EVENTS CALENDAR

ABA BUSINESS LAW SPRING MEETING
The Committee and its Subcommittees will meet in conjunction with the 2010 Spring Meeting of the ABA Business Law Section
Sheraton Denver Downtown Hotel
Denver, CO
April 22-24, 2010

ABA ANNUAL MEETING
The Committee and its Subcommittees will meet in conjunction with the ABA Annual Meeting
Fairmont/InterContinental
Mark Hopkins Hotels
San Francisco, CA
August 6-9, 2010

NASAA 2010 FALL CONFERENCE
The Committee and its Subcommittees will meet in conjunction with the Annual Meeting of the North American Securities Administrators Association
Marriott Baltimore Waterfront Hotel
Baltimore, MD
September 26-29, 2010

ABA BUSINESS LAW SPRING MEETING
The Committee and its Subcommittees will meet in conjunction with the 2011 Spring Meeting of the ABA Business Law Section
Boston, MA
April 14-16, 2011

BLUE SKY BITS AND PIECES
By: Ellen Lieberman
Debevoise & Plimpton LLP

Texas Securities Commissioner Denise Voigt Crawford assumed the Presidency of the North American Securities Administrators Association for the second time in September at NASAA’s 92nd Annual Conference in Denver. Others named to prominent positions were North Carolina Deputy Securities Administrator David Massey as President-Elect; Robert M. Lam of Pennsylvania as NASAA’s New Member Advocate; and Matthew J. Neubert of Arizona as NASAA Ombudsman. NASAA’s Board of Directors for 2009-2010 includes Fred Joseph, Immediate Past NASAA President and Colorado Securities Commissioner; Rick Hancox,
Executive Director of the New Brunswick Securities Commission; **Mark Connolly**, New Hampshire Director of Securities Regulation; **Chris Biggs**, Kansas Securities Commissioner; **Joe Borg**, Director of the Alabama Securities Commission; **Bruce Kohl**, Director of the New Mexico Securities Division; and **Melanie Senter Lubin**, Maryland Securities Commissioner. NASAA’s Section Chairs are **Ralph Lambiase**, Director of the Connecticut Division of Securities, chairing the Broker-Dealer Section; **Jack Herstein**, Nebraska Bureau of Securities, chairing the Corporation Finance Section; **Jim Ropp**, Delaware Securities Commissioner; chairing the Enforcement Section.; **Patricia Struck**, Wisconsin Securities Division Administrator, chairing the Investment Adviser Section; and **Tung Chan**, Hawaii Commissioner of Securities, chairing the Investor Education Section.

**Eric R. Dinallo**, who served as Chief of the Investment Protection Bureau of the New York State Attorney General’s Office under then-Governor **Eliot Spitzer**, has thrown his hat in the ring for New York Attorney General. The current New York Attorney General, **Andrew M. Cuomo**, is expected to run for Governor of New York. The New York Times said: “[Dinallo] is credited with dusting off the Martin Act, the sweeping New York state securities law, and devising a way for Mr. Spitzer to use it to prosecute Wall Street corruption and make a national name as state attorney general.” More recently, Dinallo served as New York’s Insurance Commissioner and his performance in that role won high praise from Warren E. Buffett. The Times further reported that Dinallo would change the focus of the Attorney General’s Office to “consumer[s] — and investor-based cases that go to people’s everyday financial lives — their phone bills, their credits cards, their mortgages,” which sounds as though the Martin Act and blue sky could take a back seat to other enforcement efforts.

New York Attorney General Andrew M. Cuomo has created the new position of Special Deputy Attorney General for Investor Protection and named **David Markowitz** to that slot. Markowitz has been Chief of the Investor Protection Bureau and involved in the Bureau’s investigations of auction-rate securities and of the Bank of America-Merrill Lynch merger.

Florida has announced that **Frank L. Widmann** has accepted the position of Director of Securities. He previously served as New Jersey Deputy Attorney General, Chief of the New Jersey Bureau of Securities, and as its Chief Securities Regulatory Officer. He is also a past President of NASAA.


**Erik Christiansen**, our Committee’s Utah Liaison, was appointed by Utah Governor Jon M. Huntsman, Jr. on June 17, 2009 to serve a four-year term as a Commissioner for the Utah Division of Securities. He is a shareholder of Parsons Behle & Latimer and Chair of the firm's Securities Practice Litigation Group, and he also practices in the areas of trade secrets and partnership dispute litigation, as well as non-compete and non-solicitation agreement litigation relating to employment. Previously he practiced at Milbank, Tweed, Hadley & McCloy and Stroock & Strock & Lavan. He is admitted to the bar in Utah and California.

**John L. Mericle**’s firm, Harris, Mericle &Wakayama, in Seattle, Washington, has announced an office move from Seattle’s Wells Fargo Center after 25 years, with a new location “up the hill” at 901 Fifth Avenue. John is the Committee’s Washington liaison.

**Martin A. Hewitt**, editor of the Blue Sky Bugle, has taken on the FINRA and blue sky practice as counsel at the New York office of Alston & Bird LLP.

**Mark T. Lab** has joined Lowenstein Sandler PC in their Roseland, New Jersey, office as Counsel continuing in the blue sky and FINRA practice area.
The Securities and Exchange Commission has named Robert W. Cook, of Cleary Gottlieb Steen & Hamilton LLP’s Washington office, as Director of the Trading and Markets. He obtained his undergraduate and law degrees from Harvard and a Master of Science in Industrial Relations and Personnel Management from the London School of Economics.

Michael E. Stevenson has announced his retirement as Washington’s Director of Securities effective January 31, 2010. No successor has been named.

FROM THE CHAIR – RANDOM RANTS AND RAVES

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

A.  “But Wait, There’s Still More!” - Electronic Form D and Rule 506 Notice Filing Issues

Regrettably, the saga which began with my first “Random Rants and Raves” column in the January 2009 issue of the Bugle continues. As my loyal readers know, the SEC amended Regulation D (“Regulation D”) under the Securities Act of 1933 (the “1933 Act”), so as to change Form D and provide for the voluntary, and then mandatory, electronic filing of that form through the SEC’s EDGAR system. Our Committee members continue to report repeated headaches in effecting notice filings pursuant to 1933 Act § 18(c)(2)(A) with the states for issuers relying on Rule 506 of Regulation D (“Rule 506”), notwithstanding the clear preemptive language of 1933 Act § 18 regarding what states may require for these filings, and NASAA’s efforts, laudably led by David Weaver, General Counsel of the Texas State Securities Board (the “SSB”), to encourage the states to adopt a uniform approach to these filings, with a view towards development of NASAA’s own electronic filing system for Rule 506 notices.

Thus, we’re still finding states that persist in requiring, by rule or policy statement (or routinely requesting by comment letter or otherwise), that Rule 506 issuers submit: (i) manually-signed Form D’s, despite the fact that Form D’s filed with the SEC since March 16, 2009 are signed in electronic format; (ii) separate manually-signed Form U-2 Uniform Consents to Service of Process, despite the fact that Form D now includes a built-in consent designed to supplant Form U-2, that state laws and rules rarely require submission of any particular form of consent, and that the states have long accepted the built-in consents in Forms BD, ADV and U-4 for broker-dealer, investment adviser, agent, and investment adviser representative filings, in lieu of Form U-2; (iii) the Appendix to the old paper version of Form D (deleted from the electronic version); (iv) a Form U-2A Uniform Form of Corporate Resolution; (v) a report of the date of first sale in the particular state; (vi) per-state sales information; and/or (vii) a copy of any offering materials distributed to investors. Of course, there are also a number of states which have jumped on the bandwagon to impose additional filing fees on late filers. While I hate to sound paranoid, I believe that the states which have persisted in following these non-uniform approaches to Rule 506 notice filings have done so solely to make the filing process as cumbersome as possible, despite the fact that these idiosyncratic requirements provide little or nothing by way of additional investor protections.

B.  NASAA’s War on 1933 Act Section 18(b)(4)(D)

For those of us who attended the NASAA Annual Conference in Denver this past September and sat through the “NSMIA 13 Years Later: Rule 506 Transactions Demonstrate the Need for Change” program moderated by Joe Borg, the Alabama Securities Commissioner (replete with Commissioner Borg’s appearance in dark glasses and trenchcoat, and a dramatic introduction of the panelists to the “Mission Impossible” theme song), we heard an incredibly one-sided program. With no dissenting views expressed, the panelists questioned the validity of Rule 506, characterized Rule 506 offerings as a hotbed of fraud and other problems, and lambasted the SEC for its failure to police these offerings, principally in reliance on the report by the SEC’s Office of Inspector General, “Regulation D Exemption Process” (Report No. 459, March 31, 2009), available for download from http://www.sec-oig.gov/Reports/AuditsInspections/2009/459.pdf (the “OIG Report”).

More recently, Denise Voigt Crawford, the Texas Securities Commissioner and NASAA President, testified on January 14, 2010 before the United States Financial Crisis Inquiry Commission. As regards NSMIA’s preemption of state regulation of Rule 506 offerings, Commissioner Crawford testified as follows:
“There is very little in the legislative history of NSMIA that discusses private placements. What commentary exists defends federal preemption on the grounds that private placements, like exchange listed securities, involve offerings that are ‘national in scope.’ Preemption of state regulation of private offerings, however, results in a very different consequence than preemption of state regulation of public offerings subject to SEC supervision under the 1933 Act. Unlike listed securities, private placements are exempt from federal registration and for all practical purposes, exempt from federal oversight. NSMIA’s preemption of state regulation of private placements, therefore, created a regulatory black hole – today no one regulates these offerings.” NASAA Reports (CCH) ¶ 17,079, at 17,211.

1. **A Little History Lesson**

I will grant that the published legislative history of NSMIA is sparse as to why Rule 506 offerings were included as “covered securities,” other than a statement in a June 17, 1996 report by the House Committee on Commerce on H.R. 3005, the “Securities Amendments of 1996,” which ultimately became NSMIA. In that report, it is stated, with regard to proposed Section 18(b)(4) of the 1933 Act:

“...[S]ecurities sold in private transactions under section 4(2) of the Securities Act would be ‘covered securities,’ and thus preempted, if offered or sold pursuant to a [Securities and Exchange] Commission rule or regulation adopted under such section 4(2). The Committee intends that the section 4(2) exemption from State regulation facilitate private placement of securities consistent with the public interest and the protection of investors.” H.R. Rep. No. 104-622, at 32 (1996).

However, those of us who were representing clients effecting private offerings complying with 1933 Act § 4(2) or Rule 506 prior to NSMIA remember all too well that the preemptive results of NSMIA remember all too well that the preemptive results of NSMIA were most welcome, given the plethora of non-uniform state exemptions governing private placements at the time NSMIA was enacted. Prior to NSMIA, virtually every state had at least one form, and in many cases multiple forms, of a “private placement” exemption from securities registration, in many cases modeled on or derived from Section 402(b)(9) of the 1956 version of the Uniform Securities Act (the “1956 USA”), 1 Blue Sky L. Rep. (CCH) ¶ 5542. That provision, obviously designed to exempt “mom and pop” offerings by small businesses, simply encompasses an offering (not restricted to issuers) to not more than 10 persons (other than the “institutional buyers” covered by the 1956 USA § 402(b)(8) exemption), provided that the offeror reasonably believed that all non-institutional buyers in the state were purchasing for investment, and that no commission or other remuneration was paid or given directly or indirectly for soliciting any prospective non-institutional buyer in the state. Either by means of statutory amendments, or by means of rules or orders promulgated by the state securities administrators, these exemptions ultimately morphed into a hodgepodge of conflicting and confusing provisions which oftentimes seemed to do little to foster investor protection by their distinctions, but seemed primarily designed to impose inexplicable bureaucratic obstacles to persons attempting to avail themselves of these provisions.

As a result, prior to the promulgation of Regulation D on April 15, 1982, an issuer attempting to effect an exempt interstate private offering complying with 1933 Act § 4(2) for federal purposes was faced with state provisions imposing a variety of conditions, such as: (i) a limit on the number of offerees and/or purchasers in the particular state (or everywhere); (ii) a mandatory pre-offer, pre-sale and/or post-sale filing with the state, including submission of a state-specific notice form, typically together with copies of the offering materials employed and certain other documents (e.g., the issuer’s certificate of incorporation, by-laws, certificate of limited partnership, or limited partnership agreement), which materials and documents might or might not be reviewed and commented on, at the whim of the state, as well as a consent to service of process and a filing fee; (iii) inclusion of a special state legend or other state-specific disclosures in the offering materials, subscription document and/or document evidencing the securities (e.g., stock certificates); (iv) obtaining special representations or covenants from local investors as regards their compliance with state-specific requirements (e.g., acknowledging that they couldn’t transfer or resell the securities for a minimum period of time without registration, or representing that their investment didn’t exceed a percentage of their net worth); or (v) restricting the payment of commissions or other remuneration for local solicitations to broker-dealers or agents...
registered under the state’s Blue Sky law (or prohibiting such payments to anyone). While I won’t go into the details, a good example of a complex and confusing state exemption (which appears to have been initially premised on 1956 USA § 402(b)(9)) may be found in North Carolina Securities Act § 78A-17(9), 2A Blue Sky L. Rep. (CCH) ¶ 43,122, and Rule .1205(b) – (c) thereunder, 2A Blue Sky L. Rep. (CCH) ¶ 43,415, which Rule applies to offerings under § 78A-17(9) of “direct participation program securities” solely in reliance on 1933 Act § 4(2) or 3(a)(11) or in reliance on Rule 504 of Regulation D, and to offerings of “viatical settlement contracts,” but not to offerings in reliance on Rule 505 of Regulation D (“Rule 505”) or Rule 506.

Subsequent to the SEC’s adoption of the original version of Regulation D, the members of NASAA adopted a “Uniform Limited Offering Exemption” (“ULOE”) on September 21, 1983, NASAA Reports (CCH) ¶ 6201, which was intended to serve as a model rule for the states to adopt, so as to exempt offerings complying with Rule 505 or Rule 506. However, ULOE imposed a number of additional conditions and restrictions on issuers seeking to avail themselves of the exemption, not all states adopted a version of ULOE, and some of the states which did adopt a version of ULOE made revisions to NASAA’s model rule so that, for example, an issuer which might be subject to a so-called “bad boy” disqualification in one state might not be disqualified in another. Furthermore, as reflected in footnote 1 to ULOE (Id. at 6101), NASAA indicated several concerns with exempting Rule 506 offerings arising out of the lack of a dollar limit on such offerings, and therefore concluded that “Rule 506 is not adopted as part of the basic ULOE”; therefore, it’s my recollection that several states restricted their versions of ULOE to Rule 505 offerings.

Thus, at the time the NSMIA legislation was being considered in Congress, an issuer attempting to effect a Rule 506 offering across state lines was faced with the daunting and expensive task of trying to comply with a complicated and non-uniform web of Blue Sky law exemptions. Reading between the lines, it was this frustrating experience which Congress was addressing by including Rule 506 offerings as “covered securities” in 1933 Act § 18(b)(4)(D). In any event, it’s curious that Commissioner Crawford singled out Rule 506 offerings in her testimony, considering that the “covered securities” offerings designated in 1933 Act §§ 18(b)(4)(A) – (C), i.e., those exempted by 1933 Act §§ 4(1), 4(3), 4(4), and 3(a)(2), (3), (5) – (9), and (12) – (14), are effected without any filing with the SEC.

Even today, as clearly evidenced by the “Exemptions: Limited Offerings/Reg. D” table at 1 Blue Sky L. Rep. (CCH) ¶ 6251, at 2363 – 2370, there remain a surfeit of disparate state exemptions for private offerings, other than those governing Rule 506 notice filings (and I note that this table doesn’t include any exemptions for offers and sales to institutional investors).

2. Would a Return to the Pre-NSMIA Status Quo Assure Better Investor Protection?

In Commissioner Crawford’s testimony to the United States Financial Crisis Inquiry Commission, she also complained that:

- “NSMIA prohibits a state from being able to scrutinize Rule 506 private offerings and those who market them”;
- “States are prohibited from conducting reviews and from regulating disclosure documents”;
- “No conditions may be imposed on offering documents, including advertising and sales literature used in connection with the offerings”; and
- “No longer able to screen offerings on the front end, states retained jurisdiction only to investigate and bring enforcement actions with respect to fraud or deceit in connection with securities or securities transactions.”

NASAA Reports (CCH) ¶ 17,079 at 17,213.

Curiously, however, it’s my recollection (and I believe that my memory is still fairly good, even in my dotage) that, during the pre-NSMIA years, even when I was forced to make a pre-offer or pre-sale filing of offering materials with a state for a Rule 506 (or 1933 Act § 4(2)) offering to perfect that state’s private placement exemption (even under a ULOE provision), I rarely received comments on the materials with regard to disclosure and/or “merit” issues, and it generally seemed that the state’s review was limited to making sure that (i) any idiosyncratic exemption notice form required by the state was
properly completed and all requisite exhibits were submitted, (ii) the offering materials included any special state legend or other disclosures, and (iii) a check for the proper filing fee was included (and didn’t bounce). While obviously my experience may not have been the same as other attorneys effecting these filings at that time, I really wonder to what degree a return to the old patchwork of state exemptions would, in fact, ensure prospective investors that private offerings have been fully vetted by their local regulators (and you can bet that the regulators won’t agree to stand behind their handiwork by waiving sovereign immunity and subjecting themselves to liability in the event an offering they reviewed turns out to be fraudulent). In any event, it must be remembered that these filings were still being effected to perfect exemptions from registration, not registrations. Thus, if the state legislature or state administrator creating these exemptions contemplated that they would entail a full pre-offer review of the issuer’s offering materials, why bother characterizing them as exemptions at all?

It is particularly ironic that many states (Texas included) have had self-executing exemptions in their statutes and/or rules for years, whereby limited offerings may be made with no filing whatsoever. For example, see the exemption provided under Section 5.1(c) of the Texas Securities Act (the “TSA”), 3A Blue Sky L. Rep. (CCH) ¶ 55,105, and Rule 109.13(a) – (e), (i) and (j) promulgated by the SSB thereunder, 3A Blue Sky L. Rep. (CCH) ¶ 55,563, exempting what amounts to a good 1933 Act § 4(2) (or, for that matter, Rule 505 or 506) private offering (with constraints on public solicitation and transfer or resale comparable to those found in Rules 502(c) and 502(d), respectively, of Regulation D), provided that: (1) there are not more than 15 non-institutional purchasers in Texas during any 12-month period; and (2) the Texas investors are either (a) “well informed” (i.e., they’ve received appropriate offering materials prior to purchase) and “sophisticated” (i.e., (i) the investment isn’t material compared to the investor’s financial capacity, with a presumption of non-materiality if the investment doesn’t exceed 20% of the investor’s net worth, (ii) the investor or the investor’s purchaser representative has knowledge of finance, securities and investments generally, and (iii) the investor or the investor’s purchaser representative has experience and skill in investments based on prior participation); or (b) “well informed” and have a relationship with the issuer or its principals evincing trust between the parties. In particular, I note that the foregoing exemption has no “bad boy” disqualification comparable to the ULOE exemption (Texas did adopt a separate ULOE exemption applicable to Rule 505 and 506 offerings, which may be found in SSB Rule 109.13(k), and which currently applies solely to Rule 505 offerings).

It is also ironic that NASAA endorsed the 2002 version of the Uniform Securities Act (the “2002 USA”), Section 202(14) of which includes a self-executing exempt transaction for an issuer’s sale to not more than 25 non-institutional purchasers in the state during any 12 consecutive months, provided that (a) no general solicitation or general advertising is used, (b) commissions or other remuneration are not paid or given, directly or indirectly, other than to a state-registered broker-dealer or agent, for soliciting prospective purchasers in the state, and (c) the issuer reasonably believes that all non-institutional purchasers are purchasing for investment. 1 Blue Sky L. Rep. (CCH) ¶ 5607. Other states have chosen to treat individuals qualifying as “accredited investors” under Rule 501(a) of Regulation D as “institutional investors” for purposes of exemptions comparable to 2002 USA § 202(13), Id., or 1956 USA § 402(b)(8), 1 Blue Sky L. Rep. (CCH) ¶ 5542, or have simply adopted self-executing exemptions for offers and sales to any “accredited investor” within the meaning of Rule 501(a).

Thus, it’s apparent that not all state legislatures (including Commissioner Crawford’s), nor even some state securities administrators, believe that it’s necessary to require filings or review of offering materials for all types of private offerings, including those to individual investors. Accordingly, it’s somewhat bewildering why NASAA would try to portray a repeal of 1933 Act § 18(b)(4)(D) as a panacea for its perceived problems with Rule 506 offerings.

3. **Are Rule 506 Offerings Really Rife with Fraud?**

As part of its anti-Rule 506 campaign, NASAA has certainly raised a major public clamor about alleged widespread fraud in connection with Rule 506 offerings – see, e.g., “NASDAQ Identifies Top 10 Investor Traps” (Aug. 18, 2009), reprinted at NASAA Reports ¶ 19,131, identifying “Private Placement Offerings” as one of the top ten. The question is whether the states have presented sufficient evidence to support their claims that fraud and other problems are rampant in Rule 506 offerings, so as to justify a return to the “bad old
days” and the possibility of full-blown reviews of these offerings by the states. While I certainly don’t condone fraud in connection with any securities offering, notwithstanding NASAA’s pronouncements or Commissioner Borg’s program at last year’s NASAA Annual Conference, I have seen little or nothing by way of meaningful statistics that the states are overwhelmed by problems with Rule 506 offerings. Considering that, according to page 42 of the OIG Report, there were 20,021 Form D filings with the SEC in calendar year 2008 alone, one would think that there should be hundreds, if not thousands, of state civil, criminal, or administrative proceedings involving Rule 506 offerings. In the absence of significant statistical evidence to the contrary, I see no reason to make all Rule 506 issuers suffer because of the misconduct of a miniscule minority of miscreants claiming the exemption.

In examining the two examples of enforcement proceedings involving Rule 506 offerings brought by the SSB and described in Commissioner Crawford’s testimony (NASAA Reports (CCH) ¶ 17,079 at 17,214), I question whether restoring full-blown review power to the states would have averted the alleged fraud in the first case, while it seems apparent that the SSB faced no problems in promptly pursuing the respondents in the second case.

Thus, in the first case, against one Raymond Minardi, described as the managing member of the issuer’s general partner, it is stated that “it was found that Minardi made material misstatements and material omissions in relation to the offering.” While Commissioner Crawford doesn’t provide details of the nature of those misstatements or omissions or how they came to the SSB’s attention, as a practical matter, what would have been the likelihood that a pre-offer or –sale review of the offering materials by the SSB in that case would have uncovered those misstatements or omissions? Unless some third party brings the misstatement or omission to a regulator’s attention during the course of its review of a filing (even a full-blown securities registration), it would be highly unusual for a regulator to discover such a violation on its own. Further, Commissioner Crawford gripes that while the issuer was placed in receivership and Minardi was ordered to cease from engaging in fraud, he wasn’t prohibited from participating in subsequent offerings “due to the restraints imposed by NSMIA.” Id. To the contrary, it is submitted that by reason of the states’ preserved antifraud authority in 1933 Act § 18(c)(1), if Minardi’s prior activities entailed such egregious violations of the TSA, the Texas authorities should have sought a permanent injunction against his involvement in any securities offering in the future (while I’m not sure whether such permanent injunctions are authorized by the TSA or otherwise, as opposed to injunctions against future violations of the TSA, I’m advised that such relief has been granted in enforcement proceedings brought by other state securities administrators as an equitable remedy). Granted, a “bad boy” disqualification provision in Regulation D applicable to Rule 506 offerings might have provided a simple means of banishing Minardi from participating in future Rule 506 offerings based on his misconduct in this case, but it wouldn’t stop him from offering and selling securities in reliance on one of the self-executing exemptions otherwise available under the TSA or the SSB’s rules, nor even from serving as a principal of an issuer registering its securities under the TSA, provided that he fully disclosed his nefarious past.

In the second case, against one Randy Weaver and TierOne Converged Networks, Inc., it was alleged that there were a number of material omissions and misrepresentations concerning Weaver’s past misdeeds. To get some further background, I reviewed the actual Order issued by the SSB on May 19, 2008 (Order No. ENF-08-CDO-1654, available from the SSB’s website at http://www.ssb.state.tx.us/Enforcement/files/1654.pdf). I also reviewed two essentially identical Form D filings made with the SEC by the issuer on March 17 and April 14, 2008 (and available from EDGAR) for what appear to be the offering in question; according to the two Form D’s, the issuer was offering $3,000,000 of shares of its preferred stock, and had sold $29,400 of shares to two accredited investors, and $2,000 of shares to one non-accredited investor, in Texas, out of total sales of $251,300 to 14 accredited investors in 12 states and the one non-accredited investor in Texas. First and foremost, assuming that the issuer filed its Form D’s with the SSB at or about the same time as its SEC filings, it is quite impressive that the SSB clearly had no problem uncovering the alleged problems with this offering and bringing its action within two months after the initial filing with the SEC, notwithstanding that no offering materials were required to be filed with the SSB. While it’s unclear from Commissioner Crawford’s presentation or the SSB’s Order how the omissions and misrepresentations came to the SSB’s attention, I believe that it’s not uncommon for some states to run the names of the parties listed on a Form D through FINRA’s “BrokerCheck” system and other
databases available to them. If such a search turned up negative information about the issuer or one of the other named persons material enough to warrant disclosure to investors (I would suggest relying on Items 103 and 401(f) of SEC Regulation S-K as guidelines in that regard), it is believed that a state could commence an investigation of the offering in accordance with its preserved antifraud authority under 1933 Act § 18(c)(1) to determine whether such disclosure had, in fact, been made to prospective investors. While, as evidenced by the Order in this case, the SSB could only order the respondents to cease and desist from their offering without curing the alleged omissions and misrepresentations and otherwise committing fraud, and could not shut it down entirely, it is submitted that such action is all that could or should have been taken in this case, particularly considering that the undisclosed matters involving Weaver were unrelated to the issuer, and had occurred 3 – 4 years before the offering. In any event, while the Order in this case was issued post-sale, I’d be curious as to how often the SSB has been able to halt a fraudulent unregistered securities offering prior to any sales in Texas. (While probably not important in the scheme of things, the individual respondent named in the SSB’s Order is actually “Kevin Weaver,” who is listed in the issuer’s Form D as its President and CEO (unless “Randy” was a nickname or an alias, which isn’t clear from the Order).)

In order to get a sampling of more recent actions under the TSA, I decided to review the civil, criminal, and administrative proceedings for 2009 reported on the SSB’s website, to see how many involved a defendant or respondent who had claimed reliance on Rule 506 or had effected a Form D filing with the SEC. See the 34 indictments, convictions and sentences in criminal cases (no civil cases were included) reported at http://www.ssb.state.tx.us/Enforcement/2009_Civil_and_Criminal_Actions.php, and the 15 cease and desist orders issued by the SSB and designated by an “Order No. ENF-09-CDO-” prefix, reported at http://www.ssb.state.tx.us/Enforcement/Recent_Administrative_Actions.php?vid=2009.

Since none of the criminal case summaries mentions that the defendant had allegedly offered securities in reliance on Rule 506 or that a securities issuer had made a Form D notice filing with the SEC or the SSB, and the listing of cease and desist orders doesn’t describe the violations alleged to have been committed by the respondents, I then reviewed EDGAR to determine whether any of the entities named in the SSB proceedings had made a Form D filing with the SEC. Based on such review, it appears that only one of the entities (Monarch Fund L.P.) referenced in one of the criminal proceedings (a May 11, 2009 criminal conviction of Brittian Wayne Bowers) had made a Form D filing; however, there’s no indication that the entity was charged in, or was otherwise a target of, that proceeding, and considering that Mr. Bowers was convicted of misapplication of fiduciary property and theft of property, it’s not even clear whether Mr. Bowers had even been charged with violations of the TSA. Further, Form D filings were found for only two of the entities named in the 15 cease and desist orders (Dorothy of Oz LLC and Cougar Resources, LLC); it’s unclear, however, from the orders issued in those matters whether a filing had been made with the SSB by the issuer, or whether the issuer had otherwise asserted state preemption by reason of Rule 506. (Interestingly, the Form D filed with the SEC by each of those two issuers was filed after the date of the SSB’s orders, and it appears that the SSB halted each offering before any sales were effected in Texas.)

While I have neither the time nor inclination to review every state’s website to determine how many civil, criminal, or administrative proceedings have actually been brought against issuers which claimed reliance on Rule 506, if the SSB’s website is any indication of what states have actually encountered and the actions they have taken (and the SSB is certainly one of the more aggressive enforcers of its Blue Sky law), I suspect that these cases are actually few and far between. Further, I suspect that most problems (particularly as regards fraudulent activities) have arisen in connection with unregistered offerings for which filings have been made with neither the SEC nor any state, and with regard to which little or no consideration was given to compliance with federal or state securities law, whether deliberately or negligently, an age-old problem that has nothing to do with Rule 506 or NSMIA preemption. Frankly, I suspect that many of the issuers targeted in state civil, criminal, or administrative proceedings may be raising a defense of preemption by reason of Rule 506 purely as an afterthought, solely because their attorneys suggested it at that time, and not because they considered its availability, let alone how to comply with the Rule and applicable state laws, before the offering commenced.
Further, I believe that recent court decisions with regard to purported Rule 506 offerings certainly don’t disadvantage the states. Thus: (1) courts have placed the burden of proof on an issuer claiming Rule 506 covered securities status (and thus preemption under NSMIA) to prove that it has, in fact, complied with the requirements of the Rule (see, e.g., Risdall v. Brown-Wilbert, Inc., 753 N.W.2d 723, [2008-2009 Transfer Binder] Blue Sky L. Rep. (CCH) ¶ 74,727 (Minn. 2008)), the same way that courts have traditionally placed the burden of proof on a person claiming reliance on an exemption from securities registration under a Blue Sky law; and (2) the states are certainly not preempted from pursuing Rule 506 issuers for fraud (see, e.g., Papic v. Burke, No. AC 28698, [2008-2009 Transfer Binder] Blue Sky L. Rep. (CCH) ¶ 74,760 (Conn. App. Ct. March 17, 2009)). Finally, I don’t believe there is any factual support for NASAA’s claims that eliminating 1933 Act § 18(b)(4)(D) and returning to the pre-NSMIA practice of making pre-offer or pre-sale filings, including offering materials, with the states for Rule 506 offerings would be a panacea. In this regard, as evidenced by the case of Black Diamond Fund, LLLP v. Joseph, No. 08CA0883, [2008-2009 Transfer Binder] Blue Sky L. Rep. (CCH) ¶ 74,771 (Colo. Ct. App. May 28, 2009), discussed in detail in my column in the September 2009 issue of the Bugle, any problems with a Rule 506 offering would rarely, if ever, be detected by a state securities administrator until after the damage has been done, in that violations typically seem to involve an issuer which: (i) engaged in general solicitation or general advertising in violation of Rule 502(c) of Regulation D (certainly a fact never disclosed in either Form D or the offering materials for a purported exempt private offering – would an issuer announce beforehand in its offering document that it planned on engaging in such prohibited activities?); (ii) paid commissions to unregistered or disqualified persons to sell the securities (another fact which wasn’t disclosed by the issuer in Black Diamond and probably wouldn’t be disclosed in the case of other less-than-honest issuers); and/or (iii) employed offering materials (or made oral presentations) which included material misrepresentations or omitted material information.

In sum, I believe that the states have failed to provide sufficient evidence either that Rule 506 offerings are awash with fraud, or that issuers claiming reliance on the Rule consistently violate its conditions (or at least those deemed “significant” by reason of Rule 508 of Regulation D). Probably the most common “violation” identified by the states is an issuer’s failure to file its Form D with the SEC and/or the states within 15 days after sale; however, filing a Form D, timely or otherwise, is not a condition of Rule 506 but an independent condition in Rule 503 of Regulation D, so any such failure cannot result in loss of “covered securities” status for purposes of any applicable state law, and certainly doesn’t amount to fraud, but at best a technical violation. Accordingly, I see no basis for the states’ campaign to repeal the NSMIA preemption for Rule 506 offerings and a return to those awful days of yesteryear when issuers conducting private offerings in multiple states were faced with a gallimaufry of confusing state exemptions, and with investors ultimately bearing the additional expense of the issuer’s compliance with these provisions, with little, if any, benefits derived in return.

C. Sen. Dodd’s NSMIA Nightmare

As those of you who have been following our Listserv postings the last several months should know, lame-duck Sen. Christopher Dodd (D-Conn.), Chair of the Senate Banking Committee, circulated a “discussion draft” of a 1,136-page bill ambitiously titled the “Restoring American Financial Stability Act of 2009.” With the suspected encouragement or instigation of NASAA, Section 928 of that bill would have deleted 1933 Act § 18(b)(4)(D), thereby repealing “covered securities” status for securities offered in accordance with Rule 506. Fortunately, that bill went nowhere.

(1) require the SEC to “conduct a rulemaking” within 120 days after enactment of the Act to determine whether to designate certain Rule 506 offerings as not qualifying as “covered securities,” considering the size of the offering, the number of states in which the security is being offered, and the nature of the offerees;

(2) require that the SEC review any filing made with regard to a Rule 506 offering within 120 days, and that any filing which is not reviewed within the 120 day period would no longer be a covered security unless the SEC determined, within the same 120-day period, that (a) there’s been a good faith and reasonable attempt by the issuer to comply with all applicable terms, conditions and requirements of the filing, and (b) any failure to comply with such terms, conditions and requirements “are [sic] insignificant to the offering as a whole”;

(3) permit states to impose notice filing requirements “substantially similar to filing requirements required by rule or regulation under section 4(4) that were in effect on September 1, 1996”; and

(4) require the SEC to implement procedures not later than 180 days after enactment of the Act, after consultation with the states, to promptly notify the states upon completion of its review of Rule 506 filings.

In reviewing these four conditions, the first condition portends the possibility that the SEC might use its authority to curtail the types of Rule 506 offerings qualifying as “covered securities.” Thus, the SEC might exclude offerings open to non-“accredited investors,” or offerings above (or below) a particular dollar threshold, or which are to be effected in more (or less) than a particular number of states.

The second condition is truly bewildering, in that it: (a) would result in total uncertainty as to the status of a Rule 506 offering as “covered securities” for up to 135 days after sale, assuming that a Form D is filed by no later than the 15th day after sale in accordance with Rule 503 of Regulation D, while the SEC mulls over the filing; (b) is unclear as to how the SEC could determine that an offering still involves “covered securities” within 120 days after filing if it failed to review the filing within that period in the first instance; and (c) doesn’t address the consequences if the offering is determined not to constitute “covered securities.” Thus, considering that Rule 506 notice filings are effected post-sale, while an offering which doesn’t pass muster under Rule 506 may nevertheless qualify for the 1933 Act § 4(2) exemption, does this condition mean that the SEC’s failure to review the filing or make a favorable “covered securities” determination within 120 days after filing could result in the issuer being subjected to rescission or damages actions by investors, or to administrative, civil or even criminal proceedings by state officials, premised on a sale of unregistered securities under applicable Blue Sky laws, in the absence of another exemption from registration?

As regards the third condition, while I recognize that this provision is derived from the current version of 1933 Act § 18(b)(4)(D), aside from the incorrect reference to filing requirements “under section 4(4)” rather than “section 4(2),” this provision makes little sense, particularly considering that the SEC substantially rewrote the notice filing requirements in Rule 503 of Regulation D, so as to provide for electronic filings of Form D, initially on a voluntary basis as of September 15, 2008, and then mandatorily as of March 16, 2009. SEC Rel. No. 33-8891 (Feb. 6, 2008), 73 Fed. Reg. 10592 (Feb. 27, 2008). Thus, while this provision may have made sense when Section 18(b)(4)(D) was enacted back on October 11, 1996, it doesn’t make much sense now, particularly since states have been conforming their notice filing requirements to the SEC’s current requirements. In any event, given that 1933 Act § 18(c)(2)(A) basically governs the contents of all state notice filings for “covered securities,” so that an initial state notice filing for a Rule 506 offering should consist solely of a copy of the Form D filed with the SEC, a consent to service of process (which is now built into Form D), and a filing fee, it would appear that this provision serves no purpose other than to add further confusion to the process.

Finally, given the long-standing antagonism between the SEC and the states with regard to Rule 506 offerings, I question whether the 180-day period for the SEC and the states to reach some agreement on the means by which the SEC would provide the notification described in the fourth condition is realistic.

It is noted that Section 926 of the revised bill did not receive a warm reception from NASAA. See the March 16, 2010 press release available at...
While not directly affecting the “covered securities” status of Rule 506 offerings, Section 412 (on pages 380-381) of Sen. Dodd’s bill provides that the SEC must, by rule, increase the $200,000/$300,000 income and $1,000,000 net worth tests applicable to natural person “accredited investors” pursuant to Rule 501(a)(5) and (6) of Regulation D, “in light of price inflation since those figures were determined,” and would also require that the SEC adjust those figures not less frequently than once every 5 years, “to reflect the percentage increase in the cost of living.” In this regard, it is noted that the SEC already proposed adjustments to those thresholds every five years in accordance with inflation, starting July 1, 2012, in Rel. No. 33-8828 (Aug. 3, 2007), 72 Fed. Reg. 45116, 45126 (Aug. 10, 2007), but that proposal has been languishing since then with no adoption date in sight.

D. Some Thoughts on “Merit Review” in the Era of State-Sponsored or -Sanctioned Gambling

In preparation for a September 30, 2009 conference on “The Future of State Regulation of Financial Services” sponsored by Brooklyn Law School and held at my law firm, I decided to look into the extent of state-sponsored or –sanctioned gambling activities, for purposes of analogy to the practice of so-called “merit reviews” of securities registration applications under “fair, just and equitable” or comparable review standards in a number of Blue Sky laws.

Thus, according to the American Gaming Association’s “State of the States 2009 – The AGA Survey of Casino Entertainment” report (the “AGA Survey”), available for download at http://www.americangaming.org/assets/files/aga_sos_2009web_FINAL.pdf, in 2008, 37 states had gambling casinos of one kind or another, including land-based or riverboat casinos, racetrack casinos (note that the AGA Survey does not cover legalized gambling on horse or dog racing), Native American tribal casinos, card rooms, or electronic gaming devices. According to the “Casino City” website, http://us.casinocity.com/, all states, other than Hawaii, Tennessee, Utah, and Vermont, have some form of legalized gambling, including casinos, horse tracks, and dog tracks. Further, according to a survey available at http://www.usa.gov/Topics/Lottery_Results.shtml, 41 states, the District of Columbia, and Puerto Rico have state lotteries, including instant-win scratch-off games, Lotto and daily games. States derive significant revenues from gambling and lotteries; thus, as set forth on page 6 of the AGA Survey, U.S. commercial casinos contributed $5.66 billion to state and local governments during 2008. In particular, as set forth on page 16 of the AGA Survey, the state of Michigan, which has traditionally been a vigorous “merit reviewer” of securities filings (and a state particularly hard-hit by recent economic woes), derived $321.63 million in gaming tax revenue from its 3 casinos in 2008 (not counting any income taxes which might have been payable by the 8,568 casino employees, who earned $481.11 million), while the casinos grossed $1.360 billion from gaming revenues. Interestingly, a table on page 6 of the AGA Survey reflects that while consumer spending at commercial casinos in Nevada and New Jersey declined by 9.7% and 8.5%, respectively, from 2007 to 2008, spending increased by 1.9% at Michigan’s commercial casinos.

More recently, on November 3, 2009, voters in Ohio, another notable “merit review” state which previously only authorized horse racing (at seven tracks) and a poker room in Toledo, and which is facing a budget deficit and a 10% unemployment rate, approved a referendum by a 53 - 47% vote that would allow one gambling casino in each of the state’s four largest cities – see http://www.casinocitytimes.com/news/article/vote-paves-way-for-vegas-style-casinos-in-ohio-180297.

As regards state lotteries, as set forth on the Texas Lottery Commission’s website, http://www.txlottery.org/export/sites/default/Supporting_Education/:

“The Texas Lottery has generated well over $17 billion for the state of Texas since the first ticket was sold in 1992. Prior to 1997, the proceeds were allocated to the General Revenue Fund. Since 1997, all Texas Lottery proceeds have been transferred to the Foundation School Fund to support public education in our state. The Texas Lottery has contributed more than $12 billion to the Foundation School Fund, and of that total, $1 billion was contributed in fiscal year 2009. Other Texas Lottery funds such as unclaimed prizes revert back to the state for programs authorized by the Texas Legislature. Beginning fiscal year 2010, Texas Lottery...
Proceeds will also benefit the Fund for Veterans Assistance.”

Considering that no state that I’m aware of imposes any limits on the amounts its citizens may risk by way of a lottery or at a casino or other gambling venue; requires casinos or lottery ticket vendors to prominently disclose the odds against winning; or otherwise restricts lottery players or casino gamblers to persons who can afford a loss and who understand that the odds against winning may be astronomical, isn’t the application of “merit review” by such a state to a securities registration filing inconsistent, if not hypocritical? Contrast the lack of any such state restraints on citizens participating in lotteries or gambling with a securities offering where investors are provided with a prospectus disclosing the risks of the offering and other relevant information, and where investors may also be required to satisfy minimum income and/or net worth standards or other conditions as a condition of participating. Certainly nothing stops a senior citizen from gambling away the proceeds of his or her Social Security check via the state lottery or at a slot machine, but that same senior citizen may not be able to invest any part of that check in a securities offering which the same state may deem not to be “fair, just and equitable” under its Blue Sky law based on some objective or subjective standards. It’s rather ironic that state securities administrators will rail over a senior citizen’s loss on a securities investment and will be quick to blame the issuer, broker-dealer or investment adviser involved, yet state officials are notably silent if the same senior citizen were to lose the same amount at a slot machine or craps table at a local casino. Likewise, state officials will gleefully honor a minimum wage earner who luckily wins millions in the state lottery, irrespective of the fact that he or she may have been buying $20 of lottery tickets per week (a proportionately significant amount of his or her take-home pay) for years beforehand.

It’s understood (and prospectuses generally prominently disclose) that investors in risky securities offerings may lose some or all of their investment, and it’s acknowledged that it’s probably unlikely that a state lottery commission will be unable to honor a winning lottery ticket or that a private casino would fail to pay off a big winner. But I believe that the comparison still holds – are the odds of winning a lottery or a particular casino game any better than the chance that a securities investor will ultimately make a profit on resale, or be paid promised dividends, principal, or interest? If a state is willing to put its citizens at financial risk by means of lotteries and casinos (where the state stands to make substantial profits), with little or no prior disclosure of the risks or control over who may gamble or play the lottery, why shouldn’t those same citizens be entitled to invest in any securities, so long as the risks are fully disclosed to them or financial suitability standards imposed on the types of persons who may invest?

A MESSAGE FROM NASAA PRESIDENT DENISE VOIGT CRAWFORD

By Denise Voigt Crawford
Securities Commissioner, Texas Securities Board
President, NASAA

As a career public servant, I believe that regulation is the proper province of government. It is not a profit-driven business and cannot be subject to a traditional cost-benefit analysis. After all, how do you measure the benefit of restoring to an elderly investor her life savings? NASAA Members are all true believers in the demonstrated power of state and provincial securities regulators to protect our citizens from fraud and abuse. It is the passion for our mission that is crucial for our success.

Lately I have been reflecting on how dramatically the world’s appreciation of the importance of sound financial regulation has evolved as a result of the Great Recession. Virtually all developed countries are reforming their financial regulation, which failed to identify, much less rein in, unlimited risk-taking, industry practices based upon flawed economic models and the inability or unwillingness of national governments to address these matters. While this catastrophe was the result of many failures, I am very proud to say that a failure of state securities regulation was not one of them.

Through the years, states have been the undisputed leaders in criminal prosecutions of securities violators because we believe in serious jail time for securities-related crimes. We have successfully exposed and addressed the profound conflicts of interest among Wall Street stock analysts by requiring changed behavior. We led all regulators on late trading and market timing in mutual funds. We address on a daily basis abusive sales practices targeting vulnerable senior investors.
We continue to lead the effort to ensure that investors receive redemptions for their frozen auction rate securities that were marketed as safe and liquid investments; an effort that has already resulted in the largest return of funds to investors in history. In the last few years, it has been state and provincial securities regulators who have been at the forefront of investor protection. Our record demonstrates clearly that we have the will and ability to regulate.

Our credibility as effective governmental regulators is at its zenith. We will use our good reputation in every way possible to influence the direction of financial regulatory reform so that it works for, not against, investors.

The future looks bright. The Obama Administration’s position in support of state regulation and the comments of key members of Congress reflect recognition of the vital protections state regulators provide. This has not always been the case.

Years ago, states used to be able to cap mutual fund fees. States had the legal authority to question, and revise if appropriate, the level of executive compensation in many initial public offerings of securities. States could review and stop bad actors such as those with prior convictions for securities fraud from relying on SEC Regulation D, Rule 506 (“Reg D”). The areas of state law preemption often mirror the types of fraud and abuse inflicted on investors. This is not a coincidence.

Without question, the most harmful area of state securities preemption has been Reg D offerings. Since they also enjoy an exemption from registration under federal securities law, Reg D offerings receive virtually no regulatory pre-screening at any level of government. Only enforcement actions are brought and they are rare.

As a result of short-sighted state law preemption, investors have been exposed to far more risk in private placement offerings than Congress likely could have imagined. Investors deserve better than this. At a minimum, Congress should reinstate state regulatory oversight of all Rule 506 offerings.

The need for a systemic risk regulator to identify and address risks across the economic spectrum is being debated, as is who or what could best do the job. Some support giving this additional responsibility to the Federal Reserve, others, including NASAA, support the creation of a new “Systemic Risk Council” made up of federal and state financial regulators in the securities, insurance and banking sectors.

A one-size-fits-all model of regulation is not the best model. It results in an insular culture that stifles creative regulatory insights and responses. It also invites regulatory capture by becoming too closely aligned with the industry it is set up to regulate. A large, overly centralized regulatory scheme can also get bogged down in bureaucracy and become slow to act. Sadly, we have seen all this happen at the SEC.

State and provincial regulators, on the other hand, are decentralized, directly accountable and can respond swiftly to investors’ complaints before their money and confidence are gone. This was illustrated most recently in how we handled the auction rate securities investigations.

We were quick, innovative, and aggressive. These are the hallmarks of effective regulation and are typical attributes of NASAA members.

In the coming months, we will focus on several areas of investment adviser regulation that cry out for change. NASAA has long called upon Congress to extend the fiduciary duty standard to all financial professionals who give investment advice regarding securities. Currently investment advisers have this duty but broker-dealers do not. What is fiduciary duty? It is simply the duty to put the client’s interest first. Differing standards of care create confusion and distrust and do not serve the best interests of investors. We recognize that so-called “harmonization” of standards is simply code for adoption of a lower standard and is therefore unacceptable.

Also with regard to investment advisers, the current dividing line between federal and state regulation of investment advisory firms is $25 million of assets under management. The SEC might increase this to $100 million of assets under management. NASAA has endorsed such a change and will work closely with the SEC to make this happen.

Finally, NASAA’s position regarding investment adviser regulation is that it should continue to be the responsibility of state and federal governments that are accountable to the investing public. We each must be funded adequately to carry out our responsibilities. A self-regulatory organization for investment advisers is inappropriate because it embodies a flawed approach to regulation since a self-regulatory
organization is inherently conflicted and is not independent.

Another area of concern is arbitration. We all know arbitration is not working. It is time to end mandatory, industry-run arbitration for investors. Investors should have the right to choose between litigation and arbitration as the forum for resolving disputes with their financial services firms.

One of the greatest contributions we make to investors is investor education, which I always point out, originated with state securities regulators. It is now embraced by everyone from the President of the United States, members of Congress and Governors, to unions, Colleges and classroom professors. Regulators and the securities industry can and do work together to ensure that misinformation is not disseminated to investors under the guise of teaching them how to better protect themselves and make wise investment decisions.

If we are to advance economically as a society, we regulators must devote even more of our resources to helping increase financial literacy in our jurisdictions. Because we strongly believe that non-commercial investor education is a key driver of unbiased programs, we will work to strengthen our relationships with those parties and devote significant time and effort to educate investors, especially those who are at greatest risk. One of our key demographics for the foreseeable future is aging investors. We will continue the great work NASAA has done so far in protecting investors, especially older investors.

REGULATION D, RULE 506
A TIME FOR CHANGE – BUT WHAT TO DO AND HOW TO DO IT?

By Hugh H. Makens
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It is time to fix Rule 506! While the congressional effort by Senator Dodd is widely regarded as a tragic mistake that destroys the benefits of the Rule, the fact that a Congressional effort is made to change the Rule is an indicator that there is widespread concern over the problems that exist today with Rule 506.

Section 926 of the Financial Stability Act of 2010 (the "Dodd Bill"), provides that Section 18(b)(4) of the 1933 Act would be amended to allow for a reverse preemption by empowering the Commission to remove preemption where the offering is not of "sufficient" size or scope. Further, preemption under Rule 506 would be lost if the Commission did not follow the mandate to review an offering within 120 days of filing, unless a review by a state securities commissioner determines that a good faith effort was made to comply with Rule 506 and any differences from compliance are immaterial, in which case preemption is not lost.

There are a few minor problems with this approach. The offering is likely to have been completed before the 120 days period expires; the issuer would not know whether it has a valid exemption under federal or state law until after the offering is complete, hence no sane issuer would rely on the exemption; the SEC does not now and will never in the future routinely review private offerings since it has neither the staff nor time to do so; any review could result in changes which would compel a rescission offer, which is particularly difficult when the money has been spent; it is impossible to review a document and know whether Rule 506 compliance has been achieved, since the method of offering is not covered in the document so no review could reveal whether there had been improper general advertising or solicitation or the status of investors; and no regulator will do the necessary due diligence to determine whether the disclosure appears to be adequate. On top of this, an enforcement action followed by civil actions is possible if the offering did not meet regulatory muster. That is just the start of a list of horribles, but serves to illustrate the fallacy of the concept underlying Section 926.

NASAA's reaction to this unworkable compromise from earlier drafts was not positive. In a comment on March 15, 2010, the NASAA Director of Communications stated:

"We continue to encourage the committee to return to the states the full authority to review private placement offerings made under SEC Rule 506 of Regulation D. In its current form, the Dodd bill merely provides states the ability to review certain Form D filings in those cases where the SEC does not perform its own review within 120 days. While this provision attempts to remedy the current situation in which there is essentially no federal or state regulation for private placements, it is a disappointment for the
investing public and deserves more meaningful and substantive consideration."

While there are many meritorious provisions to the Dodd Bill, Section 926 is obviously not one of them. The problems should iron out as the bill progresses and a more logical approach is developed.

Tensions have been mounting between the North American Securities Administrators Association ("NASAA") and the Securities and Exchange Commission ("SEC") over state perception of problems with the present structure of the 1933 Act's Regulation D, Rule 506, the most commonly used private offering exemption. There have been serious problems with many Regulation D offerings, which have badly hurt investors for no valid reason. The SEC can, and should take steps to patch the holes in Rule 506, particularly when the changes will have little impact on the manner in which legitimate Rule 506 offerings are done.

NASAA has testified before Congress on this problem recently, the latest being by President Crawford on October 6, 2009, though the prior president, Fred Joseph, had done so on two prior occasions. President Crawford has also given testimony before the Financial Crisis Inquiry Commission on January 14, 2010, arguing for removal of the preemption of state involvement with Regulation D, Rule 506 offerings.

NASAA believes that, without question, the most harmful area of state securities preemption has been Regulation D offerings. NASAA's position can be summarized as follows. They have observed that since private offerings also enjoy an exemption from registration under federal securities law, Reg D offerings receive virtually no regulatory prescreening at any level of government. Only enforcement actions are brought, and they are rare. As a result of shortsighted state law preemption, investors have been exposed to far more risk in private placement offerings than Congress likely would have imagined. Investors deserve better than this. They believe that at a minimum, Congress should reinstate state regulatory oversight of all Rule 506 offerings by removing the preemption in Section 18(b)(4)(D) of the 1933 Act.

The NASAA argument is built around the belief that in some ways, Rule 506 was designed to aid the con man in his or her sales efforts. The present structure has four major problems:

1. One can sell to accredited investors, regardless of their financial sophistication—present accredited investor requirement presume that the unsophisticated, inexperienced widow with $1,000,000 in net worth meets the Ralston Purina suitability standards.

2. There is no mandate to provide information to accredited investors, apart from the anti-fraud rules that con men usually ignore anyway.

3. The only way to protect investors against con men is to cut off the use of the Reg D safe harbor, which lends credibility to the documents provided to victims by con men.

4. States should have the ability to require delivery to the state of the offering materials when states have a concern that fraudulent offerings may be occurring, and no evidentiary standard should be imposed which would impair their ability to request the private placement memoranda. NASAA believes strongly that the only way to prevent fraud is by cutting it off before the con man gets his hands on the investor's cash.

I presume that NASAA is particularly concerned with certain groups of victims, including those who lack either or both professional advisers and financial sophistication, as well as business or investment experience. If the investors can't read or comprehend financial statements with any degree of understanding, it is hard to justify the carve out under the present accredited investor standard.

What possible justification can there be for not providing these people with meaningful disclosure about key material information, as described later in this article?

Unfortunately, NASAA has not done a good job of forcefully making its arguments. Too often testimony and written communications are couched in generalities and occasional examples. A sophisticated approach targeting specific types of problems would be more persuasive in motivating change by Congress and the SEC.
The SEC itself has reservations about the efficacy of Rule 506. By way of background, one should consider that the most pertinent parts of Rule 506 have not been updated since the Rule was adopted in 1982. Proposed changes to the Rule were put out by a prior Commission for comment in 2007, but no action has been taken since that time.

On April 7, 2010, the SEC proposed new rules to regulate asset-backed and mortgage-backed securities. These products are often sold to accredited investors citing an exemption from securities registration under Regulation D, Rule 506, and underlying hedge funds to which they are offered often raised their capital in reliance, at least in part, on the Rule 506 exemption. The proposed rules would mandate that an issuer would provide to any investor who requests such information, all information that would appear in a fully registered 1933 Act offering. Thus, even though the investors presumably would virtually all be accredited, the Rule 506 offering standards were deemed insufficient to protect investors.

There is a false premise in Rule 506 which is that no written disclosure needs to be provided to accredited investors. In the real world, this is just not true for several reasons.

1. Legitimate Rule 506 offerings generally provide fairly extensive private placement memoranda, since that is expected in the market. Sophisticated investors receive many investment opportunities. If there is not sufficient information to justify further inquiry, the proposed offering gets tossed into the circular file. Except in one on one, or a very limited number of investor offerings, it is essential to provide a PPM or the equivalent.

2. The idea that certain essential information need not be provided for Rule 506 offerings is not based on practice. Investors want to analyze the offering and determine the nature of the transactions, the background and the track records of promoters, the terms of the deal (which may end up being negotiated), compensation, conflicts, etc. If you don’t have enough information to trigger interest, sophisticated investors are not going to come to a promoter and beg for it.

3. The standards for disclosure in private placement memoranda (PPMs) have been deteriorating over recent years. The rash of litigation against hedge funds by supposedly knowledgeable institutional or highly sophisticated investors, and the tremendous losses suffered by many, suggest that the quality and extent of disclosure is going to improve, not diminish, for future deals.

4. Legitimate deals do not really need the relaxed disclosure approach offered by Rule 506. They do need a practical approach to disclosure, recognizing that in some instances potential investors will do their own due diligence and negotiate terms, while others will employ a bevy of experts to examine different facets of the offering. Further, the deals with a very limited number of investors are generally done under the umbrella of Section 4(2), often without using Rule 506.

Perhaps the most glaring mistake at the time of the adoption of Rule 506 was the failure to address the problems of those with regulatory track records, be they criminal, civil, or administrative, and whether these problems arose at the federal or state level. The SEC, in adopting Rule 506, could have followed the example of its Regulation A and added a list of disqualifiers of persons who could use the exemption with its aura of legitimacy. The states in response to Regulation D adopted the Uniform Limited Offering Exemption that included an expanded list of disqualifiers. Then in 1996 along came the National Securities Markets Improvement Act, which preempted state regulation of Rule 506 offerings except that states could require forms, fees, and enforce their anti-fraud provisions.

At this moment, any con man or past securities violator is free to use Rule 506, and thus claim compliance with federal exemptive standards, regardless of whether they meet them or not. This is true even if offering materials fail to disclose prior adverse regulatory history. What is the logic for this? Whose side are the regulators supposed to be on?

The negative side of the structure of Rule 506 does not remotely outweigh the benefits it provides to legitimate business in raising capital. We have no numbers to evaluate, but my personal experience and
that of attorneys to whom I speak suggests that the vast preponderance of what they see is for the benefit of investors and the greater public good is served by the existence of the exemption. This suggests that what is needed is repair, not replacement, despite the age and depreciation that the Rule has endured.

What should be done? For consideration of our members and readers, I propose the following steps be taken by the SEC. If this approach or a reasonable modification of it, is accepted, then I see no reason for statutory amendment.

**PROPOSED SOLUTION**

On August 3, 2007, the SEC published Release 33-8828 asking for comments on changes to Regulation D. Amidst the storm of chaos from the financial collapse in our country, and a multiplicity of mixed messages received from commentators on the proposed changes to the Rule, the process has ground to a halt. The heat arising from NASAA's concerns and frustrations is bringing this issue to the fore in a political, rather than reasoned environment. Unless the SEC acts soon to address some of the basic anti-fraud concerns, products like Section 926 of the Dodd Bill appear, which serve the interests of no regulators. When NASAA can refer to the use of Rule 506 in the offering by Stanford Financial, involving one of the largest Ponzi schemes in history, the result tends to be polarization rather than rational discussion. A combined approach between the SEC and NASAA would be most productive. Let's start at the SEC where there are several important steps which should be undertaken.

1. Establish a computerized database of "bad boys" against which names of promoters, insiders, and selling agents on Form Ds can be compared. During the Jurassic Period of securities regulation, the SEC did maintain such a database, albeit on a manual basis. It was possible for counsel to check for potential wrongdoers as part of their due diligence process with an inquiry into name matches which would trigger further investigation. The SEC should make public the computerized database of those with securities violations so that attorneys preparing PPMs and those performing due diligence can find the wrongdoers and prevent sales by them before they do harm.

2. The SEC should actually compare the names on the Form Ds with the list for instances which might trigger further investigation or referral to a state, and also start follow-ups on the unregistered broker-dealers whose names appear on the Form Ds, since many of these individuals and entities have prior regulatory histories.

3. OCIE should create brokerage firm and investment adviser inspection protocols that look beyond the obvious, and probe for "selling away" (the second most common violation in the world of registered representatives) and improperly prepared PPMs. One need look no further than the Supreme Court's decision in the *ETS Payphon e* case with its thousands of victims, many obtained through "selling away," to identify the need and the proper approach.

4. An internet search will reveal the sites that offered "canned" PPMs for Rule 506 offerings. Since they can lay the foundation for a series of frauds, addressing the activity early on can prevent abuse.

5. The SEC should modify the preemption to Rule 506 to permit states to make inquiries where a regulatory concern may exist. This should not open the door to a carte blanche review by the states of all or a predominance of the offerings, since there has been no justification provided for such an expansive and unnecessarily intrusive approach. However, the present system harms investors and the level of interference of such a special circumstance state review should be minimal in relation to offerings as a whole. If the SEC can enter into agreements with foreign nations, it should be possible to craft an approach with NASAA for a protocol on dealing with what kind of PPMs would routinely be called for review. While "bad boys" and unregistered broker-dealers should trigger state access to offering documents, that is too tight a limit and the scope of access should be based on a practical consideration of where investor abuse is most likely to occur.
6. Mandate that Rule 506 is unavailable to those with a Securities Violators record (or at least reach the prohibitions imposed by ULOE) unless a waiver is obtained from the regulatory entity that originally issued the violation order and the event is clearly disclosed to investors in writing prior to their purchase. The patina of legitimacy provided by claiming Regulation D, Rule 506 preemption would disappear for those with regulatory histories.

7. Remove accredited investor status for those who meet the victim class now being abused by the inadequacy of the present Rule. Present practice in preparation and analysis of investor questionnaires makes the evaluation easy (except for those attorneys who instead of asking for facts, simply require self-certification).

8. Add a provision to Rule 506 mandating that the burden of proof of the exemption or preemption lies with the issuer, and not with the regulator, and that it would be necessary to show compliance with the Rule in all material respects in order to claim the exemption.

9. Add a note to Rule 506 that specifically addresses the impropriety of cold calling to recruit investors who do not have the kind of prior relationship contemplated by the no-action letters issued by the Division of Corporate Finance pertaining to Regulation D.

10. My most controversial proposal involves a mandate for minimum disclosure in all private placements. These disclosures would be aimed at the areas in which fraud has most commonly been found in enforcement proceedings relating to private offerings. These are as follows:

   • All insider, promoter, broker, and finder compensation.

   • All loans or similar financial arrangements with this same group and their family members and affiliates.

   • All conflicts of interest, actual or potential, involving this group.

   • A detailed discussion of the experience of promoters and insiders, which would reflect on their ability to successfully accomplish the purpose of the offering.

   • Status of all material contracts for offerings by non-reporting companies, since a frequent abuse by con men is to indicate that a contract will be forthcoming shortly where there is little or no basis for such a statement.

   • Regulatory backgrounds of promoters and insiders.

   • Detailed statement of use of proceeds, rather than a generalized and meaningless statement.

   • Specific, rather than just generalized standardized, risk factors that go to the possibility/probability of success of the venture and the quality of management.

   • Current Financial Statements for the issuer.

NASAA also has a critical role to play in helping the SEC staff understand the scope of problems that states are identifying. It should answer the questions:

1. In what instances do you need to have access to PPMs?

2. How do you prevent that access from impairing the needs of legitimate businesses to raise capital?

3. When do you believe that your ability to freely access information that relates to an enforcement concern is impaired?

4. What steps should be taken to further protect investors in Rule 506 offerings, short of routine reviews of PPMs.
5. Does the present Form D adequately address the needs for information that might detect illegal activity? If not, how could it be improved?

Can and will NASAA and the SEC work together effectively to address problems? On the one hand, the SEC has not made an effort to protect against preemption of state law and on some occasions has been a supporter of preemption; on the other hand, NASAA has felt compelled to respond by pointing out the regulatory failures of the SEC. Both sides must recognize that there are no perfect systems, and that the best system will emerge from cooperation, not dissention.

On a joint basis, federal and state regulators should recognize:

1. That there are certain industries or segments of these industries, which have a long history of abusive practices. They frequently use boiler room tactics to solicit investors. Their offering materials often fail to disclose either the record of the promoters or their prior fund raising and operational efforts. Both regulators should target these for scrutiny when Form D filings are made.

2. To the states, all enforcement is local. It relates to your state, and often regulators acquire knowledge about people and activities in their states which the SEC staff could not possibly hope to know absent a local presence. States should be free to inquire into those offerings, which could cause regulatory concern given their knowledge, background, and experience. This should obviously not occur on a routine basis.

3. The SEC and NASAA should put out a plain English announcement to registered representatives and those salesmen in the insurance industry that sell investment products, even when promoters tell them that what they are to sell are not securities. They should be warned that selling investments illegally will be cause for one to be barred from the industry, to repay investor losses, to recapture their commissions, and to potentially go to jail. The ETS Payphones case and the incredible abuses in the viatical industry are easy examples to cite in such a release.

4. The SEC should open communications with Insurance Commissioners to urge them to take steps to prevent illegal securities sales activity by insurance agents.

5. During investment adviser inspections examine the PPMs which come to the Advisers or which the advisers create, for compliance with reasonable disclosure and meeting anti-fraud minimum disclosure.

The SEC and states have worked together effectively and cooperatively in recent times on enforcement issues. This is not just a corporate finance issue, nor an enforcement issue, and in fact, the scope of the issue touches almost all units within the SEC. How does one break down silos and develop a universal approach that solves the problem? How will state/federal cooperation be enhanced? Time will tell if it can be done.

DEAR SENATOR DODD: DON’T REPEAL NSMIA’S PREEMPTION OVER RULE 506 OFFERINGS; IT WILL HURT SMALL BUSINESS AND THE ECONOMY

By Rutheford B. Campbell, Jr.
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The History of Preemption of State Blue Sky Laws

In 1985, I wrote an article proposing that Congress preempt state authority over the registration of securities. The article was generated by my experience in practice and was based on an exceedingly simple notion: It is irrational to impose 51 separate and different regulatory regimes on companies – especially small businesses – when they attempt to access external capital.

That, of course, was where we were at the time. The Securities Act of 1933 dictated the federal regime, and each state had its own mini-1933 Act. The result was a bizarre system that could only be explained by reference to the historical manner in which it had developed. It was a system that imposed
unnecessarily high transaction costs on capital formation, a burden that fell disproportionately on small businesses.

As is often the case in our academic writings, my article hit with a dull thud and was assigned, it appeared, to the dust bins of history.

In the mid-1990s, however, the subject caught the eye of Congress, and a stout House bill was introduced to deal with this problem. The bill, the Capital Markets Deregulation and Liberalization Act of 1995, offered a complete preemption of state authority over the registration of securities, except for offerings made under the intrastate exemption.

Intense lobbying efforts, including efforts by the North American Securities Administrators Association (NASAA), resulted in dramatic changes in the bill. The changes robbed small businesses – and, indeed, the economy generally – of most of the benefits that would have been generated by the broad preemption in the original bill.

As finally signed into law, the bill, renamed the National Securities Markets Improvement Act of 1996 (NSMIA), failed to preempt state authority over offerings exempt under Rule 147 (the intrastate exemption), Rule 504 and Rule 505 (Regulation D) and Regulation A. These, of course, are vital exemptions for small issuers. The only significant preemption for small business that survived the lobbying efforts was preemption of state authority over Rule 506 offerings. Otherwise, the pre-NSMIA disadvantages for small issuers continued and, indeed, continue today.

The Impact of Section 926 on NSMIA

If enacted into law, Section 926 of the Restoring American Financial Stability Act of 2010 (the Act) will as a practical matter largely eliminate this preemption of state authority over Rule 506 offerings. The Section, once again, appears aimed at small business capital formation.

Enacting Section 926 into law will hobble the legitimate capital formation efforts of our small domestic businesses. The Section will increase significantly and unnecessarily the costs of raising capital for small domestic businesses – an essential part of our national economy – by saddling them with expensive, unnecessary, and multiple regulatory regimes.

Indeed, if enacted into law, the impact of the Section will be precisely contrary to one of the principal purposes of the regulatory reform in the Act, which is to ensure the flow of capital to small domestic businesses and thus provide fuel for the recovery from our recent economic crisis.

At the same time, Section 926 will provide no meaningful protection for investors from the sharp practices that caused our recent financial crisis.

Presently, investors in small business offerings under federal Rule 506 are protected by tough state and federal antifraud provisions, each carrying significant civil liabilities and criminal penalties. Rule 506 also requires that all investors are either: (a) “accredited” (meaning that the investor must either be an institution, an insider or wealthy); or (b) sophisticated (able to evaluate the merits and risks of the transaction) and provided with the same information that they would receive in a registered offering. In many cases, therefore, investors in Rule 506 offerings actually are accorded more protection than investors in registered offerings.

4 It has been reported that the President of the North American Securities Administrators Association has blamed the recent financial crisis in part on unregistered securities offerings under Rule 506 of Regulation D. See John Cook's Venture Blog, guest post by Bill Carleton and Joe Wallin, 3/15/10, http://techflash.com/seattle/2010/03/congress_attack_on_angel_financing.html (“The President of NASAA, Denise Voigt Crawford, has publicly testified that federal preemption over Rule 506 offerings contributed to the recent financial crisis.”). Such a statement, if accurately reported, is a wild exaggeration that is unsupported by credible evidence or empirically demonstrable facts.

As a result, subjecting Rule 506 offerings by small businesses to 50 additional state registration regimes – which will be the impact of Section 926 – adds no meaningful protection to investors. It only raises transaction costs for small business capital formation, and it does so in a disproportionate, unfair and inefficient manner.  

Securities Offerings under Rule 506; Section 926 of the Act

Rule 506, provides an exemption from the federal registration requirements. The exemption is designed to balance the need for capital formation and investor protection. The balance struck in Rule 506 was worked out by the SEC with the benefit of its decades of experience and thoughtful consideration.

The Rule protects investors by requiring that they all are either: (a) “accredited” (meaning that the investor must either be an institution, an insider or wealthy); or (b) sophisticated (able to evaluate the merits and risks of the transaction) and be supplied with the same information that they would receive in a registered offering. The idea, of course, is that “accredited” investors – institutional investors, for example – are able to fend for themselves, as are sophisticated investors who are supplied with the same information that would be contained in a registration statement. Also, Rule 506 generally limits the offering to 35 non-accredited purchasers, prohibits any general advertising, and imposes restrictions of resales of securities acquired in Rule 506 transactions.

Rule 506 is one of the most attractive vehicles for small businesses that are attempting to raise capital. A significant part of Rule 506’s benefit for small business issuers is that the offerings are subject only to federal law. States, as a result of NSMIA, are prohibited by federal preemption from imposing state regimes on top of the requirements of Rule 506.

If enacted, Section 926 would effectively destroy this important provision of NSMIA, thus allowing each of the 50 states to impose its own separate and distinct registration requirements on Rule 506 offerings. This would mean, for example, that a small business attempting to raise $2 million in capital through a Rule 506 offering in 10 states would have 11 sets of securities laws to satisfy – 10 state laws and one federal law.

Such an approach to the regulation of small business capital formation is irrational. Indeed, it is difficult to imagine a more problematic approach than one that requires small businesses attempting to raise vital capital to comply with 11 sets of laws, laws which are part of very complex regimes that most likely vary from state to state, and all designed to achieve the same goal.

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6 The principal pernicious effect of Section 926, which is the basis for my comments, is stated in this paragraph: The Section raises the costs of capital for small businesses without providing any protection for investors. The Section, however, is also subject to criticism because it is confusingly drafted, puts the SEC in the awkward, difficult and costly (for taxpayers) position of, first, having to draft general rules respecting “covered securities” based on unclear statutory criteria. The SEC is then pressed into service under the Section to “review any filings” made in connection with Rule 506 offerings. The Section seems to be based on some misperception about what is filed with the SEC in connection with Rule 506 offerings, which is only a Form D. Also, the Section offers no criteria that the SEC is to use in its review nor what the Commission should do if it finds the offering not to its liking. Nonetheless, under the terms of Section 926, failure on the part of the SEC to conduct this “review” costs the issuer its preemption.


9 The authority for the Commission’s Rule 506 is Section 4(2) of the 1933 Act, which provides an exemption from registration for “transactions by an issuer not involving any public offering”, 15 U.S.C. § 77d(2) (2010). Both Rule 506 and Section 4(2) have rich histories, tracing their interpretive roots back to the Supreme Court decision in SEC v. Ralston Purina, 346 U.S. 119 (1953).

Unfortunately, however, that will be the impact of Section 926, and, as too often is the case, the pernicious effects will fall disproportionately on small businesses.

**The Importance of Small Businesses to Our National Economy**

Small businesses are an important part of our national economy. However one looks at the matter – whether in terms of the number or percentage of business units, the types of goods and services provided, employment or innovation – small businesses are significant in our everyday lives and vital to the economy of our nation.

Perhaps better than any other source, data compiled by the Small Business Administration show the economic importance of small businesses. These data show, for example, that there are nearly 5 million businesses in the United States that employ fewer than 20 employees. Firms in this smallest of size categories – less than 20 employees – account, therefore, for almost 90% of the total business units in the United States. Continuing to focus on absolute numbers of small businesses, the SBA data report nearly five and one-half million business firms have less than 100 employees. Thus this somewhat larger version of a small firm accounts for slightly over 98% of the total business units in the United States.

Another, perhaps even more revealing, measure of the importance of small businesses is employment. Here one finds that the smallest firms, those with less than 20 employees, provide nearly 19% of all the jobs in the United States, while firms with less than 100 workers provide approximately 37% of all jobs. In absolute numbers, firms employing less than 20 employees provide work for slightly more than 20 million persons, and all firms employing less than 100 workers provide employment for nearly 40 million people.

Small businesses also provide dynamic energy for our economy that is not properly impounded in the

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11 This section reproduces verbatim, including footnotes, a portion of my article, Rutheford B Campbell, Jr., *Regulation A: Small Businesses’ Search for “A Moderate Capital”*, 31 Del. J. Corp. L. 77, 84 (2006) (hereinafter “Campbell, Small Businesses’ Search”).


13 Data demonstrating the significance of small business to our economy can also be found in U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2000. Particularly relevant to this article and supportive of the SBA data are the data found at *Id.*, Table 861, p. 545 (96.5% of all business tax returns filed for 1980 were filed by entities with less than $1 million in receipts; 13.8% of all business receipts during that year were generated by entities with less than $1 million in receipts), and at *Id.*, Table 874, p. 555 (in 1980, 22.7% of total national payroll came from firms with less than 20 employees, and 48.9% of total national payroll that year came from firms with less than 100 employees).
Small entrepreneurs appear to generate a disproportionately large amount of job creation, opportunities for historically disadvantaged groups and innovation. In short, they provide much of the entrepreneurial spirit that drives our market economy.

In the area of job creation, small businesses are vital. One finds various statements regarding the percentage of jobs created by small businesses, some statements putting the percentage as high as 75%. SBA data, for example, show that in a recent two year period, 50.2% of all new jobs were created by firms of less than 20 employees.\(^{22}\)

SBA data also show the increases in women-owned and minority-owned firms.\(^{23}\) Not surprising, the SBA states that “[s]mall business continued to be an important means by which women, minorities, and immigrants entered the American economic mainstream and managed to increase their share in the economy.”\(^{24}\)

Finally, although hard data regarding innovation are difficult to find, both estimates and opinions suggest the importance of small businesses to innovation. By one estimate, for example, small firms generate 55% of all manufacturing product innovations and more than twice the innovations per employee as large firms.\(^{25}\)

\(^{21}\) SBA data show, for example, that during 1996-1997, 95.5% of all firm births involved firms with less than 20 employees, and 99.9% of all firm failures were of firms with less than 20 employees Id. at 84, Table A.9 (during 1996-1997, 564,197 of the total of 590,644 firm births involved firms with less than 20 employees, while 500,014 of the 500,536 firm deaths involved firms with less than 20 employees). Although one must exercise care in using these numbers, certainly they show the dynamic nature of the investment and disinvestment by small entrepreneurs. The data show that small entrepreneurs are risk takers, willing to invest in new enterprises, services and products.

\(^{22}\) Id. During 1998 firms with less than 20 employees provided 18.8% of the jobs in our economy. Id. at 61, Table A.4.

\(^{23}\) Id. at 102, Table A.14.

\(^{24}\) Id. at 17.


### The Importance of External Capital for Small Businesses\(^{26}\)

Data confirm that small businesses need external capital and that their need for external capital increases as they grow in size. Data show that slightly over 85% of firms with 10 to 19 employees utilize some form of credit as a source of financing. That number increases to slightly over 90% for firms employing between 20 and 99 persons.\(^{27}\) Refocusing on traditional loans only, data suggest that about 75% of firms employing 10 to 19 persons and around 80% of all firms employing between 20 and 99 persons rely on traditional loans as a form of financing.\(^{28}\)

Financial institutions are a major source for the debt capital utilized by small businesses. SBA data show that about 55% of firms with 10 to 19 employees finance through loans from financial depository institutions. The number goes to around 70% for firms with 20 to 99 employees.\(^{29}\) Although somewhat less important, non-depository financial institutions, such as finance companies, provide financing to approximately 35% of small firms with between 10 and 19 employees and nearly the same percentage of all firms with between 20 and 99 employees.\(^{30}\)

Economic efficiency explains small businesses’ reliance on institutional credit. Depository

\(^{26}\) This section reproduces verbatim, including footnotes, a portion of my article, Campbell, Small Businesses’ Search, supra note 14, at 885.

\(^{27}\) Id. (in 1993, for example, 88.7% of firms with 10 to 19 employees and 91.1% of firms employing between 20 and 99 persons utilized some form of credit as a source of financing).

\(^{28}\) Id. (in 1993, 75.5% of firms employing 10 to 19 persons and 81.4% of all firms employing between 20 and 99 persons relied on traditional loans as a form of financing).

\(^{29}\) Id. at 176, Table 5.15, (in 1993, 54.4% of firms employing 10 to 19 persons and 70.7% of all firms employing between 20 and 99 persons relied on loans from depository institutions).

\(^{30}\) Id. (in 1993, 35.5% of firms employing 10 to 19 persons and 34.5% of all firms employing between 20 and 99 persons relied on loans from non-depository institutions).
Financial institutions, for example, are able to amass capital relatively easily from deposits and other sources. Financial institutions also are efficient in evaluating and diversifying risk and pricing the capital they lend to small businesses. They are engaged in multiple, repeat transactions and as a result are experienced and efficient in credit analysis.

Financial institutions, however, are normally limited in the type of capital they are able or willing to supply small businesses. Regulatory limitations explain part of this problem. Banks, for example, are typically foreclosed from making equity investments in their business customers31 and are limited as to the size of a loan they can make to a single customer.32 In addition to such regulatory limitations, the culture of banking and perceptions about what amounts to sound banking practices limit significantly the kind of loans that banks are prepared to make to small businesses. For example, banks usually require collateral that is more than sufficient to liquidate the loan in the event of default and, in the case of loans to corporations, require an equity cushion supporting their loan. Such rules, often imposed as a matter of sound business practices, limit the types of business loans that banks are willing and able to make.

The normal progression for a growing, small business, therefore, is to exhaust its line of institutional credit and then to seek other sources of external capital. It is here where small businesses encounter some of their most challenging problems.

Structural Impediments to Small Businesses’ Efficient Search for External Capital33

Small businesses’ difficulties in finding external capital are not caused by a supply inadequacy. Literally, there are billions of dollars available in the broad capital market for nearly any risk/reward combination.34 The problems for small businesses are, instead, the difficulties they face in identifying potential investors and the costs of connecting themselves with the investors’ demand. In short, it is the ubiquitous problem of transaction costs.

Two related circumstances are important in that regard. First, financial intermediation is unavailable to small businesses. Second, their relative offering costs are very high.35 Reputable, competent underwriting services are not available for offerings by small businesses. The simple reason is that the proceeds from small offerings cannot support the expenses encountered by an underwriting firm, who must learn the company, evaluate the deal, sell the deal, and absorb the residual risk of liability that is generated by the offering, and ultimately earn a reasonable return on their capital.36

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31 For example, national banks and Federal Reserve-member state banks are limited “to purchasing and selling . . . securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account,” except “under such limitations and restrictions” as the comptroller may prescribe. 12 U.S.C. § 74 (2005).

32 A national bank may lend up to 15% of its unimpaired capital and surplus to a single borrower. 12 U.S.C. § 84(a)(1) (2005). An additional 10% may be lent, if the loan is secured by “readily marketable collateral, as determined by reliable and continuously available price quotations.” 12 U.S.C. § 84(a)(2); see also 12 C.F.R. § 32.2(m) (2005) (providing an expansive definition of “readily marketable collateral”). For an extensive discussion of the exceptions, qualifications, and the penalties for noncompliance with 84(a), see 1 MILTON R. SCHROEDER, THE LAW AND REGULATION OF FINANCIAL INSTITUTIONS ¶ 7.04 (6th ed. 2003).

33 This section reproduces verbatim, including footnotes, a portion of my article, Campbell, Small Businesses’ Search, supra note 14, at 88.

34 Consider, for example, the data prepared by Ibbotson, which track historical returns on various categories of investments from risk free government obligations through small cap companies. RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 152, Table 7.1 (5th ed. 1996) (average rates of return on various broad types of investments, 1926-1994).

35 See, e.g., JAMES D. COX, ROBERT W. HILLMAN, DONALD C. LANGEVOORT, SECURITIES REGULATION CASES AND MATERIALS 251 (3d ed. 2001) (reporting a “recent estimate” for the expenses of an IPO as “$150,000-$300,000 in fees to counsel; $100,000-$150,000 for the audit; $10,000-$20,000 for underwriter counsel expenses . . . and $50,000-$100,000 for printing”).

36 For example, if one imagines a small offering of $500,000, a 10% underwriting spread would generate only $50,000. This is substantially below a fee sufficient to support the expenses outlined in the text.
Professors Gilson and Kraakman have described the value of financial intermediation for firms attempting to access external capital. Reputable professional underwriters, they observe, provide issuers with the “sales force and facilities necessary to sell the securities” and act as “an information and reputational intermediary.” Further, underwriters reduce “processing costs”, which are “obviously lower for a single investment banker than for a disparate group of individual buyers,” and reduce the investors’ “verification costs.”

Small issuers, therefore, who are forced to sell their stock without the assistance of reputable, competent underwriters, are unable to capture the transactional efficiencies described by Gilson and Kraakman, and this drives up their transaction costs. Small businesses do not have trained personnel who are able to sell their securities in an efficient, competitive manner. Most obvious, company employees do not know where to find potential investors and do not know how to sell them if they are able to find investors. Also, the company itself is unable to provide investors with the same level of verification of facts and credible analysis provided by underwriters. The strong self interest of a company issuing and selling its own securities makes the investors less willing to rely on the company’s information and analyses and thus requires that each investor underwrite the expense of its own verification and analysis.

The second, related problem faced by small businesses is that the other offering expenses are very high. Here we are dealing, for example, with expenses such as accounting and legal expenses, and one should appreciate that it is relative, not absolute, offering expenses that are important. To use an extreme example, $500,000 in offering costs on a $50 million offering will certainly not kill the transaction, while $500,000 in offering expenses on a $500,000 deal will kill the transaction.

Accounting, legal and other expenses on small deals easily can exceed $50,000, and such amounts bulk large relative to the total yield from a small offering. When added to the costs due to the lack of financial intermediation services, one is able to appreciate the extreme structural and economic disadvantages that small entrepreneurs encounter when they attempt to access external capital.

The disproportionately high transaction costs that small issuers face when they attempt to access non-institutional capital have important economic effects on society. Inability of small firms to compete effectively in the capital market makes small firms less competitive in their product market. Efficient allocations of productive assets are distorted and in extreme cases, small firms may expire, even though the small firm may otherwise be a very efficient producer. In such cases, larger firms that are less efficient (except for their transaction costs in connection with capital formation) will replace small firms that are more efficient (except for their transaction costs in connection with capital formation).

In light of structural and cost issues, one should not be surprised to find a minuscule number of public offerings by small businesses. Data show, for example, that in 1999, there were only 101 registered initial public offerings by firms with $10 million in assets or less. THE STATE OF SMALL BUSINESS 2000, supra note 15, at 27, Table 1.10. In 1998, such firms made only 62 IPOs. Id. These data capture the predictable result of the high transaction costs on small businesses’ access to capital in the public market.
The Impediment to Small Business Capital Formation Imposed by State Blue Sky Laws

The pernicious effects of these structural impediments to efficient small business capital formation are significantly exacerbated by state blue sky laws. As described in the preceding section, small businesses approach the capital markets without financial intermediation and with small capital needs. Imposing multiple, repetitive state regulatory regimes on their capital formation activities makes access to external capital more expensive or, in some cases, practically unavailable for small businesses.

Once again, it is the matter of relative, not absolute transaction costs. To restate the prior example, if a small business wants to offer securities – or even just test the water – in 10 states, the small business faces the obligation to comply with 11 regulator regimes. If the small business wants to cast its net widely by exploring its options nationwide, it is required to comply with 51 regulatory regimes. The impact on small business capital formation is obvious.

Conclusion

Reports suggest that NASAA is the principal proponent of Section 926. 44

NASAA is a well meaning and honorable group of blue sky administrators, and blue sky laws and state securities administrators have important roles to play in ensuring the efficiency and honesty of our capital markets. Nonetheless, in this case NASAA and the state administrators do themselves and the capital markets a disservice in this effort to eliminate the preemption over Rule 506 offerings.

The proponents of this change are subject to criticism both in the tactics they employ and, more importantly, in the law they propose.

As a matter of tactics, inserting this unrelated but important provision in Senator Dodd's bill of over 1,300 pages, a bill that is one of the most complex regulatory reform legislation in anyone's memory, ensures that this important provision will not receive adequate attention and a fair debate. This alone is a reason to remove the provision from the Bill.

More importantly, as described above, Section 926 is just bad regulatory law. It will impose on the capital formation process additional costs with no benefit in terms of material investor protection.

Small businesses – but even more importantly, our national economy – will be the losers if this Section is enacted into law.

EDITORIAL

By: Martin A. Hewitt
Alston & Bird LLP

Practitioners often find themselves at odds with regulators. While this relationship is often adversarial, it need not be. After all, the goals are the same if one steps back. Way back. (Ok, maybe way, way back!) The point is that, while there is a natural tension between investor protection and capital formation, the overarching goal is to provide the investor with a level of comfort upon which to make cogent investment decisions. To the extent investors lack such confidence, capital formation is all but impossible; therefore, the states continually stress their commitment to investor protection.

One question that is seldom asked is, from whom do investors need protection? While many, but certainly not all, states work under the assumption that investors must be protected from nefarious issuers, brokers and dealers from being sold nothing more than pieces of the clear blue sky, investors also need to be protected from that scariest of all creatures, themselves. While I don’t think anyone disputes that there are a minority of issuers, brokers, and dealers who believe their goal is to rob orphans and widows of their monetary resources, most issuers, et al, do their best to abide by myriad applicable laws at both the federal and state levels to encourage investment by well educated investors. By well educated, one should not be limited in scope to only institutions, but also, investors who have the requisite cognitive skills to appreciate the written word and ability to analyze a particular offering. Unfortunately, many investors hold the belief that all investments are basically

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riskless and, to the extent various regulators have approved such investments, they are of the opinion that such approval permits them to invest without penalty or risk of loss. Alan Parness writes above that when one invests in lottery drawings each week, with state mandate, that such investor has little expectation to reap any meaningful profit. (Statistically, I understand that purchasers have a much greater chance of being struck by lightning which, while not desirable, would certainly alleviate the need for future successful investments!)

I digress. The one question gnawing at me is, does an issuer do a disservice to its current investors if such issuer continues to seek approval from a particular state or territory long after an offering has gone effective? Or looking at it another way, can the expense incurred in such attempts (often times resulting in rather impressive legal fees) be perceived by the investors who ultimately pay such fees, as unreasonable in relation to the number of potential investors in such jurisdiction? This question may appear to be made tongue in cheek, but the issue is of no slight importance. As stated above, while we can all agree that the states have the right and, in such instances when they have the ability to review an offering, the duty to do so, there comes a point at which chasing after state approval becomes something of a fool’s errand. For instance, registration of securities at the state level is often quickly completed for all but a handful (or less) of states. Often times, an examiner’s questions devolve into what appear, to many practitioners and clients to be a mobius strip from which, once an issuer goes down that track, there is no turning back. Granted, the flip side of this question is from the regulator who asks “why can’t they just answer the question I keep asking over and over and over again?” While that frustration is understandable, the examiner must ask if the question even has an answer at the time it is asked. Further, some questions appear to issuers’ counsel to be nothing short of arbitrary and capricious. There is no doubt that the various NASAA Guidelines carry great weight, but as practitioners we have to contend with inconsistent and often times contradictory interpretations of such guidelines from one jurisdiction to the next.

Perhaps one answer is to have the investors of a particularly difficult state pay for registration fees directly. After all, there is no benefit to investors from other states and, more often than not, the cost of registration in certain recalcitrant states is far greater than for those jurisdictions which take a more practical approach. Now, by practical I do not mean that the various jurisdictions should not rigorously review a registration statement, but with some jurisdictions practitioners get the sense that state examiners believe they are in a game of “Where is Waldo.” They start with the assumption that there is something nefarious about an offering (a.k.a. Waldo) and it is their job to find him. What is particularly troubling about this viewpoint is that those issuers who are engaging in fraudulent practices are not taking the time to register their securities in any jurisdiction whatsoever.

The goal is to not only protect the investor but to also allow investors the opportunity to make prudent and financially sound investments. Part of the solution is that examiners need more than a checklist of what each offering must contain in its registration statement. There needs to be a practical application of statutes, rules, and regulations both within one jurisdiction and among various jurisdictions. Nothing is gained when an issuer expends time and money trying to register securities in a state which is, for the sake of protecting investors (from themselves as well as from truly fraudulent issuers) actively discouraging honest issuers from providing investors the opportunity to make intelligent decisions regarding the allocation of their assets. The bottom line is that no one should have a problem with vigorous review of securities offerings in the various jurisdictions in order (to the extent possible) to prevent fraud, but there needs to be a realization that the vast majority of issuers are not miscreants, but rather are entities legitimately trying to raise capital. We, both as practitioners and regulators, need to understand that there is a larger goal than just protecting investors or capital formation. The larger goal is to further the nascent economic recovery now under way. If investors are permitted (and one may question why investors need jurisdictional permission) by the various states and territories to make investments, then any resulting profits can then be put to use in such a manner as to help further stimulate the economy.
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