**EVENTS CALENDAR**

**NASAA 2012 FALL CONFERENCE**
The Committee and its Subcommittees will meet in Conjunction with the Annual Meeting of the North American Securities Administrators Association
San Diego, CA
Hotel Del Coronado
September 9-11, 2012

**ABA BUSINESS LAW MEETING**
The Committee and its Subcommittees will meet in Conjunction with the 2012 Fall Meeting of the ABA Business Law Section
Washington, DC
The Ritz-Carlton Hotel
November 16-17, 2012

**ABA BUSINESS LAW SPRING MEETING**
The Committee and its Subcommittees will meet in Conjunction with the 2013 Spring Meeting of the ABA Business Law Section
Washington, DC
Hilton Hotel
April 4-6, 2013

**IN THIS ISSUE**

**ALL IN THE FAMILY – THROUGH THE SEC’S EYES**

By: Shane B. Hansen – Committee Chair
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Federal and state securities laws require registration and regulation of any person meeting the definition of an “investment adviser” unless an exclusion or registration exemption is available. In 2010, the massive Dodd-Frank Wall Street Reform and Consumer Protection Act significantly amended the Investment Advisers Act of 1940 ("Advisers Act").
Congress repealed the private adviser registration exemption (no advertising with fewer than 15 clients in a 12-month period) in order to regulate various types of privately offered investment funds. Congress created an exclusion from that definition for a “family office” as defined by the Securities and Exchange Commission (“SEC”). Pursuant to that amendment, the SEC adopted Rule 202(a)(11)(G)-1 (the “Family Office Rule”) in Release No. IA-3220, 2011 SEC LEXIS 2123 (June 22, 2011). Responding to comments, the SEC made a number of adjustments from the proposing release, Release No. IA-3098, 2010 SEC LEXIS 3359 (October 12, 2010).

Section 203A(b)(1)(B) of the Advisers Act preempts state laws requiring the registration, licensing, or qualification of an investment adviser, or a supervised person of an investment adviser, with respect to any person excepted from the definition of under Section 202(a)(11). Therefore, satisfying the conditions in the SEC Family Office Rule exempts a family office from state-level regulation other than antifraud and related enforcement provisions.

**Overview**

A family office is excluded from the definition of “investment adviser” if its ownership, control, and clients satisfy all of the conditions in the SEC’s Family Office Rule. In order to qualify for the exclusion, a “family office” must:

1. Have no clients other than “family clients”;
2. Be wholly owned by “family clients”;
3. Be exclusively controlled, directly or indirectly, by one or more “family members” and/or “family entities”; and
4. Not hold itself out to the public as an investment adviser.

This exclusion from investment adviser registration and regulation covers the family office’s directors, partners, members, managers, trustees, and employees in so far as they are acting within the scope of their employment by the family office.

In order to accomplish Congressional public policy objectives, as well as accommodate the myriad ways families manage their wealth, the SEC’s defined terms quoted above contain a number of important exceptions and nuances. For example, the term “family clients” includes former family members, as well as family-related trusts, foundations, charities, and non-profit organizations, but only if those entities exclusively benefit or are exclusively funded by family members or family clients. Directors, executive officers, and certain employees providing investment-related services are defined as “key employees” of the family office, allowing these non-family members to be included among “family clients”. There are limited exceptions to the “wholly” owned and the “exclusively” controlled requirements related to key employees. Grandfathering provisions allow certain non-conforming investment advisory services and family office-advised investments to continue: some through March 31, 2012, some through December 31, 2013, and some indefinitely. The Advisers Act’s antifraud provisions do continue to apply to the grandfathered services and related activities.

With these notable exceptions, generally, a family office cannot, directly or indirectly, advise about or manage securities owned or contributed by non-family members. So-called multi-family offices will not satisfy the Family Office Rule’s conditions. Unless grandfathered, non-family members must seek investment advisory services from someone other than the family office if the exclusion’s conditions are to be satisfied. The SEC’s Family Office Rule is not characterized as a “safe harbor”, but it still cannot be violated. Either its conditions are satisfied or they are not. If not satisfied, the family office may be required to register as an “investment adviser” under federal or state securities laws unless a different exemption is available or an exclusion order is obtained from the SEC staff. Depending on the family office’s structure, another potential exemption might include the private fund adviser exemption in Section 203(m) of the Advisers Act or similar state exemptions.

Finally, there is a wide range of activities not regulated under the Advisers Act that are unaffected by the SEC’s Family Office Rule. For example, a family office may provide various types of professional and personal services not involving securities, such as accounting, tax, travel, security, or household services—and may provide those services to non-family members. A family office may advise about or manage various types of investments that do not involve securities. Typically, directly held investments in physical assets such as real estate or
collections of art, cars, or rare coins do not involve securities. However, when these assets are bought, sold, or held indirectly through investment vehicles such as limited partnerships, limited liability companies, or corporations, those ownership interests may be “securities” subject to federal and state securities laws, and managing those securities would likely be subject to investment adviser regulation.

**Key Definitions**

1. **“Family Member”**. The concept of a “family member” is central to the rule’s application. Under the rule a “family member” means the lineal descendants of a single common ancestor, which is arbitrarily limited by the rule to 10 generations from the youngest generation served by the family office. The family office may select any common ancestor, living or deceased. The common ancestor need not be the creator of the family’s wealth or the founder of the family office. Oddly, read literally, neither the common ancestor nor a spouse or “spousal equivalent” is defined to be a “family member” for purposes of the rule. Consequently, in order to include a family office founder and/or spouse/equivalent among the qualifying family members, it is necessary to select one of their parents as the common ancestor. The family office may change its designated ancestor from time to time. Because of the 10 generation limitation, however, changing the selection will affect the depth and breadth of the family tree that can be served by the family office. For example, advancing the designated ancestor by one generation includes one younger generation but cuts off the family lines extending from the former ancestor’s siblings. The SEC’s adopting release includes an exhibit graphically depicting the effect of the common ancestor’s selection.

For purposes of the rule, “family members” include not just lineal descendants of the designated ancestor, but also their spouses/equivalents, “adopted children, step-children, foster children, and minors for whom a family member is a legal guardian. These children and minors remain family members through adulthood. A “spousal equivalent” means a “cohabitant occupying a relationship generally equivalent to that of a spouse.”

The rule also addresses the effect of divorce and death upon the family tree. The rule defines a “former family member” as a spouse/equivalent, or stepchild that was a family member but is no longer a family member due to a divorce or other similar event”—once a family member, always a family member for purposes of the rule. This approach is predicated on the complexity of family wealth management through various investment vehicles. This avoids forcing investment divestitures when family members and spouses/equivalents split-up. Once divorced or separated, the former family member’s existing children remain family members but subsequently born children are not family members for purposes of the rule. Notably, in-laws or siblings of a non-family member spouse/equivalent are not included among family members for purposes of the rule and cannot be advised by a family office.

The estate of a family member, a former family member, a key employee, a former key employee, or a former key employee’s spouse/equivalent continues to be a permitted family client under by the rule, subject to certain limitations with respect to former key employees. However, it is important to note that recipients of estate distributions, trust distributions, and gifts, as well as changes in current beneficiaries and other involuntary transfers, to anyone outside of the family and its related interests cease to be covered by the family office exclusion. Consequently, the rule provides a transition period of up to one year following involuntary transfers allowing a non-family member recipient to retain a third-party investment adviser or, if necessary, divest the family office-advised investments. Continuing to advise, directly or indirectly a non-family member after this transition period ends results in disqualifying the family office from the rule’s exclusion.

Other key definitions in the rule turn on a qualifying family member’s ownership, control, or benefit from the family office’s investment advice or management services. These distinctions are drawn to differentiate family offices from investment advisers serving the general public for whom government regulation serves as an important investor protection.

2. **Family Client**. A family office must be wholly owned by—and may only provide investment advice and management services to—a “family client”. By design, this term is broader than just family members and encompasses a wide range of family-related entities and relationships. This allows broad latitude in structuring and implementing a family’s wealth management strategies within the
scope of a family office’s services. “Key employees” of the family office are also included, allowing them to receive investment advisory services, participate in family investment opportunities, and own a non-controlling interest in the family office. More specifically, a “family client” includes:

- Any family member and any former family member.
- Any non-profit organization, charitable foundation, charitable trust, or other charitable organization for which all of the funding came exclusively from one or more related family clients, including charitable lead trusts and charitable remainder trusts whose only current beneficiaries are other family clients and charitable or non-profit organizations.
- Any irrevocable trust in which one or more other family clients are the only current beneficiaries.
- Any irrevocable trust funded exclusively by one or more related family clients in which related family clients and non-profit organizations, charitable foundations, charitable trusts, or other charitable organizations are the only current beneficiaries.
- Any revocable trust of which one or more other family clients are the sole grantor(s).
- Any company wholly owned, directly or indirectly, exclusively by, and operated for the sole benefit of, one or more other family clients. As explained below, a “company” is broadly defined to include, among others, a pooled investment vehicle or private investment entity whose sole investors are family members or other family clients. The SEC removed the control limitation (but not the now redundant word “exclusively”), so for this purpose a company may have non-family member directors and officers. The SEC does not explain what “operating for the sole benefit” means if anything more than receiving profits and distributions.
- Any “key employee” of the family office and, subject to certain post-employment limitations explained below, any former key employee of the family office.
- Any key employee’s spouse/equivalent or their trusts as explained below.
- Any estate of a family member, former family member, key employee, or, subject to certain post-employment limitations, a former key employee.

As underscored above, the scope of a “family client” considers only current beneficiaries and ignores contingent or remainder beneficiaries. However, once distributions are made to contingent or remainder beneficiaries outside of the family and its related interests, those assets cannot be advised by the family office. Similarly, once distributions are made to non-profit organizations, foundations, or other charities that are also funded by non-family members, those assets and entities may not be served as family clients. These distinctions are predicated on allowing the family to manage its own assets, but not the assets owned or contributed by non-family members. The one-year post-distribution transition period only applies with respect to involuntary transfers, so gifting transactions may require pre-planning.

Recognizing that the old private adviser exemption was not predicated on family relationships, and desiring to avoid disrupting existing co-investing and related client relationships, Congress included a limited grandfathering exception in the amended law, which the SEC repeated in its rule—neither exemplifies a plain English drafting style. A family office that was exempt from investment adviser registration on January 1, 2010 (presumably relying upon the old private adviser exemption), may continue providing investment advice to:

- Individuals who, at the time of their investment, are officers, directors, or employees of the family office who (i) previously invested with the family office before January 1, 2010; and (ii) are “accredited investors” as defined in the SEC’s Regulation D.
- Any company owned exclusively and controlled by family members (which is included in the “family client” definition above but, as used here, apparently without regard to whom it benefits).
- Certain registered investment advisers to the extent they co-invest with the family office in
those opportunities they identify for the family office and under certain quantitative limitations.

Directors of the family office are included within the defined scope of a “key employee”, discussed below, but notably some officers and employees are not included. For those not included, the family office will need to rely upon the grandfathering provision that is limited by its two conditions above. The premise for this grandfathering provision was, apparently, to avoid disrupting historical co-investment patterns. The underscored language above creates potential ambiguity whether it is limited to old and new family office-advised investments or whether it would also permit advice to be rendered to separately managed accounts held by non-family officers, directors, or employees.

Notably, if a family office relies upon this grandfathering provision with respect to any non-family client, the exclusion from investment adviser regulation is not lost but the family office does become subject to the antifraud prohibitions in paragraphs (1), (2), and (4) of Section 206 of the Advisers Act, apparently with respect to all of its clients.

3. **Key Employee**. As noted above, “key employees” are among the persons identified as family clients, so these individuals may receive investment advice and advisory services from the family office. They may also own a non-controlling interest in the family office, such as might be granted through incentive or deferred compensation plans or arrangements. A “key employee” includes:

- Any natural person who is an “executive officer”, director, trustee, general partner, or person serving in a similar capacity of the family office or its “affiliated family office”.

- Any other employee of the family office or its “affiliated family office” who, in connection with his or her regular functions or duties, participates in the investment activities of the family office or “affiliated family office”. However, such employee must have been performing, for at least 12 months, functions and duties related to the investment activities, thus assuring a degree of knowledge and experience for the individual to protect his or her own interests.

As used above, the rule defines an “executive officer” as the “president, any vice president in charge of a principal business unit, division or function (such as administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions, for the family office.” This does not include executive officers of other companies (other than affiliated family offices), such as a portfolio company held for investment.

A key employee’s spouse/equivalent can also be a “family client” but only to the extent he or she holds a joint, community property, or other similar shared ownership interest with that key employee when the advice is given or the family office-advised investment is made. Also included is any trust for which both (i) a key employee (not necessarily the same one) is the trustee or authorized decision-maker; and (ii) each settlor or other person who has contributed assets to the trust is a key employee (including a current and/or former spouse/equivalent as noted above).

A former key employee of the family office may only continue to be included among family clients to the extent of previously made or contractually committed investments. Upon the end of employment, the former key employee may no longer receive investment advice from the family office, and may not invest additional assets with a family office-advised trust, foundation or entity except pursuant to pre-existing commitments. However, divestitures of previously made investments are not required unless and until an estate distribution is made to someone outside of the covered family. Accordingly, the family office’s advisory services may continue with respect to investments or contractual commitments made prior to the end of employment. The rule does not correlate the end of employment to any date associated with the adoption of the family office exemption; consequently, a key employee whose employment ended before the new rule’s adoption should still be eligible for treatment as a former key employee.

A “key employee” does not, however, include any non-executive officer who is not performing investment advisory functions. For example, it does not include officers or employees whose responsibilities are not related to the family office’s investment advisory services, such as accounting, tax planning and preparation, security, personal, or
household services. Moreover, it does not include any employee performing solely clerical, secretarial, or administrative functions even if those services are related to investment advisory activities. By virtue of this limitation, noninvestment-related and clerical, secretarial, or administrative employees are not within the scope of a “family client”. Consequently, generally speaking, these groups of family office employees may not own, receive any investment advisory services, or participate in the family’s investment opportunities unless covered by the grandfathering exception explained above.

4. “Family Entity.” One or more family members and/or family entities must “exclusively control” the family office. A “family entity” includes all of the family-related trusts, foundations, non-profit organizations, companies, estates, or other entities listed above as a “family client”, but explicitly excludes key employees (and their spouses/equivalents) and their related trusts. The term “family entity” is used in the rule to describe, and thereby limit, the scope of persons who are permitted to “exclusively control” the family office. The term “exclusively” was added by the SEC to clarify that “control” cannot be shared with individuals or companies that are not family members or family entities. This limitation prevents one family office from serving one or more unrelated families—sometimes described as multi-family offices. The “exclusively” qualification to “control” raises questions about non-family members serving as directors and officers; however, this apparent issue is addressed by another definition and an SEC staff interpretation.

As defined in the rule “control” means “the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of being an officer of such company.” Commonly, officers do exercise a “controlling influence” in performing their duties so this special carve-out permits a family office to employ non-family members as officers. This carve-out does not, however, address whether non-family member may serve as directors of the family office.

In January 2012, the SEC staff posted on its website various interpretive questions and responses to provide additional guidance about its rule. (See Staff Responses to Questions About the Family Office Rule at http://sec.gov/divisions/investment/guidance/-familyofficefaq.htm (Updated January 19, 2012). The staff’s Q&A does not provide any analysis or explanation, but does specifically address the treatment of non-family member directors. In Question I.1, the SEC staff asks and answers:

Q: A family office has a board of directors with seven directors, of which four are family members and three are non-family members. Under the governing documents of the family office, each director has an equal voting power and no minority veto power. Does this satisfy the standard . . . that a family office must be “exclusively controlled” by family members and/or family entities?

A: Yes, assuming there are no special shareholders agreements or other arrangements that would give someone that is neither a family member nor a family entity control over the management or policies of the family office.

Consequently, notwithstanding the explicitly stated “exclusivity” qualifier in the rule that is intended to prevent any sharing of control, according to the SEC staff it is apparently permissible for the family office’s board to include a minority of non-family members—even sharing voting rights—so long as non-family members cannot block a majority of the family members’ decisions. The staff’s position seems to contradict the rule’s explicit language but it is an important accommodation permitting many existing management structures to continue.

5. “Company.” The term “company” is used throughout the rule to describe not just the family office itself but also various types of family-related interests. As defined in the Advisers Act, a “company” means, among other things, a corporation, a partnership, an association, a joint-stock company, a trust, or any organized group of persons, whether or not incorporated.” While not explicitly identified, “company” has been broadly interpreted to include limited liability companies and other types of legal entities. Consequently, the term includes various types of pooled investment vehicles commonly used in family wealth management and estate planning. The term is not limited to business or other operating entities.

6. Affiliated Family Office. The Family Office Rule defines—but the SEC’s adopting release does not explain—the possibility of more than one family office serving different branches of the same family.
Under the rule an “affiliated family office” is one that is “wholly owned by family clients of another family office and that is controlled (directly or indirectly) by one or more family members of such other family office and/or family entities affiliated with such other family office and has no clients other than family clients of such other family office.” The term “affiliated family office” is only used by the rule in the context of defining “key employees” described above. The mind-bending definition’s scope is not entirely clear and may have been grafted into the final rule to address a specific situation.

**Conclusion**

In many ways, the SEC’s Family Office Rule is deceptively simple. The four basic conditions, enumerated above, appear to be straightforward. There are, however, plenty of bedeviling details in the application of the rule’s operative definitions. Those definitions will be fertile ground for no-action letters and, hopefully, more FAQ. As an aside, the SEC staff is to be commended for publishing guidance through its web-based FAQ. Those FAQ can be logically organized and are more easily found than an accumulation of fact-specific no-action letters. Stay tuned for further developments.

THE CURMUDGEON’S CORNER – SOME FURTHER THOUGHTS ON RULE 506 OFFERINGS

By: Alan M. Parness
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This issue’s column provides updates on issues pertaining to the ever-popular Rule 506 offerings and investment advisers.

A. Wassup with the “EFD”?

I had hoped that my most recent critical comments in the December 2011 issue of the Bugle would have lit a fire under the collective derrieres of our friends at the North American Securities Administrators Association (“NASAA”), and would have finally gotten NASAA’s long-awaited and -promised “one-stop filing system” (which has been assigned the acronym “EFD,” for “Electronic Filing of Form D”) for notice filings of offerings complying with Rule 506 (“Rule 506”) of Regulation D (“Regulation D”) promulgated by the U.S. Securities and Exchange Commission (the “SEC”) under the Securities Act of 1933, as amended (the “Securities Act”), off the ground. Considering that Willie Neumann, NASAA’s outside consultant on the EFD project, took umbrage at my prior criticism of the glacial pace of the EFD project at the NASAA Annual Meeting last September, I was hoping that my last column would have spurred Neumann et al to at least announce the launch of the promised “Beta” testing of the EFD. A search of the NASAA website on August 20, 2012, however, turned up nothing new (and, frankly, no mention at all!) about the EFD, and an attempt on the same date to access the website “http://efd.nasaa.org/,” a site purportedly set up by NASAA for information about the EFD, once again turned up a blank page.

Having heard from others in the Blue Sky community that Neumann was no longer on the EFD project (although it was unclear whether his departure was voluntary or involuntary) and that the EFD was officially dead, like a good reporter, I decided to go directly to Heath Abshure, the Arkansas Securities Commissioner and Chair of NASAA’s “Regulation D Electronic Filing Committee,” which is in charge of the EFD project, to check on its current status. Here’s Mr. Abshure’s verbatim response to my inquiry:

“NoMr. Neumann is no longer NASAA’s program manager for the development of the Form D filing system, it does not mean that the project ‘is no longer moving forward.’ Late last year, the developer with whom NASAA contracted to build the system unilaterally terminated the development contract after informing NASAA that it would not honor its contractual obligations. NASAA is in the process of selecting a new vendor and, in fact, is meeting with candidates at the end of this month. Once a vendor is selected and a new contract is signed we expect the project to be complete in 6-8 months.”

The foregoing was reiterated at the NASAA Ombudsman’s Meeting at NASAA’s Annual Public Policy Conference in Washington, D.C. on May 7, 2012. As readers may recall from my past Bugle columns discussing the sorry history of the EFD, it’s now been: (1) over five years since the SEC first proposed the electronic filing of Form Ds through the
EDGAR system in SEC Release No. 33-8814 (June 29, 2007); (2) over four years since the SEC adopted the final rules for the electronic filing of Form Ds in SEC Release No. 33-8891 (Feb. 6, 2008); and (3) over two years since NASAA entered into a Memorandum of Understanding with the SEC on April 5, 2010 concerning the creation and operation of the EFD. Considering that chronology, I’m not overly optimistic that the EFD will see the light of day this year (if ever), and I’m wondering whether the seemingly interminable delays mean that the EFD is simply a victim of the general antipathy of NASAA members towards Rule 506 offerings and perhaps a feeling among the state regulators that the EFD will only make things too easy for issuers relying on the Rule 506 exemption and its preemptive effect on Blue Sky laws.

I also find it ironic that in an October 21, 2011 letter from Jack Herstein, President of NASAA, to the leaders of the House Financial Services Committee, reprinted at NASAA Reports (CCH) ¶ 13,264, in which NASAA raised objections to provisions of H.R. 2930, the proposed “Entrepreneur Access to Capital Act,” as regards that bill’s deregulation of so-called “crowdfunding” offerings, NASAA also announced that it had voted to establish a special “Small Business Capital Formation Committee” which would “examine and propose steps that may be taken collectively by state securities regulators to promote and facilitate the formation of small business capital.” Query whether making the Form D filing process as cumbersome and expensive as possible for small and new businesses by the prolonged delay in bringing the EFD to fruition is among the “steps” that NASAA is proposing?

B. SEC Rules Affecting Rule 506 Offerings

As most of our Committee members know, the SEC was supposed to adopt, by July 21, 2011, amendments to Rules 501(a)(5) and 506 of Regulation D, as mandated by Sections 413(a) and 926 of the “Dodd-Frank Wall Street Reform and Consumer Protection Act,” Pub. L. No. 111-203 (the “DFA”). These provisions required the SEC to: (a) adjust the over $1,000,000 minimum net worth standard for natural person accredited investors in any SEC rules under the Securities Act (such standard also appears in Rule 215(e) under the Securities Act, promulgated under Securities Act § 2(a)(15)), so that the value of the primary residence of such an investor would have to be excluded from the investor’s net worth; and (b) create certain “bad actor” disqualifications from use of Rule 506.


As regards the “bad actor” disqualification, while the SEC proposed amendments to Rule 506 to add such a provision in Release No. 33-9211 (May 25, 2011), reprinted at 76 Fed. Reg. 31518 (June 1, 2011), that proposal was still pending as of August 20, 2012, and engendered a host of comment letters, including one which our Committee submitted jointly with other ABA committees. See, http://www.sec.gov/comments/s7-21-11/s72111.shtml. While the SEC’s most recent “Regulatory Flexibility Agenda,” Release No. 33-9260 (Sept. 16, 2011), reprinted at 77 Fed. Reg. 8082 (Feb. 13, 2012), lists this rule proposal as being in the “final rule stage,” with final action anticipated this past December, the last I heard about the proposal was that the SEC staff was working through the comment letters they received in response to Release No. 33-9211 and was preparing recommendations for the Commission; one of the major issues to be resolved involves the retroactive application of the “bad actor” disqualification provisions.

C. Title II of The JOBS Act – Effect on Rule 506 Offerings and a Cautionary Note

Public Law 112-106, the “Jumpstart Our Business Startups Act” (the “JOBS Act”), was signed into law on April 5, 2012 (see, http://www.gpo.gov/fdsys/pkg/PLAW-112publ106/pdf/PLAW-112publ106.pdf). Title II of the JOBS Act, consisting solely of Section 201, and titled the “Access to Capital for Job Creators Act,” incorporates and supplants H.R. 2940, which I
discussed in my column in the December 2011 issue of the Bugle. As enacted, Section 201(a)(1) of the JOBS Act requires the SEC to amend Rule 506 within 90 days of enactment (i.e., by July 4, 2012) to provide that the prohibition on general solicitation and general advertising in Rule 502(c) of Regulation D shall not apply if all purchasers of the securities are accredited investors, with a requirement that the issuer take “reasonable steps to verify” that such purchasers are accredited, using methods determined by the SEC, and Rule 506 will continue to be treated as a regulation issued under Securities Act § 4(2). So as to reinforce the point that amended Rule 506 will conform to Section 4(2), Section 201(b) of the JOBS Act amends Securities Act § 4 to add a new paragraph (b), stating that offers and sales exempt under Rule 506 “shall not be deemed public offerings under the Federal securities laws as a result of any general advertising or general solicitation.”

Unfortunately, the SEC missed the July 4 rulemaking deadline, and it’s unclear as to when any such rules will be proposed, let alone adopted. In this regard, it is noted that the ABA, NASAA, and a host of others have submitted pre-proposal comments to the SEC concerning rulemaking under JOBS Act § 201. See, http://www.sec.gov/comments/jobs-title-ii/jobs-title-ii.shtml. In particular, the critical comments from NASAA and others focused on the “reasonable steps to verify” language in Section 201(a)(1), asserting that issuers would have to do more than merely rely on representations from investors as to their “accredited” status.

Assuming that the SEC ultimately establishes reasonable conditions for verification of the “accredited investor” status of purchasers, Rule 506 issuers willing and able to abide by those conditions and restricting sales to accredited investors may look forward to being freed from the constraints of Rule 502(c) of Regulation D, and proceed to open up their websites or otherwise publicly advertise or promote their offerings (I would assume that any generally-available solicitation or advertising materials will have to indicate that sales are restricted to “accredited investors”). However, such issuers must be aware that Title II of the JOBS Act has no effect on Blue Sky laws (except insofar that offerings complying with amended Rule 506 will continue to be treated as “covered securities” within the meaning of Securities Act § 18(b)(4)(D)). Therefore, an issuer which would rather rely (or which has previously relied) on a self-executing or otherwise less-onerous de minimis or other exemption in a particular state, in lieu of effecting a Rule 506 notice filing, may discover that such an exemption will not (or will no longer) be available if it engages in general solicitation or general advertising in that state. Thus, in the case of states enacting a version of the 2002 Uniform Securities Act (the “2002 USA”), while 2002 USA § 202(14) provides a self-executing exempt transaction for an offer and sale by an issuer to not more than 25 purchasers in the state during any 12 consecutive months, one of the conditions of that exemption is that “a general solicitation or general advertising is not made in connection with the offer to sell or sale of the securities.”

By way of actual examples where reliance on amended Rule 506 may prove problematic, see: (1) Section 59.035(5) of the Oregon Securities Law (the “OSL”) and Rule 441-35-010 thereunder, 3 Blue Sky L. Rep. (CCH) ¶¶ 47,104 and 47,553, which provides a self-executing exemption for offers and sales to any accredited investor (including natural persons), “but only if there is no public advertising or general solicitation in connection with the transaction”; and (2) OSL § 59.035(12), 3 Blue Sky L. Rep. (CCH) ¶ 47,104, which provides another self-executing exemption for an offering resulting in not more than 10 purchasers in Oregon (other than certain institutional investors) during any 12 months, provided that, among other conditions, “no public advertising or general solicitation is used in connection with any transaction under this exemption.” Thus, while a Rule 506 issuer may currently be able to rely on either of those exemptions and avoid making a covered securities notice filing (and a $250 filing fee) under OSL § 59.049(3) and Rule 441-49-1051 thereunder, 3 Blue Sky L. Rep. (CCH) ¶¶ 47,105AA and 47,556Q, if that issuer were to engage in general solicitation or general advertising as permitted by amended Rule 506, it appears that it would have no choice but to make a notice filing.

Knowledgeable Blue Sky practitioners have counseled Rule 506 issuers to take advantage of self-executing exemptions under state laws and rules where available and practical (i.e., in the case of a continuing offering, it probably isn’t advisable to rely on a de minimis exemption where there is a possibility that the issuer may exceed the applicable numerical limit on offerees or purchasers in the exemption), in lieu of effecting a notice filing, particularly if the issuer might otherwise face
sanctions for a late notice filing in the particular state (see Part D of this column in that regard). With the advent of amended Rule 506, however, practitioners will have to reconsider whether these alternative exemptions will remain available to an issuer taking advantage of the general solicitation/general advertising option. If some practitioners think that states may amend these exemptions to remove or revise prohibitions on general solicitation or general advertising in conformity with amended Rule 506, I believe that it is doubtful that NASAA would encourage states to take such action. See, in this regard, the comments by Jack E. Herstein, President of NASAA, in a September 27, 2011 letter to certain House members, reprinted at NASAA Reports (CCH) ¶ 13,263, in which, among comments on other pending legislation, he expressed NASAA’s opposition to “The Access to Capital for Job Creators Act of 2011” (H.R. 2940), an earlier version of Title II of the JOBS Act, on the basis that removing the prohibition on general solicitation for Rule 506 offerings “would exacerbate the regulatory black-hole created in 1996, when Congress passed the National Securities Markets Improvement Act (NSMIA) and stripped the states of their authority to fully regulate in this area.”

Accordingly, with the advent of general solicitation or general advertising for Rule 506 offerings, I expect that Rule 506 issuers will be making more state notice filings, in lieu of relying on self-executing exemptions, and those issuers will have to become attuned to the need to make timely notice filings to avoid sanctions. Thankfuly, to the best of my knowledge, none of the so-called “institutional investor exemptions” from securities registration in Blue Sky laws, such as 2002 USA § 202(13), prohibits general solicitation or general advertising, so that a Rule 506 issuer engaging in permitted general solicitation or general advertising and which is willing and able to restrict sales in certain states to the types of investors specified in such exemptions (assuming all such investors are also accredited) may continue to rely on such exemptions and avoid notice filings. In that case, however, it is recommended that generally-available solicitation or advertising materials clearly indicate that the securities are being offered and sold in certain states solely to certain types of institutional investors which are also “accredited investors.”

D. States’ Continuing Harassment of Rule 506 Issuers

I’d like to offer special thanks to Committee member and our California state liaison, Keith Bishop, for the January 18, 2012 posting in his “California Corporate & Securities Law Blog,” “Enforcing Form D Filings – A Misguided State Policy” (see, http://calcorporatelaw.com/2012/01/enforcing-form-d-filings-a-misguided-state-policy/). [First, however, a shameless plug for Keith: if you’re not already a subscriber to his Blog, you should be, since not only does Keith provide timely information about developments in California securities and corporate law (as well as developments at the SEC and in Nevada corporate law), but his postings are always literate (who else regularly includes extended quotes in Latin or Greek in a legal blog, and I’m not talking res ipsa loquitur or spanakopita?) and oftentimes amusing – see “Newsletter” on the home page at http://calcorporatelaw.com/ to subscribe.] In any event, Keith cited my column in the December 2011 issue of the Bugle, in which I questioned the statistics in NASAA’s 2010 Enforcement Report concerning Rule 506 offerings, and then he went on to criticize the states for misusing enforcement resources to pursue Rule 506 issuers for late notice filings as “a form of low hanging enforcement fruit.”

While I recognize that many, if not most, Blue Sky laws authorize the administrator to impose administrative sanctions on, or bring civil actions in court, against persons who violate any provision of the statute or any rule adopted or order issued thereunder (see, e.g., 2002 USA §§ 603 and 604), as I pointed out in my last column, it is questionable whether such actions are permissible under NSMIA in the case of a late notice filing, since Securities Act § 18(c)(3) would appear to provide the sole remedy premised on a failure to comply with a state’s notice filing requirement – a suspension of the offering until a proper filing is effected. Nevertheless, I continue to receive reports from Committee members that more and more states are insisting on receiving information concerning the “date of first sale” in the particular state which triggered the notice filing (notwithstanding that, in most cases, neither the state’s statute, nor any rule or order thereunder, requires an issuer to provide such information), and then using that information as a pretext to sanction the issuer with a monetary penalty and/or some form of administrative order, premised solely on the late filing (and some states have even asserted the legally-
spurious position that a late filer has lost the use of the Rule 506 exemption, notwithstanding the fact that there is no basis for that position under Regulation D and courts have held to the contrary).

From my experience, these late filings are more often than not the product of an oversight or a misunderstanding on the part of the issuer, and not a deliberate attempt to evade the filing requirement. For example, the issuer may have erroneously advised its counsel that a sale took place in the state where an entity-investor was organized, rather than the state where the investor’s office was located and the offering was actually effected, or the issuer may have erroneously concluded that the investor qualified under a self-executing “institutional investor” or some other exemption and that a notice filing therefore wasn’t required, but counsel subsequently determined otherwise. Nevertheless, and notwithstanding the absence of any allegations of fraud or complaints by local investors, some states persist in treating these filings as “cash cows” to fatten their coffers at the expense of issuers (which expense, of course, ultimately comes out of investors’ pockets), and boost their enforcement records, as I suspect is the case with many of the proceedings against Rule 506 issuers reflected in the NASAA Enforcement Report.

While there are some states which seem to have simply resolved this quandary by imposing minimal penalty fees for late filings (e.g., Iowa charges $100 for an on-time filing, or $250 for a late filing), some other state penalties are clearly disproportionate to the fee charged for an on-time filing. Thus, for example, Kansas charges $250 for an on-time filing, or the greater of $500 or 0.1% of the amount sold in Kansas, up to a maximum of $5,000, for a late filing, while Maine charges $300 or a late fee of $800. Is there any justification for Kansas charging 200% (or possibly 2,000%) of the normal fee, or Maine charging 267% of the normal fee, for a filing received one day late? Even more egregious is Mississippi, which charges $300 for an on-time filing, but imposes an additional late fee of 0.1% of the amount sold in the state, up to $5,000.

Without conceding that any such sanctions are actually permissible under NSMIA, it is submitted that these monetary penalties are totally disproportionate to the violation, particularly when one considers the fact that it should take a state examiner mere minutes to review one of these filings, whether or not it’s timely (in fact, if one were to consider the amount of time most state examiners probably spend reviewing each of these filings, the fees charged by most states even for an on-time filing probably exceed my own exorbitant hourly billing rate).

As I’ve said repeatedly in the past, I certainly don’t have any problems with states pursuing issuers who effect fraudulent Rule 506 offerings, or who negligently or deliberately violate one or more of the fundamental terms of Rule 506, such as engaging in general advertising or general solicitation (at least under the current version of the Rule), so as to void any claim of NSMIA preemption. However, there’s no justification for states to dedicate scant staff and other resources to sanction an issuer solely for effecting a late notice filing; those states which have been engaged in or which may be contemplating this practice reveal themselves to be nothing more than a taxing entity, since such a “violation” has nothing to do with investor protection, but is solely a revenue generator for the state.

E. State Investment Adviser Regulation Post-Dodd-Frank

My articles in the December 2010, April 2011 and September 2011 issues of the Bugle went into extensive detail on investment adviser regulation under federal and state law resulting from the amendments to the Investment Advisers Act of 1940 (the “Advisers Act”) by the DFA. However, while NASAA and some individual states have made an effort to smooth the way for SEC-registered advisers who were forced to make the “switch” from federal to state registration and regulation by June 28, 2012 by reason of the DFA amendments (see, http://www.nasaa.org/1719/ia-switch-resource-center/), or who no longer qualify for SEC registration, there remain many unresolved issues which such advisers must face. I suspect that many advisers who made the switch were, or who register with one or more states in the future will be, surprised as to the lack of uniformity among the states in a number of respects and differences from the regulatory scheme under the Advisers Act and the SEC’s rules thereunder.

First of all, the application process in many states entails direct submission of additional documents and forms, in addition to the standard Form ADV filed electronically via the Investment Adviser
Registration Depository (“IARD”). Thus, for example, in Connecticut, an adviser must submit originals or copies of: (i) a “Connecticut Supplement” to Form ADV, (ii) its financial statements with a “Registrant’s Certificate,” (iii) its standard form of advisory agreement, (iv) any advertising and sales literature which may be distributed to clients and prospective clients, (v) a “Form DBA-1” (relating to a trade or assumed name), (vi) any disclosure document furnished to clients in lieu of Part 2 of Form ADV, and (vii) “employer consent letters” for multiple registration of “investment adviser agents.”

In addition, state applicants must submit documentation to register one or more individuals associated with the adviser as “investment adviser representatives” (principally a Form U-4 for each individual, filed electronically via the IARD). By way of contrast, while Advisers Act § 203A(b)(1)(A) and SEC Rule 203A-3 thereunder govern when an associated person of an SEC-registered adviser may be subject to state registration as an “investment adviser representative,” and such registration may be required only when the associated person has a “place of business” in the state, individual state laws will govern who must register as an investment adviser representative of a state-registered adviser (and this may cover a broader group of individuals associated with the adviser than under the SEC’s rule), and the registration requirement will generally apply, regardless of whether the “representative” has a place of business in the state.

Second, as I have pointed out before, pursuant to Advisers Act § 222(b) and (c), a state may not enforce any books and records, net capital or bonding requirement on an adviser in addition to, or higher than, any such requirement under the law of the state in which the adviser maintains its principal office and place of business (as those terms are defined in SEC Advisers Act Rule 222-1), provided that the adviser is registered in that state and is in compliance with the applicable requirement of that state. However, other than such limited preemption, all bets are off when it comes to other substantive requirements that a state may choose to impose on registered advisers, so that an adviser registered in multiple states may be subject to multiple provisions governing such matters as custody requirements and limits on performance fees.

As regards performance fees, while a number of states have statutory provisions or rules which permit an adviser to charge the same performance fees as may be permitted to SEC-registered advisers under Advisers Act § 205(a)(1), (b), (c) or (e) and any SEC rule (in particular, Rule 205-3) thereunder (see, e.g., Section 36b-5(d) of the Connecticut Securities Law, 1A Blue Sky Rep. (CCH) ¶ 14,104), other states have no such provision (see, e.g., Delaware Securities Act § 73-305(c)(1) and (d), 1A Blue Sky L. Rep. (CCH) ¶ 15,131, which doesn’t even authorize the Commissioner to adopt a rule or issue an order permitting different fees than those allowed by the statute). There are also a number of states which haven’t incorporated the federal limits by reference, but rather enacted a statutory provision or adopted a rule modeled on an earlier version of Advisers Act § 205 or Rule 205-3 (note that the SEC’s authority to create the Rule 205-3 exemption was added as Advisers Act § 205(e) in 1996), so that an adviser registered in one of those states may actually be paid a performance fee on different or, in certain cases, less-stringent terms than presently allowable under the SEC rule (see, e.g., North Carolina Investment Advisers Act § 78C-8(c)(1), (d) and (f) and Rule .1805 thereunder, 2A Blue Sky L. Rep. (CCH) ¶¶ 43,183 and 43,497C). Until these states update their laws or rules to conform to the current version of Advisers Act § 205 and the rules thereunder, advisers registered in those states must abide by their outdated requirements, which may require a change in the fee arrangements with clients in those states to the extent they conflict with the federal standards which the adviser previously abided by.

Finally, one unresolved issue is a jurisdictional one. Thus, most Blue Sky laws apply not only to an adviser’s dealings with clients in the particular state, but to its dealings with clients outside the state when the advice is rendered from the state. See, in this regard, 2002 USA Securities § 610(f), whereby 2002 USA § 502, which, among other things, authorizes adoption of rules specifying the contents of investment advisory contracts, will “apply to a person if the person engages in an act, practice, or course of business instrumental in effecting prohibited or actionable conduct in this State, whether or not either party is then present in this State.”

In light of a statutory provision of this nature, would a state insist that its regulatory scheme must apply to an adviser with a place of business in the state when its advisory arrangements with clients in other states
are managed out of its local office, regardless of conflicts with the requirements of those other states? Thus, would an adviser with its sole place of business in Delaware, which, as noted above, has strict limits on performance fees, be prohibited from charging performance fees to a client in Connecticut to the extent permitted by Connecticut law, which fully coordinates with SEC Rule 205-3? In this regard, it is noted that even if the securities administrator of the state where the adviser’s office is located doesn’t object to the adviser’s arrangements with its clients in other states, query whether those clients could seek recourse under the law of the adviser’s home state to the extent the arrangements conflict with that law? By analogy, there have been cases where an investor in state A has been able to seek rescission of a securities purchase from a seller in state B, where the securities were registered in state A, but not in state B, and there was no exemption in state B’s law comparable to 2002 USA § 202(20). I can see this issue as a bit of a ticking time bomb for state-registered advisers, and particularly for SEC-registered advisers making the “switch.”

BLUE SKY BITS AND PIECES

By: Ellen Lieberman
Debevoise & Plimpton LLP

The North American Securities Administrators Association (NASAA) has named Joseph Brady to fill the position of general counsel. Former NASAA General Counsel Rex Staples is taking on the new position of director of investigations for the Certified Financial Planner Board of Standards Inc. Previously he served as a branch chief for enforcement and compliance in the Washington State Securities Division. He received his law degree from Gonzaga University and bachelor’s degree from the University of Washington.

Heath Abshure, the Securities Commissioner for the Arkansas Securities Department, has been named Preston DuFauchard. Abshure also serves as chair of a new NASAA Small Business Capital Formation Committee, and as chair of NASAA’s Corporation Finance Section.

NASAA announced on June 12, 2012 that Craig Goettsch was elected Vice Chair of the SEC Investor Advisory Committee. He is Securities Counsel and Director of Investor Education and Consumer Outreach for the Iowa Insurance Division’s Bureau of Securities., a former NASAA President, Board member and Treasurer. The Committee is to advise the SEC on regulatory priorities, the regulation of securities products, trading strategies, fee structures, the effectiveness of disclosure, and on initiatives to protect investor interests, promote investor confidence and the integrity of the securities marketplace. It was established as required by Section 911 of the Dodd-Frank Act.

Governor Jerry Brown named Jan Lynn Owen as new California Commissioner of Corporations in December 2011 (replacing Preston DuFauchard). The appointment requires state Senate confirmation within one year. She was chief consultant to the Senate Banking Committee in the California Legislature from 1992 to 1995, a deputy commissioner at the Department of Financial Institutions under former Governor Gray Davis from 1996 to 1999 and acting commissioner from 1999 to 2000. She served as executive director of the California Mortgage Bankers Association from 2000 to 2002, and state director of government and industry affairs at Washington Mutual from 2002 until its collapse in 2008 and take over by JP Morgan Chase, where Owen remained as vice president of government affairs until 2009. From 2009 to 2010 she was a strategic initiatives manager at Apple Inc and 2010 through 2011 the principal at The Jan Owen Group.

Governor Jerry Brown also appointed John R. Hanna as General Counsel of the Department of Corporations. He was a partner at Hanna and Scott since 2004, and an attorney at Horton Barbaro and Reilly from 1980 to 2004. He has also served as a Trustee of the Rancho Santiago Community College District., a member of the City of Santa Ana Planning Commission, the City of Santa Ana Personnel Board, and the Board of Directors of the Consolidated Transportation Service agency of Orange County. Hanna received his JD degree from Loyola Law School.

Gregory C. Strong has been appointed Delaware Securities Commissioner.

The Pennsylvania State Senate has confirmed the appointment of Vincent J. Gastgeb as a member of the Pennsylvania Securities Commission.. He joins Bob Lam, chairman, and Steve Irwin.
Pamela P. Epting was named Florida's new Director, Division of Securities in February 2012. She had served as interim Director of the Division and as Bureau Chief of the Division of Securities Bureau of Regulatory Review. Earlier this year, Robert Kynoch replaced Bill Reilly as Bureau Chief of the Florida Division of Securities Bureau of Securities Regulation.

Congratulations to Committee member Deborah Schwager Froling in the Washington, D.C. office of Arent Fox LLP, who has been named President-Elect of the National Association of Women Lawyers. She also serves as our Committee’s Director to the Meetings Committee of the ABA Business Law Section and co-Chair of the Committee’s Securities Registration Subcommittee.

Della P. Richardson left her securities law practice at Carter Ledyard & Milburn LLP and has joined the legal and compliance team at TPG Capital, a global private investment firm. She served as the Committee’s point person to the Committee on Diversity of the ABA Business Law Section.

Gary M. Emmanuel joined the Corporate and Securities Group of Sichenzia Ross Friedman Ference LLP in 2011 in New York City. His practice focuses on securities, corporate finance, mergers and acquisitions and general corporate law. He graduated from Queen Mary College, University of London, with honors in English and European Law and has a master’s degree in law from the Benjamin N. Cardozo School of Law where he was awarded the Dean’s Award for Excellent Academic Performance. He is admitted to practice in New York and in Israel and currently serves as the Committee’s Representative on Regulation D Electronic Filing Issues.

Alan Baden, a past Chair of this Committee, has transferred from Vinson & Elkins' New York office back to its Houston office where he continues his practice in securities law.

Robert Colby will join FINRA as general counsel. Colby has been a partner at Davis Polk & Wardwell’s Washington, D.C. office since 2009 and, before that, was at the SEC where he served as a staff attorney since 1981 and then deputy director of the Trading and Markets Division from 1993 to 2009. He also served as an adjunct professor at Georgetown University Law Center. Colby will succeed Grant Callery who will retire October 1, having been at FINRA (then the NASD) since 1979. Marc Menchel, FINRA’s general counsel for regulation, will be leaving June 1 for private practice.

Robert E. Plaze has retired as Deputy Director of the SEC Division of Investment Management, after serving at the SEC for almost 30 years. He previously received the SEC's Distinguished Service Award, and twice its Law and Policy Award. A graduate of Georgetown University and Georgetown University Law Center, he played a key role in creating the regulatory regime for investment advisers and investment companies.

The SEC has named John J. Cross III as Director of its new Municipal Securities Office created under the Dodd-Frank Wall Street Reform and Consumer Protection Act. He has served as Associate Tax Legislative Counsel in the Office of Tax Policy at the U.S. Treasury Department, as a partner at national municipal bond specialty law firm Hawkins Delafield & Wood LLP, and as counsel at the Internal Revenue Service in the Financial Institutions and Products division. He was a board member of the National Association of Bond Lawyers and of the editorial board for Municipal Finance Journal. He is married to Meredith Cross, Director of the SEC’s Division of Corporation Finance.

We sadly report the death James Snell whom many of us have worked with at the Illinois Securities Department, most recently in Registrations and Exemptions.

THE SWITCH

By: JEFF BUSH
Indiana Chief Deputy Securities Commissioner

Of all the sections of 2010’s Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”)
1, one area that did not see much contentious debate was the “switch” of mid-size investment advisers from Securities and Exchange Commission (“SEC”) registration to the states. With a number of firms undergoing the switch, the states have provided multiple resources and have otherwise taken steps to make the switch an easy and efficient process for the firms involved.

1 Pub. L. 111-203
Until the mid-1990’s, all investment advisers were required to register with both the SEC and with any state that required registration. In 1996, Congress passed the National Securities Markets Improvement Act\(^2\), which divided the previously dual regulation model of investment advisers into SEC registered and state registered. Those firms registered with the SEC were required to submit a “notice filing” to the states in which they were formerly registered. The line between SEC and state registration was drawn using each firm’s assets under management (“AUM”), which is the amount of funds that an investment adviser manages on behalf of all clients. Those with AUM over $25 million were to be registered with the SEC. Those with AUM under $25 million registered with the states. With registration came the ability for prospective, random examinations, and while states can investigate federally covered investment advisers if they have cause, random examinations without cause are prohibited.

Recognizing that most states were positioned to assume a larger workload, Congress through Dodd-Frank adjusted the AUM break point from $25 million to $100 million. States will now have full regulatory authority, including the ability to examine without cause, over investment advisers with AUM of $100 million or less, with a few exceptions. Congress also provided that when an investment adviser is required to register with more than 15 states, it may opt to register with the SEC. Those with AUM under $25 million registered with the states. With registration came the ability for prospective, random examinations, and while states can investigate federally covered investment advisers if they have cause, random examinations without cause are prohibited.

As a result of this legislation, most investment advisers with AUM between $25 and $100 million will switch from SEC to state registration. The SEC set out deadlines through which each investment adviser would determine whether it should switch to the states or remain with the SEC. By March 31, 2012, each firm was to determine its current AUM and update its Form ADV filed on the Investment Adviser Registration Depository. By June 28, 2012, each firm had to withdraw or reaffirm its registration with the SEC. Individual states may have different registration timelines for switch firms, and investment advisers are encouraged to contact the states in which they must be registered.

Even though investment advisers switching from SEC to state registration and vice versa is nothing new, due to fluctuations in a firm’s AUM, states have taken steps to make the switch process as easy and efficient as possible. The North American Securities Administrators Association (“NASAA”) has created a website of information entitled the “Switch Resource Center.”\(^5\) The Switch Resource Center includes links to each state’s specific registration requirements and contact information for any questions. The website also provides information on presentations and conferences given by the individual states to those switching to state regulation. These presentations describe the registration process and inform firms regarding what the states expect to see in an examination. The goal of states has been to make the transition as seamless as possible and also to take the mystery out of compliance.

Another area in which the states are assisting the switching firms is the coordinated review process, which was extended through April 30, 2012. Coordinated review is a process to assist investment advisers registering in more than 3 but fewer than 15 states. A firm requesting coordinated review can fill out a form available on the NASAA website and submit all materials to the states with which it is registering. The states will then discuss the firm’s application through 1 or more conference calls and coordinate all questions and requests in responding to the application. The result of the coordinated review process is that the responses to the application are streamlined, speeding up the approval process for the applying firm in all states.

The Switch is a large shift in regulatory structure, but the states have prepared in advance for the additional burden and have provided additional resources to help firms undergoing this shift.

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\(^2\) Pub. L. 104-290

\(^3\) 15 U.S.C. 80b-3(a)(2)(A)

\(^4\) 17 CFR § 275.203A-1(a)(1)

CANADIAN REGISTRATION REQUIREMENTS FOR NON-CANADIAN INVESTMENT FUND MANAGERS

By: Paul G. Findlay and Rebecca A. Cowdery
Borden Ladner Gervais LLP

Two groups of Canadian securities regulatory authorities each recently finalized their approach to whether a non-Canadian investment fund manager (IFM) needs to be registered as such in the local Canadian province or territory. This regulatory development may have significant implications for any U.S. investment fund manager that has offered or issued (or will offer or issue) securities of a hedge fund, pooled fund or other investment fund to residents of Canada.

What is an IFM?

An IFM is defined as the person or company that directs the business, operations or affairs of an investment fund. An investment fund is an issuer whose primary purpose is to invest money provided by its securityholders and either (i) whose securities entitle the holder to receive on demand, or within a specified period after demand, an amount computed by reference to the value of a proportionate interest of the net assets of the issuer, or (ii) does not invest for the purpose of exercising or seeking to exercise control of an issuer or being actively involved in the management of any issuer in which it invests (in either case other than an investment fund). Therefore, a private equity fund or a venture capital fund, would not typically be considered an investment fund, but most mutual and pooled funds and many hedge funds would be considered investment funds.

Exemption for IFMs Ending

In 2009, the Canadian securities regulatory authorities instituted a requirement for IFMs to register. However, IFMs that did not have their head office in Canada were provided a temporary exemption.

The temporary exemption ends on September 28, 2012.

The Canadian authorities have split in their approach to the IFM registration requirement. One group of three provincial regulators – Ontario, Quebec, and Newfoundland and Labrador (the Three Provinces) – considers that an IFM that manages investment funds whose securities are distributed in their province generally should register as an IFM in that province, regardless of where the IFM is located and actually carries on the activity of managing investment funds. These regulators have issued Multilateral Instrument 32-102 Registration Exemptions for Non-Resident Investment Fund Managers (the Three Province Rule) and Companion Policy 32-102CP which provide limited exemptions from IFM registration, generally in circumstances where there are no significant connecting factors to the applicable province, including no active solicitation in the province or where only “permitted clients” invest in the funds.

The other group of regulators (the Rest of Canada), has issued Multilateral Policy 31-202 Registration Requirement for Investment Fund Managers (the Rest of Canada Policy) that contains guidance on when a non-resident IFM is required to register in those jurisdictions. These regulators do not take the position that distribution of securities of an investment fund in their jurisdiction necessarily means that the IFM is carrying on the activities of an IFM in the jurisdiction. Rather, there are additional factors that must be considered before a IFM must apply for registration. [Note that New Brunswick, which was originally aligned with the Three Provinces, deserted them and joined the Rest of Canada.]

Timing

Both instruments are expected to be effective on September 28, 2012 (subject to government approvals in certain jurisdictions). If an IFM concludes it must be registered in one or more jurisdictions, the firm must apply for such registration in the applicable jurisdiction(s) by December 31, 2012. If a firm wishes to avail itself of one of the exemptions provided for in the Three Province Rule, it should take steps right away to amend its practices with respect to distribution of its funds in Ontario, Quebec, and Newfoundland and Labrador, so that the exemptions will be available immediately on the Rule coming into force.

Three Province Rule

Under the Three Province Rule, subject to the exemptions discussed below, registration would be
required by a non-Canadian IFM in a province that is one of the Three Provinces unless:

(i) no residents of that province are securityholders of an investment fund managed by the IFM; or,

(ii) the IFM and the investment funds it manages have not, at any time after September 27, 2012, actively solicited residents in the province to purchase securities of the investment funds.

Under the Three Province Rule, by distributing securities of an investment fund in a particular province or territory, the manager of that fund is considered to be “acting as an investment fund manager” in that province, notwithstanding that the IFM and the funds are situate and are actually managed in another jurisdiction. This means that while non-resident portfolio managers of non-Canadian investment funds that are distributed in one of the Three Provinces will not be subject to registration as an adviser, the non-resident IFM of those same investment funds will likely become subject to registration as an IFM – a peculiar result.

A non-Canadian IFM will be able to rely on an exemption from the IFM registration requirements where all securities of the investment fund distributed in the particular province were distributed only to “permitted clients” (primarily institutions and very high net worth individuals) under prospectus exemptions and the following conditions apply:

(1) The IFM does not have its head office or a principal place of business in Canada;

(2) The IFM is incorporated, formed or created under the laws of a non-Canadian jurisdiction;

(3) None of the investment funds is a reporting issuer in any province or territory of Canada;

(4) The IFM files with the applicable securities regulatory authority a Notice of Regulatory Action in prescribed form within 10 days of the date on which it commences to rely on this exemption;

(5) The IFM has submitted to the applicable securities regulatory authority a prescribed form which appoints an agent for service and submits to the jurisdiction of such province and submits annual filings in each applicable province; and,

(6) The IFM has notified the permitted clients of prescribed information about the non-registered and non-resident status of the IFM.

The Three Provinces have provided guidance on what is considered to be “active solicitation”: intentional actions taken by an investment fund or its IFM to encourage a purchase of the fund’s securities. Included would be such things as:

- Direct communication with residents of a province to encourage purchases of securities;
- Advertising in Canadian or international publications or media (including the internet), if the advertising is intended to encourage the purchase of the fund’s securities by residents in the province; and,
- Purchase recommendations made by a third party to residents of the province if the third party is entitled to compensation from the IFM or the fund for the recommendation or subsequent purchase.

Active solicitation does not include:

- Advertising in Canadian or international publications or media (including the internet) only to promote the image or general perception of an investment fund;
- Responding to unsolicited enquiries from prospective investors in the province; and,
- The solicitation of a prospective investor that is only temporarily in the province.
Rest of Canada Policy

The Rest of Canada Policy takes a significantly different approach. It indicates when the securities regulators would consider an IFM to be carrying on the activities of an investment fund manager in a particular province or territory, in which case it would be required to register in that jurisdiction. An IFM would be required to register if it directs or manages the business, operations or affairs of an investment fund from a physical place of business (or its head office is) in a province or territory. If an IFM doesn’t have such a presence, it should consider what IFM functions and activities it performs in a province or territory, including:

- Establishing a distribution channel for the fund;
- Marketing the fund;
- Establishing and overseeing the fund’s compliance and risk management programs;
- Overseeing the day to day administration of the fund;
- Retaining and liaising with the fund portfolio manager, the custodian, the dealers and other service providers of the fund;
- Overseeing advisers’ compliance with investment objectives and overall performance of the fund;
- Preparing the fund’s prospectus or other offering documents;
- Preparation and delivery of unit holder reports;
- Identifying, addressing and disclosing conflicts of interest;
- Calculating the net asset value (NAV) and NAV per share or unit;
- Calculating, confirming and arranging payment of subscriptions, redemptions; and
- Arranging for the payment of dividends or other distributions, if required.

The Rest of Canada Policy makes it clear that no single function or activity would be determinative and, in particular, the presence of security holders and the solicitation of investors do not automatically require an IFM to register in a province or territory, an approach that is directly contrary to the approach taken in the Three Province Rule.

IFM Registration Requirements

Non-Canadian IFMs that would be required to be registered will be subject to the proficiency and conduct requirements associated with being an IFM registrant. The IFM category is primarily a “firm” registration category with the ultimate designated person (UDP) and chief compliance officer (CCO) being the only registered individuals. The CCO is subject to Canadian-based proficiency requirements. As a firm, registered IFMs are subject to, among other things, requirements for:

- Capital and insurance;
- Financial reporting;
- Conflicts of interest management;
- Record keeping; and,
- Compliance systems, including having written policies and procedures.

Non-Canadian registered IFMs will also be required to provide a specified notice to fund security holders about their “non-resident” status.

Immediate Action Required

For non-Canadian IFMs that have residents of one or more of the Three Provinces as securityholders of one of their investment funds, IFM registration is not required if no further active solicitation occurs in these provinces after September 27, 2012. However, if a non-Canadian IFM wants to actively solicit investors after that date in one of the Three Provinces for any of its funds, it would appear that it would have to apply to register as an IFM by December 31, 2012, if any of the investors in the funds are not permitted clients (and this may be difficult to determine now). Non-Canadian IFMs in this situation may wish to consider requiring all non-permitted clients in the Three Provinces to redeem their securities in the investment funds if this is possible under the governing documents. If all of the investors in the funds are permitted clients, the IFM should comply with all of the conditions of the permitted client exemption on or before September 27, 2012 (or a later date when solicitation first starts thereafter) – i.e. file the prescribed forms and provide the securityholders in the Three Provinces with the required information.
Complying with the Two Approaches

Going forward, we expect most non-Canadian IFMs to conduct any offerings of investment funds managed by them so as to comply with the permitted client exemption, at least in the Three Provinces. Care should be taken, however, to ensure that the IFM’s activities in the Rest of Canada do not cause the IFM to have to register as an IFM in one of these jurisdictions. In the Rest of Canada, it is irrelevant (for these purposes) whether or not the investors are permitted clients.

OUTSIDE BUSINESS ACTIVITY: PART TWO – WHERE THE RULES NOW STAND

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

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

I. Introduction

Part 1 of this series of articles, published in the previous issue of The Blue Sky Bugle, discussed in detail the applicable self-regulatory organization rules with respect to outside business activity, proposed revisions to those rules, and applicable Notices to Members. This Part 2 discusses arbitration, litigation, and statutory and common law theories of liability and defenses in the outside business activity and selling away context. Part 3, to be published in the next issue of The Blue Sky Bugle, will discuss compliance and supervisory procedures regarding outside business activity.

II. FINRA Mandatory Arbitration Requirements

A. The FINRA Arbitration Rules

FINRA rule 12101, the Code of Arbitration Procedure (“Code”) applies “to any dispute between a customer and a member or associated person of a member that is submitted to arbitration under rules 12200 or 12201.”

Given the mandatory language of rule 12200, members and associated persons should seek to understand the scope of its application, and the breadth of the terms “customer” and “business activities.” FINRA rule 12100’s only limitation on the term “customer” is that “a customer shall not include a broker or dealer.” The term “business activity” is not specifically defined in the FINRA code. Notably, however, rule 12200 does not limit arbitration to cases involving conduct at the member firm where the associated person is employed. The sheer breadth of potential claims and claimants which can be included in these extremely broad terms would seem to indicate that most situations involving a registered representative and another party, who is not a broker or dealer, could arguably be brought to arbitration. Fortunately, various court interpretations of the FINRA rules provide some guidance as to their scope and limitations.

Further, shareholder derivative actions will not be arbitrated under Rule 12205.

6 The requirement of Rule 12101 applies to individual claims by customers. Rule 12204 prohibits arbitration of class action claims unless under specific provisions a party has opted out or the class is not certified and under certain other conditions.
B. Court Interpretations

1. “Customer.” Several federal cases have set out the parameters of who is, and is not, a “customer.” In so doing, circuit and district courts have recognized that the term “customer” must not be defined so broadly as to upset the reasonable expectations of FINRA members. Generally, courts are less likely to find a party to be a “customer” of the member firm where that party has no written agreement with the member firm and does not invest with a member firm, but rather with a third party, non-employee, who invests with the member firm. In such cases, the relationship is usually considered too tenuous to render the investor a “customer” of the member firm.

Courts are far more likely to recognize that a party is a “customer,” for purposes of arbitration, if that party is an investor who invests directly with a member firm. However, courts have held that a direct customer relationship between the member firm and the purported customer is not necessary, so long as there is “some nexus between the investor and the member or associated person.” For example, if a broker is complicit in misleading an investor into thinking that the investor is a “customer,” then the investor may be considered a “customer” for purposes of the FINRA Code. Further, if the associated person of the member firm induces, or shepherds, the investment, then the investor is likely a “customer” of that firm. Thus, in a typical “selling away” case, to the extent an investment is made through an associated person of the member firm, the investor may very well be considered a “customer” of the member, for purposes of compelling arbitration.

2. “Business Activities.” Courts which have addressed the term “business activities” of the member or the associated person have regarded it quite broadly. Courts which have addressed the issue in the selling away context have usually considered the investment through an associated person as constituting an “activity” which falls within the scope of the rule. Indeed, courts have nearly

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7 The discussion of the case law and all of the interpretations is beyond the scope of this article. The court of appeals and district court cases herein are provided as an illustration of the wide scope given to the definition of “customer,” and “business activities” of the member or associated person.

8 Fleet Boston Robertson Stephens, Inc. v. Innovex, Inc., 264 F.3d 770, 772 (8th Cir. 2001) (holding that when the relationship between the parties is more tenuous, courts should determine if there is some form of business relationship that must include some brokerage or investment services between the parties); Oppenheimer & Co. v. Neidhardt, 56 F.3d 352, 357 (2d Cir. 1995); Wheat, First Sec., Inc. v. Green, 993 F.2d 814, 820 (11th Cir. 1993) (recognizing that courts are guided by the notion that the term “customer” should not be too narrowly construed, nor should the definition upset the reasonable expectations of FINRA members).

9 Herbert J. Sims & Co., Inc. v. Roven, 548 F. Supp. 2d 759 (N.D. CA 2008); see also Brookstreet Securities Corp. v. Bristol Air, Inc., 2002 U.S. Dist. LEXIS 16784, at *23 (N.D.CA 2002)(ruling that a customer relationship was not established when investors interacted only with their investment advisor, who maintained an account with the member firm, but was not an employee, agent or registered representative of the firm – even if the investment advisor would be a “customer” of the member firm).

10 Id.; see also Bensadoun v. Jofe-Riat, 316 F.3d 171 (2nd Cir. 2003) (finding that, where investors pool funds and relinquish all investment authority to a third party who deals with a member firm, that third-party, not the investors, will normally be considered the “customer”); Morgan Keegan Co. v. Drzayick, 2011 U.S. Dist. LEXIS 129366 (noting that investors are not customers of a broker-dealer if they have not opened, maintained, controlled or traded in an account at [the broker-dealer] or entered into an account or customer agreement with [the broker-dealer]).
universally found that disputes arising from a firm’s lack of supervision over its brokers arise “in connection with” business activities of the member, so as to compel arbitration.\(^{16}\)

Based on the breadth of the terms used in the FINRA rules and court decisions, outside business activities of the associated person may be subject to arbitration where the “customer” may in fact never have had a customer agreement or effected a transaction that was recorded on the books of the broker-dealer because the member did not know of it. Indeed, the activity of the associated person in dealing with any person investing in securities (whether or not at the member firm) generally will bring the associated person and the member within the scope of FINRA rules for mandatory arbitration.

III. Outside Business Activities Claims and Defenses

A. Civil Claims

Theories of civil liability against a registered representative for his or her outside business activity include (among other things) express and implied remedies under the federal and state securities laws, common law claims, breach of contract, and state statutory consumer fraud claims. The merit of such claims depends upon the specific facts of individual cases and a discussion of them is well beyond the scope of this article.

Theories of civil liability against the firm when a registered representative is engaged in outside business activity, however, are more limited.\(^{17}\) In many outside business activity cases, the member broker-dealer may not even know of the activity of the associated person. Notwithstanding, the member still may have potential liability under theories of vicarious liability. Those vicarious liability theories include respondeat superior, agency, and control person liability under federal and state law. These theories will each be discussed in turn below.

1. **Respondeat Superior.** Respondeat superior, which is Latin for “let the master answer,” is a legal doctrine imposing liability on an employer for the acts of an employee performed within the course of the employee’s employment. Although respondeat superior is a state common law doctrine, Courts have held that it also applies to statutory causes of action, including actions for securities fraud.

   Where the registered representative is an independent contractor, respondeat superior arguably is inapplicable because the doctrine generally applies only to employer-employee relationships. However, even where an employer-employee relationship does exist, respondeat superior is arguably inapplicable to selling away cases because the registered representative is engaged in a “private securities transaction” which by definition, is “a securities transaction outside the regular course or scope of an associated person’s employment with a member firm.” NASD rule 3040(e).\(^{18}\)

   2. **Agency (Actual and Apparent Authority).** Because employees are agents of their employers within the scope of employment, agency is often confused with respondeat superior. However,

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\(^{17}\) For example, though Congress specifically provided for private rights of action for violations of select securities laws (e.g.,

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\(^{18}\) NASD Rule 3040(e) is proposed to be amended by proposed FINRA Rule 3110(b)(3) (RN 08-24 (May 2008)) (applicable to “investment banking or securities business outside the scope of the member’s business”). See Section II.B and C.
agency is a doctrine distinct from respondeat superior, which can apply to both employees and non-employees. Generally, an agency relationship is created when a principal (the firm) grants either actual authority or apparent authority to an agent (the registered representative) to engage in the conduct which caused the harm.

Firms generally prohibit private securities transactions without prior written approval. In selling away cases, approval has rarely been granted and, accordingly, actual authority to engage in selling away transactions rarely exists. Thus, most claimants in selling away cases rely upon apparent authority.

Apparent authority generally exists when a firm – through the firm’s own words and conduct – vests the registered representative with the appearance of actual authority to engage in the conduct and the claimant relies, to his or her detriment, upon that appearance of authority. Whether apparent agency exists can be a factually intensive question affected by such factors as:

- whether the firm’s agreement with the customer spells out the limitations of the representative’s actual authority;
- whether the representative, the documents, or other individuals involved in the selling away activity tell the claimant the investment is or is not sanctioned by the firm;
- whether the representative conducts the selling away activity under a business name other than the name of the firm;
- whether the representative conducts the selling away activity out of the firm’s office (as opposed to a separate office or home);
- whether the representative furthers the selling away activity using the firm’s name, logo, letterhead, email, or through some other means indicating firm involvement; and
- the extent of contact between the investor and people not affiliated with the firm, but involved in the selling away activity.

The above is not meant to be exhaustive of the factors that affect apparent authority, but they do illustrate a pattern. Each factor considered in a determination of whether apparent agency exists relates either to the steps the firm took to cloak the registered representative with the appearance that the representative was acting on behalf of the firm or to the reasonableness of the claimant’s reliance upon the appearance of authority during the selling away activity.

3. Control Person Liability under the Exchange Act. Control person liability is another argument for imposing liability upon a firm for the conduct of a registered representative. Control person liability can arise under Section 20 of the Exchange Act, which provides:

Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.\(^\text{19}\) (emphasis added.)

Section 20 control person liability differs from common law doctrines of respondeat superior and agency in several important respects. For example, the common law doctrines generally can be used to impose liability for any cause of action, whether it arises from common law or statute. Thus, courts have held that a registered representative’s violation of the federal securities law or violation of common law can be imputed to the firm through respondeat superior. By comparison, Section 20 control person imputes liability only for breaches of the Exchange Act. Thus, if a registered representative breaches a common law duty (common law fraud for example), Section 20 does not impute the representative’s

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common law liability to control persons of the representative.

The standard of conduct for imposing liability under Section 20 is also very different. Section 20 does impose liability based solely upon the control person’s relationship with the primary violator. However, a control person can avoid liability under Section 20 if he acted in “good faith” and did not “directly or indirectly induce the act or acts” constituting the primary violation. Because the firm generally knows very little or nothing about the selling activity in a selling away case, the firm’s direct or indirect inducement of the conduct is rarely an issue. Good faith, however, is the subject of a great deal of litigation.20

Courts have generally held that a firm acts in “good faith” if it has and enforces a reasonable system of supervision over the conduct of its registered representatives. Courts have also held that, to impose liability upon the control person, the failure in supervision must amount to scienter or recklessness—negligence generally is not enough. Scienter requires “an extreme departure from the standards of ordinary care” posing “a danger of misleading buyers that was either known to the control person or was so obvious that the control person must have been aware of it.”

4. Control Person Liability under the 1933 Act. Control person liability can also arise under Section 15 of the Securities Act of 1933 (the “1933 Act”), which provides:

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under section 11 or 12 [(15 USCS § 77k or 77 l)], shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.21

Just as Section 20 of the Exchange Act can only impute liability for violations of the Exchange Act, Section 15 of the 1933 Act (where applicable) can only impute liability to a control person for breaches of the 1933 Act. In the selling away context, the 1933 Act commonly becomes important when the associated person mistakenly believes that the investment is not a security, resulting in a claim for rescission under the 1933 Act. At least one court has held, in this context, that a firm is not liable under Section 15 where the firm had “no knowledge of or reasonable ground to believe” that: (i) the sale of an investment was taking place; (ii) that the investment was unregistered; and (iii) that the associated person was making use of the mails or facilities of interstate commerce in connection with the sale or offer.22

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20 It should be noted, however, that even if “bad faith” can be established against a firm with respect to an established primary violation of the Exchange Act, the Private Securities Litigation Reform Act (“PSLRA”) specifically limits liability against a firm to a percentage of loss, representing the firm’s proportionate share of fault compared to the total fault of everybody involved. Subsection (f) of the PSLRA states:

2. Liability for damages

A. Joint and several liability

Any covered person against whom a final judgment is entered in a private action shall be liable for damages jointly and severally only if the trier of fact specifically determines that such covered person knowingly committed a violation of the securities laws.

B. Proportionate liability

i. In general

Except as provided in paragraph (A), a covered person against whom a final judgment is entered in a private action shall be liable solely for the proportion of the judgment that corresponds to the percentage of responsibility of that covered person.

PSLRA §21(D)(f)(2); 15 U.S.C. §78u-4(f)(2). Indeed, in any private action, before imposing any liability upon a firm, even after determining liability exists, a trier of fact is required to make findings with respect to whether the firm violated the securities laws knowingly, and the percentage of responsibility (if any) for the loss “measured as a percentage of the total fault of all persons who caused or contributed to the loss incurred by plaintiff.” PSLRA §21(D)(f)(3); 15 U.S.C. §78u-4(f)(3).

21 Securities Act of 1933 Section 15; 15 USCS § 77o.

5. **State Control Person Liability.** Blue sky laws also incorporate provisions that impose control person liability, but some blue sky laws define “control person” much more narrowly than the Exchange Act. Some blue sky laws, for example, define “controlling person” as a “person offering or selling a security or a group of persons acting in concert in the offer or sale of a security, owning” sufficient shares of the security to control the company. Arguably, in a selling away case, because the firm did not offer, sell, or act in concert in the offer or sale, the firm should not be liable as a control person under these narrower blue sky law definitions. Of course, claimants may still argue that the firm is liable for the blue sky law violation of a registered representative under the doctrines of respondeat superior or agency discussed above.

6. **Direct Liability.** In addition to secondary liability theories like respondeat superior, agency, and control person, claimants’ attorneys often seek to impose liability upon firms in selling away cases for their own direct conduct. A claimant may, for example, attempt to sue a firm for negligently hiring the registered representative who engaged in the selling away activities or attempt to claim that the firm’s new account agreement contained an implied contractual term that the firm would safeguard any investment sold through the registered representative, whether or not known or made through the firm. Whether such theories have merit generally is dependent upon the law of the jurisdiction and the facts presented by a specific case.

7. **Practical Application.** At hearing or trial, Claimants’ attorneys focus on small details which, with Herculean effort, a firm could have investigated to uncover the selling away activity. Because selling away cases are litigated after the selling away activity has come into the focused view of 20-20 hindsight, the connection between slight information and the outside business activity can appear much more obvious than it would or could have been to the firm at the time the activity was occurring. As a result, in many cases jurors and arbitration panels unintentionally impose liability against firms using standards significantly lower than those discussed above.

The authors find that many times firms are sued for outside business activities of associated persons where the firm has absolutely no knowledge of the activity. Sometimes, the associated person did not understand that the activity was an outside business activity involving securities and did not understand the importance of reporting it to the firm and sometimes the associated person's selling away is a deliberate attempt to defraud. In some cases, firms are sued by “investors” who thought they were dealing with the firm, but in other cases, the investor knew the firm was not involved and sometimes, the claimants have even aided the associated person in affirmatively concealing the activity.

As noted above, even FINRA has recognized that notwithstanding the very best supervisory and compliance policies, procedures and controls, firms will not detect all selling away activity. Even with the very best policies, procedures and controls, selling away claims can be very difficult to defend and liability is often wrongly imposed upon firms, particularly in arbitration, not because the claimant proved the elements of his or her case, but because the firm is the only deep pocket and the decision-maker feels a great deal of sympathy for the injured investor. This can occur even when the investor was never a customer of the broker-dealer.

### B. Regulatory Liability

1. **General.** Unlike civil liability from private actions, there are additional theories in enforcement actions. Enforcement by the SEC, FINRA, or state regulatory agencies is not limited to the above vicarious liability theories, but also includes aiding and abetting and in the case of FINRA, failure to supervise.

2. **SEC.** Exchange Act §§15(b)(4)(E) and 15(b)(6) generally spell out the supervisory responsibility of broker-dealers and persons who may be supervisors. The Exchange Act indirectly mandates supervisory procedures by providing that the SEC may sanction a broker-dealer and its supervisory personnel, a broker-dealer or an associated person who has violated the securities laws, or who “has failed reasonably to supervise, with a view to preventing violations of the provision of such statutes, rules and regulations, another person who commits such a violation if such person is subject to his supervision.” Subsection (E) further provides that no person shall be deemed to have failed reasonably to supervise any other person if:

23 15 USC § 78(o)(b)(4)(E) and 78(o)(b)(6).
(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such person, and

(ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and systems without reasonable cause to believe that such procedures and systems were not being complied with.\(^\text{24}\)

3. FINRA. Although private litigants should not be entitled to pursue actions based directly upon them, FINRA itself can and does pursue regulatory actions based directly upon violations of its rules. In addition to pursuing violations of FINRA rule 3210 and NASD rules 3040 and 3050, FINRA often pursues actions for violations of Conduct rule 2010 (Standards of Commercial Honor and Principles of Trade) and 2310 (Suitability)\(^\text{25}\) against registered representatives who engage in selling away. In these same cases, FINRA often pursues the firm, and in extreme cases, the individual charged with supervising the registered representative, for violations of NASD rules 3010 and 3012 (Supervision) and/or FINRA rule 3070 (Reporting Requirements).

4. State Regulators. State securities departments or divisions generally have the independent authority to investigate and, where violations of state law have occurred, to issue temporary or permanent cease and desist orders, suspensions, or monetary sanctions against individuals, broker-dealers, investment advisors, or others. State regulators often impose sanctions even where FINRA or the SEC have already acted to punish the wrongdoer or the firm.

IV. Conclusion

Most disputes with customers are arbitrated. In rare cases, a claimant’s attorney chooses to file a claim in state or federal court under common law or statutory securities law. Establishing liability requires in most selling away cases a showing of agency or of control person liability. Robust supervisory procedures with respect to outside business activities diminish the likelihood that a claimant can establish apparent agency and bolster a defense of good faith. However, even with the best procedures, outside business securities activities may occur and not be detected. If the procedures are reasonably adequate and reasonably enforced, the broker-dealer should have defenses under both federal and state law.

Part 3 of this series of articles, which will be published in the next issue of *ABA Blue Sky Bugle*, will discuss supervision and compliance procedures that may be used by firms.

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\(^{25}\) Rule 2310 will be replaced by FINRA rule 2111 (January 2011) currently scheduled to become effective July 9, 2012.
validates and continues all activities initiated under these acts as well as all orders, resolutions, regulations, rules and decisions issued thereunder. Hence, all filing requirements and filing fees required under the 1972 Act and the TDL will remain unchanged by Act 86.

Administration of the 1972 Act and all securities regulatory functions will be vested in a Deputy Secretary for Securities who will be appointed by the Department Secretary. The Commissioners will become part of a new Banking and Securities Commission which will consist of five individuals of whom one will be a designee of the Governor, one will be the Department Secretary or his designee acting ex officio and three will be appointed by the Governor with the advice and consent of the Pennsylvania Senate. The Commissioners will become part of a new Banking and Securities Commission which will consist of five individuals of whom one will be a designee of the Governor, one will be the Department Secretary or his designee acting ex officio and three will be appointed by the Governor with the advice and consent of the Pennsylvania Senate. The Governor will select one member to be chair and the Department Secretary will serve as vice-chair.

However, the powers of the new Banking and Securities Commission will be limited principally to an adjudicatory role with respect to administrative proceedings brought before the Department under laws administered by the Department and will have only those other duties as may be determined by the Department Secretary. The jurisdiction of the newly constituted commission will be expanded to include administrative proceedings involving not only alleged violations of the 1972 Act but also other laws administered by the Department, such as statutes relating to mortgage brokers, check cashers, pawn shops, etc.

It is anticipated that events affecting filings under the 1972 Act such as address changes or changes in the payee on checks representing filing fees will be timely announced by the Department. All filings required to be made through CRD and IARD will continue to be made through those licensing systems pursuant to current PSC rules and orders.

EDITORIAL
By: Martin A. Hewitt
Attorney at Law

There is so much going on in our regulatory world, be it the Dodd-Frank Act or the JOBS Act, that it is sometimes difficult to focus on any one aspect of all of the rule making. In fact, what often happens sneaks up on us and we are left scratching our head trying to figure out just why one thing or another has occurred.

Recently, several states have started issuing comment letters regarding Reg. D, Rule 506 offerings. Specifically, upon effecting the standard notice filing with one state or another (Form D, a filing fee, and in a few jurisdictions a uniform consent to service of process – though this last item is now incorporated into the Electronic Form D), practitioners have been receiving state letters asking for the name and address of the investment adviser involved in the issuance of securities. Further, proof has been requested regarding proper state registration.

Many practitioners are flummoxed by this request. First, and foremost, in the context of funds, the investment adviser has one client – the fund. Usually, the fund does not have contact with any investors. This is one reason why Form D requires information, not about the investment adviser, but rather the broker/dealer involved in the distribution of securities for which transaction based compensation is received. It is the broker/dealer who is in the “best” position to act nefariously (though I believe it is a only a small minority that I believe do so), which is why information regarding the broker/dealer is required on the Electronic Form D.

In order to clarify this issue, I spoke with Joseph P. Borg, Director of the Alabama Securities Commission. Alabama is one of those states issuing comment letters on notice filings made pursuant to Rule 506 offerings. I asked one question – why? There were several reasons. First, he said that there have been many instances of fraud in Alabama regarding Rule 506 offerings and that investment advisers were part of that problem. Further, Mr. Borg said that he has catalogued – instances of fraud/misrepresentations in almost 250 Reg D filings and believes that getting information about the related investment adviser will help slow the fraud committed in Alabama. He stated that Reg D filers are approaching smaller IAs who in many instances rely solely on the Reg D issuer for matters of compliance, or non compliance. Second, he said that as part of the recently completed IA switch, he wants to make sure that those investment advisers conducting business in his state are in compliance with state law.

Regarding the first point above, I had to point out that, as I have said many times before, Electronic
Form D is the wrong utensil for catching fraudsters and likened it to trying to flip hamburgers with a fly swatter. By the time the Electronic Form D is filed, if it is fraudulent, the horse is out of the barn and the investors have already been parted from their money. I know I am safe in saying that there is no practitioner in our industry who wants to see fraud occur. It helps neither us, nor our clients. It should be noted that the vast majority of Rule 506 offerings are conducted in compliance with all applicable federal and state law. These offerings provide much needed working capital, thereby enabling business to grow and hire more employees, which is crucial in the current economy. And while Mr. Borg agrees that a better way should be utilized, he stated that the States must use whatever authority remains to them to protect their citizens. According to Mr. Borg the “gatekeeper” function (licensing review for prevention) has been preempted and only enforcement action remains, which, by its very nature is always ‘after the fact’. Also, he stated that it seems that a number of Reg D ‘mills’ have sprung up and in several instances created their own broker-dealer and/or utilized small IAs as well as small BDs as the conduit to the local market for sales. In one series of cases tracked by Alabama, a Reg D ‘mill’ had dozens of fraudulent Reg D filings totaling an estimated 1 billion dollars. For a number of their filings, they enlisted small broker dealers and/or small IAs for distribution, and in others, investors were ‘cold called’ directly. Mr. Borg said that after action by Alabama, including criminal convictions, the broker dealer was shut down but the full extent of losses to investors (many of which would not have qualified in the first place) is still not known.

Regarding Mr. Borg’s second point, I can certainly understand that as Director of the Alabama Securities Commission, he wants to know who is acting as an investment adviser in his state. The point here is that such information has not been asked for previously in the notice filing context. Furthermore, as much as states don’t want to hear the words “federal preemption,” the law of the land has been that issuers can satisfy the requirements of Rule 506 so long as they file that which is filed with the SEC (the Electronic Form D), pay a filing fee, and provide (in an increasingly limited number of jurisdictions) a uniform consent to service of process. As stated above, the Electronic Form D requires information regarding broker/dealers involved in the offering. And, while it doesn’t require information regarding the identity of the investment adviser, it does ask that the filer indicate if the adviser is exempt from registration. Joe stated that he was entitled to ask for this additional information, not pursuant to Rule 506, but pursuant to the antifraud provisions of his jurisdiction and pursuant to the States’ authority to verify proper licensing.

While that last point above can be argued in good faith on both sides, I suggest that the issue in this instance is communication. If several of the states want this information and even if practitioners don’t believe they have the right to ask for it we are left with two questions. First, is this truly a fight worth having? After all, if I were in Joe Borg’s shoes (not that I could even begin to fill them!), I would like to know who is talking to investors in my state. Second, and perhaps more important to practitioners is, why ask for this information in a comment letter? A notice filing does not, except in rare instances, result in a follow-up letter from the states. This does not help practitioners trying to encourage clients to supply the necessary information required by Form D in a timely fashion.

I would like to suggest that a better tactic for the states would have been to communicate with us beforehand regarding this change in policy. There are states that require certain information in the cover letter to the Electronic Form D filed in their jurisdiction and we all include it as a matter of course. Rather than having practitioners deal with the fallout of receiving a comment letter, we believe it would make better sense to communicate with us. This would save time for everyone as we could include this information in our cover letters and take a lot of the stress out of what should be a simple process of making a notice filing.

And now I would like to end with my usual mini-rant. After many years of publishing three issues of the Blue Sky Bugle each year, we missed the first of the year because of the lack of articles. There is so much of which to write. When we all see each other at meetings, no one is at a loss for words. Please put some of those words on paper and send them along. We need various perspectives at this juncture in our regulatory lives. If someone is reading this who is not a lawyer, but has something to say, don’t be shy. Remember, the next deadline for the Blue Sky Bugle is Halloween. Please send treats – not tricks – to hewitt@mhewittlaw.com
Photo Credit: For those of you who don’t recognize our new Committee mascot on the Blue Sky Bugle masthead, it is a “blue footed booby.” Alan Parness took this photo in the Galapagos Islands in May, 2010.
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Watch for it.

The Committee’s listserv is available to committee members for posting comments, arguments, updates, news relating to Blue Sky Law, the people who practice Blue Sky Law, and the people who administer Blue Sky Law.

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