DIVERSE STATES DIRECT NEW DISCLOSURE AND PENALTIES

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(Legislation status as of October 1, 2003)

California legislation effective January 1, 2003 followed in the footsteps of Sarbanes-Oxley, as previously reported in this publication. But California and a number of other states have continued and expanded the scope of this activity, enacting or considering SOXA-like disclosure measures, and other measures that increase penalties for securities law violations. Although not professing to be a complete 50-state survey, or indeed a complete summary of the legislation, you may be interested in some of the measures recently enacted in California, Connecticut, Illinois, Kansas, Nevada, North Carolina, Ohio, Oregon, Rhode Island, Texas, Washington, and under consideration in Pennsylvania and South Carolina.

CALIFORNIA

Senate Bill 434 was chaptered by the Secretary of State as Chapter 876, Statutes of 2003, on October 12, 2003. This law gives the Attorney General concurrent authority with the commissioner of corporations (and, the law provides, without duplication of effort) to bring an action or conduct an investigation when it appears any person has violated or is about to violate state securities law, permits the Attorney General to ask for assistance not only from a state agency but also from an agency of another state or the United States and to disclose information and documents to such agencies if they agree to maintain confidentiality to the extent required by the provision. The law adds a new penal code provision making it a misdemeanor with a penalty of $25,000 fine and/or one year imprisonment for each violation to knowingly and willfully falsify, misrepresent, or conceal a material fact or cause someone else to do this in an investigation for violation of the state’s securities, commodities or business and professions law.

Senate Bill 523 was chaptered by the Secretary of State as Chapter 876, Statutes of 2003, on October 12, 2003. This law provides, without duplication of effort) to bring an action or conduct an investigation when it appears any person has violated or is about to violate state securities law, permits the Attorney General to ask for assistance not only from a state agency but also from an agency of another state or the United States and to disclose information and documents to such agencies if they agree to maintain confidentiality to the extent required by the provision. The law adds a new penal code provision making it a misdemeanor with a penalty of $25,000 fine and/or one year imprisonment for each violation to knowingly and willfully falsify, misrepresent, or conceal a material fact or cause someone else to do this in an investigation for violation of the state’s securities, commodities or business and professions law.
materially false or misleading written or oral statements intended to materially increase or decrease the value of the entity’s shares were made by an officer, director, manager or agent, or such persons made misstatements or concealed material facts to deceive a regulatory body or avoid a regulatory or statutory duty, if the conduct is not abated within the 30-day period. The law imposes civil penalties of up to $1,000,000 for failure to make such disclosure.

Senate Bill 777 was chaptered by the Secretary of State as Chapter 484, Statutes of 2003, effective January 1, 2004. The bill extends existing provisions to make it illegal for an employer to retaliate against an employee of a corporation or limited liability company for refusing to participate in an illegal activity, or for reporting to government agencies activities violating state or federal regulations (retaliation for reporting violation of state or federal statute was already illegal) or violation of fiduciary responsibilities to shareholders or members (provided the employee has reasonable cause to believe the action would be illegal or result in such violation). The law doubles civil penalties to $10,000 per violation, also applies to government employees, but does not apply where lawyer-client privilege would be violated. The law requires the state’s attorney general to maintain a whistleblower hotline and refer calls to appropriate agencies, and requires employers to display the hotline number and employee rights.

Assembly Bill 1031 was chaptered by the Secretary of State as Chapter 473, Statutes of 2003, effective January 1, 2004. The law increases penalties for securities fraud and insider trading by issuers as defined in Section 2 of SOXA up to $25,000,000 and 5 years in prison, and increases certain other penalties for issuer violation of securities law and for acting as an unlicensed broker. The law makes it unlawful to knowingly alter, destroy or conceal a document to intentionally impede, obstruct, or influence the administration or enforcement of the securities law. The corporations commissioner is given additional grounds upon which to deny, suspend or revoke broker-dealer or investment adviser licenses or impose discipline including disciplinary action taken by other U.S. or foreign governments for violation of their regulatory schemes. The law limits information as to investment advisers, including certain criminal history, that the commissioner can disclose to the public.

Connecticut

Public Act 03-259 was signed into law by the Governor July 9, 2003. Most of the provisions became effective October 1, 2003. Among other things, the law increases the fines for certain banking and accounting law violations and the offense level for certain white-collar crimes and conditions financial institutions’ ability to effect certain mergers and consolidations in part on whether they have adequate anti-money laundering programs, policies, and procedures and a record of compliance with anti-money laundering laws and regulations.

The law extends the look back period that permits the banking commissioner to revoke, deny, suspend, restrict, or condition a broker-dealer or investment adviser applicant's registration or activities on the basis of discipline by other governmental or SRO authorities. It also permits the commissioner to order a person who violated the securities law or engaged in a dishonest or unethical practice in the securities or commodities business both to make restitution and to disgorge sums obtained by the violation or bad practice. The law prohibits an individual or publicly held corporation with reasonable knowledge that a state investigation is likely to begin from altering, concealing or destroying documents for the purposes of obstructing or influencing an investigation by the state pertaining to publicly held securities.

The law creates whistleblower protections for employees of publicly held corporations and their subcontractors who assist in investigations or proceedings regarding certain state and federal white-collar crime laws. It requires each officer of a corporation organized under the laws of or authorized to transact business in Connecticut who is subject to the requirements of SOXA section 906 to certify (in the manner required by SOXA) that the financial statements of the corporation fairly present, in all material respects, the financial condition and results of operations of the corporation and makes a CEO or CFO so certifying and knowing that not to be the case subject to up to $1,000,000 and ten years imprisonment, and $5,000,000 and twenty years imprisonment if the act was willful. The law prohibits accountants from altering, destroying, or concealing documents relating to an audit until seven years after the audit's conclusion. The law makes it a violation of state law for an accounting firm to violate PCAOB requirements, deems violation of state law provisions regarding state investigations, accountants, and certification of financial statements to be an unfair or deceptive trade practice, and increases the penalties that the State Board of Public Accountancy may impose.

Illinois

Public Act 93-580, enacted and effective August 21, 2003, among other things, makes failure to maintain books and records required by an SRO or the SEC grounds for denial, revocation and suspension of registration of a broker-dealer, investment adviser or agent; permits the securities regulator to appoint special agents to conduct investigations with police powers to enforce the state securities law, authorizes the Secretary of State, after a showing of probable cause in a judicial hearing, to seize assets obtained in
violation of securities law and to seek forfeiture of the assets to be used to compensate injured investors; prohibits (and makes violation a class 3 felony) any person from knowingly influencing, coercing or misleading a person engaged in preparation or audit of financial statements or appraisals to be used in the offer of securities to render them materially misleading.

Public Act 93-0496, enacted and effective August 21, 2003, inter alia, makes certain misconduct by corporate officers or directors a crime, including with the purpose to defraud or evade a financial disclosure reporting requirement of Illinois or under Section 13(A) or 15(D) of the Securities Exchange Act to cause or attempt to cause the corporation or its accounting firm to fail to file a financial disclosure report or to file such report with a material omission or misstatement.

**Kansas**

New provisions under the Kansas Securities Act provide that the following are level 8 felonies: (1) misleading, coercing, manipulating or intentionally influencing a person in connection with financial statements used in the offer or sale of securities; (2) destroying, falsifying or concealing a record with intent to obstruct and investigation; and (3) retaliation against a whistleblower providing truthful information relating to a violation of the Kansas Securities Act. Civil and criminal penalties for securities fraud were increased and may vary in severity based on the amount of loss or if the violation involved elderly or disabled persons.

**North Carolina**

Senate Bill 925 became Chapter 413 with some provisions effective August 14, 2003, and others (in particular penalty and obstruction provisions) effective December 1, 2003. The law, among other things, changes the Section 203(b)(3) exclusion for investment advisers to an exemption from registration; provides that the issuance, with the intent to deceive or defraud; of analyses, reports, or financial statements that are false or misleading in any material respect is prohibited as a deceptive or fraudulent device, scheme, or artifice to manipulate the market in a security; makes it a felony to make a statement to securities administrator that is false or misleading, deliver a document that is false or misleading in a material respect, or destroy, alter or conceal a document, if done willfully for the purpose of interfering with an audit or examination under the securities law. The law also increases penalties under the securities law for certain losses that exceed $100,000, and extends the statute of limitations for violations (other than registration violations) from two to three years after discovery but not later than five years after contract of sale or three years after the person should have discovered the violation if a fraudulent act conceals the violation.

**Ohio**

House Bill 7 was signed into law on June 17, 2003 and became effective September 16, 2003. The law extends certain statutes of limitation for civil and criminal liability under the securities law to five years. The law also prohibits a person from knowingly influencing, coercing, manipulating or misleading any person engaged in preparation, compilation, review or audit of financial statements to be used in the purchase or sale of securities for the purpose of rendering the financial statements materially misleading. The law also amends the securities law to permit securities registration to be denied if the issuer does not disclose in the prospectus that any future transaction with an officer, director or 5% shareholder will be on terms no less favorable to the issuer than could be obtained from an independent third party, that any outstanding loan from the issuer must be repaid within six months of offering (except credit from a bank), that any future loan from the issuer will be for a bona fide business purpose and approved by a majority of disinterested directors or will be a loan permitted by Section 13(k) of the Securities Exchange Act.

NASD and the New York Stock Exchange may inspect documents filed with the Ohio Securities Division in connection with offerings made under Section 4(2) of the Securities Act of 1933 and under Rule 505 of Regulation D of the 1933 Act. NASD and NYSE may also inspect confidential law enforcement investigatory and trial preparation records made available to the Securities Division.

**Oklahoma**

Laws 2003, Ch. 86, effective November 1, 2003, adds as a basis for suspension or revocation of a broker-dealer or investment adviser registration impeding the conduct of an investigation or examination or refusing to provide copies of relevant records, and extends to 45 days the time period for the securities regulator to issue a registration. The regulator must start proceedings to suspend or revoke a registration within one year after actually knowing the material underlying facts (extended from 90 days). The law also authorizes the court to impose asset freezes and other additional remedies for violation of the securities law.

**Oregon**

Senate Bill 609 signed into law on August 11, 2003, specifies that persons who offer, as well as those who buy or sell, in violation of securities laws may be liable for damages. The law also adopts additional provisions that impose liability for offering or selling by means of material untrue statements or omissions consisting of actual damages, including any commission, plus interest and attorney fees for a class action; sets a time limit for such action; and provides liability as well for those who materially aid, and those
who directly or indirectly control and every partner, limited liability company manager, officer or director of, a person who is liable, unless they sustain the burden that they didn’t know and couldn’t reasonably have known. The law permits court appointment of a receiver and provides for fines up to $20,000 for each securities law violation, and for a continuing violation, each day's continuance is a separate offense with a maximum penalty of $100,000; a court may award attorney fees to the securities regulator, or to a defendant who prevails if there was no reasonable basis for the regulator’s claim.

**Pennsylvania - (Proposals)**

Pennsylvania, in reaction to corporate scandals and the Sarbanes-Oxley federal legislation, set up two politically balanced advisory committees in August of 2002 to devise appropriate legislation relating to judiciary and finance matters. These committee held public hearings and thereafter had legislation introduced. The legislation has passed the House and is awaiting action by the Senate Banking and Insurance Committee.

House Bill 547 would increase the amount of administrative assessments by the Pennsylvania Securities Commission for each violation of Pennsylvania blue sky law by a state-registered broker-dealer, agent, investment adviser or investment adviser representative or affiliate thereof, and would remove monetary ceilings on the total amount of such assessments.

House Bill 552 would permit recovery of short swing profits in a manner similar to that under section 16 of the Securities Exchange Act of 1934 for purchases or sales in Pennsylvania, but would provide certain exemptions similar to those under section 16. The legislation would apply only to corporations that have more than 100 shareholders and only to securities that are not registered under section 12 of the Securities Exchange Act of 1934.

House Bill 553 similar to the provisions of SOXA, would permit a court to impose a temporary freeze on extraordinary payments, which could be placed in a court-ordered escrow for 45 days and kept there longer through a series of extensions, during an investigation of possible violations of Pennsylvania blue sky law by an issuer that is not subject to 1934 Act reporting requirements but has more than 100 equity security holders or any of its directors, officers, controlling persons, agents or employees.

House Bill 561 resulted from concern about exposure of municipal pension plans, which may be state-administered or administered by the individual municipal entities. This would change the state’s blue sky law so that a municipal pension plan would not be deemed an institutional investor and sales to a municipal pension plan would not be able to utilize the state’s transactional institutional investor exemption from securities registration. The bill would also make it unlawful for an investment adviser not to disclose to a Pennsylvania public school district or municipal pension plan the direct and indirect compensation the advisor would pay to others with respect to any particular investment advice or to obtain the district or plan as an advisory client, and would make it a separate offense to defraud such district or plan in connection with the purchase or sale of a security.

House Bill 595 would permit the court, in restitution litigation, to award not more than 10% of the total amount of funds collected to the Pennsylvania Securities Commission to pay for its assistance in obtaining such restitution.

House Bill 599 would increase the statute of limitations for civil securities fraud from four to five years.

House Bill 600 would codify in statute existing regulatory interpretation that permits the Pennsylvania Securities Commission to deny securities registration on account of loans made to insiders (other than loans described in Section 13(k)(2) or (3) of the 1934 Act (SOXA provisions)).

House Bill 604 would permit the Pennsylvania Securities Commission to suspend the state-registration of a broker-dealer, investment adviser, sales representative, or investment adviser agent for nonpayment of an arbitration award. The bill would also create three new criminal offenses in connection with knowingly altering, destroying or shredding certain documents or retaliating against a whistle blower, and would increase the criminal penalty for certain offenses.

**Rhode Island**

House Bill 6020, signed into law on June 27, 2003 and immediately effective, removes a cap of $100,000 on civil penalties for violation of securities laws and permits penalties of $10,000 to be imposed for an unlimited number of violations without a cap.

**South Carolina - (Proposed)**

Proposed House Bill 3114 would make it illegal to engage in certain activities in connection with a transaction in securities such as fictitious price quotes, creating a deceptive appearance of trading activities, issuing deceptive reports or financials; would make it illegal to use fraud or deceit in advising on the sale or purchase, or the purchase, of a security; and would permit punitive damages for such violations and for fraudulent offers or sales of securities. The bill would make it a felony, subject to imprisonment for up to 10 years and fine of up to $50,000, to willfully make a false or misleading statement for the purpose of interfering with the performance of an audit,
examination, or investigation by the securities regulator, or to willfully create, alter, conceal or destroy a document or obstruct the securities regulator in performing his duty. The bill would also permit withdrawal of a securities registration application only as per order of the securities regulator, and would remove as a bar to suing for an illegal or fraudulent sale of securities, a prior offer to refund consideration plus interest. The bill would also void a public procurement contract if an officer, director, or owner of an unincorporated entity, or affiliate of any of them, was either convicted of violating state or federal securities law within the prior 10 years (and the entity must certify that is not the case) or is incorporated in a non-U.S. tax haven jurisdiction, even if its stock trades principally in the U.S.

TEXAS

Texas Senate Bill 1060 was signed into law and is currently effective. The law makes it a felony carrying a fine of up to $5,000 and/or a prison term of two to ten years to act as an investment adviser or investment adviser without being appropriately registered in the state, permits the Texas Attorney General in an action for fraud relating to the sale of a security to obtain disgorgement of any economic benefit and permits regulators to assist securities regulators of another state or foreign jurisdiction by conducting an investigation to determine if a person has violated or is about to violate the other jurisdiction’s securities law.

Texas Senate Bill 1059 was signed into law and became effective September 1, 2003. The law creates a Corporate Integrity Unity within the office of the attorney general to assist in the enforcement of the laws relating to corporate fraud or other similar illegal activities. The law also requires state governmental entities to adopt standards of ethical conduct applicable to their outside financial advisors, financial consultants, money or investment managers, or brokers with respect to the management or investment of any state funds, and contracts for such financial services would be voidable if the standard of conduct were violated. Providers of such financial services would have to disclose, via annual reports and updates, any pecuniary interest in a party to a transaction with the state entity and any other relationship with such a party if independent judgment might reasonably be diminished.

WASHINGTON

House Bill 1219 signed by the governor and effective July 27, 2003 makes it punishable by up to ten years in prison and/or a fine of up to $500,000 to shred, alter or conceal a record or other object, or attempt to do so, with the intent of impairing its integrity or availability for use in an official proceeding under the state’s blue sky law. Other provisions clarify that willful violation of blue sky laws, rules and orders are a Class B felony, increase monetary penalties for certain violations, extend the statute of limitations for prosecutions to the later of five years after violation or three years after discovery, and authorize the blue sky regulator in fraud cases to obtain investigative costs with interest in addition to disgorgement and restitution.

FLORIDA ENFORCEMENT ACTIONS ARE ABSENT - OR ARE THEY?

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Nearly one third of all securities associated persons in the United States are registered to do business in Florida. The Florida regulator, now called the Office of Financial Regulation says it has 577 currently active investigations under way, but at a time of resurgent state securities law enforcement, Florida has been conspicuously quiet. The regulators say, however, it is only the quiet before a storm.

Securities law enforcement in Florida is undergoing a radical transformation. In 1995 then newly elected state Comptroller Robert F. Milligan, a retired Marine Corps general and the first Republican ever to hold the office, announced reorganization of the state agency then known as the Florida Department of Banking and Finance. No longer would securities examiners based in the Department’s regional offices throughout the state submit their findings to the state capital for determination of appropriate action. Based on a military model, General Milligan’s plan moved such decision-making to the regional offices. Deriding the centralized system as the “stovepipe method,” the Comptroller wanted those investigating security law violations to prosecute them as well. Headquarters in Tallahassee was to provide only “regulatory support” for decisions by regional administrators primarily responsible for securities law enforcement in Florida.

This year everything changed. In 1998 Florida voters amended the state’s constitution to abolish the Comptroller and the Insurance Commissioner and shrink the state Cabinet from six to three members. Responsibilities of the resulting new cabinet officer, called the Chief Financial Officer, were left to the Florida Legislature. After four years of controversy, Governor Jeb Bush signed legislation in the summer of 2002 merging the Department of Insurance and the Department of Banking & Finance. In January 2003, Tom Gallagher was sworn in as Florida’s first Chief Financial Officer, statutory head of the Department of Financial Services. Shortly afterwards the Governor and Cabinet, sitting as the Florida Financial Services Commission, chose Don B. Saxon, longtime Director of the Florida Division of Securities, to head an
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enforcement policies. No practitioner familiar with the
reported difficulty in pinning down Florida's
regulators working with Florida through NASAA
offices, it clearly caused some problems. Other state
administrators so important to General
Milligan’s decentralized enforcement structure are
gone. Securities examiners in the regional offices are
under Bill Reilly’s ultimate supervision, but through
two supervisors, one responsible for South Florida and
one for North Florida. Robert R. Kynock is the South
Florida supervisor. A supervisor for North Florida is
Alisa G. Goldberg.

While the decentralized securities enforcement
authority of the Milligan era might have encouraged
innovation and improved morale in the regional
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Disposition of license applications of all types was
inevitably delayed if the applicant was in any way
involved in an examination pending in one of the
regional offices. This problem is now being corrected
under the new organization. Don Saxon reports all the
staff’s energy has been directed to setting up that
organization. As a result, he says, the Office of
Financial Regulation has not yet undertaken any
securities enforcement initiatives. He stresses,
however, that the Office is “gearing up” to do so.

Law enforcement, like nature, however, abhors a
vacuum. On November 18, 2003, a bill designated
SB622 was filed for consideration in the Florida
Legislature to give Florida Attorney General Charlie
Crist enforcement powers under Chapter 517, Florida
Statute. The bill would also double, from $5,000 to
$10,000, the maximum fine Florida could impose for
each violation of the state’s securities laws. The bill
will be taken up at the regular session of the legislature,
which convenes on March 2, 2004.

NASD FREE RIDING RULE REPLACED
BY HOT EQUITY OFFERING RULE

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The Securities and Exchange Commission
recently approved the National Association of
Securities Dealers, Inc.’s Rule 2790, captioned Trading
in Hot Equity Offerings (the “Rule”), originally
proposed to replace NASD’s longstanding Free-Riding
and Withholding Interpretation, IM 2110-1 (the
“Interpretation”). Although the SEC approved the
Rule on October 24, 2003, it nevertheless solicited
comments on Amendment No. 5, the latest proposed
version, for a 21-day comment period commencing on
the date of publication of the SEC release.

The Rule, while in some limited respects a
codification of existing interpretations, in general is
intended to introduce a brand new, simplified, more
easily administered regime, with bright-line tests to
ensure that NASD members make a bona fide public
offering of securities at the public offering price and do
not make use of hot issues to benefit themselves or
other industry insiders, or to reward those who may
able to direct future business to them, at the expense of
public customers. NASD has provided a transition
period for compliance. Members may comply with
either the old Interpretation or the new Rule during the three month period commencing with publication of a Notice to Members announcing SEC approval of the Rule change. (As of November 24, 2003, the Notice to Members had not been published.)


WHAT MAY NOT BE SOLD? - A NEW ISSUE

A member or a person associated with a member may not sell a “new issue” to any account in which a restricted person has a beneficial interest, with certain specific exceptions. Further, a member may not continue to hold a new issue that it acquired as an underwriter, selling group member, or otherwise, and a member or associated person may not buy a new issue in an account in which the member or associated person has a beneficial interest, again with certain exceptions. Perhaps the most fundamental change from the Interpretation is the application of the Rule to all primary public offerings of equity securities, not to debt and not just to “hot issues” and, as a corollary, elimination of a provision permitting cancellation of trades should an issue become “hot.”

The Rule defines “new issue” to mean equity IPOs and excludes from application of the Rule secondary offerings, and offerings of debt, convertible securities, investment-grade asset-backed securities, preferred securities, registered investment company securities, rights, securities in an exchange or merger or acquisition offering, ordinary shares or ADRs with preexisting foreign markets registered on a Form F-6, securities of a commodity pool operated by a commodity pool operator as defined in the Commodity Exchange Act, and securities exempted under Section 3(a)(12) of the Securities Exchange Act of 1934 (bank or savings association holding company acquisitions). The definition of “equity security” looks to Section 3(a)(11) of the Securities Exchange Act.

NEW ISSUE MAY NOT BE SOLD TO WHOM?

Absent an exemption, a member may not sell new issues to any account in which a restricted person has a beneficial interest. The Rule significantly changes the Interpretation by eliminating the category of conditionally restricted persons. Persons are now either restricted or not, although accounts in which a restricted person has a beneficial interest may nevertheless be sold a new issue if an exemption is available.

“Beneficial interest” is defined as an economic interest, such as the right to share in gains or losses, and, as under the Interpretation, requires those selling to look through entities, feeder funds and other vehicles. Beneficial interest does not include initial receipt of a fiduciary or other management or performance fee that is paid for operating a collective investment account (although if receipt of the fee is deferred and the deferred fee is invested in the collective investment account then it does become an economic, hence a beneficial, interest in the collective investment account).

A restricted person generally includes a broker/dealer, its owner, its personnel, finders and fiduciaries to the managing underwriter, and portfolio managers.

• Broker/dealers, including futures commission merchants who are registered as broker/dealers, are restricted persons; however, a hedge fund that registers, or has a subsidiary that registers, as a joint back office broker/dealer to get favorable margin treatment generally is not restricted if its new issue purchases are credited to the capital accounts of its partners and it fits within the 10% de minimis exemption (see below) so that beneficial interests of restricted persons do not exceed in the aggregate 10% of the fund. The personnel of such a joint back office broker/dealer hedge fund, however, will be restricted persons.

• A limited business broker/dealer (defined as a broker/dealer that is authorized only with respect to investment company/variable contract securities and direct participation programs) is a restricted person but its personnel and owners are not.

• Persons owning or affiliated with a broker/dealer (other than a limited business broker/dealer) are restricted persons if:

  • listed on Form BD Schedule A with an ownership code of at least 10%,
  • listed on Schedule B and don’t relate to a Schedule A person with a code less than 10%,
  • listed on Schedule C and meet similar criteria, or
  • directly or indirectly own at least 10% of a public reporting company listed on Schedule A or at least 25% of a public reporting company listed on Schedule B and such company is not listed on a national securities exchange or traded on the Nasdaq National Market.

Subsidiaries and sister companies of broker-dealers, in addition to owners, would be restricted persons because an owner (who is restricted) would be viewed as having a beneficial interest in any account held by its subsidiaries. Relief may be available pursuant to an exemption for certain publicly-traded entities that are not broker/dealers (see “Exemptions From Restricted Person Category”, below). In addition, immediate family members (defined as the
person’s spouse, parent, parent-in-law, sibling, sibling-in-law, child, child-in-law or other person to whom material support is provided) of such restricted person are also restricted persons unless neither the family member nor the restricted person materially supports (directly or indirectly provides more than 25% of the person’s income in the prior calendar year, or the person is an immediate family member living in the same household) the other, the broker/dealer which the person owns is not actually selling the new issue to the family member, and the person with the broker/dealer ownership interest has no ability to control the allocation of the new issue.

- Personnel of a broker/dealer (other than a limited business broker/dealer) are restricted persons if they are officers, directors, general partners, associated persons or employees of the broker/dealer, or agents engaged in the investment banking or securities business. In addition, immediate family members of such restricted persons are also restricted persons if the family member or the restricted person materially supports the other, if the broker/dealer personnel is employed by or associated with the broker/dealer (or its affiliate) from whom the family member is buying the new issue, or if the broker/dealer personnel has the ability to control allocation of the new issue.

- Fiduciaries and finders for a broker/dealer are restricted persons if they are finders, attorneys, accountants, financial consultants or fiduciaries to the managing underwriter with respect to the security being offered. NASD has further indicated that, with respect to a law firm or consulting firm, the restriction would apply only to those persons working on the particular offering. In addition, immediate family members of such restricted persons are also restricted persons if the family member or the restricted person materially supports the other.

- Portfolio managers are restricted persons if they have authority to buy or sell securities for a bank, savings and loan, insurer, investment company, investment adviser, or collective investment account. “Collective investment account” is defined to include hedge funds and other collective investment vehicles engaged primarily in the purchase and/or sale of securities, but not family investment vehicles or investment clubs since these vehicles generally engage in joint decision making by the investors or decision making by family members. Again, immediate family members of such restricted persons are also restricted persons if the family member or the restricted person materially supports the other.

**Exemption From Restricted Person Category**

Certain categories of persons are specifically enumerated as not restricted persons, so the prohibitions do not apply to these persons or to accounts in which they have a beneficial interest:

- registered investment company
- bank common trust fund consisting of at least 1,000 accounts not limited principally to restricted persons
- insurance company special or investment account containing funds of at least 1,000 investors or general account where the insurer has at least 1,000 policyholders, and such accounts or policyholders are not limited principally to restricted persons
- public company listed on a national securities exchange or traded on the Nasdaq National Market or foreign company that meets those listing standards, but not if the company is a broker/dealer or affiliate authorized to underwrite new issues (To determine the availability of this exemption, the seller can look at item 12 of Form BD but NASD notes that this may not be conclusive if new issues represent less than 1% of the broker/dealer’s annual revenue and are therefore not required to be disclosed at item 12. Note, too, that Rule 2750 prohibits a member’s selling securities in a fixed price offering to a person or account that is a related person of that member.)
- foreign-registered or foreign public investment company, if no owner of more than 5% of its shares is a restricted person
- Section 401(a) ERISA benefit plan not sponsored solely by a broker/dealer
- state or municipal government benefit plan
- Section 501(c)(3) charitable organization
- Section 414(e) church plan

Further, and perhaps most useful, a de minimis exemption is available for an account in which restricted persons have no more than 10% beneficial ownership. In utilizing this exemption, flexible carve-out procedures can be used to ensure that restricted persons receive less than 10% of profits from a new issue, but the specific procedures previously mandated for carve-outs under the Interpretation are no longer required. Further, a transfer of securities from a carve-out to a general account will no longer be required to be effected via a secondary market transaction, although NASD urges care to prevent the transferor from being viewed as an underwriter. NASD intends to offer guidance on use of carve-outs in a Notice to Members. The de minimis exemption may benefit restricted persons who were classified as conditionally restricted under the Interpretation.

**Other Exemptions**

A new issue can be sold to an account of a restricted person that held an equity ownership interest in the issuer for at least one year (or in a subsidiary that was bought by the issuer in the prior year) if the ownership percentage won’t increase (anti-dilution
provision) beyond what it was three months prior to the
date of filing. The Rule requires there be no special
terms and a three-month lock-up. Unlike the
Interpretation, the Rule permits tacking of ownership to
meet the one year holding period.

A new issue can be sold to an account of a
restricted person pursuant to a written stand-by
agreement if the agreement is disclosed in the
prospectus, the managing underwriter represents in
writing that it is unable to find another purchaser, and
the securities are subject to a three-month lock-up.

The Rule does not prevent an underwriter from
holding on to amounts of a new issue that the
underwriter is unable to sell in an undersubscribed
offering.

Finally, NASD may grant case-by-case
discretionary exemptions upon application.

ISSUER-DIRECTED OFFERINGS

• The issuer may specifically direct sales to
restricted persons provided a sale may be made to an
account in which broker/dealer personnel, finders or
fiduciaries or their immediate family members that are
restricted persons (described above) have a beneficial
interest only if the person or their immediate family
member is an employee or director of the issuer or its
parent or subsidiary or the parent’s subsidiary. For this
purpose, an entity is presumed to be a subsidiary of its
parent if the parent has the right to vote, sell or direct
the sale of 50% of a class of the subsidiary’s voting
securities. The Rule differs from the Interpretation
primarily by permitting employees and directors of
sister entities to an issuer to participate in issuer-
directed securities offerings, and by eliminating
mandated lock-up requirements.

• Sales may be made to restricted persons as
part of a big program sponsored by the issuer or its
affiliate and offered to at least 10,000 participants
where the amount and selection of offerees is non-
discretionary and the participants are not
disproportionately restricted persons (NASD suggests
calling the Office of General Counsel if guidance is
needed on this latter point).

• Sales may be made to restricted persons if
they are eligible under a demutualization offering in
accordance with the standards of the regulating
governmental agency.

PRECONDITIONS FOR SALE

Before selling a new issue to any account, a
member must in good faith have obtained (and have no
reason to believe it inaccurate) within the 12 months
prior to the sale a representation from the account
holder or person authorized to represent beneficial
owners of the account, that the account in fact is
eligible to purchase, or a similar representation from a

bank, foreign bank, broker/dealer, investment adviser,
or other conduit that all purchases are in compliance
with the Rule. The records that are the basis for the
determination must be retained for three years after the
last sale of a new issue to that account. Electronic
representations are permitted for eligible customers,
and negative consents are permitted for annual, but not
for an initial, verification.

BLUE SKY BITS AND PIECES
By Ellen Lieberman
Debevoise & Plimpton (New York)

Richard B. Smith died on November 2, 2003. He
was a partner and then senior counsel in the firm of
Davis, Polk & Wardwell, served on the Securities and
Exchange Commission, and was a member of the
National Conference of Commissioners on Uniform
State Laws. He recently headed the effort to write a
new Uniform Securities Act and was actively working
towards its adoption in the various states. He had a
long and distinguished career and history of public
service. At the time of his death, he was 75 years old.
The cause of death was pancreatic cancer.

Linda C. Quinn died on November 11, 2003. Ms. Quinn was a powerful force at the Securities and
Exchange Commission where she worked for 16 years,
inter alia, as executive assistant to Chairman John
Shad, and as director of the Division of Corporate
Finance. Her legacy includes EDGAR, Rule 144A and
other changes to the securities offering process and
disclosure requirements. More recently she was a
partner at Shearman & Sterling. The cause of death
was breast cancer.

Eric R. Dinallo recently stepped down as Bureau
Chief of the New York State Office of the Attorney
General, Investment Protection Bureau, to become a
Managing Director of Morgan Stanley & Co. David D.
Brown, IV, is assuming the position of Bureau Chief;
he joined the New York Department of Law in 2003
before that had been a Vice-President and
Associate General Counsel of Goldman, Sachs & Co.,
a Managing Director of Deutsche Bank Securities and
Bankers Trust Corporation, and an associate at the firm
of Davis, Polk & Wardwell. Gary Conner, previously
at the Bureau, is rejoining in the position of First
Deputy Bureau Chief.

Michael Gunst, the Director of the Inspection and
Compliance Division of the Texas Securities Board,
left in spring of 2003 to work as a senior staff attorney
in the enforcement division of the Fort Worth District
Office of the Securities and Exchange Commission. He
was instrumental in forming and staffing the broker-
dealer inspection section of the Texas State Securities Board. The position of Director of the Inspection and Compliance Division has been filled by Bennette Zivley. David Grauer, the Director of the Enforcement Division, has also departed and his position has been filled by John Morgan. John Morgan previously held the position of Deputy Commissioner which has now been filled by Don Raschke. Joining the Board is Carla James who will step in to head the Staff Services Division, the position formerly held by Don Raschke.

Patty Loutherback, Registration Analyst, Securities Registration & Exemptions, at the Washington Securities Division, will also be joining the Texas State Securities Board (she had worked there before moving to Washington), working in registration and broker-dealer licensing. Her position in Washington has not yet been filled but Emilio Casillas at the Washington Securities Division has assumed more responsibility in the registration area.

Dan R. Waller of Secore & Waller, L.L.P. recently took over the Chair of the Securities Regulatory Committee for the American Association of Attorneys-Certified Public Accountants that was chaired by Dan Goelzer until he joined the Accounting Oversight Board, and, in his new role, Dan Waller is now busily working with the SEC and the IRS. Dan has asked for suggestions for an Attorney-CPA who might want to join his Committee. Any leads?

James A. Joven was named Indiana Securities Commission. He is a former Deputy Attorney General of the state. John W. Potocky, Registration Attorney with the Indiana Securities Division, has left to become an Administrative Law Judge with the Workforce Development Division in the Indiana Governor’s office. His responsibilities with respect to registration are being filled by Silvia B. Miller, Chief Counsel of the Indiana Securities Division, who came to Indiana and passed its bar in 2002, having gone to law school in Germany and then in Dayton, Ohio.

Tom Kluck has left his position as Securities Counsel in the Registration Section of the Missouri Securities Division (he also was involved in enforcement) and is going to the SEC in Washington, D.C. to work in their Corporate Finance Section. Melanie G. Moffat will also be leaving her post as Securities counsel in the Registration Section (where she also did enforcement and licensing work) at the end of 2003 to establish her own general private practice of law. Matt Barton, Licensing Supervisor, will step in to handle some of the registration work and it’s anticipated that additional staff will be hired.

W. Mark Sendrow left his position as Director of Securities for the Arizona Securities Division, and has gone into part-time private practice in Arizona. Victor Rodarte, Assistant Director of Securities, retired and is moving to his newly built house in Tucson. As we go to press, Matthew J. Neubert is Acting Director and LeRoy Johnson Acting Assistant Director.

STATE LIAISONS LIKE TO LISTEN
By Don Rett
Chair, Subcommittee on State Liaisons
Law Offices of Donald Rett (Tallahassee)

State liaison attorneys provide a valuable service to members of the Committee and to the state administrators. As the recipient of requests from Committee members for information about the covered state’s securities laws, regulations, and staff interpretations, the liaison benefits from learning which issues and questions arise for practitioners in other states. The liaison has the opportunity to pass this information along to the state administrator.

The liaison for each state also submits an annual report detailing anything they feel is of particular interest in securities regulation in their State, written from a perspective of an attorney practicing in the field. As a result, members receive information which they would not ordinarily come across using solely internet searches. The reports usually involve once-a-year contact with the securities administrator, or staff, to get a "view from the state house" as to what may be happening - or threatened to happen. The liaisons can provide the state administrator with the opportunity to deliver information directly to attorneys who are practicing state securities law.

The liaison’s annual report is usually prepared by the time of the Business Law Section Spring meeting, then supplemented where appropriate for the ABA Annual Meeting and the annual meeting of the North American Securities Administrators. (Supplements are generally necessary since many states, including Florida where I am located, have legislatures which do not conclude until after the Spring meeting.) Bound books are prepared for Committee members, including the liaison reports, and distributed at those meetings. I am told that the liaison reports are actually posted to the Committee’s website but - through computer ignorance - I am unable to attest to that.

The advantages are obvious: for twenty-some years now, I have invariably contacted the liaison in a state where I had a question I could not solve through my own resources. In turn, I have been pleased to refer (paying) clients to liaisons in states other than Florida. I have even contacted Liaisons on personal matters; a few years ago Peter Hutcheon (NJ) was kind enough to instruct me as to how to get my birth certificate issued.
From time-to-time we do have vacancies; if you'd be interested in serving as a state liaison to the Committee, please contact me.

We get letters . . . .

From Fred Bunker Davis
Kutak Rock LLP (Retired)

I've been reveling in retirement too much to write to The Bugle before now. But there was one e-mail inquiry from an Arizona attorney a month or so ago that got me thinking. This may have some Blue Sky significance. If you want to introduce the question to the members, it might produce some feedback. Here's the inquiry (names omitted to protect the guilty):

There is a new statute in Arizona that gives the Arizona Securities Division jurisdiction over spouses for purposes of obtaining a judgment against the community property in its enforcement actions. Arizona being a community property state, this legislation has a potentially huge impact on the Division's collection efforts. In your various practices that involve state or federal agencies, has anyone come across the issue of whether an administrative agency can "extend" its jurisdiction to include spouses of the regulated individuals? Similarly, is anyone aware of any agencies that routinely name the spouses in their enforcement actions? Any thoughts are appreciated, as there's some discussion among the private securities litigation bar in Arizona of pursuing a test case to challenge the statute. Thanks.

From Mike Underwood
Steel Hector & Davis LLP

You may want to alert your readers to Proposed Florida Bar Rule 1-3.11, which would require a member of the Florida Bar be associated in all arbitrations, except international arbitrations, conducted in Florida. Out-of-state lawyers could appear in up to three arbitrations a year without Florida co-counsel, but would have to pay $250 to the bar association for each appearance. The measure will be considered by the Board of Governors of The Florida Bar on December 5, 2003.

The proposal may be viewed online at http://www.flabar.org/tfb/TFBComm.nsf/6bfd54554e7b35f185256728004f5220/d5722ba3a24231a685256b2f006ca4c3?OpenDocument

New Subcommittee to Focus on NASD Corporate Financing Rule

Peter LaVigne, of Sullivan & Cromwell LLP (New York) and Suzanne Rothwell, of Skadden, Arps, Slate, Meagher & Flom (Washington DC) have announced formation of the Subcommittee on NASD Corporate Financing Rules. The Subcommittee, which had its initial meeting at the ABA Business Law Section spring meeting, is organized under the aegis of the Committee on Federal Regulation of Securities.

By way of public meetings and written presentations the Subcommittee intends to comment on rule proposals related to NASD's Corporate Financing Department, and may suggest changes that the Subcommittee believes should be made to proposed and existing rules. The Subcommittee will work with NASD's Corporate Financing group and provide comments about the COBRADesk (the NASD's electronic filing system), administration of COBRADesk, and NASD staff's application of the corporate financing rules.

At the initial meeting Mr. LaVigne explained that the scope of the Subcommittee's work will include NASD Rules 2710 (the Corporate Financing Rule), 2810 (the Direct Participation Programs Rule), 2720 (the Conflicts-of-Interests Rule), and 2711 (the Research Analyst Rule), and the Papilsky Rules, proposed Rule 2790 (the New Issues Rule that will replace the Free-Riding and Withholding Interpretation), and proposed Rule 2712 (the IPO Allocation Rule). Mr. LaVigne also indicated that there were other issues and rules, including rules of the SEC (e.g., SEC Regulation Analyst Certification), that would be the focus of the Subcommittee if they relate to the capital-formation process in the context of broker/dealer regulation. He also reported to the Subcommittee that he and Ms. Rothwell had held informal discussions with Joseph Price, Director, Corporate Financing Department, NASD, and that Mr. Price had expressed an interest in establishing a positive relationship with the Subcommittee.
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