

THE BLUE SKY BUGLE

A Newsletter for Blue Sky Lawyers

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EVENTS CALENDAR

The State Regulation of Securities Committee will meet in conjunction with the 2006 Spring Meeting of ABA Business Law Section to be held April 8, 2006 (10:30 AM to 12:00 PM) at the Tampa Marriott Waterside Hotel

PLAN FOR THE FUTURE

2006 Annual NASAA Fall Conference
September 17 through September 20, 2006
Westin Horton Plaza, San Diego, California

2007 Annual NASAA Fall Conference
September 30 through October 3, 2007
Seattle, Washington

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BLUE SKY BITS AND PIECES

By Ellen Lieberman
Debevoise & Plimpton LLP (New York)

F. Lee Liebolt, Jr., formerly a Chair of the American Bar Association Committee on State Regulation of Securities and a partner at Sidley Austin Brown & Wood LLP, has moved his practice to Harkins Cunningham LLP in New York and is looking forward to new challenges! We wish him great success.

The Ohio Division of Securities has a new Chief of Licensing, Bradley P. Long, as of June 27, 2005. Mr. Long was formerly Assistant to the Director of the Ohio Department of Commerce, Chief of the Division of Consumer Protection, Director of Governmental Relations for the Ohio Historical Society, and a founder of a private firm representing corporate clients and business trade associations in governmental matters. Mr. Long fills the position previously occupied by Dale Jewell, the current Commissioner.

The new Virgin Islands blue sky law will be enforced by the Office of the Lieutenant Governor, Division of Banking and Insurance, Director Deverita Carty Sturdivant. She also serves the community as a trustee of the Virgin Islands Humanities Council, which seeks to provide opportunities for the diverse population of the Virgin Islands to participate in humanities programs that promote a love of learning, encourage dialogue, enhance understanding, and share people's cultural backgrounds. She is a recognized literary talent, having won the Marguerite-Cobb McKay Prize for the year 2002 awarded by The Caribbean Writer, an international literary anthology published by the University of the Virgin Islands.

Michele Kulerman of Hogan & Hartson has been asked to sit on the Board of a non-profit group called Young Playwrights Theatre. The group is organized to teach grade school children in Washington D.C. public schools how to write plays, and the plays they write are then performed by professional actors and actresses at Kennedy Center and other private theater in the city. Break a leg, Michele!

Lawrence H. Mirel, Commissioner of the Department of Insurance, Securities and Banking, the District Government agency responsible for enforcing all laws of the District of Columbia relating to the conduct of financial services activities, has left that position. Larry N. Coates, who served as Acting Director of the Department's Securities Bureau recently retired. James [Mike] M. McManus is now Acting Assistant Director of Corporate Finance.

R. Michael Underwood, Secretary to the Committee and Chair of our Enforcement Subcommittee, previously with Steel Hector & Davis LLP, is now Counsel to Squire, Sanders & Dempsey L.L.P. as a result of the merger of the two firms in September of 2005.

It is with great regret that we note the recent passing of Marie Montagnino after a long illness. For many years Marie headed the registration department for Merrill Lynch. She was an early pioneer in the creation and development of the Central Registration Depository (CRD) for the securities industry working on behalf of the industry with the NASD, the SEC and NASAA who all relied upon and respected her knowledge of the registration process. She was the President of the Association of Registration Managers (ARM) of the securities industry for many years and succeeded in making ARM a much needed and potent voice in the compliance arena. She was admired for her dedication to provide an efficient and uniform registration process for the members of the securities industry and the securities regulators.

**CALIFORNIA DECISION HOLDS STATE
PREEMPTED BY NSMIA IN ACTION OVER
MUTUAL FUND PROSPECTUS DISCLOSURES**

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

In what appears to be a case of first impression, a California Superior Court judge recently issued an as-yet unpublished decision, sustaining the defendants' demurrer to an action brought by the California Attorney General against the distributor and investment manager for a family of mutual funds, and held that the state was preempted by the National Securities Markets Improvement Act of 1996 ("NSMIA") from asserting that certain disclosures were omitted from the funds' prospectuses and statements of additional information, in violation of the California Corporate Securities Law of 1968 (the "CSL"). Capital Research and Management Company v. Lockyer, No. BC330770, consolidated with

State of California v. American Funds Distributors, Inc., No. BC330774 (Cal. Super. Ct., Nov. 15, 2005).

As described in a press release issued at the time the lawsuit was filed (Rel. No. 05-021, March 23, 2005, www.ag.ca.gov/newsalerts/2005/05-021), California Attorney General Bill Lockyer brought this action, alleging that American Funds Distributors Inc. ("AFD") and Capital Research and Management Company, the distributor and investment manager, respectively, for the American Funds family of mutual funds (about 29 funds in total), violated provisions of the CSL by failing "to adequately inform investors about \$426 million in 'shelf space' payments made to dozens of broker-dealers to sell and recommend American Funds," and asserted that such payments "are little more than kickbacks to buy preferential treatment." The complaint sought disgorgement of all profits the defendants obtained as a result of violating provisions of the CSL, restitution for investors, civil penalties of up to \$25,000 per CSL violation, and an injunction prohibiting future violations. The press release noted that in 2004 the Attorney General had settled similar "shelf space" actions against PA Distributors, the distributor of the PIMCO funds, and Franklin Templeton Distributors, Inc., the distributor of the Franklin Templeton funds, and that a suit was pending against Edward D. Jones & Co., a broker-dealer, for failing to adequately disclose its receipt of about \$300 million in "shelf space" payments from seven preferred mutual funds, including American.

As reflected in the decision, the State's complaint was premised on statutory claims under CSL § 25401 [in relevant part, making it unlawful to offer or sell securities in the state by means of a written communication which omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading], and CSL § 25216 [in relevant part, prohibiting a broker-dealer or agent from effecting transactions in, or inducing or attempting to induce the purchase or sale of, a security, by means of any manipulative, deceptive or other fraudulent scheme, device, or contrivance; in turn, Cal. Department of Corporations Rule 260.216(b) defines the phrase "manipulative, deceptive or other fraudulent scheme, device, or contrivance" to include material omissions of the type prohibited by CSL § 25401].

In the decision, the court sustained defendants' demurrer to the complaint, finding no express preemption, but concluding that there was implied preemption, of the State's claims by NSMIA. While not elaborated upon in the decision, since the issuers in question were all

investment companies registered under the Investment Company Act of 1940 (the “1940 Act”), they all qualified as issuers of “covered securities” within the meaning of Section 18(b)(2) of the Securities Act of 1933 (the “1933 Act”), as amended by NSMIA. As such, 1933 Act § 18(a)(2)(A) prohibits states from directly or indirectly prohibiting, limiting, or imposing any conditions upon the use of any offering document that is prepared by or on behalf of the issuer of a “covered security.”

As regards express preemption of the State’s action by NSMIA, the court focused on the plain wording of NSMIA, and noted the apparent conflict between 1933 Act § 18(a)(2)(A) and the “savings clause” in 1933 Act § 18(c)(1), preserving the right of states, consistent with Section 18, “to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions.” The court concluded that since the preamble to Section 18(a)(2)(A) subjected the preemptive language therein to the condition, “Except as otherwise provided in this section,” which would include § 18(c)(1):

. . . the express preemption provision, when read in conjunction with the savings clause, is ambiguous on its face as to what state claims are permitted. Hence, in this case, the plain wording of the statute does *not* contain the “best evidence” of Congress’s intent. Slip op. at 11-12.

Accordingly, the court concluded that the defendants failed to demonstrate that the State’s claims were expressly preempted by NSMIA.

The court then went on to consider whether the State’s claims were implicitly preempted by NSMIA, analyzing NSMIA as to whether there was “field preemption” or “conflict preemption.” As regards “field preemption,” the court concluded that Congress did not intend to occupy the “entire field” of securities regulation, since there was clear recognition of concurrent federal/state jurisdiction over securities. As regards “conflict preemption,” however, the question was whether there was a direct conflict between the federal scheme and the State’s claims, *i.e.*, whether the suit stood “as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress in enacting NSMIA.” Slip op. at 14.

In its analysis, the court quoted liberally from portions of the House Commerce Committee Report on NSMIA

(H.R. Rep. No. 104-622, 104th Cong., 2d Sess. 1996 at 16 and 34), and from the Joint Explanatory Statement of the Committee of Conference (H.R. Conf. Rep. 104-864, 104th Cong., 2d Sess. 1996 at 40), to the effect that the “savings clause” in 1933 Act § 18(c)(1) was not intended to permit state securities regulators to use their preserved antifraud authority to regulate the securities regulation and offering process by commenting on and/or imposing requirements on the contents of prospectuses for “covered securities,” but would preserve enforcement actions for fraud or deceit (such as for a prospectus containing fraudulent financial data or failing to disclose that the principals had previously been convicted of securities fraud). Thus, the court concluded that the preemption issue boiled down to whether the Attorney General’s complaint

. . . would operate either: 1) in the nature of a prohibition on the circulation of an offering document that does not include a disclosure that the State believes is necessary; or 2) in the nature of a prohibition on prospectuses containing “fraudulent financial data” and/or a prohibition on common law fraud or deceit. Slip op. at 15-16.

The court then found that the State was seeking to require the defendants to make disclosures in their prospectuses and statements of additional information that were not in the nature of “fraudulent financial data” or indicative of common law fraud or deceit, but rather represented an attempt by the State to “impermissibly seek to require or impose conditions on the disclosure of information for covered securities,” and that:

The notion that a California court or jury may determine the materiality or adequacy of disclosures (or non-disclosures) is inconsistent with, and would undermine, NSMIA. It would place Investment Company Act Funds in the untenable position of having to seek review of their offering statements by regulators in all states in which their shares are sold. Such would be the antithesis of the national regulation of securities offerings contemplated by NSMIA. Slip op. at 17.

The court concluded that the State was seeking to impose disclosure requirements that exceeded the detailed requirements of SEC Form N-1A, the registration statement form adopted by the SEC for registration of open-end management investment companies under the 1933 Act and/or the 1940 Act (and

the court noted that the State did not allege a failure to comply with Form N-1A's requirements).

According to an article about the decision in the Nov. 30, 2005 issue of BNA's *Securities Law Daily*, a spokesman for the California Attorney General reportedly said that the state would "definitely" appeal the ruling.

The AFD case reflects the obvious tension between the clear preemptive effect of 1933 Act § 18(a) as regards states' authority over requisite disclosures by issuers of "covered securities," and the "savings clause" of 1933 Act § 18(c)(1). Other than the specific examples cited in the decision of blatant financial fraud or the omission of facts concerning securities fraud convictions of principals, it is unclear where the line may ultimately be drawn in a case where a state alleges that a particular misrepresentation or omission rises to the level of "fraud or deceit" within the scope of § 18(c)(1). Of course, it is certainly reasonable to conclude that the legislative intent behind NSMIA was to create a single disclosure framework for covered securities, based on SEC guidelines, without second-guessing by the states.

It also seems, however, that in the case of a state challenging a particular omission from a prospectus, SEC Rule 408(a) under the 1933 Act, which provides that, "[i]n addition to the information expressly required to be included in a registration statement, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading," may provide leeway for another court to go beyond the literal requirements of SEC registration statement forms, including the provisions of SEC Regulation S-K ("Reg. S-K") incorporated therein, to conclude that the particular omission constitutes non-preempted fraud or deceit, irrespective of the fact that the applicable registration form didn't specifically require such disclosure. Thus, for example, query whether a state might successfully challenge a covered securities issuer's failure to disclose that one of its executive officers or directors was the subject of a material civil, criminal, or administrative proceeding of the type described in Item 401(f) of Reg. S-K, but deliberately omitted such information in accordance with that provision because the proceeding occurred over five years prior to the date of the particular offering?

Further, it must be remembered that a number of other "covered securities" within the scope of 1933 Act § 18 (e.g., securities sold in reliance on the 1933 Act § 4(1), § 4(3), or § 4(4) exemption, securities sold in a private

offering exclusively to "accredited investors" in reliance on the exemption under Rule 506 of SEC Regulation D under the 1933 Act, or governmental securities sold in reliance on the 1933 Act § 3(a)(2) exemption) aren't governed by SEC registration forms, and therefore would appear to be fair game for state actions claiming material misrepresentations or omissions, in the absence of any objective guidance from the SEC as to what offering documents for such securities offerings must contain.

THE INTERNET AND THE NEW JERSEY BUREAU

By Jordan Weinreich
Hartman, Doherty & Rosa, LLC

New Jersey's take on the Uniform Securities Law gives the New Jersey Bureau of Securities (the "Bureau") broad jurisdiction over persons who sell or offer to sell securities into or from New Jersey (subject to a few small exceptions such as NSMIA of course). N.S.J.A. 49:3-51. Under New Jersey law, absent an exemption, an issuer that offers or sells securities within the Bureau's jurisdiction must register the offering with the Bureau. Similarly, it is unlawful for any person to act as a broker-dealer, agent, investment adviser or investment adviser in New Jersey unless that person is registered or exempt from registration. This is a simple enough concept, but like many other areas of the law, the Internet makes the subject a bit dicier. The posting of information on a website may constitute an offer of securities or investment services for purposes of the New Jersey Securities Law, thus triggering registration requirements.

Currently, the Bureau's policy regarding offers and dissemination of information over the Internet is found in administrative orders and published no-action letters. Although no-action letters provide guidance on adhering to New Jersey's securities law, the Bureau adds a caveat to their letters that the position taken by such letters concern enforcement actions only and does not represent a legal conclusion regarding the applicability of the Uniform Securities Law to the applicant's proposed activities. Positions taken in no-action letters are based solely on the representations made by the applicant and any different facts or conditions might elicit a different response from the Bureau. Simply put, if you really want to know what to do, request your own no-action letter.

For the most part, communications made on the Internet are directed not only to particular recipients, but also to anyone with access to the Internet. The Bureau

recognizes that any of these communications made by, or on behalf of, an issuer, which are for the purpose of raising capital, are offers within the purview of N.J.S.A. 49:3-49(j)(2) which defines “offer” or “offer to sell” to include every attempt or offer to dispose of, or solicitation of any offer to buy, a security or interest in a security or investment advisory services. Therefore, these offers come within the scope of N.J.S.A. 49:3-51 and trigger the registration and sales literature filing requirements in NJSA 49:3-60 and N.J.S.A. 49:3-63 respectively.

In an Administrative Order dated August 28, 1996, the Bureau Chief recognized that certain issuers do not intend to offer and sell securities in New Jersey, and would exempt these Internet offers if the following conditions are met:

1. The Internet offers indicate directly or indirectly, that the securities are not being offered to persons in New Jersey;
2. The offers are not otherwise specifically directed to any person in New Jersey by or on behalf of the issuer; and,
3. No sales of the issuer’s securities are made in New Jersey as a result of the Internet offering until such time as the securities being offered have been registered under the applicable New Jersey statute.

The Bureau does not dictate the use of any one particular technology or screening method to protect against solicitation in these instances but instead leaves it to the website operator to determine a method that complies with the above three conditions.

Often the sale of securities and the sale of investment advisory services go hand in hand. In certain instances, by distributing information on available products and services over the Internet, people or organizations could be construed as “transacting business” for purposes of N.J.S.A. 49:3-56 (registration requirement of broker-dealers, agents, and investment advisors), triggering the registration requirements of that section. This is because these webpages could be viewed by any person in the State regardless of the intent of the person operating the website. The Bureau offers an approach similar to the three conditions above when dealing with the Internet issues relating to broker-dealers, investment advisors, and broker dealer agents. In an administrative order dated September 2, 1997, the Bureau chief laid out a number of conditions to be followed which would allow

a person or organization to be exempt from the registration requirements of N.J.S.A. 49:3-56.

Most similar to the offer requirements, the website must contain an unspecified mechanism that is “designed reasonably to ensure that prior to any subsequent, direct communication with prospective customers or clients in [New Jersey], said broker dealer, investment advisor, or broker-dealer agent is first registered in New Jersey or qualifies for an exemption or exclusion from such registration.” This condition is intended to prevent a New Jersey resident from encountering an unregistered broker-dealer, agent, or investment adviser over the Internet. Of particular interest are the Bureau’s restrictions on websites of broker-dealer agents. The following requirements add an extra layer of vigilance by making the broker-dealers responsible for their agents’ websites:

1. the affiliation with the broker-dealer of the broker-dealer agent must be prominently disclosed;
2. the broker-dealer with whom the broker-dealer is associated retains responsibility for reviewing and approving the content of any website by a broker-dealer agent;
3. the broker-dealer with whom the broker-dealer is associated must first authorize the distribution of information on the particular products and services through the website; and,
4. in disseminating information through the website, the broker-dealer must act within the scope of the authority granted by the broker-dealer.

The Bureau recognized that since the Internet is accessible from all 50 states, if there was no available exception, a company’s representatives would only be authorized to use the Internet to discuss the services they offer if they are properly registered as a representative in all 50 states and they would only be permitted to use the Internet to discuss securities which are also properly registered in all 50 states. One example of a situation involving this issue comes from a no-action letter. In this letter, a representative of a nationally registered broker-dealer proposed a two-tiered Internet gateway that would allow the registered broker-dealer to offer and sell the company’s investment products on its website to New Jersey residents if the representative, as well as the securities discussed, were registered in New Jersey. The broker-dealer Applicant proposed this mechanism so that the Applicant’s representatives in states other than New Jersey could establish websites which would provide

information on the services the representative offers, without being registered in New Jersey. When users first accessed the website, a prompt required the user to enter his state of residence. This provided the user with access to any of the home-pages of the Applicant's broker-dealers that were registered in the user's state of residence. Once the user arrived at the broker-dealer's website, the user was prompted once again to enter such user's state of residence in order to obtain information about any of the Applicant's products that were registered securities in that state.

Another example of tiered Internet gateway is the Angel Capital Electronic Network, originally known as ACE-Net and now found at www.activecapital.org. This Internet-based listing service is sponsored by the United States Small Business Administration. Investors using this website certify on an Investor Application that they conform to the SEC's definition of an Accredited Investor found at 17 CFR 230.501(a), and they pay a fee of \$250.00. Individuals, or entrepreneurs as they are referred to on the site, can raise from \$250,000 to \$5 million from the sale of securities without having to register them with the SEC or state regulatory agencies.

An offer made through activecapital.org into or from New Jersey would be exempt from securities registration pursuant to NJSA 49:3-50(B)(13), since it involves an offer or sale delivered through an electronic database that is restricted to persons who have been pre-qualified as accredited investors. Active Capital's legal status derives from a no-action letter issued by the Securities and Exchange Commission and Model Accredited Investor Exemption (MAIE) of 48 states as overseen by NASAA. New Jersey's Bureau Chief issued an Order on March 23, 1998 adopting the MAIE. The MAIE was developed to specifically accommodate activecapital.org and similar sites.

It seems that the easiest means of compliance with the three requirements of the August 28, 1996 Administrative Order and the broker-dealer, agent, and investment advisor requirements of the September 2, 1997 Administrative Order is a website with restricted access. From a regulatory perspective, these conditions are simple enough to enforce if the issuer or broker-dealer, broker-dealer agent, or registered representative are located in New Jersey; they are simple enough if the broker-dealer, agent or investment advisor is at the very least registered in New Jersey because the revocation of their license would probably trigger nationwide revocation. All the conditions discussed above are an attempt by the Bureau to regulate offers of securities and investment services coming into or originating from

New Jersey via the Internet; this is not limited only to websites originating in the United States. The tricky issue lies not in the applicability of State securities laws to offshore Internet offers, but the enforceability of these laws. Besides the fact that State regulatory agencies such as the Bureau may lack the means to enforce their laws on a foreign issuer or broker dealer, they may lack the jurisdiction to shut down or mandate gateway mechanisms on websites that may even be overtly directed towards U.S. investors.

The SEC, in its International Series Release No. 1125, offers some guidance similar to New Jersey's published no-action letters. The SEC would not consider an offer made by a non-U.S. offeror as targeted at the US if "the website offeror implements procedures that are reasonably designed to guard against sales to U.S. persons in the offshore offering. For example, the offeror could ascertain the purchaser's residence by obtaining such information as mailing addresses or telephone numbers prior to sale." Similar to New Jersey, the SEC does not dictate the use of any one particular technology or screening method to protect against general solicitation. The SEC leaves it to the website operator to develop an effective method for restricting access to its website.

The SEC also takes a restrictive view of investment services over the Internet, concluding that a foreign adviser providing advisory services over the Internet would generally be holding himself out as an investment advisor. Similar to New Jersey, a foreign investment adviser can be exempt from registration under Federal securities laws if they restrict access to their websites. The recurring theme in the SEC's paper is that "measures reasonably designed to guard against sales to U.S. persons" can exempt securities and their salesmen from registration under Federal law. These Federal laws face the same enforceability issue when the website operator has no presence in the United States; especially when the company hosting the website is located in a foreign jurisdiction.

Securities laws are meant to be preventative in nature but these laws are often violated, creating some loss that the laws seek to redress by punishing the perpetrator. It should be noted that a private right of action is available for fraud or material misrepresentation regarding securities offers made over the Internet. Federal Courts have recognized U.S. jurisdiction over fraudulent conduct where substantial conduct or effects occur in the US. *Itoba Ltd. v. LEP Group PLC*, 54 F.3d 118 (2nd Cir. 1995). District courts have also permitted jurisdiction pursuant to *Itoba* over foreign defendants in actions

brought by the SEC. SEC v. Batterman, 2002 U.S. Dist. LEXIS 18556 (S.D.N.Y. 2002). New Jersey has no specific long-arm jurisdiction statute and instead mirrors federal procedure. It is likely that the Bureau could pursue foreign nationals and organizations for fraudulent conduct pursuant to Itoba.

N.J.S.A. 49:3-71 provides the basis for New Jersey's private right of action for securities fraud, allowing for the recovery of consideration paid for a security or for investment advice and any loss due to the advice, together with interest from the date of payment of the consideration for the investment advice or security and costs. Unfortunately, as with foreign defendants in any type of lawsuit who fail to appear in a lawsuit, the enforcement of a default judgment may require an attempt to collect in the defendant's home jurisdiction which may or may not be possible.

The vast and expanding size of the Internet makes it impossible to monitor all communications made over the Internet that violate securities laws. Regulators have little ability to enforce compliance with local laws when websites are located in foreign jurisdictions. The best hope is greater cooperation between the securities regulators from different jurisdictions which makes organizations such as NASAA and the International Organization of Securities Commissions more important than ever.

NEW BRANCH OFFICE LICENSING PLAN POSES SPECIAL RISKS FOR BROKER- DEALERS IN FLORIDA

By R. Michael Underwood
Squire, Sanders & Dempsey L.L.P.

It was still the last century when Pamela Epting, now Chief of the Bureau of Regulatory Review of the Office of Financial Regulation in the Florida Department of Financial Services, started talking to other regulators about uniform registration of securities and investment advisory branch offices. New York Stock Exchange member firms have always been required to obtain prior approval of the Exchange before operating a new branch office, but the NASD and most states require only notice of the new branch. Connecticut, Nevada, Texas and Vermont required that branch offices receive a state license before operating. Florida is unique in not only requiring the regulator's approval before a branch office can operate, but also giving customers a right to rescind securities purchases made through an unregistered branch office. Sections 517.12(4) and 517.211(1), Fla. Stat. (2004).

Until the turn of the century, securities dealers doing business in Florida faced civil liability on top of regulatory headaches every year on April Fools Day, the day after every Florida branch office license expired. Firms that failed to renew as provided by Section 517.12(11), Fla. Stat. (2004) found no grace period and no provision for retroactive licensing. Securities transactions made through the branch after the license expired and before a new application could be filed and approved were all subject to rescission at the customer's election. Unless the firm made a rescission offer under Section 517.211(1) Fla. Stat. (2004) to all of its customers in the hiatus, the civil liability continued for at least two years and possibly as long as five years.

Chapter 2000-123, Laws of Florida (2000) removed the customer's rescission rights in cases of non-renewal of branch office licenses. The civil liability continues to exist, however, for branch offices that have never been registered. Rescission offers to customers under Section 517.211(1), Fla. Stat (2004) remain common in Florida. As many broker-dealers in Florida have unfortunately discovered, not making a rescission offer when the firm has been discovered to have operated unlicensed branch offices in Florida, especially when an administrative order has been entered, is to invite a class action lawsuit or, at least, a customer arbitration. Such firms have also discovered that there is no defense to such actions. Sale of securities through an unlicensed branch office is a strict liability offense in Florida.

With such high stakes on Florida branch office licenses, it is not surprising Florida was a leader of the effort to make the process more uniform and rational. Florida's Pam Epting has been part of the Working Group assembled by NASAA, NASD and NYSE, since the Working Group's inception, to study branch-office registration. That group's work has led to two significant changes in the law; first, a uniform definition of branch office (SEC File No. SR-NASD-2003-104) approved by the SEC on September 16, 2005, and, second, creation of Form BR to replace Schedule E on Form BD and Form ADV (SEC File No. SR-NASD-2005-030), approved October 7, 2005. The regulatory scheme has now been deployed with Web CRD Release 7.1 on October 31, 2005.

The new definition of "branch office" is significantly broader than the former definitions in NASD Rule 3010(g)(2) and Florida Rule 69W-200.001(9), Florida Administrative Code ("F.A.C."). No longer would a location with only one agent not otherwise held out as a branch be definitionally exempt from branch office licensure. The former NASD provision at 3010(g)(3)

allowing non-branch locations to report directly to the home office is now repealed. Registered representative's residences, if used for securities or investment advisory business, will become "branch offices" unless several conditions are met. Many firms are likely to find the new definition will require state licensure of business locations formerly not deemed branch offices. Membership Agreements with NASD may have to be amended and some firms may find they have expanded beyond the limitations of the Safe Harbor for Business Expansions provided by 1M-1011-1 and are required to reapply for NASD membership under NASD Rule 1017.

Moreover, all broker-dealers and investment advisers with physical operations in Florida must assure that all Florida business locations are properly licensed with the state. This is because Florida and NASD have been cooperating to "pre-populate" the new Forms BR based on members' now obsolete Schedule E. By operation to Florida's Rule 69W-200.001(9)(a)3., F.A.C., any location designated a branch office on Schedule E is automatically a "branch office" for Florida licensing purposes. No amnesty is authorized for Florida to "grandfather" operating branch offices into state licensure. All securities business conducted through an unregistered Florida branch office is, by statute, subject to rescission by customers, or, significantly, a class of such customers.

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FROM THE CHAIR: PREEMPTION AND OTHER MATTERS

By Ellen Lieberman
Debevoise & Plimpton LLP

We had a productive and enjoyable meeting in Minneapolis in conjunction with NASAA's Annual Meeting on September 11, 2005. A plaque was presented to Marty Miller of Willkie Farr & Gallagher LLP in appreciation and recognition of his service as past Chair of the Committee.

There were less festive moments, as well. The date of our meeting brought back memories of September 11, 2001, and we also focused to some degree on Hurricane Katrina and the devastation wrought by that storm. We were pleased to learn that NASAA was posting emergency state regulatory orders providing relief for those affected by the hurricane, and that website was subsequently provided to the Committee by listserv,

together with helpful SEC and American Bar Association sites. Some of us had an opportunity to hear first hand about the tragedy from Frederick Boyd, Securities Investigator located in Baton Rouge, and his colleagues and we were pleased to learn that Harry Stansbury, who retired about a year ago as Deputy Commissioner of Securities for the State of Louisiana, was safely plucked from the roof of his home where he had sought refuge and been trapped for two days during the aftermath of the hurricane.

There were several topics that seemed to permeate the meeting, in addition to Katrina and the unseasonably hot and humid weather of Minneapolis, and one that resonated deeply with the NASAA community was preemption.

Preemption. NASAA is greatly concerned about preemption-- in all of its guises. A panel discussion at the NASAA Conference focused on Preemption: Congress and the Courts. Concerns have been expressed about OCC's holdings preempting certain state banking regulatory authority over national banks and their operating subsidiaries, State Farm Bank's attempt to have OTS determined to be the sole regulator of agents who market State Farm Bank products including certificates of deposit; federal preemption of consumer privacy legislation; potential creation of an overriding federal scheme for insurance regulation; and federal legislative attempts (thus far aborted) to preempt certain state remedies for violation of blue sky laws. In the September 2005 issue of The Blue Sky Bugle, Jeffrey Spill, Deputy Director of Securities Regulation for the State of New Hampshire, took aim against attorneys' arguing preemption in defending mutual funds against accusations by state regulators of fraud for failure to disclose to investors revenue sharing and directed brokerage arrangements. On July 1, 2005, NASAA expressed concern that state authority to protect investors was being undermined "by various threats to use the regulatory, legislative and judicial processes" and, by resolution, NASAA expressed its opposition to preemption of state securities authority.

We understand and empathize with the concerns of NASAA and the individual state regulators. In her luncheon address at the NASAA Annual Meeting, Patricia Struck, Administrator of the Wisconsin Division of Securities and NASAA President, said "When a state or provincial securities regulator asks for a response from a broker-dealer or investment adviser, provide it-- promptly. While you may not agree with our positions at times, I do expect you to respect our authority."

And we concur that showing respect for the authority of blue sky administrators is essential, but sometimes a state regulator's authority to take certain action or impose a certain remedy may be in doubt. Particularly following the abuses of the late 1990s and the successes of some high profile state regulators in addressing abuses, some blue sky regulators (and indeed, some members of the NASD and SEC staff) have tried to push the enforcement envelope. We would be concerned if we perceived that regulators were attempting to thwart legitimate and appropriate efforts to question and clarify the jurisdiction of regulators to take certain actions. We would be equally concerned if, by implicit threat or otherwise, state regulators attempted to preclude a challenge to state action based on the possibility that states are overstepping their jurisdictional bounds. Our federal constitution and state constitutions guarantee to all citizens due process including the right to raise any legitimate argument in defense. If preemption or lack of jurisdiction is such a defense, then the right to raise it is guaranteed as part of the American way of life. And so we agree with President Struck—respect, definitely! But within the bounds of, and with equal respect for, due process of law.

Form D. NASAA and the SEC are working on an electronic (and shorter) version of the Form D, and we expect to have some input into that process. If you have particular thoughts or concerns, please contact Hugh Makens of Warner Norcross & Judd LLP who is working on this project as a representative of the NSMIA Subcommittee chaired by Mike Liles of Karr Tuttle Campbell and Kathy Duggan of Cahill Gordon & Reindel LLP. This undertaking is in addition to the survey being compiled by Mike Liles and Kathy Duggan's NSMIA Subcommittee for which they already circulated an informational request. If you haven't given them your feedback, please check the listserv archives and take the time to respond because the results will be of interest to all of us

Branch Office. There was a great deal of discussion at the Minneapolis meeting on the proposed new definition of "branch office," a collaborative effort of the NASD, the New York Stock Exchange and NASAA. The proposal also envisions electronic filing of branch office information with federal and state authorities. Some concerns were expressed, however, that brokers may suddenly have more branch offices than had been the case and if any branch office slips between the cracks, in Florida, for example, sales through an unregistered branch office may be the basis of a suit for rescission.

Other Committee Matters. The next Committee meeting will be in Tampa during the Spring Meeting of the ABA Business Law Section April 6-9, 2006. Once the exact time of the meeting has been set, we will share that information with Florida Commissioner Don Saxon who has already indicated that he will try to attend our meeting. In Tampa we hope to co-sponsor a CLE program on securities law enforcement with the Committees on Federal Regulation of Securities and Criminal Laws, and we anticipate that R. Michael Underwood of Squire, Sanders & Dempsey L.L.P. will serve as one of the program chairs and help organize the event. More details will follow via the listserv.

Some of the Committee officers had a very cordial and productive meeting on September 12 with Acting California Corporations Commissioner Wayne Strumpfer, Chief Advisor to the Commissioner Mark T. Uyeda, Acting Deputy Commissioner Alan Weinger and Acting Chief Deputy Commissioner and Deputy Commissioner, Securities Regulation Division, Anthony Lewis. We discussed various aspects of California's treatment of employee benefit plans, its new electronic filing of Form 25102(f), its lack of an exemption corresponding to Federal Rule 701, its efforts at education particularly targeting affinity groups, elderly, and the military and their families, and an upcoming audit of the Department by state auditors. We expect to be in further communication with these gentlemen about the issues that were raised and to express our appreciation for their willingness to communicate and work with us on these important issues.

Denny Crawford who is the Texas Securities Commissioner is also the Chair of NASAA's Corporate Finance Section. Denny has expressed her interest in reaching out to and working with the ABA Committee, and we are delighted to participate. Current thinking calls for one or more open meetings of the NASAA Corporate Finance Section with ABA Members dialing in and become participants. As plans become more concrete, information will be circulated through the Committee listserv.

At our Minneapolis meeting, we revived the concept of stand along subcommittee meetings. We will try to do more of the same at next year's Annual Meeting of NASAA in San Diego, if possible following the full meeting of the ABA Committee. During the year, some of the subcommittees may communicate via listserv or e-mail, and others may arrange interim conference calls. If you would like to be more involved, please reach out and contact the subcommittee chairs. Contact

information is on the Committee's website. We want and need your input!

If you have blue sky colleagues who have not joined the ABA Business Law Section (including those whose practice includes or is primarily in enforcement-related matters), please urge them to do so, and then they can become members of our Committee and any of its subcommittees for no additional charge and have access to The Blue Sky Bugle, the listserv and any of our other resources. If you have something to share with the full Committee, please send it to the listserv at BL-STATEREGS@MAIL.ABANET.ORG.

Do stay in touch by phone (212) 909-6096 or e-mail (elieberman@debevoise.com) (or let's do lunch!) and share your ideas and concerns with me. See you in Tampa if not before.

FORM D - CHANGES ARE COMING

By Hugh H. Makens
Warner Norcross & Judd LLP

The SEC is in the process of considering amendments to Form D to clarify the wording of the Form, eliminate information that does not serve a purpose, add information that will assist review, correct inaccuracies in wording, and prepare the Form for conversion to electronic filing on EDGAR. The primary contact at the SEC on this project is Gerald LaPorte, head of the Office of Small Business Policy. NASAA has been working closely with Gerry, with Mike Stephenson of the Washington Securities Division coordinating a Small Business/Limited Offering NASAA Project Group effort. Randy Schumann, the General Counsel of the Wisconsin Department of Financial Institutions, and a member of the Corporation Finance Section helped coordinate our efforts.

At the October 2005 NASAA meeting in Minneapolis, the State Regulation of Securities Committee was invited to provide comment to NASAA on recommended revisions to Form D. This was an informal opportunity to receive ideas and input on the Form before drafting was complete. The SEC has made substantial progress in its revision, and our comments have been helpful to that process.

Our effort was coordinated through our NSMIA subcommittee, headed by Mike Liles of Karr Tuttle Campbell and Kathy Duggan of Cahill Gordon & Reindel LLP. I acted as coordinator for the project gathering comments and then submitting them on behalf

of the subcommittee after coordinating with Ellen Lieberman. We received about ten comment emails/letters which provided thoughtful commentary. In addition, the Paralegal Roundtable provided comments which we provided as an attachment to our letter.

SUMMARY OF COMMENTS

Our comments on the Form were as follows:

Page 1:

The "Name of the Offering" line item could be more accurately entitled "Aggregate Offering Amount and Type of Security." The meaning of the present title is not clear.

The box "(check if this is an amendment and name has changed, and indicate change)" could be eliminated or consolidated under the existing line item entitled "Type of Filing."

"Address of Principal Business Operations" could be eliminated, since many companies have business operations in multiple states, and even internationally. Confusion results as to which address(es) must be provided.

Under "Type of Business Organization," the form makes a distinction between "limited partnerships already formed" and "...those to be formed," which is unnecessary when considered with the next item which lists the date or estimated date of formation which reveals the same information.

Page 2:

Under "General Instructions," the "*Where to File*" line should be updated to reflect the SEC's current mailing address.

An investment fund often has neither executive officers nor principal place of business, and often the registered office is used, or the address of the general partner or manager of the LLC is used. You might wish to expand the concept to address which office you want under those circumstances.

A definition of the term "Promoter" under Section A, Item 2, would be helpful as it is not clear and causes confusion. This was a frequent comment that I received. Also, for LLCs, add a bullet point for "Each Manager or Managing Member of limited liability company issuers."

The definition “Beneficial Owner” – should be clarified to state that it doesn’t include 10% owners of limited partner interests. Clarify in the instructions that you don’t need to amend the form to reflect later changes in beneficial ownership as the result of additional sales of securities for which the form is being filed.

There is inadequate room for footnotes and explanations in this section. Some entities have convoluted structures, e.g., a limited partnership with a corporate general partner with an LLC as an owner of the corporation. Either there must be more flexibility in the question, or you need more room for explanation.

Page 3:

There is a question about whether the offering permits joint ownership of a single unit. Why is this needed?

You have a question on minimum investment from an individual. Should this not cover entities as well?

Limit your questions about commissions from sales to investors to “US investors.”

If an issuer lists the name of the broker-dealer, regardless of the number of agents, this should be sufficient.

Under Section B, Item 2, add a box to check, as appropriate, if the issuer reserves the right to accept less than the minimum investment stated (this is a common occurrence). Some issuers are footnoting their Form D’s to address this problem currently.

Under Item 4, the line titled “State in Which Person Listed Has Solicited or Intends to Solicit Purchasers” should be revised to state: “States in Which Person or Entity is Licensed or Registered to Sell Securities.” It is not possible for issuers and their counsel to know where participating broker-dealers and their representatives have solicited or intend to solicit investors. Changing the focus to where broker-dealers and representatives are licensed would provide an objective test. Solicitation tends to be a moving target, and often arises in a spur of the moment event, e.g., during a phone call from a client in another state. New representatives coming to a firm will have customers not anticipated originally.

Page 4:

Some hedge funds do not set a maximum amount on the offering. They raise what they can. While this seems

illogical, it does happen. Should you consider a more flexible approach on this item?

You should recognize that in some instances money is not collected until immediately before closing, so the question relative to amount sold should reflect this concept.

It is unnecessary to separate out the amounts relating solely to organization expenses of the issuer. The information is not helpful, and it is often not broken out on legal bills. It is not material enough to warrant inclusion separately. Also, in many instances the issuer bears this cost.

Predicting a 12 months’ management fee is very difficult if it is dependent on the value of assets under management. Will the market go up or down? Will the securities purchased be winners or losers? Consider a different approach.

Add an additional category for “Investment.”

Page 5:

The federal signature fails to recognize the complexities of entities conducting offerings. It seems to assume a corporate form is used. We recommend broadening the concept of the title, or alternatively making it clear that all types of executive officers, e.g. LLC managers, general partners, etc., are included within the concept. Also, both the state and federal signature pages should be consistent as to the name and title of signor.

In some instances, LLCs will name officers and directors, even though not specifically contemplated in the authorizing statutes; make clear that they would be included.

Page 6:

State Signature - Each of 1-4 should be marked as “Not Applicable” if the filing is made in reliance on Rule 506. Unless NASAA does a major reform of ULOE, Rule 505 is meaningless in any event; use a separate form.

Among areas where you could consider cutting back information are:

1. Both Executive Offices and Principal Place of Business.
2. Expense disclosures. (Does anyone do anything with them?)

-
3. Do you really need a state signature page?
 4. Do you need state by state information? Probably not.
 5. If the state fee is graduated, let them pay what they choose and sell up to that amount. This system worked well for mutual funds for 50 years. Issuers can always pay more, and if they are paying, they are likely to be mindful of the need not to oversell.
 6. Add a statement: "A notice is deemed filed with a state on the earlier of the date it is received by the state, or, if received after the date on which it is due, on the date it was mailed by U.S. registered or certified mail to that state." (This is an issue in some states which specifically provide in their statutes that it is not deemed filed until actually received.)
 7. A statement relative to the effect of preemption on state filings should be added. Several state examiners do not yet understand that a late filing does not destroy the exemption until a state demand is dishonored.
 8. 10% limited partners are generally not control persons.
 9. Bad boy provisions are preempted in a 506 offering, and accordingly should not be included on a 506 form.
 10. The breakdown of "Use of Proceeds" is arbitrary and not reflective of reality for some types of offerings. Consider reducing and generalizing.

Page 7:

The Virgin Islands recently passed the Uniform Securities Act of 2002, so it should have a row in the Appendix.

OVERVIEW

We did not attempt to pass judgment on particular comments, but rather just acted as scribes to compile information and pass on the comments. We did combine similar comments into a single comment in preparing the letter, and also shortened some of the more extensive commentary, but tried not to alter substance. The response from subcommittee members was outstanding.

We anticipate that the Form will be sent out for public comment in the relatively near future. Nonetheless, the opportunity from NASAA, which indirectly aids the

SEC, by providing informal feedback is certainly appreciated.

As Form D is used increasingly by individual states or enforcement purposes, particularly in the area of identifying "finders" and other unregistered sales persons, the content of the Form is important, and since the Form is more likely to find its way into proceedings, it is important that the information be accurate and complete. By eliminating confusion over some of the questions, the task of the attorneys and paralegals becomes easier.

Please take time to review the new version of Form D when released for comment, and if you have suggested improvements, communicate them to Ellen Lieberman and me. If enough come in they may warrant a comment letter to the SEC working with the Federal Regulation of Securities Committee. We will also need to work with NASAA to get the new form universally accepted by the states.

EDITORIAL

By Martin A. Hewitt
Cadwalader, Wickersham & Taft LLP

As my first full year as editor of The Blue Sky Bugle comes to an end it is time pause and reflect on what has been accomplished on these pages.

First, I would like to thank everyone who has contributed articles to The Blue Sky Bugle this year. Contributors have ranged from lawyers at various law firms to in-house counsel and regulatory agencies. It has been a pleasure to edit these contributions (not that much editing was needed). As editor I am privileged and thankful to work with so many knowledgeable and talented people.

Second, I look forward to the coming year. This next year will be one of great change, as all years are. More states (to varying degrees) will be adopting and implementing the Uniform Securities Act (2002). Also, as new issues arise, we can all use The Blue Sky Bugle as a meeting place for the healthy exchange of ideas and points of views from the various types of lawyers described above. There is so much to accomplish to ensure that the markets are permitted to operate in a free atmosphere on the one hand while investors are protected on the other; this requires constant vigilance on the part of all parties and it is a delicate balance that must be maintained.

Finally, my hope for the coming year is that we are able to attract many and varied contributors to the Bugle. I always make it a point to end my editorials with the same quote from Tom Lehrer “Life is like a sewer system; what you get out of it depends entirely upon what you put into it.”

Happy Holidays

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