**EVENTS CALENDAR**

The State Regulation of Securities Committee will meet in conjunction with the 2005 Annual NASAA Fall Conference to be held September 11 through September 14, 2005 at the Hilton Minneapolis, Minneapolis, Minnesota

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**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

**BLUE SKY BITS AND PIECES**

By Ellen Lieberman
Debevoise & Plimpton LLP (New York)

IT IS WITH GREAT SORROW THAT WE REPORT THE UNTIMELY DEATH ON JULY 11, 2005 OF GRACEANN M. MCKEON, A BLUE SKY LAWYER FOR THIRTY YEARS AT THE FIRM OF SULLIVAN & CROMWELL LLP. SHE IS SURVIVED BY HER BROTHER PETER MCKEON OF SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP, AND HER SISTER MARIANNE MCKEON OF DEWEY BALLANTINE, LLP, WHO ARE ALSO MEMBERS OF OUR BLUE SKY COMMUNITY, AS WELL AS OTHER SIBLINGS, VIRGINIA, AGNES, FRANCINE, PAUL AND ANDREW, HER FATHER, PETER T., BROTHERS AND SISTERS-IN-LAW AND Nieces and nephews. IN HER YEARS AT SULLIVAN & CROMWELL, GRACEANN TRAINED MANY OF OUR COLLEAGUES IN THE BLUE SKY BAR, INCLUDING ED ALTERMAN, BOBBORESTA, MARK LAB AND, OF COURSE, HER SIBLINGS PETER AND MARIANNE MCKEON. FAMILY AND FRIENDS SAID THAT GRACEANN’S MOST AVID INTERESTS WERE TRAVEL IN EUROPE AND EATING AT GOOD RESTAURANTS, AND THE FAMILY JOKE WAS THAT GRACEANN DIDN’T REVISIT A CITY BECAUSE OF THE ART OR ARCHITECTURE, BUT BECAUSE OF A PARTICULARLY GOOD DISH THAT SHE ONCE HAD EATEN THERE. APPROPRIATELY, SHE NAMED HER LOYAL AND VERY GENTLE GERMAN SHEPHERD, SPICE.

Bruce E. Johnson of Morrison & Foerster LLP in San Francisco has stepped down as co-editor of The Blue Sky Bugle, passing the baton entirely to Martin A. Hewitt of Cadwalader, Wickersham & Taft LLP in
New York. Many thanks go to Bruce for his stewardship of the Bugle along with great appreciation for his years of productive and diligent work permitting state securities lawyers to communicate, share their knowledge and efforts, and generally stay in touch. Our thanks as well to Martin who recently served as co-editor and has now become editor in chief, for undertaking this important job so that the Bugle, the voice of the Blue Sky community, can continue to be heard. But Bruce will not step out of the spotlight entirely since he has agreed to take on the role of co-chair of the employee benefit plan subcommittee with Michele Kulerman of Hogan & Hartson LLP.

While we’re saying farewell and thanks—Martin Miller of Willkie Farr & Gallagher LLP will conclude his term as Chair of the Committee on State Regulation of Securities following the ABA Annual Meeting in Chicago. Many kudos as well to Marty for his three years of service as Chair. His term of office coincided in some respects with the post-Enron reemergence of Blue Sky law as a force to be reckoned with, with special emphasis on the enforcement arena. We do live in interesting times! Marty has helpfully and graciously agreed to continue to remain active on the ABA Committee and will co-chair the broker-dealer/investment-adviser subcommittee with David M. Katz of Sidley Austin Brown & Wood LLP.

Other changes at the helm—Chairman William Donaldson left the Securities and Exchange Commission on June 30, 2005. He was a founder of the former brokerage firm Donaldson, Lufkin & Jenrette, a former chair of the New York Stock Exchange and the first dean of the School of Management at Yale University. He stepped in at the SEC in 2002 in the turbulent aftermath of Harvey Pitt’s reign, and was an activist Chair particularly in enforcement, hedge fund investment adviser registration and other matters—he sided with the Democratic minority for a 3-2 split on several SEC initiatives including last minute adoption of investment company governance rules. Donaldson’s successor is Christopher Cox, Republican Congressman from California. Cox, a graduate of Harvard Law School and Harvard Business School, practiced securities law as a partner at Latham & Watkins, served as Senior Associate Counsel to President Ronald Reagan, and was a federal court of appeals clerk. President George W. Bush, in the interim, named Commissioner Cynthia Glassman as Acting Chairperson. Senate Democrats have asked President Bush, and he agreed, to name Annette Nazareth, who was the director of market regulation at the SEC, to the Commission to replace Commissioner Harvey Goldschmid, and to name Commissioner Roel Campos, a Democrat, to a second term.

Larry N. Coates, Assistant Director of Corporate Finance for the District of Columbia since 2000 and before that Acting Director of the Securities Bureau, retired on May 27, 2005. Currently serving as Acting Assistant Director of Corporate Finance is James M. (Mike) McManus, who had been Securities Examiner.

Wayne Strumpfer was appointed Acting Corporations Commissioner of the California Department of Corporations, on April 12, 2005. Prior to this appointment he served as Acting Deputy Commissioner of the Enforcement Division of the California Department of Corporations with responsibility for all charging decisions and investigations regarding violations of the securities and franchise laws and worked closely with local law enforcement and other state and federal entities. Other positions he held were Deputy Executive Director of the California District Attorneys Association, Interim Executive Director of the Office of
Criminal Justice Planning, Assistant Chief Deputy of the Office of the Inspector General, Executive Director of the Fair Political Practices Commission, Deputy Attorney General of the State of California, Deputy District Attorney of the County of Sacramento and Chief Law Clerk at the United States Attorney’s Office for the Eastern District of California.

Indiana Secretary of State Todd Rokita appointed former Securities Commissioner Wayne Davis to replace current Commissioner James Joven, who will continue on as Special Counsel to the Secretary for Securities matters. Silvia Miller left the Indiana Securities Division on May 6, 2005 and has accepted a position with the Indiana Criminal Justice Institute as a Director for Legal and Legislative Affairs.

Former Maine Securities Administrator (and former NASAA President) Christine A. Bruenn was sworn in by Governor John E. Baldacci as commissioner of the Department of Professional and Financial Regulation. She will oversee insurance, banking, securities and consumer credit regulation, as well as 41 professional licensing boards and registration programs. Her successor as Maine Securities Administrator has not yet been selected.

Michigan’s Office of Financial and Insurance Services (OFIS) Commissioner hired Linda Cena as its new Securities Manager, giving her responsibility for the overall direction, development, management and evaluation of the Securities section of OFIS. Ms. Cena has worked in Michigan for Jackson National Life Insurance Company (JNLI) for the last 10 years, where she was also a key participant in the development of a securities broker/dealer division for JNLI.

And some social news—Alan M. Parness, Counsel at Cadwalader, Wickersham & Taft LLP is pleased and proud to announce the wedding of his son, Michael Parness, to Ms. Kelli Tuggle, on June 4, 2005. The wedding was held on St. John, US Virgin Islands,—Alan claims—in honor of the new Virgin Islands Uniform Securities Act.

BLUE SKIES FOR THE VIRGIN ISLANDS
By: Leigh F. Goldman, Esq. (LGoldman@vilaw.com) Tom Bolt & Associates, P.C.

It’s not just blue skies for vacationers anymore. Newly adopted laws in the Territory of the United States Virgin Islands provide a reason for securities oriented businesses in the Virgin Islands to look up along with the vacationers. An entire chapter of new laws on the regulation of industry was passed on August 12, 2004 and codified at Virgin Islands Code Title 9, §§ 601 through 672, known as the “Uniform Securities Act.”

Enforcement of the new regulations has been charged to the Office of the Lieutenant Governor of the Virgin Islands, Division of Banking and Insurance, under the leadership of Director Deverita Carty Stirdivant. Banking and Insurance Division’s new jurisdiction will register investment advisers and brokers doing business in the Virgin Islands, maintain the integrity of the Virgin Islands securities market and protect investors by promoting investor education and fraud prevention. The Securities Division of the Tennessee Department of Commerce and Insurance has been hired to assist the Territorial Government in establishing procedures and training programs. Included in this is training in organizational structure; uniform forms; securities registration; industry regulation; broker-dealer registration; enforcement; and
interpretive opinions. Several members of the Banking and Insurance Division have
gone for training in Tennessee in an effort to
familiarize themselves with the skills
required for knowledgeable implementation
of the new laws. In recognition of the new
commitment to developing a regulated state
securities market, the North American
Securities Administrators Association
(“NASAA”) is currently amending their
forms to include the Virgin Islands. In order
to share knowledge and work for mutual
compliance with new laws and regulations,
local businesses affected by the laws have
combined to establish the “Virgin Islands
Financial Services Association”, still under
formation. For more information on the
Virgin Islands Financial Services
Association, please contact Atty. Deniece
Rainey at Tom Bolt & Associates, P.C.

Significant delays in implementation of the
Securities laws have arisen due to a
combination of factors including the
implementation of the new laws without an
increase in either skilled or unskilled staff
and the training currently underway by the
already existing staff. Further, the program
is as yet unfunded and running off the
general budget for the Banking and
Insurance Division. Finally,
contemporaneous to its passing Blue Skies
laws, the Legislature of the Virgin Islands
passed new laws regarding non-bank ATM
machines, to mortgage brokers and
miscellaneous other laws whose regulation
and enforcement has passed to Banking and
Insurance. Securities related changes have
also been made to the Virgin Island
Corporate Code to ease the ability of
domestic corporations to become publicly
held stock corporations.

1 See Press Release #163, U.S. Virgin Islands,

WORD FROM THE OLD CHAIR

By Martin R. Miller
Willkie Farr & Gallagher LLP (New York)

During the past three years, which went very
quickly, I have been honored to serve as
Chair of the Committee on State Regulation
of Securities. I have practiced in the blue
sky area for over twenty years and am happy
to have known many Committee members
for almost as long. I am also happy that my
successor as Chair is the very capable Ms.
Ellen Lieberman.

Since the enactment of the National
Securities Markets Improvement Act of
1996 my practice has continued to involve
an ever growing mix of related securities
and regulatory matters in addition to blue
sky work. However, I have always felt that
because we have a grounding in the state
securities law, we bring to the table a
sophistication in meeting the needs of clients
that someone who knows only the federal
law would lack.

However, many of us remain the sole person
at our firms dealing with state securities
regulation and covering both state and
federal securities law in even a narrow
practice area can be a daunting task.
Therefore, as I have said before in this
column, it becomes more important for us to
look to the Committee and our colleagues to
help us keep current with state securities
law. The states continue to enact changes to
their rules and regulations, and the recent
flurry of federal and SRO regulation has
also had its impact on blue sky practice as
the recent investment adviser changes
demonstrate. Therefore, I encourage
everyone to continue to make use of the
Listserv, bl-stateregs@mail.abanet.org, and
the Bugle, and submit articles, comments or
questions. I encourage all of our Committee
members to review the list of
Subcommittees (which have been
reorganized) and contact Subcommittee chairs, many of whom are new, to sign up for membership in Subcommittees that are of interest. I also encourage all of the Committee members who are members of the various Federal Regulation of Securities Committees to remember to report any new developments effecting blue sky practice discussed in those meetings, as well as other groups or bar associations to our Committee. Please also keep in mind any topics or developments which would lend themselves to a joint panel or discussion with a State Regulation Subcommittee at ABA or other meetings.

WORD FROM THE NEW CHAIR
The Importance of Communication
Ellen Lieberman
Debevoise & Plimpton LLP

I have been a member of the Committee for over two decades and the work of the Committee, as well as the contacts I’ve established with Blue Sky practitioners in every jurisdiction, has proved to be a valuable resource for Blue Sky law and “lore.” Of course, knowing what other people are doing or how they interpret statutes and rules will not substitute for one’s own in-depth look at and analysis of the law—but it is helpful to bounce things off colleagues, to learn of interpretations or issues that may not otherwise be readily apparent, and to increase that feeling of comfort by knowing what the Blue Sky bar is generally doing on a particular matter. This resource works because the Blue Sky community generously communicates and shares its knowledge and experience.

I am honored to be assuming the role of Chair of the ABA Committee on State Regulation of Securities immediately following the August Annual Meeting of the ABA. If I have an agenda for the coming year it would be summarized as communication and sharing. Whether in our meetings (coming up in Chicago this August, Minneapolis this September and Tampa in April of next year), through Committee reports and the Blue Sky Bugle or via the listserv, or individually through one-on-one interaction among Committee members, I’d like us to share more knowledge. Whose law is changing? Is there a new interpretation? Will there be a turnover among some state’s regulators? How are people completing certain portions of Form D? Which states have jurisdiction over certain offers and sales? Can you rely on particular exemptions for certain perhaps unusual transactions? Has there been a change in federal law, or a change in interpretation, that will impact on some aspect of Blue Sky law?

It would be great if the subcommittees could come to life—with active membership and real projects.

• Mike Liles of Karr Tuttle Campbell and Kathy Duggan of Cahill Gordon & Reindel LLP will be co-chairing a newly revised subcommittee on NSMIA exemptions and an informational request has already been circulated and can be found in the listserv archives—please take the time to respond because the results will be of interest to all of us.

• Michele Kulerman of Hogan & Hartson LLP will also be reinventing the subcommittee on employee benefit plans and welcomes as her new co-chair Bruce Johnson of Morrison & Foerster LLP (his knowledge of California law should be invaluable). They will need your help in defining the questions and gathering the answers—contact them and become an active participant in the Committee and that subcommittee.
• Martin Hewitt of Cadwalader, Wickersham & Taft LLP is going to jump start the Blue Sky Bugle to rev it up to at least three issues a year. We will ask a staff of contributing editors to help him do just that—so far Phil Rutledge of Shumaker Williams, P.C. and Patty Whelan of Wilmer Cutler Pickering Hale and Dorr LLP have agreed to contribute articles (or convince others to do so) and we urge you to volunteer as well.

• Don Rett of Tallahassee, Florida, will continue to chair the state liaison subcommittee, and we are indeed appreciative of the opportunity to get input from 53 jurisdictions; the newest liaison team is from the US Virgin Islands, Tom Bolt with his associate Leigh Goldman, both of Tom Bolt & Associates, PC, and we welcome them aboard. But don’t stand on ceremony—we should all view ourselves as liaisons and if our state has adopted a new law or interpretation, brought a significant enforcement action or otherwise acted in a manner that others would want to know about, please contact the liaison or the enforcement subcommittee and also consider sharing the information by listserv and/or via the Bugle.

• Marty Miller of Willkie Farr & Gallagher LLP, to whom we are truly grateful for his stewardship of the Committee during the past three years, has volunteered to co-chair the subcommittee on broker-dealers and investment advisers with David Katz of Sidley Austin Brown & Wood LLP, and your input in determining its agenda and implementing its projects for the coming year will be crucial.

• Alan Parness of Cadwalader, Wickersham & Taft LLP will serve as Vice Chair of the Committee and will also continue as chair of the subcommittee on direct participation, commodities and other hybrid securities.

• Mike Underwood of Steel Hector & Davis LLP will serve as Secretary of the Committee and will also continue as chair of the subcommittee on enforcement with Rick Slavin of Cohen and Wolf P.C. serving as vice chair.

• Phil Feigin of Rothberger Johnson & Lyons LLP will head the subcommittee on the Uniform Securities Act (2002) with co-chair Lynn Naefach of Wachovia Securities, and keep us abreast of adoptions, discrepancies in language and implementation, and other issues; please keep an eye on what your state is doing and share the information with Phil, Lynn and the rest of us.

• The subcommittee on international securities will be chaired by Ellen Creede of Cleary Gottlieb Steen & Hamilton LLP and Paul G. Findlay of Borden Ladner Gervais LLP.

Keep an eye on NASAA’s agenda for its annual meeting in Minneapolis, because some of our subcommittees will have stand alone meetings on Sunday, September 11, prior to our full Committee meeting which is scheduled for 10 a.m. I urge you to attend the subcommittee meetings and get involved.

If you have something to share with the full Committee, you can send it to BL-STATETREGS@MAIL.ABANET.ORG and the ABA staff will then submit it for my approval before it actually reaches the full membership.

If you have blue sky colleagues who have not joined the ABA Business Law Section,
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 Bugle, the listserv and any of our other resources.

Please 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 Minneapolis.

PREEMPTION: A NEW SPIN ON AN OLD THEME

By: Jeffrey Spill, Esquire*
New Hampshire Bureau of Securities Regulation

Introduction

Attorneys defending mutual fund complexes against accusations of fraud by state regulators are returning to the old theme of preemption to aid them in their defense against claims of failure to disclose to investors material conflicts of interest particularly in the area of revenue sharing and directed brokerage arrangements. The new spin is that defenders are turning to the courts as opposed to Congress for help. In a resolution adopted by the North American Securities Administrators Association “NASAA” at the annual Administrators Meeting in Alberta, Canada, state regulators have expressed concern over recent attempts to bypass Congress in order to preempt state regulatory authority.

Revenue Sharing and Directed Brokerage

For those securities lawyers who have managed to avoid the confusing world of mutual fund regulation, revenue sharing takes place when a mutual fund adviser or distributor pays additional compensation to broker-dealers to provide “shelf space” or priority marketing of a mutual fund. Directed brokerage is an arrangement whereby the mutual fund adviser agrees to execute the fund’s portfolio trades with a broker-dealer in exchange for shelf space. Directed brokerage is prohibited by NASD Rules. Revenue sharing violates securities laws when it is not adequately disclosed to investors. Recently, state securities administrators have been actively pursuing enforcement action against this activity under state laws which define fraud as the failure to disclose material information to the investor in the offer, purchase, or sale of a security. Typically, under these laws, there is no proof of scienter required.

Revenue sharing and directed brokerage arrangements can have numerous harmful effects. Best execution of fund portfolio transactions does not take place if the primary focus is on increasing sales of shares instead of best execution. Pressure to generate commissions for broker-dealers in exchange for shelf-space increases portfolio turnover which drives up fund costs and reduces fund performance. Active portfolio turnover may disrupt the fund investment strategy. Broker-dealers recommend funds that provide the best compensation rather than the funds that are best suited for customer needs or which have better performance. Investors are kept in the dark from conflicts of interest. Fund distributors and advisers driven by increased fees grow the fund at the expense of quality and price ultimately harming the shareholders.

Preemption

Generally, the presumption is against preemption and the burden of proving it is on the person asserting it. The defense of preemption falls into three categories: Express preemption when Congress expresses a clear intent to preempt state law in a given area of federal regulation; field preemption when in the absence of express preemption language, it is shown that
Congress intended by enacting a comprehensive legislative scheme to occupy an entire field of regulation; and conflict preemption when compliance with both federal and state law is impossible, or state law is an obstacle to the accomplishment of Congress’ purpose and objective in enacting the law. Black letter law in this area requires that those who make a claim of preemption must look to the wording of legislation to determine whether Congress intended state law to be preempted. Also relevant in the analysis is discerning the structure and purpose of the federal statute comprising the regulatory scheme.

Recent Actions

When the State of New Hampshire recently filed suit against American Express Financial Advisers (“AEFA”) for allegations centered on the sale of proprietary mutual funds, defenders invoked Section 203A of the Investment Advisers Act of 1940 and claimed that since AEFA was a federally covered adviser, the state had no jurisdiction to regulate in a way which would have the effect of requiring AEFA to amend its ADV. Following the AEFA case, California sued American Funds Distributor Inc. and its investment adviser Capital Research and Management Co. for allegations of fraud in the fund’s failure to adequately disclose its revenue sharing and directed brokerage agreements with the brokerage firm of Edward Jones. California’s suit came on the heels of an SEC settlement with Edward Jones on December 22nd, 2004 over the same conduct. American Funds fired back with a claim of preemption under Section 18 of the Securities Act of 1933. More specifically, the defenders argue that since a mutual fund is a covered security, the state is powerless to regulate in a way which would have the direct or indirect effect of requiring the fund to alter its prospectus disclosure. These promoters of the preemption argument also claim that the SEC’s enactment of Rule 10b-10 is further evidence of federal preemption in the area of fee disclosure. Rule 10b-10, also known as the “confirmation rule”, controls the information to be disclosed in the trade confirmation statements of the brokers. Rule 10b-10 requires a broker-dealer to disclose any remuneration received from third parties for securities transactions. Part and parcel of the Rule 10b-10 argument is a citation to the case of Press v. Quick & Reilly, 218 F.3d 121 (2nd Cir. 2000), in which the SEC announced in an amicus brief that Rule 10b-10 disclosures can be satisfied through a fund prospectus. Proponents of the preemption argument claim that further obligations of disclosure imposed by the states would only serve to frustrate the SEC’s regulatory authority and would conflict with federal disclosure requirements. They argue that there can be no failure to disclose when there is no duty to disclose. They further argue that the National Securities Markets Improvement Act (“NSMIA”) was enacted to correct inefficiencies in the securities markets caused by conflicting state regulation.

From on High

On April 27, 2005, the United States Supreme Court handed state regulators a decision which could be the proverbial big stick to fend off the ugly beast that is preemption. In the case of Bates v. Dow, the court in a matter which interpreted FIFRA (Federal Fungicide, Insecticide, and Rodenticide Act), rejected the notion that a civil action which may induce the target to change its disclosure is not a “requirement” for the target to act. At this point you may be saying to yourself, what do fungus, insects, and rodents have to do with securities law. Some would say don’t even go there, but I will anyway. FIFRA is federal legislation which establishes the
requirements for labeling by manufactures of Insecticide, Fungicide, and Rodenticide. The statute has a misbranding provision which takes effect if a pesticide label is false, misleading, or lacks adequate instructions or warnings. It prohibits the states from enacting any requirements for labeling which would be additional to or different than those under FIFRA. In Bates, a group of Texas farmers sued Dow chemical for defective design, defective manufacture, negligent testing, breach of express warranty, and violation of the Texas Deceptive Trade Practices Act (“DTPA”) when the Dow chemical they used damaged their peanut crops. Petitioners alleged that Dow marketed a pesticide which they knew or should have known would stunt the growth of peanuts grown in soil with pH greater than 7.0. The label stated that the pesticide was recommended in all areas where peanuts were grown. It turns out that typical Texas soil has 7.2 pH, and as a consequence of using the Dow chemical, the crops were damaged. Under federal law there was no requirement for a warning on the label so the farmers sued under state law. The Respondent argued that the state claims were preempted because an unfavorable jury verdict would have the affect of requiring Dow to add a warning to its label, and therefore, subject them to additional labeling requirements. The court ruled that law suits and jury verdicts are not to be considered as state imposed requirements, and even though they may induce action on the part of the target of the suit, they are not to be considered as the imposition of state requirements. The court described the inducement test as, “unquestionably overbroad”. Id. at page 11. Further, the court ruled that the state civil claims were not the type of state action that FIFRA intended to preempt. The court was very clear that, had Congress intended to preempt these state claims, they would have specifically indicated as such in the legislation.

The analogy that can be drawn to state securities regulation is that state fraud claims which may induce a target to change its disclosure cannot be considered state requirements for disclosure. Stated differently, when Congress carved out in the Investment Advisers Act and the Securities Act the state’s ability to enforce fraud claims against federally regulated entities, their lack of limitation in this area may mean the death knell for the claim of preemption. The court in Bates could not have been clearer in its message that if Congress intended to limit state powers in an area that the states traditionally regulate, it would be crystal clear in the legislation. No doubt there will be much debate and speculation over what exactly was meant by Congress to be preempted by NSMIA. It would be difficult to argue that the state fraud jurisdiction carve-outs of NSMIA limit the states ability to take fraud action in any way shape or form. Therefore, it can be argued that unless there is further definition by Congress, state fraud action against federally regulated entities are fully viable even though they may effect the way securities offerings and disclosures are written.

More Good News

There are other major flaws with the preemption argument other than the fact that Congress has withheld any express statement on preemption in this area. Section 203A of the Investment Advisers Act of 1940 is silent on the matter of disclosure preemption. The statute recites preemption in the areas of registration, licensing, and qualification only. The SEC’s announcement in Release IA-1633 that the Investment Advisers Act of 1940 preempts state disclosure provisions belays the question of whether states can commence a
fraud action for the failure to disclose material information. Defenders have the same problem with Section 18 of the Securities Act of 1933. That section preempts any state law requiring registration or qualification of a covered security except as provide for in that section. The exception is the state fraud jurisdiction savings clause. Further, as suggested in Bates, a state securities fraud action, which may induce further disclosure, is not a statutory “requirement” to disclose.

An even greater burden for defenders to overcome is the fact that federal disclosure law requirements are consistent with state laws which prohibit the failure to disclose material information making the conflict of laws argument weak at best. Rule 10b-10 requires the disclosure of transactional fees, and Sections 10 Section 17 of the Securities Act of 1933 require the disclosure of material information in the purchase or sale of a security. Revenue sharing and directed brokerage agreements are the type of material information contemplated by these statutes.

Conclusion

In conclusion, the Bates decision seems to provide strong support against the defense of preemption in regulatory matters. According to Bates, the inducement argument is overly broad. State fraud claims based on a failure to disclose material information may induce additional disclosure, but a state claim is not a “requirement” for disclosure. Further, state fraud claims are consistent with federal law in the area of mutual fund disclosure requirements.

* Author’s Disclaimer: The opinions expressed in this article are my own and not those of the Bureau.

Secondary Market Sales of Municipal Bonds: Can I Sell This Muni Bond to a Guy in Iowa?

Pamela W. Peterson
Assistant General Counsel
UBS Financial Services Inc.

The opinions contained herein are solely those of the author and should not be attributed to her employer, nor considered in any way as anyone’s corporate policy.

Pamela W. Peterson has been employed in the financial services industry since 1987 (she started on October 18, 1987 and swears she had nothing to do with the market events on the next day). During that time she has worked for two major investment banks as counsel to their municipal securities business units, and is currently Associate General Counsel at UBS Financial Services Inc. She is a 1999 graduate (summa cum laude) of Seton Hall University Law School.

An alarming number of non-lawyer participants in the municipal securities industry believe that new issues of municipal bonds do not require any kind of blue sky survey. Sometimes this belief can be founded in the nature of the issue (very small, and expected to be sold, albeit as a public offering, entirely to in-state residents.) Sometimes this belief is founded in a giddy misinterpretation of the provisions of the National Securities Market Improvement Act.² “NSMIA means you don’t have to do worry about those old blue sky laws anymore, right?” they say. In-house counsel at underwriting firms sigh patiently, count to ten, and then begin explaining the law: “Well, yes and no….”

Happily, most of the larger underwriting firms do get the law right. Recognizing that municipal bonds are often sold to investors across state lines,³ these firms always

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³ This occurs for a variety of reasons, including the possibility that a sale is initially made to a
require a blue sky survey for an initial offering. That generally solves the problem for new issues underwritten and sold by that firm or members of that underwriting syndicate (providing, of course, that the survey is competent).

But the secondary market sale of municipal bonds poses different kinds of problem. In practice, blue sky law is thought of most frequently in the context of new issues, when an offering and a distribution to the public clearly takes place. However, state laws do not necessarily distinguish the secondary sale of a few municipal bonds from a sale of twenty thousand shares of $5 stock. The blue sky questions usually turn on other criteria than the number of units of a security sold.

Moreover, institutions who originally purchased large blocks of bonds at the time of issue (a typical size for such blocks would be bonds with a total par value of $15,000,000) may eventually decide to sell such positions back into the secondary market. Typically, these securities were regional dealer headquartered outside the state of issuance, for later sale to a client in the state of issuance.

As an example, the fundamental commandment of Maine Blue Sky law is: “A person may not offer or sell any security in this State unless the security is registered under this Act, the security or transaction is exempt under this Act or the security is a federal covered security.” 32 M.R.S. 10401 (emphasis added). However, later in the Maine Act we learn that the following transaction is exempt from that rule: “Any isolated nonissuer transaction, whether effected through a broker-dealer or not.” 32 M.R.S. 10502.2 (A). Among the reasons why brokers hire blue sky lawyers is the difficulty of deciding if selling six $5000 Florida bonds to three assorted investors who summer in Maine (and winter in Florida) will be considered “isolated” transactions.

never covered by any private placement exemption from registration, only by the usual 3(a)2 and/or 3(a)4 exemptions in the Securities Act of 1933, and the break-up of a large position like this might be what securities lawyers sometimes call a “deemed” underwriting of an “issue”—even though it occurs six months after the initial issuance. In other words, the disposition of this large block of securities by way of a sale back to assorted clients (with various brokerage firms are involved) may not be an initial offering, but could be an offering and a distribution all the same. There’s a nightmarish possibility for brokers.

Finally, what about all those secondary trades that are small trades, customer-to-customer, either inside or outside the legal boundaries of any particular brokerage firm? A large number of municipal bond transactions are done as either “riskless principal” transactions or as ordinary

4  As an example, the fundamental commandment of Maine Blue Sky law is: “A person may not offer or sell any security in this State unless the security is registered under this Act, the security or transaction is exempt under this Act or the security is a federal covered security.” 32 M.R.S. 10401 (emphasis added). However, later in the Maine Act we learn that the following transaction is exempt from that rule: “Any isolated nonissuer transaction, whether effected through a broker-dealer or not.” 32 M.R.S. 10502.2 (A). Among the reasons why brokers hire blue sky lawyers is the difficulty of deciding if selling six $5000 Florida bonds to three assorted investors who summer in Maine (and winter in Florida) will be considered “isolated” transactions.

5  Section numbers of the Securities Act of 1933, codified as 15 USC 77c(a)2.
6  Codified as 15 USC 77c(a)4.
7  An example of a “riskless principal” trade: Broker Alpha, working through a firm known as a “broker’s broker,” has offered the securities for bid, and received at least one bid, which is satisfactory to Customer Aleph (and in Broker Alpha’s professional opinion, is a fair and reasonable price.) Customer Aleph sells the bonds to Broker Alpha, which then sells (via the broker’s broker firm) to Broker Beta, which then sells to its Customer Begel, who made the winning bid. Customer Aleph receives certain benefits from this method: 1) no need to deal with the complex operational issues of selling an interest-accrued security; 2) Broker Alpha takes some risk after all (in case Customer Begel reneges); and 3) Broker Aleph is obliged to determine if the bid(s) are fair and reasonable (or at least to advise the customer if that can’t be determined, and do the transaction as agent rather than principal.)
principal transactions in which the brokerage firm, to accommodate a customer who needs to realize cash on municipal bond holdings, agrees to take the bonds into its own inventory for an undetermined period of time. In both kinds of transactions, the bond passes through the broker’s inventory and the broker assumes the risks of ownership. Of course, even in a true at-risk principal transaction, almost all of the time the broker will sell the bonds to another customer rather than retaining them. How should a broker (or a broker’s broker) determine if those sale transactions, particularly ones that will be made to a customer residing outside the state of issuance, are acceptable under state securities laws?

First, let’s clearly understand that there is no central database which allows rapid-access, computerized, data-field-searchable blue sky information for all municipal bonds. Nor is there likely to be one. The major problem is the sheer enormity of securities issued. The CUSIP Bureau says that there are bonds issued in 1989 won’t mature till 2019; they’re still trading.

Although it is customary in many jurisdictions to place a summary of critical blue sky information on the front cover of official statements for bond issues, there is no legally required format for official statements, since the bonds are exempt from registration. A typical blue sky legend says “These securities may not be sold to residents of State1, State2, State3…. Sometimes blue sky information is only distributed via internal syndicate communications, even if a blue sky memorandum is or will be part of the closing documents for the bond issue. For non-syndicate members, especially long after the issuance date, obtaining that analysis can be very difficult.

Some brokers do maintain such a database for bonds which they have underwritten, although, given the long maturity of municipal bond issues, blue sky data for older bonds may not be included. Computer data storage in, say, 1978 was considerably different and more expensive than it is in 2005.

The trade organization for the corporate and municipal bond financial services industry.
around 1.5 million individual CUSIP numbers (active and outstanding, i.e., not matured) associated with municipal bonds. Generally, an issue of bonds—containing securities with varying maturities, interest rates, and call features—does not require more than one blue sky analysis. However…..

Consider the case of a municipal issue that contains eight securities identified as part of Series A (tax-exempt, secured by a pledge of revenues from a special hotel tax, credit-enhanced by a moral obligation of the issuer, a political subdivision of a large city)—and four securities identified as Series B (taxable, subordinated debt, backed by a pledge of revenues from the Convention Center operation and a mortgage interest in the land on which it sits). Unless I’m misreading the advice I receive from blue sky lawyers, the analysis is quite different for these securities and may require that sales of the Series A and Series B securities comply differently with the blue sky laws of certain states.

So, simply based on the number of existing securities and the potential complexity of each issue, we have a rather daunting task ahead, if we were foolish enough to think “Well, it’s just a lawyers-versus-time-and-paper problem.”

Just for fun, let’s say that a really competent lawyer could locate the offering document, find the blue sky statement in it, and manually enter the data into a computerized database in less than five minutes per CUSIP. (Wildly optimistic, but this is merely hypothetical.) This assumes that ALL offering documents can be retrieved via Internet search, that the blue sky information is NOT in a separate document, that the lawyer merely enters whatever is present with no attempt to decide if the conclusions reached for the new issue are still applicable for the secondary trading of those bonds, and that quality control consists of merely verifying that the CUSIP numbers are accurately matched to the blue sky status of each security. Calculation follows:

5 minutes $\times$ 1.5 million CUSIPS = 7.5 million minutes

+ 60 minutes/hour = 125,000 hours

+ 30 working hours/week = 4.167 work-weeks

+ 48 work weeks/year = 86.8 years.

All we have to do now is decide how many lawyers we want to work on this full time (and who will pay for their work, and subsequent psychiatric rehabilitation) to determine how many years it will take to construct a complete, accurate municipal bond blue-sky database. Don’t forget that new CUSIPs will be added while we work.

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14 CUSIP= Committee on Uniform Securities Identification Procedures. It is not uncommon to find written references in brokerage firm’s internal materials to “cusips” meaning “individual securities” – the acronym having morphed into a separate word in financial services jargon. The CUSIP Service Bureau “exists for the primary purpose of uniquely identifying issuers and issues of financial instruments within a standard framework, and disseminating this data to the financial marketplace via various media.” See http://www.cusip.com/, which also has an excellent description of the entity’s history and operations.

15 A typical municipal bond “issue” actually comprises about 15 to 45 different securities with varying maturities, interest rates, call dates, and possibly differing priority of repayment in the event of issuer defaults. Each security has an individual CUSIP number.
A second kind of complexity arises as well. Municipal securities lawyers attempting to penetrate the mysteries of any given state’s laws regarding the post-NSMIA remaining requirements for securities “notice” registration can be forgiven for thinking “Hmmm, these laws don’t seem to fit bond transactions very well. Especially for secondary trades. This ‘seasoned securities’ exemption here is all about ‘SEC-registered, exchange-traded’ securities—and the ones I’m worried about were exempt from SEC registration in the first place and trade over-the-counter. Gosh. What to do?”

There are several approaches. Of course, the least legally risky solution is to prohibit any sales to customers located outside the issuance state if blue sky information on a particular security is unavailable. This first approach is economically unfeasible and would have a material inhibiting effect on the market. Americans change their residences all the time (often just after they retire) and frequently do not remember to sell their municipal bonds at the time they hold the yard sale before the moving truck arrives. Once the customer arrives in a new state and realizes that he or she now pays state tax on the bond interest (several months later at tax time, when a new CPA breaks the bad news), the customer sells the bonds to a broker who likely will re-sell to a client in the state of issuance (who can realize the full tax advantage). Where, exactly, did all these transactions take place (considering that we’re really talking about changing information in a DTC computer file, anyway)?

The second approach, one adopted by many brokerage firms, is to try and create (or pay for) a global blue sky survey—not intended as a replacement for new-issue surveys, but as a useful tool for decision making on secondary trades. Such surveys have usually been organized to allow a user to rapidly review a summary of the law in each major U.S. jurisdiction. At the finest level of detail, however, a user is often compelled to turn to an actual blue sky lawyer to resolve “gray area” questions about a particular security.

One purpose of this article is to raise the possibility of a third approach to the problem of secondary trading in municipal issues. That approach calls for an attempt to find the similarities among blue sky laws in multiple jurisdictions, so far as possible, in order to narrow the range and kind of bonds for which sophisticated “exception analysis” is required. If, for instance, eighteen U.S. states simply have no registration requirement whatsoever (even notice registration) for bonds which are characterized as “general obligation” bonds, that eliminates a fairly large subset of municipal bonds from the need to perform that analysis. More to the point, it does not increase the legal risk for the securities dealer. If a subset of U.S. states also eliminates blue sky requirements for “essential services” revenue bonds, that is also a low-risk area.

Lawyers may object that this leaves legal decisions to non-lawyers. However, the fundamental character of municipal

16 U.S. Census Data from the 1990 census suggests that over 50% of the population between the ages of 20 and 70 had moved between states at least once in the past five years. See The Decline and Rise of Interstate Migration in the United States: Evidence from the IPUMS, 1850-1990, J.L. Rosenbloom & W.A. Sundstrum, 2002, Table 1.

17 Insert sound effects here: spines of numerous

Bugle readers snapping as they leap to their phones to answer this question. At ease, attorneys! I was speaking rhetorically.
securities is actually a factual determination and one which most municipal trading desk personnel are extremely good at doing. Men and women who trade municipal securities all day long will not easily confuse a water and sewer revenue bond issue which is “double-barreled” (also backed by a general obligation pledge of the issuer) with an industrial development bond which is backed ultimately by a second mortgage on a widget manufacturing facility located in a formerly blighted area. If traders’ knowledge can be combined with clear legal guidelines for even one-third of all secondary sales without full blue-sky information, considerable efficiencies will result.

The problem, then is to create a differently organized “global” survey that is aimed at rapidly and clearly identifying those bonds at one end of the spectrum (very low legal risk) from those at the other end of the spectrum (very high legal risk)—and also to establish criteria for those in the middle. The brokerage firm then applies its internal risk management process. The conservative risk management position would be: if you can’t absolutely, positively identify this bond as one with no registration requirements in the jurisdiction where it is delivered (assume that delivery equals sale in that jurisdiction, a second conservative assumption)—then DON’T SELL IT!

A more sophisticated risk matrix might also take into account the credit rating of the security and its time to maturity. While it is theoretically possible that a purchaser might choose to demand rescission on a bond purchase by threatening to report a seller for blue sky violations, that eventuality is far less likely for highly rated municipal bonds. Finally, a sophisticated risk matrix should probably also consider the dollar value of the sale.

The numerical analysis tools of risk managers can be applied here to optimize the legal risk of any secondary sale across state lines. And an analysis of this sort, coupled with an internal risk matrix, certainly does not mean that there will be no role for blue sky lawyers. There are inevitably gray areas which will call for sophisticated blue sky analysis, and the kind of inquiry to (and personal relationships with) state securities regulators that enable in-house counsel to confidently tell Louie on the desk to go ahead and authorize the trade.

As long as creative bankers and cash-starved municipalities seek new ways to raise cash, the need for attorneys who can interpret state securities law will not vanish.

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FLORIDA ENACTS SWEEPING LEGISLATION RE: VIATICALS
Donald Rett
Law Office of Donald Rett

During the recently-concluded session of the Florida Legislature, the Florida Securities and Investor Protection Act (“FSIPA”) was amended in a way to virtually do away with the “viatical problem”.

To accomplish that, the 2005 legislature (in CS for SB2412) added the term “viatical settlement investment” to the FSIPA definitional section. The newly-added term (at s.517.021(23)(w) is defined as “…an agreement for the purchase, sale, 

18 The cumulative default rates on AAA and AA rated municipal bonds over the last eighteen years is zero. See Standard & Poor’s U.S. Municipal Rating Transitions and Defaults, 1986-2003, published April 21, 2004. A-rated municipal debt, over the same period, has a default rate of .07.
assignment, transfer, devise, or bequest of all or any portion of a legal or equitable interest in a viatlicated policy, as defined in…” chapter 626 of the Florida Statutes. The title of Chapter 626 is “Insurance Field Representatives”.

Since a “viatical settlement investment” is now defined in Florida as a “security”, it must be registered with the Florida Office of Financial Regulation prior to being sold in Florida (sec. 517.071, F.S.), unless an exemption from that process can be validly claimed (but, see below). However, since sec. 517.071(1) F.S. excludes from Florida securities registration that which is a “federal covered security”, an argument might be mounted that a Rule 506 offering of a viatical settlement investment might escape securities registration in Florida; however, Florida - like most other States—also focuses on the actual seller of the securities, which itself must also be registered as a “dealer” unless an exemption from that process is similarly available.

It is highly unlikely that an offering of viatical settlement investments would be welcomed at any registered Florida broker-dealer firm. Hence, unless the seller of the viatical settlement investment is also the “issuer” of those securities, and unless the actual sales transactions are executed solely by the issuer’s “bona fide employees”, then Florida’s Rule 69W 500.016 (which exempts from Florida securities registration those offerings under section 4(2) offerings of the Securities Act of 1933) would seem on its face to thwart a Rule 506 claim.

Amendments to Ch. 626 by this Act would seem to similarly thwart a large-scale distribution of viatical settlement investments. Such amendments to Ch. 626 are not discussed in this article; however the entire bill (which prints out at forty-six pages) was posted on the Website the last time I looked.

New section 517.072 has been added to FSIPA, to say that the following “exempt securities” are not available where viatical settlement investments are the securities being offered: 1) s.517.051(6)—a non-common stock security, which has been outstanding and in the hands of the public for at least five years, and which pays or has paid a fixed return with no defaults in principal or interest during that same term of years; 2) s.517.051(8) the “current transaction” exemption, for a “note, draft”, etc., with a face amount of $25,000 and a nine-month maturity; and, 3) s.517.051(10) which provides a “safe harbor” for insurance or annuity products which are “…subject to the supervision of the insurance regulator…”, or other agencies of similar purpose.

Section 517.072, F.S., also removes the availability of the following five transactional exemptions if a viatical settlement investment is involved: 1) s.517.061(2), where the transaction is for the sale of a security pledged in good faith as security by a pledgeholder or mortgagee, in order to liquidate a bona fide debt; 2) s.517.061(3), where the transaction is an “isolated” one and the vendor is not the issuer or underwriter of the securities, and is disposing of his or her own property, with no benefit to the issuer or underwriter; 3) s.517.061(8), for sales between corporations where the sales price of the securities is $50,000 or more, and both buying and selling corporations have assets of $500,000 or more; 4) sales pursuant to Florida’s private placement transactional exemption; and 5) the offer or sale of any security effected by or through a Canadian dealer which, while having no physical presence in Florida, nevertheless is
registered pursuant to Florida’s dealer section.

A limited number of exclusions from the term “viatical settlement agreement” are provided at s.517.021(23)(a). The first is where the transfer or assignment of an interest in a previously viaticated policy is made by a natural person who transfers or assigns no more than one such interest in one calendar year. The second exclusion would be where the provision of stop-loss coverage to a viatical settlement provider, financing entity, or related provider trust as those terms are defined in s.626.9911 F.S., by an authorized or eligible insurer. Third, the transfer or assignment of a viatical policy from a licensed viatical settlement provider to a limited set of recipients. The fourth would be available where the transferee is a certain type of financial institution, or a “qualified institutional buyer” (see below), or where the transferee is an accredited investor. Finally, the last type of exclusion is where a transfer occurs by a conservator who has been appointed by a court of competent jurisdiction.

The term, “qualified institutional buyer” is now defined in the securities statute, but in a broader way than it previously was when in Florida’s rules. By this new law, a qualified institutional buyer is defined as any such person defined as such by the SEC in Rule 144a, “…or any foreign buyer that satisfies the minimum financial requirements as set forth in such rule”. sec. 517.021(19) F.S.)

In conclusion, by bringing viatical settlement investments within the purview of Florida’s securities act, and by apparently removing all possible exemptions from registration, such instruments must undergo our beloved merit review system. Good luck.

(During the last century, Don Rett was the Director of Florida’s Division of Securities, which is now known as the “Office of Financial Regulation”. He serves as Chair of the Committee’s sub-committee on “Liaison with Securities Administrators and NASD”. He was recently appointed by the Chair of the Florida Bar’s Business Law Section to be a member of The Special Committee on the Florida Securities and Investor Protection Act.)

NEW YORK NOW REQUIRES SERVICE OF PROCESS TO A U.S. ADDRESS

By: Ellen Lieberman, Debevoise & Plimpton LLP, and Alan M. Parness, Cadwalader, Wickersham & Taft LLP

The New York State Department of State has determined it will now reject any filing for a business or not-for-profit entity that includes an address for service of process outside of the United States or United States territories. Previously, the Department would accept a service of process address anywhere in the world. This new policy applies both to consents to service of process, and to certificates of merger or amendment or other similar filings that include an address for service of process.

The rationale given by the Department is that it is required by law to send a copy of any process served on the Department to the address for service of process by certified mail, return receipt requested. The United States Postal Service, however, will not deliver mail to any jurisdiction outside the United States or United States territories by certified mail, return receipt requested. Thus, process previously sent by certified mail outside the United States was returned to the Department and ultimately destroyed without redelivery. For that reason, the
Department has determined to no longer accept such non-United States addresses. Accordingly, unless a foreign company has an available address in the U.S., at least as far as “Martin Act” (NY Gen. Bus. Law Art. 23-A) filings are concerned, the simple solution is not to file a Form U-2 for such a foreign company. In this connection, if you read NY Gen. Bus. Law § 352-a carefully, nowhere is there a requirement for issuers to actually file a consent. Section 352-a simply provides that if a foreign issuer’s securities are sold in NY and it hasn’t filed a designation of the Secretary of State (“SOS”) pursuant to NY Bus. Corp. Law § 1304, or a designation of the SOS to accept service in a proceeding under NY Gen. Bus. Law Art. 23-A, then the New York Attorney General (“NYAG”) may serve the issuer (or a nonresident officer thereof) by mail addressed to its last known place of business or such officer’s residence. Likewise, NY Gen. Bus. Law § 352-b provides that foreign broker-dealers, salesmen and investment advisers (and partners, principals, officers and directors of such broker-dealers and investment advisers) doing business in NY are deemed to have irrevocably appointed the SOS as agent for service of process in any proceeding under NY Gen. Bus. Law Art. 23-A, although such persons may file a designation of the SOS as such an agent.

While the NYAG has required foreign issuers, broker-dealers and investment advisers to file designations unless they’re qualified under NY Bus. Corp. Law § 1304 (note that NY Gen. Bus. Law §§ 352-a and 352-b haven’t been updated to recognize qualification of foreign limited partnerships under NY Part. Law § 121-902, or foreign limited liability companies under NY Ltd. Liab. Co. Law § 802), there is clearly no statutory obligation to file such designations under NY Gen. Bus. Law §§ 352-e, 359-e, or 359-eee, nor pursuant to the NYAG’s rules thereunder (see, however, the “Submission” section of NYAG Policy Statement 104 at 2A Blue Sky L. Rep. (CCH) ¶ 42,579 at p. 37,565). Compare the clear statutory obligation of issuers to file consents under other states’ Blue Sky laws as a condition of registration. See Uniform Securities Act §§ 302(b), 303(b), and 304(b), each referencing the consent required by § 414(g), and Uniform Securities Act (2002) §§ 303(b) and 304(b), each referencing the consent required by § 611. A similar specific obligation is imposed under other Blue Sky laws on applicants for broker-dealer, agent, investment adviser, and investment adviser representative registration. See Uniform Securities Act § 202(a), referencing § 414(g), and Uniform Securities Act § 406(a), referencing § 611.

Accordingly, foreign companies may, but need not, effect designation filings in New York for purposes of the Martin Act.

NASAA PROPOSES AMENDMENTS TO COMMODITY POOL GUIDELINES
By: Benjamin L. Nager
Sidley Austin Brown & Wood LLP

The North American Securities Administrators Association, Inc. (“NASAA”) recently issued a proposal (the “Proposal”) to amend the NASAA Statement of Policy on the Registration of Commodity Pool Programs (the “Commodity Pool Guidelines”). The amendments were published for a 30-day comment period on the NASAA website (www.nasaa.org) on May 27, 2005. The Commodity Pool Guidelines were last amended in 1990. A majority of States use the Commodity Pool Guidelines to review
publicly-offered commodity pools for which registration is sought therein.\(^{19}\)

One of the proposed revisions to the Commodity Pool Guidelines is to conform the treatment of trail commissions, payable to qualified sales agents/representatives, to recent interpretations promulgated by the National Association of Securities Dealers, Inc. (the “NASD”). As a result, the payment of trail commissions under the Proposal would become subject to the 15% limitation set forth in Section IV.A of the Commodity Pool Guidelines with respect to the payment of “organizational and offering expenses”. Currently, the Commodity Pool Guidelines specifically exclude trail commissions from such 15% limitation.\(^{20}\)

NASAA states that the reason underlying the proposed change regarding trail commissions is because the NASD recently changed its policy in respect of the payment of trail commissions. Until Fall 2004, the NASD permitted public commodity pool program trail commissions to be paid to selling agents who were also duly licensed with the Commodity Futures Trading Commission (the “NASD Commodity Pool Trail Commission Policy”). Pursuant to NASD Notices to Members 04-07 and 04-50, and Securities and Exchange Commission Release No. 34-50065 (July 22, 2004), however, the NASD Commodity Pool Trail Commission Policy was rescinded in respect of commodity pools which were filed with the NASD’s Corporate Financing Department (the “Department”) on or after October 12, 2004. In respect of these pools, trail commissions are subject to the 15% cap on “organization and offering expenses” under NASD Rule 2810 (which governs certain terms and conditions of public direct participation programs, such as commodity pools, that are sold by NASD member broker-dealers). Commodity pools filed with the Department prior to October 12, 2004, however, are grandfathered and still receive the benefit of the NASD Commodity Pool Trail Commission Policy, even if offered on or after October 12, 2004.

Unfortunately, the Proposal does not incorporate the NASD’s grandfathering provision and, thus, fails to distinguish between commodity pools which were filed with the Department prior to October 12, 2004 and those filed with the Department on or after such date. Therefore, under the Proposal, if adopted by NASAA and the various States, a State could refuse to approve the annual registration renewal of a public commodity pool which is grandfathered under the NASD Commodity Pool Trail Commission Policy and, thus, which permits the payment of trail commissions, without limitation, to qualified sales agents/representatives.

Some members of the NASAA Securities Registration and Exemption Project Group, which proposed the amendments to the Commodity Pool Guidelines, have stated

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\(^{19}\) The Commodity Pool Guidelines do not apply to privately-offered programs conducted in accordance with Section 4(2) of the Securities Act of 1933 and Rule 506 thereunder.

\(^{20}\) Pursuant to a comment to Section IV.A of the Commodity Pool Guidelines, “[c]ompensation paid to sales agents of commodity brokerage commissions (trail commissions) will not be considered objectionable offering expenses under Section IV.A.” Although trail commissions are not necessarily paid from a program’s brokerage commissions, the States have interpreted the Commodity Pool Guidelines as not subjecting trail commissions paid to appropriately qualified sales agents/representatives, in accordance with the NASD’s prior policy, to the 15% limitation in respect of organizational and offering expenses. The Proposal would delete this comment.
that any difference between the treatment of trail commissions under the Proposal and by the NASD is unintentional. Several comment letters urged NASAA to revise the proposal in order to track the NASD’s grandfathering provisions.

The other proposed amendments are intended to revise provisions in the Commodity Pool Guidelines that are inconsistent with the current practice for commodity pools. The other proposed changes are:

- Permitting a special valuation date and redemption when the general partner or managing owner of the commodity pool is removed or withdraws so that the general partner or managing owner will not be required to maintain an investment interest in the commodity pool after it ceases to act in such capacity. If the general partner or managing owner redeems its interest as of a special valuation date, the participants in the program shall also be given an opportunity to redeem their interests on that special valuation date at the net asset value per unit as of that date.

- Permitting the sponsor of the commodity pool to pay the expenses of such pool—the current Commodity Pool Guidelines provide that all expenses of a program must be billed directly to and paid by the program.

- Permitting the payment of incentive fees as frequently as redemptions from the commodity pool are permitted—the current Commodity Pool Guidelines only permit the payment of incentive fees no more frequently than quarterly.

- Permitting redemption fees to be charged to an investor during the first two years after the issuance of interests to such investor—the current Commodity Pool Guidelines permit redemption fees to be charged only during the first two years after the commencement of trading.

As of the date of this article, NASAA has not yet adopted the Proposal.

EDITORIAL

By Martin A. Hewitt
Cadwalader, Wickersham & Taft LLP

I would like to take this opportunity to thank the many contributors to this issue of the Bugle. We have articles from law firms, regulators, and in-house counsel. Each provides a unique insight into our world as practitioners in our field.

My special thanks go to Pam Peterson, Ellen Lieberman, Leigh F. Goldman, Martin R. Miller, Jeff Spill, Donald Rett, Alan M. Parness, and Benjamin L. Nager

As stated in the last issue of the Bugle, my goal as editor of the Bugle is to provide a forum for practitioners and regulators alike to discuss various matters of importance to our community at large. To that end, I once again ask all readers of this publication to contact me via email to let me know what topics you would like to see addressed in this space. To make the process more efficient, I have determined that there will be three deadlines a year; Valentine’s Day, Bastille Day, and Halloween. My reason for these dates is that they are easy to remember and thus more user friendly to possible contributors.

Again, I would like to thank all the contributors to this Bugle and, as always end with my favorite quote from Tom Lehrer “What you get out of a sewer system is based entirely upon what you put into it.”
Please put in your contributions on a regular basis.
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Secretary: R. Michael Underwood
Steel Hector & Davis LLP, Ste. 601, 215 S. Monroe St., Tallahassee, FL 32301-1846

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Willkie Farr & Gallagher LLP, 787 7th Ave., New York, NY 10019-6018
David M. Katz
Sidley Austin Brown & Wood LLP, 787 Seventh Ave., New York, NY 10019

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Chair:
Martin A. Hewitt
Cadwalader, Wickersham & Taft LLP, One World Financial Center, New York, NY 10281

Direct Participation, Commodities & Other Hybrid Securities

Chair:
Alan M. Parness
Cadwalader, Wickersham & Taft LLP, One World Financial Center, New York, NY 10281

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Co-Chairs:
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Hogan & Hartson LLP, 555 Thirteenth St. NW, Washington, DC 20004-1109
Bruce Elwood Johnson
Morrison & Foerster LLP, 425 Market St., San Francisco, CA 94105-2406

Enforcement

Chair:
R. Michael Underwood
Steel Hector & Davis LLP, Ste. 601, 215 S. Monroe St., Tallahassee, FL 32301-1846
Vice-Chair:
Richard Slavin
Cohen and Wolf, P.C., 1115 Broad Street, Bridgeport, CT 06604-4247

International Securities

Co-Chairs:
Ellen M. Creede
Cleary Gottlieb Steen & Hamilton, 1 Liberty Plaza, New York, NY 10006-1404
Paul G. Findlay
Borden Ladner Gervais LLP, 40 King St W Toronto, ON M5H 3Y4

Liaison with Securities Administrators and NASD

Chair:
Donald A. Rett
1660 Metropolitan Circle, Tallahassee, FL 32308
NSMIA  
Co-Chairs:  
Mike Liles, Jr.  
Karr Tuttle & Campbell, 1201 Third Avenue, Suite 2900, Seattle, WA 98101  
Kathleen Duggan,  
Cahill Gordon & Reindel LLP, 80 Pine St., New York, NY 10005  

Uniform Securities Act of 2002  
Co-Chairs:  
Philip Alan Feigin  
Rothgerber Johnson & Lyons LLP, 1200 17th St., Suite 3000, Denver, CO 80202-5835  
Lynn D. Naefach  
Wachovia Securities, WS 1012, 10750 Wheat First Drive, Glen Allen, VA 23060
STATE LIAISONS

ABA BUSINESS LAW SECTION
COMMITTEE ON STATE REGULATION OF SECURITIES

AL
Ms. Carolyn L. Duncan
Ritchie Duncan & Goodwin, LLC
312 North 23rd Street
Birmingham, Alabama 35203-3878
E-Mail – cduncan@rdg-law.com
(205) 251-1288 (Work)
(205) 324-7832 (Fax)

AK
Mr. Julius J. Brecht
Wohlforth, Argetsinger, Johnson & Brecht, a Professional Corporation
900 West 5th Avenue, Suite 600
Anchorage, Alaska 99501-2048
Firm E-Mail – wajb@alaska.net
Direct E-Mail – jbrecht@wvjb.com
(907) 276-6401 (Work)
(907) 276-5093 (Fax)

AZ
Mr. Dee Riddell Harris
Carmichael & Company LLC
2415 E. Camelback Rd., Suite 700
Phoenix, Arizona 85016
E-Mail – deeharris@carmichaelandco.com
(602) 508-6088 (Work)
(602) 840-6824 (Home Fax)

AR
Mr. John S. Selig
Mitchell, Williams, Selig, Gates & Woodyard, P.L.L.C.
425 West Capitol Avenue, Suite 1800
Little Rock, Arkansas 72201-3525
E-Mail – jselig@mwsgw.com
(501) 688-8804 (Work)
(501) 688-8807 (Fax)

CA
Mr. Bruce Elwood Johnson
Morrison & Foerster LLP
425 Market Street
San Francisco, CA 94105
E-Mail – bjohnson@mofo.com
(415) 268-6628 (Work)
(415) 268-7522 (Fax)

CO/MT/WY
Mr. Robert J. Ahrenholz
Kutak Rock LLP
1801 California Street, Suite 3100
Denver, Colorado 80202
E-Mail – robert.ahrenholz@kutakrock.com
(303) 297-2400 (Work)
(303) 292-7799 (Fax)
CT
Ms. Susan E. Bryant
Six Forest Park Drive (06032)
P.O. Box 444
Farmington, CT 06034-0444
E-Mail – sebry@aol.com
(860) 674-0111 (Work)
(860) 675-4204 (Home)
(860) 674-0011 (Fax)

DE
Mr. Andrew M. Johnston
Morris, Nichols, Arski & Tunnell
1201 North Market Street
P. O. Box 1347
Wilmington, Delaware 19899-1347
(302) 658-9200 (Work)
(____) ____-_____ (Home)
(302) 658-3989 (Fax)

DC
Ms. Michele A. Kulerman
Hogan & Hartson L.L.P.
555 Thirteenth St., N.W.
Washington, D.C. 20004-1109
E-Mail – makulerman@hhlaw.com
(202) 637-5743 (Work)
(301) 279-6772 (Home)
(202) 637-5910 (Fax)

FL
Mr. Donald A. Rett
Law Office of Donald Rett
1660 Metropolitan Circle
Tallahassee, Florida 32308
E-Mail – drett52687@aol.com
(850) 298-4454 (Work)
(904) 894-0700 (Home)
(850) 298-4494 (Fax)

GA
Robert D. Terry
B/D Solutions
Eleven Piedmont Center, Suite 125
Atlanta, Georgia 30305
E-Mail – Rterry@bdsolutions.com
(404) 303-8840 x.204 (Work)
(877) 423-4636 (Home)
(404) 250-9972 (Fax)

HA
Mr. David J. Reber
Goodsill Anderson Quinn & Stifel
1099 Alakea Street, Suite 1800
Honolulu, Hawaii 96813
E-Mail – dreber@goodsill.com
(808) 547-5611 (Work)
(808) 395-7994 (Home)
(808) 547-5880 (Fax)

ID
Mr. Jeffrey W. Pusch
Marshall Batt & Fisher, LLP
101 South Capitol Boulevard, 5th Fl.
P.O. Box 1308
Boise, Idaho 83701
E-Mail – jwpusch@marshallbatt.com
(208) 331-1000 (Work)
(____) ____-_____ (Home)
(208) 331-2400 (Fax)
IL
Ms. Misty S. Gruber (312) 876-7920 (Work)
Sonnenschein Nath & Rosenthal LLP (____) ____-____ (Home)
8000 Sears Tower (312) 876-7934 (Fax)
233 South Wacker Drive
Chicago, Illinois 60606
E-Mail – mgruber@sonnenschein.com

IN
Mr. Stephen W. Sutherlin (317) 639-5454 (Work)
Stewart & Irwin (317) 733-8084 (Home)
251 East Ohio Street (317) 632-1319 (Fax)
Suite 1100
Indianapolis, Indiana 46204
E-Mail – SSutherlin@Stewart-Irwin.com

IA
Mr. Matthew L. Fornshell (216) 696-8700 (Work)
Kohrman Jackson & Krantz P.L.L. (____) ____-____ (Home)
One Cleveland Center, 20th Floor (216) 621-6536 (Fax)
1375 East Ninth Street
Cleveland, OH 44114-1793

KS/MO
Mr. William M. Schutte (913) 234-7414 (Work)
Polsinelli/Shalton/Welte (913) 451-6205 (Fax)
6201 College Blvd., Suite 500 (913) 345-0054 (Home)
Overland, KS 66211
E-Mail – wschutte@pslaw.com

KY
Mr. Manning G. Warren III (502) 852-7383 (Work)
University of Louisville (____) ____-____ (Home)
Louis D. Brandeis School of Law (502) 852-0862 (Fax)
2301 South Third Street
Louisville, Kentucky 40292
E-Mail – mgw111@louisville.edu

LA
Mr. Carl C. Hanemann (504) 582-8156 (Work)
Jones, Walker, Waechter, Poitevent, (504) 861-3992 (Home)
Carrere & Denegre, L.L.P. (504) 582-8012 (Fax)
Place St. Charles
201 St. Charles Avenue, 51st Floor
New Orleans, Louisiana 70170-5100
E-Mail – chanemann@joneswalker.com
ME
Mr. Wayne E. Tumlin (207) 774-1200 (Work)
Bernstein, Shur, Sawyer & Nelson, P.A. (____) ____-____ (Home)
100 Middle Street - W. Tower (207) 774-1127 (Fax)
P.O. Box 9729
Portland, ME 04104-5029
E-Mail – wtumlin@mainelaw.com
wtumlin@bernsteinshur.com

MD
Mr. Wm. David Chalk (410) 580-4120 (Work)
Piper Marbury Rudnick & Wolfe LLP (____) ____-____ (Home)
6225 Smith Avenue (410) 580-3001 (Fax)
Baltimore, MD 21209-3600
E-Mail – david.chalk@piperrudnick.com

MA
Ms. Anne (Polly) G. Plimpton (617) 248-7514 (Work)
Testa, Hurwitz & Thibeault, LLP (617) 731-6180 (Home)
125 High Street (617) 248-7100 (Fax)
Boston, Massachusetts 02110
E-Mail – plimpton@tht.com

MI
Mr. Shane B. Hansen (616) 752-2145 (Work)
Warner Norcross & Judd LLP (616) 942-7063 (Home)
111 Lyon Street, N.W. (616) 752-2500 (Fax)
Grand Rapids, Michigan 49503
E-mail – shansen@wnj.com

MN
(See Iowa)

MS
Mr. Daniel G. Hise (601) 985-5711 (Work)
Butler, Snow, O’Mara, Stevens & Cannada, PLLC (601) 355-1742 (Home)
P.O. Box 22567 (601) 985-4500 (Fax)
Jackson, MS 39225-2567
E-Mail – dan.hise@butlersnow.com

MO
(SEE KANSAS)

MT
(SEE COLORADO)

NE
Mr. David R. Tarvin, Jr. (402) 346-6000 (Work)
Kutak Rock LLP (____) ____-____ (Home)
1650 Farnam Street (402) 346-1148 (Fax)
Omaha, Nebraska 68102-2186
E-Mail – david.tarvin@kutakrock.com
<table>
<thead>
<tr>
<th>State</th>
<th>Name</th>
<th>Address</th>
<th>Phone Numbers</th>
</tr>
</thead>
<tbody>
<tr>
<td>NV</td>
<td>Mr. Ken Creighton</td>
<td>9295 Prototype Drive, Reno, NV 89511</td>
<td>(775) 448-0119 (Work)</td>
</tr>
<tr>
<td></td>
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<td></td>
<td>(775) 825-1844 (Home)</td>
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<td>(775) 448-0120 (Fax)</td>
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<tr>
<td></td>
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<td>E-Mail – <a href="mailto:ken.creighton@igt.com">ken.creighton@igt.com</a></td>
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<tr>
<td>NH</td>
<td>Richard A. Samuels</td>
<td>McLane, Graf, Raulerson &amp; Middleton P.A.</td>
<td>(603) 628-1470 (Work)</td>
</tr>
<tr>
<td></td>
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<td>900 Elm Street, P.O. Box 326, Manchester, NH</td>
<td>(603) 228-8636 (Home)</td>
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<td>(603) 625-5650 (Fax)</td>
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<tr>
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<td></td>
<td>E-Mail – <a href="mailto:rsamuels@mclane.com">rsamuels@mclane.com</a></td>
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<tr>
<td>NJ</td>
<td>Mr. Peter D. Hutcheon</td>
<td>Norris, McLaughlin &amp; Marcus, P.A.</td>
<td>(908) 722-0700 (Work)</td>
</tr>
<tr>
<td></td>
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<td>721 Route 202-206, P.O. Box 1018, Somerville,</td>
<td>(908) 356-4766 (Home)</td>
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<td>(908) 722-0755 (Fax)</td>
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<td>E-Mail – <a href="mailto:pdhutcheon@nmmlaw.com">pdhutcheon@nmmlaw.com</a></td>
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<tr>
<td>NM</td>
<td>Mr. Robert G. Heyman</td>
<td>Sutin Thayer &amp; Browne, 100 North Guadalupe,</td>
<td>(505) 986-5493 (Work)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Suite 202, Santa Fe, NM 87501, P.O. Box 2187,</td>
<td>(505) 982-5297 (Fax)</td>
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<td>NY</td>
<td>Mr. F. Lee Liebolt, Jr.</td>
<td>Sidley, Austin, Brown &amp; Wood LLP</td>
<td>(212) 839-5357 (Work)</td>
</tr>
<tr>
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<td>787 Seventh Avenue, New York, New York 10019</td>
<td>(212) 369-8067 (Home)</td>
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<td>(212) 839-5599 (Fax)</td>
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<td>E-Mail – <a href="mailto:lliebolt@sidley.com">lliebolt@sidley.com</a></td>
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<tr>
<td>NC</td>
<td>Ms. Heather K. Mallard</td>
<td>Womble Carlyle Sandridge &amp; Rice, PLLC</td>
<td>(919) 755-2176 (Work)</td>
</tr>
<tr>
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<td>P.O. Box 831, Raleigh, North Carolina 27602</td>
<td>(919) 639-0598 (Home)</td>
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<td>(919) 755-6077 (Fax)</td>
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<td>E-Mail – <a href="mailto:hmallard@wcsr.com">hmallard@wcsr.com</a></td>
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<td>ND</td>
<td>Mr. Craig A. Boeckel</td>
<td>Tschider &amp; Boeckel, Provident Life Building</td>
<td>(701) 258-2400 (Work)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>316 N. 5th Street, P.O. Box 668, Bismarck,</td>
<td>(701) 258-9269 (Fax)</td>
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<td>North Dakota 58502-0668</td>
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<td>OH</td>
<td>Mr. Richard S. Slavin</td>
<td>Cohen and Wolf, P.C.</td>
<td>1115 Broad Street, Bridgeport, CT 06604</td>
</tr>
<tr>
<td>OK</td>
<td>Mr. C. Raymond Patton, Jr.</td>
<td>Conner &amp; Winters</td>
<td>3700 First Plaza Tower, Tulsa, OK 74103</td>
</tr>
<tr>
<td>OR</td>
<td>Mr. Richard M. Layne</td>
<td>Layne &amp; Lewis</td>
<td>1 SW Columbia Street, Suite 1800, Portland, OR</td>
</tr>
<tr>
<td></td>
<td>(Until January 31, 2004)</td>
<td></td>
<td>111 SW Columbia Street, Suite 1000, Portland, OR</td>
</tr>
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<td>(As of February 1, 2004)</td>
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</tr>
<tr>
<td>PA</td>
<td>Mr. Michael Pollack</td>
<td>Reed, Smith, Shaw &amp; McClay LLP</td>
<td>1650 Market Street, Philadelphia, PA 19103-7301</td>
</tr>
<tr>
<td>RI</td>
<td>Mr. John F. Corrigan</td>
<td>Adler Pollock &amp; Sheehan PC</td>
<td>2300 Financial Plaza, Providence, Rhode Island</td>
</tr>
<tr>
<td>SC</td>
<td>Mr. F. Daniel Bell III</td>
<td>Kennedy Covington Lobdell &amp; Hickman L.L.A.</td>
<td>434 Fayetteville Street Mall, 19th Fl., Raleigh, NC 27602-1070</td>
</tr>
</tbody>
</table>
WI
Mr. Terry Nelson
Foley & Lardner
150 East Gilman
P.O. Box 1497
Madison, WI 53701
E-Mail – tnelson@foleylaw.com

(608) 258-4232 (Work)
(608) 836-8855 (Home)
(608) 258-4258 (Fax)

WY
SEE COLORADO

CAN
Mr. Paul G. Findlay
Borden Ladner Gervais LLP
Scotia Plaza, Suite 4400
40 King Street West
Toronto, Ontario M5H 3Y4
Canada
E-Mail – pfindlay@blgcanada.com

(416) 367-6191 (Work)
(416) 484-9862 (Home)
(416) 361-7083 (Fax)

NASD
Peter W. LaVigne
Sullivan & Cromwell LLP
125 Broad St.
New York, NY 10004
E-Mail - Lavignep@sullcrom.com

(212) 558-7402 (Work)
(____) ____-____ (Home)
(212) 558-3588 (Fax)
DIRECTORY OF EDITORS AND CONTRIBUTORS

Goldman, Leigh F.  Tom Bolt & Associates, P.C., Corporate Place, 5600 Royal Dane Mall, St. Thomas, USVI 00802
(340) 774-2944, fax (340) 776-1639 lgoldman@vilaw.com

Hewitt, Martin A.  Cadwalader, Wickersham & Taft LLP, One World Financial Center, New York, NY 10281,
(212) 504-6228, fax (212) 504-6666 martin.hewitt@cwt.com

Lieberman, Ellen  Debevoise & Plimpton, 919 Third Avenue, New York, NY 10022,
(212) 909 6096, fax (212) 909-6836 elieberman@debevoise.com

Miller, Martin R.  Willkie, Farr & Gallagher, 787 Seventh Avenue, New York NY 10019-6099,
(212) 728-8690, fax (212) 728-8111 mmiller@willkie.com

Nager, Benjamin, L.  Sidley Austin Brown & Wood LLP, 787 Seventh Avenue, New York, NY 10019
(212) 839-5300, fax (212) 839-5599

Parness, Alan M.  Cadwalader, Wickersham & Taft LLP, One World Financial Center, New York, NY 10281,
(212) 504 6342, fax (212) 504-6666 aparness@cwt.com

Peterson, Pamela W.  UBS Financial Services Inc., 51 West 52nd Street, 16th Floor, New York, NY 10019
(212) 882-5839, fax (212) 713-3493 Pamela.Peterson@ubs.com

Rett, Donald A.  Law Office of Donald Rett, 1660 Metropolitan Circle, Tallahassee FL 32308
(850) 298-4454, fax (850) 298-4494 drett52687@aol.com

Spill, Jeffrey  New Hampshire Bureau of Securities Regulation, Department of State, State House, Room 204,
Concord, NH 03301-4989
(603) 271-1463, fax (603) 271-7933
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Published by the American Bar Association Section of Business Law
Committee on State Regulation of Securities
Chair: Ellen Lieberman

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Editor: Martin A. Hewitt

To submit materials for future editions contact:
Cadwalader, Wickersham & Taft LLP, One World Financial Center, New York, NY 10281,
(212) 504-6228, fax (212) 504-6666  martin.hewitt@cwt.com

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Chicago, IL 60616