broker-dealer, an IA, bank or other financial institution that is not a FINRA member, is required to notify the employer member in writing, prior to execution of any transactions, of the intent to open the account or place an order. In such a case, the employer member should request written assurances that the other financial institution will provide the employer member with duplicate copies of confirmation statements or any other necessary information concerning the account or the order.

When an associated person opens an account or attempts to execute a securities transaction with another FINRA member, either for the associated person's account or for another account for which the associated person has discretion, the executing member has specific obligations including notifying the employer member.<sup>35</sup> The employer member may prohibit the associated person from executing personal transactions through another member or financial entity. Upon written request from the employer member, the executing member must provide the employing broker-dealer duplicate copies of confirmations, account statements and other information regarding the account. The executing broker-dealer must also notify the associated person of the executing member's intention to provide the notice and information to the employer member. Under rule 3050, both members appear to have an obligation to supervise the securities activities of the associated person at the executing firm. This means that the employer member must receive confirmations and account statements and monitor the execution of transactions just as if the transactions were executed through the employer member. This involves primarily having adequate review for manipulation and insider trading, but it also involves supervision in other areas, if unusual transactions come to the attention of either member firm. For example, if the associated person is regularly effecting transactions far beyond the person's means, such conduct may indicate a possible Ponzi scheme or outside business activities not approved by the member.

#### B. Proposed FINRA Rule 3210 – Personal Securities Transactions For or By Associated Persons

FINRA, in RN 09-22 (April 2009), proposed to revise NASD rule 3050 and replace it with a new FINRA rule 3210, "Personal Securities Transactions By or For Associated Persons."<sup>36</sup> The proposed rule simplifies and clarifies NASD rule 3050 which currently remains in effect. The proposed rule provides that an associated person may not open or otherwise establish at another member firm (referred to as the executing member) or any other financial institution any account in which securities transactions can be effected and in which the associated person has a personal financial interest. Financial institution is defined in NASD rule 3210.05 as any financial institution other than a member to include without limitation any broker-dealer that is registered pursuant to Section 15(b)(11) of the Exchange Act,<sup>37</sup> domestic or foreign non-member broker-dealer, investment adviser, bank, insurance company, trust company, credit union and investment company. It also appears from footnote 8 of the proposing release that commodities accounts would be included if securities transactions in connection with futures or commodities may be executed. The proposed rule, like the current rule, requires that as a condition to granting written consent to an associated person, the employer member must instruct the associated person to have the executing member provide duplicate account statements and confirmation to the member and requires the executing member to carry out the associated person's instruction. Subsection (b) of proposed rule 3210 requires any associated person prior to opening or otherwise establishing an account within the meaning of the rule must notify in writing the executing member or other financial institution of his/her association with the employer member. The proposed rule adds a requirement not included in NASD rule 3050 that the associated person must state in the notice provided to the executing member or financial institution whether he or she has a personal financial interest in the account. The rule notes that an account as a general matter would extend to a spouse's accounts. Subsection (c) of 3210 provides that if an executing member has actual notice that an associated person of an employer member has a

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<sup>35</sup> See NTM 97-25 (May 1997).

<sup>36</sup> It should be noted that the proposed rule has not been filed with the SEC and may be changed by FINRA.

<sup>37</sup> 15 USC §78(o)(b)(11).

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personal financial interest in an account such member is prohibited from executing securities transactions in the account unless it has obtained the employer's prior written consent or requires the executing member to provide account statements and confirmations promptly to the employer member upon receipt of an instruction from the associated person. The supplementary material provides clarifications on several points, including the following: if the account is open prior to association with employer member, within 15 days the associated person and employer must comply with the rule. Subsection 02 provides that an account at a financial institution other than a member requires that the associated person instruct the financial institution to provide duplicate account statements and confirmation to the employer. The rule in 04 requires an employer member to revoke its consent if confirmations and account statements are not promptly received in a timely manner and shall notify the executing member or other financial institutions of the revocation. The employer member is also under an obligation to receive confirmation from the financial institution or member that the account was closed.

## **VII. Conclusion**

Regulations of outside business activities are undergoing significant change. Indeed, new FINRA rule 3270 is already effective. Member firms also should take into consideration the substance of the changes that FINRA proposed for replacement of NASD rules 3040 and 3050. These proposals reflect policies and procedures that FINRA is considering for adoption and which some may argue reflect industry best practices, even though they have not yet been formally approved. Firms should be encouraged to review their rules and update their procedures where necessary.

Part 2 of this article, which will be published in the next issue of the *ABA Blue Sky Bugle*, will discuss how and when arbitration applies to selling away claims and will explore various legal theories often advanced to impose civil and regulatory liability in selling away cases.

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## **“SPOUSE” ABUSE: REGULATION D AND THE DEFENSE OF MARRIAGE**

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Efforts to revitalize the lagging economy have resulted in a recent focus on regulations that impede small business capital raising efforts. Several bills introduced during 2011 proposed to remove these impediments by amending existing regulations to make capital raising easier and less expensive for small businesses.<sup>38</sup> Despite this flurry of proposed legislation, there has been no mention of the limits currently imposed upon capital raising efforts under Regulation D as a result of the Defense of Marriage Act (“DOMA”).

Although not generally thought of in connection with securities regulation, DOMA directly impacts issuers relying upon Regulation D as a result of the use of the term “spouse” in the definition of “accredited investor” in Rule 501(a). “Accredited investors” include those who meet certain income and net worth thresholds either as an individual or, alternatively, jointly “with that person’s spouse.”<sup>39</sup> DOMA states that in determining the meaning of “any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States,...the word ‘spouse’ refers only to a person of the opposite sex who is a husband or a wife.”<sup>40</sup> Accordingly, only “spouses” as defined under DOMA qualify for the joint income and net worth

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<sup>38</sup> See, for example, H.R. 1070 – The Small Company Capital Formation Act of 2011; S. 1544 – The Small Company Capital Formation Act of 2011; H.R. 2167 – The Private Company Flexibility and Growth Act; H.R. 2940 – The Access to Capital for Job Creators Act; and H.R. 2930 – The Entrepreneur Access to Capital Act.

<sup>39</sup> Rule 501(a)(5) and (6).

<sup>40</sup> 1 U.S.C. § 7 (1997).

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accredited investors tests, which unjustly and, arguably, unconstitutionally limits the pool of accredited investors available to invest in Regulation D offerings.

The accredited investor concept was included in Regulation D “based on the presumption that accredited investors can fend for themselves without the protections afforded by registration.”<sup>41</sup> While the U.S. Securities and Exchange Commission (“SEC”) originally proposed only an individual net worth test, the definition of “accredited investor” ultimately included a joint net worth test, a change made by the SEC based upon comments that a net worth test limited to the individual investor “presented numerous problems for investors in community property states or for investors with assets held in joint name with a spouse.”<sup>42</sup> In addition, in its proposal to revise Regulation D to add the joint income test to the accredited investor definition, the SEC noted that the then-existing individual income test “ignores the reality of the two-income household as commonplace in today’s society.”<sup>43</sup>

The observations made by the SEC in the above Releases are no less applicable to today’s same-sex couples and domestic partners who, while not “qualifying” within the definition of a “spousal” relationship under DOMA, share households and finances just as “spouses” do. Where such couples meet the joint income or net worth thresholds, they should not be presumed to be any less able to “fend for themselves” than an opposite sex husband and wife. Furthermore, the “numerous problems” noted by the SEC with respect to assets held in joint name or, in those states where “marriage” and “spouse” are defined more broadly, held as community property, are certain to arise for couples with comingled assets who are not “spouses” under federal law. Perhaps most applicable is the SEC’s observation that the individual income test ignored “the reality of the two-income household” in 1987 society. It is just as clear that the use of the DOMA definition of “spouse” in the accredited investor test ignores the reality that in today’s society a “two-income household” is not limited to opposite sex husbands and wives. The use of the DOMA definition of “spouse” unnecessarily and arbitrarily excludes from the accredited investor definition same-sex couples and domestic partners

who are the equivalent of “spouses” for all relevant purposes.

As of the date of this article, same-sex marriages are permitted in Connecticut, Iowa, Massachusetts, New York, New Hampshire, Vermont and the District of Columbia, several additional states recognize some form of domestic partnership or civil union, and the issue is currently under judicial review in the State of California. In addition to the issues created by DOMA under Regulation D noted above, the inconsistency between federal and state definitions of “marriage” and “spouse” could give rise to ambiguity and cause issues for state-registered securities offerings. For example, the various Statements of Policy for Direct Participation Programs adopted by the North American Securities Administrators Association (“NASAA”) generally set forth suitability requirements, including net worth and income thresholds. The NASAA Statements of Policy do not, however, expressly establish a joint test, but rather focus on the net worth and income of, for example, the “participant” or the “security holder.” This leaves open the question of whether the terms “participant” and “security holder” are meant to encompass investors holding the investment jointly, such as spouses, and whether such investors can meet the net worth and income thresholds jointly. If so, a same-sex couple holding an investment jointly (for example, as community property in a state permitting same-sex marriage) would be treated differently under Regulation D and the NASAA Statements of Policy.

In order to remove this unnecessary impediment to small business capital raising and to address the inherent unfairness and ambiguity created by the current definition of “spouse,” Rule 501 should be amended to more accurately reflect the investor pool in today’s society. United States lawmakers need look no further than their neighbors in Canada for an example. Although the word “spouse” is used in the net income and net assets tests in the definition of “accredited investor” under Canadian securities law, such law also defines “spouse” more broadly than DOMA.<sup>44</sup> Under Canadian securities law, “spouse” is defined to include not only individuals who are “married to each other,” but also those who are “living with another individual in a marriage-like relationship, including a marriage-like relationship

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<sup>41</sup> SEC Release No. 33-6339, 46 FR 41791 (August 18, 1981).

<sup>42</sup> SEC Release No. 33-6389, 47 FR 11251 (March 16, 1982).

<sup>43</sup> SEC Release No. 33-6683, 52 FR 3015 (January 30, 1987).

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<sup>44</sup> See, National Instrument 45-106 – Prospectus and Registration Exemptions, Part 1: Definitions and Interpretation.

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between individuals of the same gender” and, in Alberta, those who are “an adult interdependent partner within the meaning of the Adult Interdependent Relationships Act (Alberta).”<sup>45</sup> While the SEC might not have the authority to adopt a definition of “spouse” that is inconsistent with DOMA, the SEC could elect instead to remove the term “spouse” from Regulation D, and instead create a new defined term that encompasses a broader set of relationships.

The broad definition of “spouse” in Canadian securities law was first included in the year 2000 as a result of the Canadian Supreme Court case *M v. H*<sup>46</sup>, which granted same-sex couples equal treatment under the Constitution of Canada.<sup>47</sup> Although the United States Supreme Court has not yet ruled upon DOMA, several lower courts have ruled that DOMA is unconstitutional and the United States Department of Justice has stated that it will no longer defend the constitutionality of DOMA as a result of the President’s opposition of DOMA and his belief that it is unconstitutional and should be repealed.<sup>48</sup> In addition, legislation to repeal DOMA is currently working its way through Congress, although similar legislation has been previously introduced without success.<sup>49</sup>

Independent of the constitutionality of DOMA as a whole, the SEC’s use of the DOMA definition of “spouse” arguably violates the Equal Protection Clause of the 14<sup>th</sup> Amendment by denying same-sex couples the ability to qualify “jointly” as an accredited investor. If under §413(b)(2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act the SEC increases the thresholds for qualifying as an “accredited investor” under Regulation D, the reliance upon the “joint” tests will become even more important and the continued use of the DOMA definition of “spouse” will result in an even greater injustice to same-sex couples who could otherwise qualify as an “accredited investor.”

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<sup>45</sup> *Id.*

<sup>46</sup> 2 S.C.R. 3 (1999).

<sup>47</sup> See, Notice of Proposed Rule, Policy and Forms under the Securities Act, 23 OSCB 6206 (September 8, 2000).

<sup>48</sup> See, United States Department of Justice Office of Public Affairs press release dated February 23, 2011, available at <http://www.justice.gov/opa/pr/2011/February/11-ag-222.html>.

<sup>49</sup> See, S.598 – The Respect for Marriage Act of 2011 and H.R. 1116 – The Respect for Marriage Act, currently in the Senate and House of Representatives, respectively. See also, H.R. 3567 – The Respect for Marriage Act of 2009, which died in committee in 2009.

Even if DOMA is ultimately repealed, the use of the term “spouse” in Regulation D without an accompanying definition will give rise to ambiguity as to what types of relationships are meant to be included. Therefore, as was done in Canada over a decade ago, the United States securities laws should be revised to define the term “spouse” or to provide a substitute therefore to encompass the variety of relationships in which accredited investors are involved in modern society.

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## EDITORIAL

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I would like to start my editorial by thanking everyone who wrote for this edition of the Blue Sky Bugle. Content is the food that feeds the Blue Sky Bugle beast. We need more of it. Please make a New Year’s resolution to write an article for the Blue Sky Bugle. There is so much to write about.

As for what to write about in this editorial, as one year ends and another one starts, there is quite a bit of unfinished rule making business. In particular, we are waiting for “Bad-Actor” provisions from our friends at the SEC. Without knowing exactly what these provisions will be, it is increasingly difficult to advise clients. While some regulators doubt it, most issuers want to comply with the law. They just need to know what the law requires.

For those of us working with Business Development Companies (“BDC’s”) there is even less guidance for issuers trying to do that which is right. There are no specific NASAA Guidelines regarding BDC’s. At the moment, we are left cobbling together bits and pieces of other NASAA Guidelines such as the NASAA REIT Guidelines and the NASAA Omnibus Guidelines among others. In fairness to the states, the lack of guideliness has created difficulty for the regulators as well as they each have to attempt to figure out what is required to protect investors and, at

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the same time, encourage capital formation. Heath Abshire, Arkansas Securities Commissioner and Mark Heuerman, Ohio Registration Chief are working hard to create NASAA BDC Guidelines. In an effort to “get it right” they are reaching out to practitioners and issuers alike in order to achieve the delicate balance between investor protection and capital formation. One New Year’s wish is that they are able to accomplish the drafting of the NASAA Guidelines sooner rather than later. To that end I know I speak for many of us when I tell them that we, the practitioners, are here to work together to create sensible guidelines for BDS’s. Mark, Heath, call us.

During the next year, regulators and practitioners will face other challenges as well. These challenges include the wonderful world of crowd funding, IA registration, and myriad other matters. The one thing we know is that the next year will be full of challenges which will create opportunities for regulators, practitioners, and issuers to work together to create an environment which fosters capital formation and thus growth and employment opportunities as well investor protection. Investors need to be confident to invest; therefore, our common goal is to make sure fraudsters are put out of business.

Finally, here is wishing everyone a happy, healthy, and prosperous New Year. As with the odd fellow pictured below, we can cross the finish line, no matter how great the distance.

Happy New Year!

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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.

Above is a picture of the odd fellow referenced above as he crosses the finish line at the Philadelphia Half Marathon.

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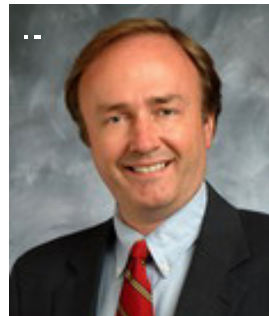
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