THE BLUE SKY BUGLE
A Newsletter for Blue Sky Lawyers

Published by the ABA Committee on State Regulation of Securities
Volume 2012, Number 2, December 2012

EVENTS CALENDAR

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

ABA BUSINESS LAW MEETING
The Committee and its Subcommittees will meet in conjunction with the ABA Business Law Section’s 2013 Annual Meeting
San Francisco, CA
The Fairmont San Francisco
August 9-11, 2013

NASAA 2013 FALL CONFERENCE
The Committee and its Subcommittees will meet in Conjunction with the Annual Meeting of the North American Securities Administrators Association
Salt Lake City, UT
October 6-8, 2013

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THE CURMUDGEON’S CORNER

By: Alan M. Parness
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For this issue of the Bugle, I decided to kvetch about something other than the states’ treatment of Rule 506 offerings and investment advisers, namely the states’ exemptions from securities registration for transactions with so-called “institutional investors.” While I believe that these provisions are important to many Blue Sky practitioners, issuers, and broker-dealers alike, they are likewise fraught with danger, due to a lack of uniformity and antiquated statutory provisions, rules, and/or interpretations. [I note that most Blue Sky laws include similar definitional exceptions or exemptions from broker-dealer and investment adviser registration (and, in turn, from agent and investment adviser representative registration), for persons effecting transactions with,
or providing advice to, institutional investors, but a discussion of those provisions will have to await a future column, although most of the critique which follows will apply to those provisions, too.]

A. The 1956 Uniform Securities Act Approach

The 1956 version of the Uniform Securities Act (the “1956 USA”) contains a straightforward exemption - 1956 USA § 402(b)(8) exempts from the securities registration and advertising filing requirements of Sections 301 and 403, respectively, of the 1956 USA:

“any offer or sale to a bank, savings institution, trust company, insurance company, investment company as defined in the Investment Company Act of 1940, pension or profit-sharing trust, or other financial institution or institutional buyer, or to a broker-dealer, whether the purchaser is acting for itself or in some fiduciary capacity.”

As explained in the “Draftsmen’s Commentary” to 1956 USA § 402(b)(8):

“The obvious justification for this exemption is that institutional investors and broker-dealers are ‘sophisticated’ buyers who do not need the protection of registration. At the same time, they do have the protection of the antifraud provisions of §§ 101 and 410(a)(2).” Louis Loss, Commentary on the Uniform Securities Act 123 (1976) [hereinafter Loss].

B. The 2002 Uniform Securities Act Approach

The 2002 version of the Uniform Securities Act (the “2002 USA”) takes a somewhat similar approach to the 1956 USA with regard to exempting transactions with institutional investors, except that it includes a uniform (and more expansive) definition of the term “institutional investor” (and further definitions of certain of the terms used in that definition).

Thus, 2002 USA § 202(13) provides an exemption from the securities registration requirements of Sections 301 through 306, and the sales and advertising literature filing requirements of Section 504, of the 2002 USA, for:

“a sale or offer to sell to:

(A) an institutional investor;

(B) a federal covered investment adviser; or

(C) any other person exempted by rule adopted or order issued under this [Act].”

In turn, 2002 USA § 102(11) defines the term “institutional investor” to mean any of the following, whether acting for itself or for others in a fiduciary capacity:

“(A) a depository institution or international banking institution;

(B) insurance company;

(C) a separate account of an insurance company;

(D) an investment company as defined in the Investment Company Act of 1940;

(E) a broker-dealer registered under the Securities Exchange Act of 1934;

(F) an employee pension, profit-sharing, or benefit plan if the plan has total assets in excess of $10,000,000 or its investment decisions are made by a named fiduciary, as defined in the Employee Retirement Income Security Act of 1974, that is a broker-dealer registered under the Securities Exchange Act of 1934, an investment adviser registered or exempt from registration under the Investment Advisers Act of 1940, an investment adviser registered under this [Act], a depository institution, or an insurance company;

(G) a plan established and maintained by a State, a political subdivision of a State, or an agency or instrumentality of a State or a political subdivision of a State for the benefit of its employees, if the plan has total assets in excess of $10,000,000 or its investment decisions are made by a duly designated public official or by a named fiduciary, as defined in the Employee Retirement Income Security Act of 1974, that is a broker-dealer registered under the Securities Exchange Act
of 1934, an investment adviser registered or exempt from registration under the Investment Advisers Act of 1940, an investment adviser registered under this [Act], a depository institution, or an insurance company;

(H) a trust, if it has total assets in excess of $10,000,000, its trustee is a depository institution, and its participants are exclusively plans of the types identified in subparagraph (F) or (G), regardless of the size of their assets, except a trust that includes as participants self-directed individual retirement accounts or similar self-directed plans;

(I) an organization described in Section 501(c)(3) of the Internal Revenue Code (26 U.S.C. Section 501(c)(3)), corporation, Massachusetts trust or similar business trust, limited liability company, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $10,000,000;

(J) a small business investment company licensed by the Small Business Administration under Section 301(c) of the Small Business Investment Act of 1958 (15 U.S.C. Section 681(c)) with total assets in excess of $10,000,000;

(K) a private business development company as defined in Section 202(a)(22) of the Investment Advisers Act of 1940 (15 U.S.C. Section 80b-2(a)(22)) with total assets in excess of $10,000,000;

(L) a federal covered investment adviser acting for its own account;

(M) a “qualified institutional buyer” as defined in Rule 144A(a)(1), other than Rule 144A(a)(1)(i)(H), adopted under the Securities Act of 1933 (17 C.F.R. 230.144A);

(N) a “major U.S. institutional investor” as defined in Rule 15a-6(b)(4)(i) adopted under the Securities Exchange Act of 1934 (17 C.F.R. 240.15a-6);

(O) any other person, other than an individual, of institutional character with total assets in excess of $10,000,000 not organized for the specific purpose of evading this [Act]; or

(P) any other person specified by rule adopted or order issued under this [Act].”

The term “depository institution,” as used in 2002 USA § 102(11)(A), is defined in 2002 USA § 102(5) (and, within that definition, the term “bank” is defined in 2002 USA § 102(3)) to mean:

“(A) a bank [i.e., (1) a banking institution organized under the laws of the United States; (2) a member bank of the Federal Reserve System; (3) any other banking institution, whether incorporated or not, doing business under the laws of a State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to be exercised by national banks under the authority of the Comptroller of the Currency pursuant to Section 1 of Public Law 87-722 (12 U.S.C. Section 92a), and which is supervised and examined by a state or federal agency having supervision over banks, and which is not operated for the purpose of evading this [Act]; and (4) a receiver, conservator, or other liquidating agent of any institution or firm included in clause (1), (2), or (3) above]; or

(B) a savings institution, trust company, credit union, or similar institution that is organized or chartered under the laws of a State or of the United States, authorized to receive deposits, and supervised and examined by an official or agency of a State or the United States if its deposits or share accounts are insured to the maximum amount authorized by statute by the Federal Deposit Insurance Corporation, the National Credit Union Share Insurance Fund, or a successor authorized by federal law. The term does not include:

(i) an insurance company or other organization primarily engaged in the business of insurance;
(ii) a Morris Plan bank; or

(iii) an industrial loan company that is not an “insured depository institution” as defined in Section 3(c)(2) of the Federal Deposit Insurance Act, 12 U.S.C. 1813(c)(2), or any successor federal statute.”

The term “international banking institution,” as used in 2002 USA § 102(11)(A), is defined in 2002 USA § 102(14) to mean:

“an international financial institution of which the United States is a member and whose securities are exempt from registration under the Securities Act of 1933.”

The term “insurance company,” as used in 2002 USA § 102(11)(B), is defined in 2002 USA § 102(12) to mean:

“a company organized as an insurance company whose primary business is writing insurance or reinsuring risks underwritten by insurance companies and which is subject to supervision by the insurance commissioner or a similar official or agency of a State.”

The term “federal covered investment adviser,” as used in 2002 USA § 102(11)(L), as well as in 2002 USA § 202(13)(B), is defined in 2002 USA § 102(6) to mean:

“a person registered as an investment adviser under the Investment Advisers Act of 1940.”

Official Comment 13 to 2002 USA § 102(11) provides the following explanations of the various categories of “institutional investor”:

“Sections 102(11)(A) through (K) are based on Rule 501(a) of the Securities Act of 1933, but do not include the paragraphs of Rule 501(a) that address individuals. Given the significant period of time since Rule 501(a) was adopted, this Act has used a $10 million minimum for several categories of institutional investor rather than $5 million minimum used in Rule 501(a).

Section 102(11)(H) concludes with an except clause meant to exclude self-directed plans for individuals from this definition.

With respect to the exclusion of Rule 144A(a)(1)(i)(H) from Section 102(11)(M), the substance of Rule 144A(a)(1)(i)(H) appears in Section 102(11)(I), but with a requirement of total assets in excess of $10,000,000.

Section 102(11)(O) is meant to reach persons similar to those listed in Sections 102(11)(A) through (N), but not otherwise listed. Under Section 503, if challenged in a proceeding, the burden of proving the availability of an exemption is on the person claiming it. An interpretive opinion may be sought from the administrator under Section 605(d).” Joel Seligman, The New Uniform Securities Act 19 (2003) [hereinafter, Seligman].

C. Issues with the 1956 USA and 2002 USA Approaches

The obvious problem with the 1956 USA § 402(b)(8) exemption is that it’s far too restrictive. In particular, the 1956 USA doesn’t further define what other type of entity might constitute a “financial institution or institutional buyer” within the meaning of the foregoing provisions. The only hint as to what the drafters had in mind may be found in Official Code Comment to Section 402(b)(8), which states:

“The term ‘institutional buyer’ is broad enough to cover, for example, a college purchasing for its endowment fund or perhaps a labor union investing its surplus funds on a substantial scale. The term may be either left to ad hoc interpretation or defined by an interpretative rule under § 412(a).” Loss at 123.

However, put into current perspective, that comment doesn’t provide any clarity as regards common questions practitioners face, namely, whether “qualified institutional buyers” (“QIBs”) within the meaning of Rule 144A (“Rule 144A”) under the Securities Act of 1933, as amended (the “Securities Act”), “qualified purchasers” within the meaning of Section 2(a)(51) of the Investment Company Act of 1940, as amended (the “Investment Company Act”), and the SEC’s rules thereunder, “institutional
accounts” within the meaning of Rule 4512(c) of the Financial Industry Regulatory Authority, Inc., and/or certain “accredited investors” within the meaning of Rule 501(a) of Regulation D under the Securities Act (“Regulation D”), should be considered “institutional buyers” within the “catch-all” language of the exemption.

Fortunately, a number of states have amended their versions of Section 402(b)(8), adopted rules, or issued orders, interpretative releases or opinions, confirming that QIBs and certain other types of entities are “institutional buyers” (the inclusion of QIBs is certainly a reasonable conclusion). For example, see Rule 510 under the Delaware Securities Act, defining the term “institutional buyer” for purposes of the exemption to include (i) “accredited investors” as defined in Rule 501(a)(1) – (4), (7) and (8) of Regulation D (but with an exclusion for certain self-directed employee benefit plans), (ii) QIBs, and (iii) entities with a net worth of at least $5 million not formed for the purpose of acquiring the securities. However, other states have taken no such action with regard to their versions of Section 402(b)(8), thereby leaving sellers and their counsel in a quandary as to whether a particular entity may or may not qualify under the exemption, whether to seek a different exemption or, worse, register the offering. This issue frequently arises in offerings relying on Rule 506 of Regulation D, where an issuer may wish to sell to a hedge fund or other private investment vehicle in a given jurisdiction, but can’t decide whether the entity qualifies as an “institutional buyer” under the applicable exemption.

Obviously, 2002 USA § 202(13), coupled with 2002 USA § 102(11), resolves a number of problems with the 1956 USA § 402(b)(8) exemption, by its inclusion of a host of additional entities as “institutional investors,” and, in particular, the “catch-all” for various types of entities with over $10 million of total assets in Section 102(11)(I). There are, however, a few questions with regard to this exemption. First, while the preamble to Section 102(11) states that the term “institutional investor” includes any of the specified persons, “whether acting for itself or for others in a fiduciary capacity,” when it comes to federal covered investment advisers and is not intended to reach transactions on behalf of others by such adviser.” Seligman at 51.

Thus, while the preamble to 2002 USA § 102(11) would have been clearer had the preamble stated “Institutional investor’ means any of the following, whether acting for itself or, except as otherwise provided below, for others in a fiduciary capacity,” the comment to Section 202(13)(B) makes clear that a sale of securities to an SEC-registered investment adviser will be exempt only if the adviser is purchasing for its own account, and not for a client (unless the client is itself an “institutional investor” or the adviser qualifies as an “institutional investor” under a different category in Section 102(11)).

2002 USA § 102(11) is also puzzling in certain respects, when it comes to the contrasting treatment of broker-dealers and investment advisers and SEC- and state-registered advisers. Thus, under Section 102(11)(E), a sale to an SEC-registered broker-dealer will be exempt, whether the broker-dealer is purchasing for its own account or for a customer’s account, if, in the latter case, the broker-dealer is acting in a fiduciary capacity (i.e., for an account over which the broker-dealer has full discretion, which ordinarily means a fiduciary relationship). Why should such a sale be exempted, while a sale to an SEC-registered adviser acting in a fiduciary capacity for a client not be exempt? Further, given the recent changes to the bifurcated regulation of investment advisers by the SEC and the states wrought by the Dodd-Frank Wall Street Reform and Consumer Protection Act, why should an SEC-registered adviser be deemed an “institutional investor” under Section 102(11)(L), yet a state-registered adviser be excluded (unless, of course, the state-registered adviser otherwise qualifies under Section 102(11), such as being an entity with total assets in excess of $10 million)? By contrast, it is noted that a private or governmental employee benefit plan with investment decisions made by a fiduciary which is a registered investment adviser in the particular jurisdiction qualifies under Section 102(11)(F) or (G), as applicable.

D. Particular State Oddities

As many practitioners know, a number of states, particularly those not adopting a version of either the
1956 USA or 2002 USA, have enacted strange, if not inexplicable, institutional investor exemptions. As detailed below, the states which stand out as the “odd men out” are California, Florida, Louisiana, Ohio, Pennsylvania, and Virginia, none of which includes an unconditional “institutional buyer” catch-all in its exemption.

While the exemption in Section 25102(i) of the California Corporate Securities Law of 1968 (the “CCSL”) and Rules 260.102.10, 260.105.2, and 260.105.14 thereunder provide exemptions from “issuer qualification” under CCSL § 25110 for a sale to a host of different entities, there is no “other institutional buyer” catch-all category among those provisions, other than for any corporation with a net worth of not less than $14 million. Aside from the obvious question as to where the idiosyncratic $14 million figure came from, it is noted that an entity organized as a limited partnership or limited liability company (such as your typical hedge fund) and which qualified as a QIB would not qualify under the foregoing exemption. Curiously, Rule 260.105.13.1 under the CCSL provides an exemption for a resale of restricted securities in compliance with Rule 144A under the Securities Act (i.e., a sale to any QIB), but that exemption applies solely to “nonissuer qualification” under CCSL § 25130, and not to issuer qualification under CCSL § 25110. Thus, in order to avoid such a qualification filing, a sale by an issuer to a hedge fund in California would have to satisfy a different exemption (or qualify as a sale of “covered securities” under Securities Act § 18).

In the case of Florida, the exemption in Section 517.061(7) of the Florida Securities and Investor Protection Act includes any QIB, but there’s no catch-all for sales to an “institutional buyer.”

As regards Louisiana, the exemption in Section 51:709(7) of the Louisiana Securities Act includes any “financial institution,” but not any “institutional buyer.” While there’s a separate exemption in Section 51:709(3) for sales in compliance with Rule 144A or Rule 144 under the Securities Act, it would not cover a sale to a QIB, other than in compliance with one of those two rules.

Section 1707.01(S) of the Ohio Securities Act defines the term “institutional investor” for purposes of the exemption in Section 1707.03(D) to include “any corporation.” The exemption doesn’t include any other catch-all category, other than an entity which qualifies as an “association engaged, as a substantial part of its business or operations, in purchasing or holding securities.” Unfortunately, there is no further explanation as to what a “substantial part of its business” means in the Act, so persons relying on that provision must proceed with caution.

As regards Pennsylvania, Section 102(k) of the Pennsylvania Securities Act of 1972 and Rule 102.111 thereunder define the term “institutional investor” for purposes of the exemption in Section 203(c), but without a catch-all, other than for a corporation or business trust or wholly-owned subsidiary thereof in existence for 18 months and with a tangible net worth of at least $10 million, or a QIB.

Finally, Section 13.1-514(B)(6) of the Virginia Securities Act provides the most restrictive institutional investor exemption, since it only covers an offer or sale “to a corporation, investment company or pension or profit-sharing trust or to a broker-dealer.” While any corporation is included under the Virginia exemption, regardless of its assets, net worth or any other test, the exemption excludes any other type of entity (other than one which fits one of the specified categories, such as a broker-dealer).

E. Now What?

Remembering the Official Comment to 1956 USA § 402(b)(8) that the “obvious justification” for these institutional investor exemptions is that there are certain investors who are sophisticated buyers who don’t need a securities registration filing with the applicable state to protect their interests (and noting that the exemption is only from the registration, not the antifraud, provisions of the statutes), it seems to me that it’s time for all states to adopt a truly uniform approach to these exemptions, using the 2002 USA §§ 202(13)/102(11) approach as the model. While I recognize that statutory changes take time, there’s certainly no reason why a state administrator which has the authority to define the term “institutional buyer” for purposes of an existing exemption by rule or order, or which has the authority to create additional exemptions by rule or order, shouldn’t take action to bring its exemption up to speed and into the 21st Century.

Is there any reason (perhaps other than preserving a revenue stream) to retain an overly restrictive exemption, or one including ambiguous or outdated
categories? It must be remembered that these outmoded exemptions have a dual adverse effect – not only may they deter an issuer or other person from selling securities to an institutional investor which isn’t clearly covered by the exemption, because the issuer doesn’t want to go to the bother and expense of complying with, or effecting a filing to perfect, a different exemption or, worse, registering the offering, but, by reducing the investment opportunities for institutional investors, they may create an incentive for such investors to relocate to a state with a less-onerous exemption.

BLUE SKY BITS AND PIECES
By: Ellen Lieberman
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A. Heath Abshire, Arkansas Securities Commissioner since December 2007, took office on September 11, 2012 as President of the North American Securities Administrators Association (NASAA). He has served as chair of NASAA’s Corporation Finance Section and is a member of the SEC’s Advisory Committee on Small and Emerging Companies.

The new NASAA Board of Directors as of September 11, 2012, in addition to Abshire, includes NASAA President-elect Steven D. Irwin, Pennsylvania Securities Commissioner; NASAA Past President, Jack E. Herstein, Assistant Director of the Nebraska Department of Banking & Finance; Fred Joseph, Colorado Securities Commissioner; Chris Naylor, Indiana Securities Commissioner; Douglas Brown, Manitoba Securities Commission Director of Legal, Enforcement & Registrations; Matt Kitzi, Missouri Securities Commissioner; Melanie Lubin, Maryland Securities Commissioner; and Patricia Struck, Wisconsin Securities Administrator.

NASAA reappointed David S. Massey, North Carolina Deputy Securities Administrator, to serve a new two-year term representing NASAA on the Financial Stability Oversight Council (FSOC). Created by the Dodd-Frank Wall Street Reform and Consumer Protection Act, FSOC is responsible for coordinating financial regulators to identify systemic risks to financial stability and is authorized to include three state regulators as non-voting members-- a state securities regulator, a state insurance commissioner, and a state banking supervisor. Massey is a former NASAA President, Director of the North Carolina Securities Division since June 1997 and before that, General Counsel for the North Carolina Department of the Secretary of State and General Counsel for the North Carolina Securities Division.

Chairman Mary Schapiro stepped down from the Securities and Exchange Commission on December 14, 2012 after four years of service. Previously she served as the chairman and CEO of FINRA, as an SEC Commissioner and as chairman of the CFTC. During her term at the SEC, the Commission brought a record number of enforcement actions and gained new powers under the Dodd-Frank Act, including a whistleblower program, and the JOBS Act. A lot of rulemaking under Dodd-Frank as well as the JOBS Act has been completed, but there remains a lot not yet final and a lot yet to be proposed.

President Obama named Elisse B. Walter, an SEC Commissioner, to succeed Ms. Schapiro as Chairman. Ms. Walter was appointed to the SEC by President George W. Bush, was sworn in July 2008, and then designated by President Obama to serve as Acting Chairman during January 2009. Prior to her recent service at the SEC, Ms. Walter was Senior Executive Vice President, Regulatory Policy & Programs, for FINRA and its predecessor NASD, General Counsel of the CFTC and Deputy Director of the SEC Division of Corporation Finance.

Meredith B. Cross will leave the SEC at the end of 2012, having served as Director of the SEC Division of Corporation Finance since June 2009. Ms. Cross led the Division’s continuing efforts to implement the Dodd-Frank and JOBS Acts. She expects to return to private practice. Previously she was a partner at Wilmer Cutler Pickering Hale and Dorr LLP in Washington D.C., worked in the SEC’s Division of Corporation Finance in various capacities from 1990 to 1998, and prior to that at King & Spalding in Atlanta and as a law clerk to Judge Albert Henderson of the U.S. Court of Appeals for the Eleventh Circuit. During her tenure as Corp Fin Director, the Division recommended close to 60 rulemaking releases for Commission action.

Elisse Walter named Lona Nallengara as Acting Director of the Division of Corporation Finance to replace Meredith B. Cross. He has served as Deputy Director for Legal and Regulatory Policy of the Corporation Finance Division. Previously he was a
partner in the Capital Markets practice group of Shearman & Sterling LLP in New York.

Also leaving the SEC will be its General Counsel since February 2011, Mark Cahn, and Director of its Division of Trading and Markets Robert W. Cook. Mr. Cahn was instrumental in developing the Commission’s rules to establish a Whistleblower Program and prior to his role as General Counsel was Deputy General Counsel for two years. He will return to private practice. Mr. Cook supervised more than 30 major rulemaking initiatives and studies under the Dodd-Frank or JOBS Act. Elisse Walter named John Ramsay to serve as Acting Director of the SEC’s Division of Trading and Markets to replace Robert Cook. Mr. Ramsay previously served as a Deputy Director for the Division of Trading and Markets, as counsel to SEC Commissioner Mary L. Schapiro, in various positions at the CFTC and NASD (now FINRA), as a partner at the law firm of Morgan Lewis and Bockius, as senior vice president of the Bond Market Association (now SIFMA), and as managing director and deputy general counsel at Citigroup Global Markets.

The U.S. House of Representatives Republican Conference elected Representative Jeb Hensarling (R-Texas) to be chairman of the House Financial Services Committee for the next congressional term. He previously served as the committee’s vice chairman, and will replace Representative Spencer Bachus (R-Alabama), stepping down due to term limits. Representative Maxine Waters (D-California) is the successor as the committee’s ranking member after the retirement of current Ranking Member Barney Frank (D-Massachusetts).

Massachusetts Senator-elect Elizabeth Warren is expected to have a seat on the Senate Banking Committee. A former Harvard Law professor, she was instrumental in establishing the new Consumer Financial Protection Bureau (CFPB) that was created under the Dodd-Frank Act. Originally considered to head the CFPB, she was not named to that post because of heavy opposition from the financial industry and Senate Republicans. Instead, they will have to work with her on the key Banking Committee, where she may have even greater pro-consumer influence. Senator Joe Manchin (D-West Virginia) is also expected to have a seat on the Banking Committee.

As of October 1, 2012, the Pennsylvania Department of Banking and the Pennsylvania Securities Commission merged into a new Pennsylvania Department of Banking and Securities. The merger was intended to save taxpayer money in the state. Glenn E. Moyer who was Secretary of the Department of Banking, became Secretary of the newly merged department and named Aimee A. Toth as Deputy Secretary for Securities in the new Department of Banking and Securities. She will oversee the administration and all operations related to the regulation of the securities industry in Pennsylvania. Toth was most recently chief compliance officer and general counsel for Allegheny Financial Group/Allegheny Investments, Ltd. and prior to 2004 a senior litigation attorney with the Pennsylvania Securities Commission. Before that she was a prosecutor in the Philadelphia District Attorney’s office, in private legal practice, and CEO of various private businesses.

Former Pennsylvania Attorney General Gerald Pappert was named by Pennsylvania’s Governor to be Chair of the Pennsylvania Banking and Securities Commission, and was confirmed as a Commissioner by the Pennsylvania Senate. The other Commissioners are Steven D. Irwin and Vincent J. Gastgeb.

New Hampshire has named Earle F. Wingate, Staff Attorney, to oversee exemption and registration filings in that state.

The New York State District Attorneys Association has named a White-Collar Crime Task Force in an effort to strengthen anti-fraud and anti-corruption laws. Manhattan Chief Assistant District Attorney Daniel Alonso and Erie County District Attorney Frank Sedita III will serve as co-chairs. The task force includes district attorneys, assistant district attorneys, private practitioners and academics and is expected to recommend legislative and executive changes to modernize white-collar law enforcement and make it more effective.

A MESSAGE FROM THE NEW NASAA PRESIDENT
By: A. Heath Abshure
NASAA President and Arkansas Securities Commissioner

As NASAA president my goals for the coming year are to fight against preemption or marginalization of state
securities regulation by advancing NASAA’s status as the most effective and balanced securities regulator in North America.

My emphasis this year will be NASAA’s response to the rapidly changing regulatory environment. I want to focus on what we can do, and if we harmonize our efforts, what we can become. If we harness our potential and speak as one, we will be the most reasonable, trusted, and influential securities regulator in North America.

State securities regulators in the United States are basically preempted from essential broker dealer and corporation finance regulation. The states still have regulatory authority over state registered investment advisers, but we just witnessed the first step toward preemption in that area—the push for a self-regulatory organization. While the first round of that battle may be over, I have no doubt that Round Two will start soon.

NASAA has long maintained a defensive position, using our admirable enforcement record to defend against further attacks on our jurisdiction. But, reliance on our enforcement efforts has done little to stem the tide of preemptive legislation coming out of Washington.

Don’t get me wrong, enforcement remains one of NASAA’s most fundamental tasks, if for no other reason, because no other regulator is going to act to protect hometown investors. However, I am concerned that this reliance, coupled with the inefficiencies resulting from divergent regulatory frameworks and requirements, will continue the trend toward preemption. I worry that state regulators may become nothing more than enforcement offices, all preempted from the ability to determine reasonable front-end regulatory measures to promote economic growth and prevent fraud.

The securities markets are too large and too diverse for one government regulator to oversee. It is woefully shortsighted to assume that one government regulator can be the most useful resource for all broker-dealers, all investment advisers, all issuers, and all investors of any size, from the ExxonMobils to the sole proprietorships, from the Calpers to the widowed retiree on Social Security.

Given the size and complexity of the market, NASAA is presented with a unique opportunity. NASAA should conduct a critical self-examination, consider the changes to securities regulation brought about by globalization and rapidly changing technologies, and stake claim to those areas where NASAA is the most efficient, effective, and appropriate regulator—the regulator most likely to serve as a valuable resource to issuers, investors, and the industry.

The markets are larger and more complicated than ever before. But, NASAA has robust tools that enable the states to act as one and speak with one voice. Rather than acting and regulating as separate entities, the states have the ability to consider important issues collectively and issue uniform guidance in a timely manner.

Consider NASAA’s ability to strike the reasonable balance between investor protection and capital formation along with NASAA’s ability to speak reasonably and collectively with one voice. Now add the benefits of NASAA’s physical presence in each state, territory, and province. It is clear to me, and I hope to most people, that NASAA needs to have an active voice that is not only heard by lawmakers, but heeded. However, history has proved that not to be the case. This is what NASAA must change.

As NASAA president, my goal is to get aggressive and focus not only on protecting the states’ existing jurisdiction, but utilizing the collective capabilities and expertise of the states to expand our jurisdiction and influence.

However, NASAA must be mindful of the advice of Coach Darrell Royal. “You can’t be aggressive and confused at the same time.” Working together, the states must develop and implement a strategy that not only wards off continued pushes for preemption, but also proves to lawmakers and industry that the states are the most able, competent and appropriate regulators to be the lead, if not the sole, regulator in a number of areas.

NASAA must show that our role strikes the most reasonable balance between investor protection and capital formation. If the JOBS Act is any indication, lawmakers appear willing to sacrifice reasonable regulation for perceived economic growth. However, reasonable regulation is essential to facilitate the investor trust necessary for economic growth. But all too often, lawmakers believe that unregulated markets promote growth. NASAA must persuade lawmakers that this belief is misguided and prove that the states are the best option to promote capital formation while at the same time maximizing safe and secure investing for consumers.

For this, we need every state administrator to establish a relationship with their legislators at home and their Congressional delegation. They need to know us if we want them to listen to us.

NASAA and the states must exhibit our ability to craft and implement regulations that are reasonable, efficient, and effective. The new Regulation A+ presents us with an opportunity to show Washington and the industry what we can accomplish. I have asked Bill Beatty and the Corporation Finance Section to make this a priority in the upcoming year. The investment adviser switch presented the same sort of opportunity. The Investment Adviser section and NASAA’s membership excelled during the switch process, serving as invaluable resources to all those involved. Now it is up to NASAA and the states to prove...
that through reasonable, effective and efficient regulation of state-registered investment advisers, a self-regulatory organization is an unnecessary burden.

However, Regulation A+ and state-regulated investment advisers are not enough. We should strive to be leaders in the timely development of uniform laws and regulations to address the rapidly changing issues in the markets. This includes responses to developments in all areas of regulation, including broker-dealers and enforcement. If NASAA can speak timely and with one voice on these issues, it will facilitate the continued development of a more efficient and effective system of state and provincial securities regulation across the board.

As I said before, NASAA need to develop on offense. The Federal Legislation Committee, working with the Board and the membership, should consider and propose a realistic legislative agenda to promote bills we want to draft. It is not enough to wait and respond to the next preemptive or equally harebrained bill. I look forward to NASAA members traveling to Washington to promote our bills.

NASAA must continue to educate and serve as an advocate for investors. This includes continuing the strong work of the investor education section. Further, we should act to identify and seek to remedy unfairness in laws, regulations or administrative procedures that threaten to harm investors, such as mandatory arbitration. When appropriate, the states must speak on behalf of small investors whose voices cannot be heard over the din of the lobbyists and industry.

In all of this, NASAA must speak with the one voice of reason; the one unbiased voice that strikes the most appropriate balance between industry and investor.

As we have seen over the past several years the securities markets and regulation of the industry continue to go through rapid changes. These changes present an opportunity that NASAA must grab to enhance its position as the most appropriately aggressive, yet reasonable and unbiased, securities regulator.

Considering NASAA’s history, excellent track record, universal reputation for fighting the good fight, and physical presence throughout all of North America, NASAA stands poised to be the most thoughtful, appropriate, and influential voice whenever changes to the system of securities regulation are being considered.

OUTSIDE BUSINESS ACTIVITY: PART THREE – WHERE THE RULES NOW STAND
This third of a series of articles is reprinted from Practical Compliance & Risk Management for the Securities Industry, November/December 2011.

By: Paul B. Uhlenhop, John S. Monical and Mitchell B. Goldberg
Lawrence, Kamin, Saunders, & Uhlenhop, L.L.C.

I. Introduction

This is Part 3 of a series of articles dealing with outside business activity. Part 1 described the applicable self-regulatory organization rules. In addition, it discussed proposed revisions to those rules and applicable NASD/FINRA Notices to Members dealing with personal outside business activities of associated persons of broker-dealers. Part 2, published in the previous issue of The ABA Blue Sky Bugle, discussed arbitration and regulatory claims and theories of vicarious liability and defenses of broker-dealers. Part 3 deals with supervision and compliance procedures applicable to outside business activities, including the changes necessary to procedures as a result of the proposed FINRA rule changes.

II. Supervision and Compliance

A. General

A firm’s supervision and compliance procedures are supposed to “be reasonably designed to achieve compliance with the applicable securities laws and regulations and with applicable FINRA rules.”¹ FINRA has interpreted this standard as recognizing that a supervisory system cannot guarantee firm-wide compliance with all laws and regulations and, accordingly, that the rules require only that the system be a “product of sound thinking” and “within the bounds of common sense,” taking into account the member firm’s business.²

In designing these systems, regulators want firms to utilize a risk-based approach which tailors the firm’s supervisory system to the firm’s business and to the

¹ See FINRA Rule 3010.

² NTM 99-45.
products that are being sold. Consequently, there is no standard set of compliance procedures or supervisory procedures to control outside business activities. Rather, in designing a firm’s system, each firm must consider the risks of unreported outside business activity and the methods of supervision of reported activity based upon the firm’s own business model. Thus, a firm with single associated person offices in widespread locations is expected to have very different supervisory procedures than a firm with large relatively good sized branch offices or Offices of Supervisory Jurisdiction (“OSJs”), each with a number of supervisory personnel on site. Similarly, a firm whose associated persons are involved in the sale of other financial products, such as insurance, real estate, or even more exotic products that may look like an investment in personal or real property, but may turn out to be securities, will have very different supervisory procedures than firms whose associated persons devote their full time to sales of mutual funds. New products also can present a special risk.

Although financial firms’ businesses vary greatly, so do the tools available to firms seeking to design supervisory and compliance procedures tailored to their business. Compliance and supervisory systems can employ different procedures for hiring, education, reviews and approvals when an associated person notifies the firm of outside activity, on-site inspections, and remote monitoring of known activity. Firms also tailor their procedures for investigating and responding to complaints from customers (and from others who may not even appear to be customers). Such complaints may signal an unapproved and unreported selling away activity. Many firms control some of the risk by prohibiting all outside business activities and in some cases all outside activities that may present a risk of inadvertent business activities. Other firms include statements in their new account forms or account statements warning customers against engaging in any outside business with an associated person and against writing checks to the associated person as opposed to the firm. Even these firms, however, have additional supervisory procedures in place which are intended to help detect unreported outside business activity and especially activity that may involve securities.

Set forth below are suggestions of various elements that might be considered in developing supervisory procedures and controls and related compliance procedures. The suggestions set forth below are not mandatory for good procedures and controls. To the contrary, many may be inappropriate for a specific firm depending upon the firm’s business and structure. Many others may be too complex and/or expensive for some firms, especially small firms. The key thing is assessment of risk and practicality for supervisory procedures and controls and compliance procedures. The discussion below is a starting point – a place for a firm to look for ideas that may be incorporated, modified, or even rejected in the firm’s design of a good supervisory system.

B. Hiring and Background Investigation

NASD rule 3010(e)\(^3\) states that a member shall have the responsibility and duty to ascertain by investigation the good character, business repute, qualifications, and experience of any person prior to submitting a U-4 for that person to associate with the firm. When performing due diligence in the hiring process, firms today generally do much more than simply rely upon the U-4 signed by an account executive. A thorough background check is typical, and in some cases often includes (and may not be limited to) a credit report, financial statement, or tax returns. Telephone calls or written requests for verification commonly are made not only to the associated person’s former firm, but to all the firms in which he has been previously employed, sometimes reaching back for the previous 10 years. In fact, some firms apply a higher level of diligence whenever they see a significant turnover in employment. It is wise for firms to obtain information about other outside organizations with which the person has been affiliated for the same period of time.

1. Employment Questionnaire. Firms often use a detailed background questionnaire completed by the proposed account executive prior to an interview. Some suggestions for the questionnaire are the following:

(i) describe all business activities for a period of ten years;

(ii) with respect to each outside business activity, provide details [dates of

\(^3\) Proposed changes to NASD Rule 3010(e) have been approved by FINRA and await SEC approval. See Section II for further information.
involvement, position, description of affiliates of the business, relationship with other individuals involved, etc. . . . ];

(iii) list all of the types of products that the associated person has sold at his former firm(s);

(iv) describe all outside volunteer or non-business activities [positions held in church, voluntary associations, clubs, family members, etc.] that may involve financial, securities or investment activities;

(v) describe all activities not disclosed above that might involve securities [partnerships, joint venture agreements, leases, management contracts, property ownership];

(vi) list all personal web sites or other web sites where the applicant is listed;

(vii) list all litigation including arbitrations and disciplinary matters; and,

(viii) list names of persons that might be contacted regarding the above.

Firms generally should seek to obtain the consent of the associated person for the member to obtain additional information, such as credit information, and to contact persons associated with any outside activity or otherwise related to information requested in the questionnaire.

2. Financial Statements, Tax Returns, Bank Accounts, Sources of Income. It may be helpful to obtain from each proposed associated person one or more of the following:

(i) tax returns for several years;
(ii) a detailed financial statement;
(iii) a list of all bank accounts;
(iv) a list of investments; and,
(v) past and present sources of income for five years.

If obtained, this information should be carefully reviewed both to consider the associated person’s holdings and for conflicts with the possible business of the member or its clients. The associated risks need to be evaluated and in some cases special supervisory procedures to minimize risks.

3. Credit Check. Firms often find it useful to obtain and carefully review a credit report for the associated person. A credit report may give more account information than some of the items in (2) above, and could be a good alternative or a first step before asking for all of the information in (2) above. Firms may wish to further investigate significant loans, debits or poor credit before hiring. Depending upon the circumstances, unsatisfied debt or spending disproportionate to income may create financial pressures upon an associated person which, in turn, could create an incentive to seek additional income through inappropriate and concealed outside business activity.

4. Legal Check. Today it is usually very easy to check electronically for pending litigation (including arbitrations or regulatory proceedings or investigations) by or against a proposed account executive in federal and in some state courts and by regulators. FINRA’s broker check should be accessed to ascertain pending complaints, investigations and litigation. If his or her name appears in litigation, a firm may wish to request and document full details of the litigation or investigation before hiring the associated person.

5. Reference Calls. For a new employee, firms may wish to:

(i) contact former broker-dealer or other former employers’ Form U-4 for 10 years (mandatory requirement for 3 years);
(ii) if the person is involved with insurance, call the insurance agency with which he or she is associated and the insurance company or underwriter;
(iii) depending upon the circumstance, contact some or all other outside business organizations disclosed to the firm;
(iv) consider review of all other outside activities to determine if participation appears extensive or signals possible securities or investment activity and if it is advisable to contact persons knowledgeable about such activities;
(v) if the associated person is involved in charitable or other community organizations, some firms ask for
references and/or confirmations of activity for each organization and under some circumstances inquiring by call or by interview; and,

(vi) if warranted, call banks where the associated person has or had bank accounts for the last 3 to 5 years.

6. Interviews. Firms often conduct a final interview after all of the information, calls, questionnaires and data have been received. After the questionnaire has been completed, some firms will have at least two supervisory personnel review the questionnaire, including one that is independent. Based upon the questionnaire, firms often conduct two or more personal interviews. Discrepancies can be investigated and a firm can prepare a memorandum as to the resolution of any issues raised by the questionnaire to protect itself from negligent hiring claims. In some cases, it may be appropriate to adopt heightened procedures if there are to be any waivers with respect to information. It is a good practice to obtain permission by the hiring supervisor from a third independent supervisory person.

7. Web Site and Social Media Checks. In many situations, firms find it worthwhile to search for and review web site(s) and web-based social media (Facebook and Twitter) of the proposed associated person and his prior employers. The site search may uncover not only sites created or known to the applicant, but also a listing on any other web site or social media. This some times will lead to disclosure of outside business activities involving other businesses or in some cases securities activities.

8. Overview of Hiring Process. The hiring process for an associated person is and should be different from that of other employees, particularly with respect to outside organizations and activities. Human relations departments tend to have a set questionnaire or application for all employees. While inquiries regarding participation in certain outside organizations [religious or political organizations for example] may be an unwise general employment practice which could subject an employer to potential scrutiny under discrimination laws, those same inquiries may be an important part of a firm’s due diligence of an associated person if the outside organization, with the help of the associated person, is or may be promoting particular types of investment products to raise funds. The organization may also have granted the person discretion to invest funds on its behalf outside the firm. Even if the organization is not involved in such activities, other conflicts could also arise if the associated person is soliciting clients for contributions to the outside organization. Political organizations present particular selling away problems and other conflicts that arise as a result of solicitations and pay-to-play business. On June 30, 2010, the SEC adopted its rules to curb pay-to-play practices in which investment advisers make campaign contributions to elected officials in order to influence the award of contracts to manage pension plan assets and other government investment accounts. Under the pay-to-play rules, political contributions by an outside business or other organization with which an associated person is affiliated or directly by an account executive or other employee may violate the pay-to-play rules. The full scope of the pay-to-play rules is beyond the scope of this article, but the pay-to-play rules should be taken into consideration in hiring new associated persons and also with respect to current associated persons’ outside business activities.

The various non-discrimination provisions of both state and federal law should be examined and the inquiries prepared carefully to ensure they are directed only to the possibility of other business activity or conflicts of interest and are not used to discriminate in the hiring process.

4 Under the rule adopted by the SEC, investment advisers may not provide investment services for corporations directly or indirectly through a pooled investment vehicle two years after the adviser or certain executives or employees make political contributions to an elected official or candidate for political office who is in a position to influence the government entities’ selection of the adviser. It also prohibits an investment adviser and certain of its employees from paying or agreeing to pay a third party placement agent or finder to solicit business from the government entity on the adviser’s behalf unless the third party is a registered broker-dealer or SEC investment adviser subject to the pay-to-play restrictions. It prohibits an investment adviser and certain of its executives and employees from soliciting or coordinating campaign contributions from others to a political official candidate or political party in a state or locality where the adviser provides or is seeking to provide advisement services. When a proposed employee has been associated with an outside organization whose activities may fall within any of the above limitations or prohibitions, the rules would be retroactively applicable in some cases. See 17 CFR 206(4)-(5) and amendments to Rules 204-2 and 206(4)-3 to the Investment Advisers Act of 1940, 15 USC 80b; see also IA Release 3043. The rules are effective September 13, 2010.
C. Education Regarding Outside Activities

1. Education of All Associated Persons.
   In many selling away cases, the associated person claims simply not to have known that the activity was prohibited. Education for associated persons concerning outside activities and the firm’s policies can help prevent these problems. Generally, firms create a documented program to educate all associated persons with respect to the firm’s policy that:

   (i) any and all outside activities should be reported to the firm before engaging in the activity;

   ii) regardless of whether the employee thinks he or she is engaged in investment activity for the organization, the employee should let the firm make the determination as to whether the employee’s activities involve a conflict of interest, investment or securities activities; and,

   (iii) the firm must pre-approve participation in organizations which involve the possibility of securities activities or other activities that might present a conflict of interest.

2. Education of Employees Who May See Outside Business Activity Information or Red Flags. Supervisors and others who may be reviewing or see outside business activity should attempt to be alert. Firms can help through education of supervisors and other persons who may come into contact with information suggesting outside business activities. There should be specific procedures for alerting compliance and alerting supervisors up-the-line if information points to unapproved outside business activity. Although supervisors should be trained to attempt to identify red flags indicating inappropriate outside business activities, in most cases it would be impossible to train them effectively to investigate them. Supervisors should not be held to the same level as a trained investigator. Investigation of red flags of outside business activities can require substantial investigative and business expertise beyond the experience or training of most supervisors. Supervisors should be trained when they see or suspect red flags indicating selling away to notify the compliance department or legal department who should use skilled investigators or outside counsel to investigate and pursue the red flags.

3. What is Securities and Investment Banking Business Activity? Firms generally include written policies in the compliance manual for employees that neither the associated person nor his supervisors are to make a decision on what does or does not constitute securities or investment banking business activity. These policies often warn associated persons that they are not to rely on letters from outside counsel (other than the firm’s counsel) and explain to associated persons that determining what is a security is so difficult that even the United States Supreme Court Justices have differed in their view as to what is a security. Products like indexed annuities, certain types of real estate investments, promissory notes, condominium vacation rental programs and a variety of other types of activities create difficult legal questions that can be far beyond the ability of associated persons or their supervisors to determine. Furthermore, the determination of whether something is a security varies between the various states and between state and federal law. Likewise, there can be a significant difference between the definition of securities in other countries and the definition of a security for purposes of federal or state securities laws in the United States.

D. Periodic Update Regarding Outside Business Activities

The member should have a policy that requires a periodic update of all outside activities of associated persons. Some suggestions include:

   (i) compliance procedures can emphasize that the firm’s policy requires that the associated person must report any outside activity to the firm prior to undertaking the activity;

   (ii) report any personal web site or social media;

   (iii) the required update on outside business activities could include all of the things that were covered in the new employment questionnaire. Some firms also periodically obtain one or more of the following;

   (1) current financial statement;

   (2) list of bank accounts;
Supervisory procedures may provide that when there is an update of outside activity and/or additional information such as financial statements, bank accounts, tax returns, and credit reports are obtained, that they be promptly reviewed and assessed. If there are exceptions, the firm can protect itself by following up and documenting their resolution. It is also helpful for supervisors to assess the person’s lifestyle and compare it to his income and its sources. The tax returns and financial statements could reveal sources of income that may need to be investigated and possibly supervised or prohibited.

A number of firms use written reminders to all supervisors and associated persons and other persons with a need to know of the necessity of updating information regarding outside business activities. An annual or more frequent reminder may be helpful. Also, many firms use an annual questionnaire as part of their updating review. The annual questionnaire should request information concerning any personal web sites or web sites or other social media where the associated person is listed or use. Some firms may do a periodic check by running an associated person’s name through a search engine to determine if the associated person has a personal web site or is listed on other web sites.

If there is new outside activity, a detailed description of the activity should be obtained either in writing or on-line from the associated person. In the event there are questions with respect to particular activities, personal interviews and further investigation may be warranted and a memorandum prepared regarding the outcome of the interview. A firm’s compliance department plays an important role in such interviews and the result of the interviews. If there are any red flags, firms may consider conducting and documenting further interviews with two separate interviewers or its firm counsel. One of the interviewers could be independent.

E. Inspections and Reviews

1. Auditing and Inspection Procedures in General. General supervisory procedures should provide for inspection of all offices as required under FINRA rule 3010(c) (which continues to be required under the proposed new supervisory FINRA rule 3110). More frequent inspections may be appropriate for offices where there are complaints or where exception reports or past inspection deficiencies evidence other possible problems. A pre-office inspection profile of the office should be prepared that may include, among many other things:

   (i) a listing of any activities, business or private, known to the member that are conducted in or outside the office that are not directly related to the member’s business;
   (ii) complaints or exception reports;
   (iii) past problems at the office; and
   (iv) a search of web sites and social media for the associated person’s activity.

Based upon the firm’s pre-audit procedures, firms can develop a plan to review and sample business activities conducted by the associated person to determine if there are any activities that have not been reported to the member.

If there are other outside securities business activities conducted at the associated person’s office, prudence may require some inspection of those activities. This may include reviewing files and other activities for inappropriate conduct, including the sale of investment products, particularly private placements, notes and other exotic securities, such as vacation condos with rental contracts and other unusual investment programs. If the associated person has a second office from which business activities are conducted, appropriate procedures can be prepared for at least a limited inspection of such office and potential outside business activities of that office. These procedures may include an on-site inspection of such office.

In inspecting branch offices, the inspector may try to obtain some idea of the lifestyle of the associated person and consider whether that lifestyle is within the person’s means. Reviewing files of the customers and, sometimes, even non-customers with which the office has business activities can be important. If problems of possible outside selling activity are detected, a firm may want to contact and interview broker-dealer customers as well as the outside business activity customers. Some firms require that all branch offices, particularly small branch offices,

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See RN 08-24 (April 2008); see also proposed Rule 3110(c).
have a log-in for individuals that actually visit the office. Other firms compare telephone records of the associated person with the telephone numbers of clients to determine if and why there are a lot of calls being made to non-clients.

2. Surprise Inspection. Surprise inspections, especially with smaller offices, can be an effective tool for investigating outside business activity. The surprise inspection is sometimes a problem for a single person office because the examiners may show up when the associated person is on vacation or is elsewhere. Some smaller firms may attempt to minimize these problems by requiring the associated person to provide notice to the firm if the person plans to be out of the office for a day or a longer period of time.

F. Complaints

As mentioned above, one sign of impermissible selling away is complaints from customers or non-customers about products that are not within the scope of the firm’s business. If a customer or non-customer complains about a transaction that has not been recorded on the firm’s books and records, the firm may have a clear sign of possible selling away. One complaint may lead to the uncovering of relatively massive selling away activities, some of which are Ponzi schemes and others which are bona fide securities but being sold in contravention of FINRA rule 3270 or NASD rule 30406 and/or the member’s policy. In other cases, the account executive may have received no selling compensation, but the member has not been notified. In many cases, when a complaint is received it is already too late to prevent the selling away because the investment sold is worthless and in the case of Ponzi schemes or other out-and-out frauds, money may have been misappropriated by the account executive or third parties. Accordingly, complaints should be promptly and thoroughly investigated.

G. Additional Thoughts on Policies and Procedures

Policies and procedures, both supervisory and compliance, should include forms designed to elicit necessary information. Some of the forms are described above, such as pre-employment questionnaires and annual update questionnaires. The supervisory procedures should spell out for both supervisory and compliance personnel how to follow up the chain and who is to follow up on information received.

Needless to say, procedures should be explicit as to who is reviewing what information and the procedures should also make clear that the primary responsibility is on the supervisory personnel. The role of the compliance department and its personnel should also be clearly defined.

H. Permission to Sell Away

Under FINRA rule 3270, if an associated person engages in business activities for compensation as defined in the rule, the associated person must notify the firm in writing with respect to such activities. If the substance of FINRA rule 3110(b)(3) is proposed and adopted to replace NASD rule 3040, the associated person also would be required to report in writing any securities or investment banking activities whether with or without compensation. In either case, if the member firm grants permission to conduct the activities, it must supervise the activities and record them on its books and records that involve securities or investment banking. Furthermore, as explained above, if there are securities activities for compensation, the transactions must be reflected on the books and records of the firm. If the activity is not for compensation, the member has the right to place conditions on the associated person’s participation. In many cases, the firm simply prohibits the activity. Under the new proposed rule, any securities or investment banking activities are required to be supervised and on the books and records of the member whether for compensation or not.

I. Reporting to Authorities

If selling away is uncovered, we recommend the firm make an extremely rapid investigation using knowledgeable counsel and compliance experts. The question of when to inform the regulators is always difficult. Unfortunately, there is no set answer as to when you should inform the regulators and which regulators you should inform. When to report depends upon the scope of the non-permitted selling activities, the number of involved investors, the

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6 FINRA rule 3110(b)(3) was proposed to replace rule 3040, but was not included in a recent SEC rule filing and is expected to be revised and renumbered.
number of associated persons and supervisory personnel, and the extent of the losses.

The Dodd-Frank whistleblower provisions and copycat state whistleblower provisions are expected to substantially impact when to report. The Dodd-Frank Act\(^7\) allows for both the SEC and the CFTC to pay rewards to eligible whistleblowers who provide the SEC with original information that leads to a successful enforcement action yielding monetary sanctions of over $1 million.\(^8\) The effective date of the legislation was July 22, 2010.\(^9\) If a firm reports to the SEC information available to it before a whistleblower reports information about a suspected problematic selling away case, it will most likely cut off the whistleblower from receiving rewards provided by the statute. Knowledge by a potential whistleblower that the firm has already reported information, although tentative, also may sway a potential whistleblower from going to the SEC. When a firm has tentative information that looks like it might possibly involve selling away and illegal transactions, ideally the firm would conduct an investigation by in-house counsel or outside counsel to ensure complete and accurate reporting to the regulators. However, if a whistleblower reaches the regulators with information as provided in the rule before the firm reports to the SEC, the whistleblower will be in line for a reward. Counsel representing an individual employee or associated person of a broker-dealer suspected of being involved or having relevant knowledge will necessarily ethically be required to explain to the witness that whistleblower rewards may be available if the witness reports to the SEC before the firm. Because of these rewards, many firms will elect to go to the SEC as soon as they have information of a possible outside business activity that involves potential illegal activity, before a thorough investigation and before the firm knows the scope of the problem or most of its details. The firm’s counsel will approach the regulators, explain what information they have, explain that the firm is conducting an independent internal investigation and agree to report back to the regulators with respect to the activity and the investigation as soon as possible. If the whistleblower thereafter does contact the regulators, unless the whistleblower provides critical new information, there should be no whistleblower rewards. This is essentially what Congress expected: a race to the SEC any time possible illegal activity is discovered. Of course, if there is continuing fraudulent activity involving the selling away, it must be stopped immediately. If the firm knows that it is unable to stop the individual’s conduct, the firm must contact the regulators immediately so that they can take appropriate action to stop it. All of these and many other factors need to be considered.

While timing is important, another serious question is whether a firm should report to FINRA, the SEC, applicable state regulators or all. In certain very serious cases, we have recommended that a firm report simultaneously to the SEC, FINRA, and the applicable states. Reporting to the SEC is more important when there are third parties outside the jurisdiction of FINRA, but not outside the jurisdiction of the SEC. If the problem involves an exchange transaction, which is unusual in connection with outside business activity, it should be reported to the exchange regulators. Firms should retain a knowledgeable counsel familiar with SEC, FINRA and state enforcement to advise them on how, when, and to whom to report.

III. Conclusion

A broker-dealer’s key to avoiding civil and regulatory liability is a robust supervisory and compliance program with respect to outside business activities. Such a program must be tailored to the firm’s unique business activities and personnel if it is to be successful.

THE WORST POSSIBLE OUTCOME – FINDERS BEWARE

By: Joseph W. Bartlett
Sullivan & Worcester, LLP

According to a client alert by Amy Natterson Kroll, Carl A. Valenstein and Margaret (Peggy)

\(^7\) See Dodd-Frank Wall Street Reform and Consumer Protection Act §922 (SEC), §748 (CFTC); see further CFTC Proposed Regulation 165 to implement the amended Section 23 of the Commodities Exchange Act.

\(^8\) The award amount is set at between 10% and 30% of the total monetary sanctions collected in the Commission action or any related action such as in a criminal case.

\(^9\) However, whistleblower rules have been proposed by the SEC and the CFTC but have not yet become effective. When the whistleblower rules which are currently proposed are finalized, they will be retroactive to July 22, 2010.
Blake, Bingham McCutchen LLP, in July 2012, from which I quote, Neogenix Oncology Inc., a public biotech firm based in Rockville, Md., and New York, surprised investors by filing for Chapter 11 bankruptcy protection. To those in the biotech industry, Neogenix, by all accounts, was a successful company with more than 500 shareholders and what seemed to be numerous clinical developments. Perhaps even more surprising than the actual Chapter 11 filing was the reason behind it.

It seems an inquiry by the U.S. Securities and Exchange Commission in late 2011 into the company’s capital raising efforts uncovered payments by the company to unlicensed individuals (i.e., individuals who should have been licensed with a registered broker-dealer) who assisted in the company’s capital raising. Reliance on unregistered persons resulted in “significant potential rescission liability and the inability to present audited financial statements” leaving the company “unable to raise funds.”

In the case of Neogenix, the company engaged several “finders” to assist with the offer and sale of its securities. How those individuals were paid is not clear, but the payments and the finders’ arrangements in question came to the attention of the SEC. Following its inquiry, the SEC determined the finders used by Neogenix were required to be licensed. As a result of the use of unregistered broker-dealers in the offer and sale of securities, Neogenix opened itself up to the possibility of shareholder suits for rescission of the purchases and sales of the securities. The Neogenix Chair wrote a letter to the shareholders, from which I quote in part:

“I also noted in my January 12th letter that our independent auditors had stated they were not prepared to review or audit the Company’s financial statements because of their uncertainty as to how to reflect the Company’s [potential financial exposure relating to any possible rescission rights. Without that review and audit, the Company cannot complete its third quarter 2011 and full-year financial statements. With input from professional advisers, the Board and management proposed to our auditors an accounting treatment of any potential rescission rights as a “contingent liability” whose probability and amount is not certain. Our external auditors did not accept the Company’s proposed accounting treatment for these potential liabilities. With the cooperation of our external auditors, we have not sought guidance from the SEC’s Office of Chief Accountant (OCA) on the proper accounting treatment of these contingent rescission rights, so that we may complete our third quarter 2011 and full-year financial statements. We do not know what guidance OCA will offer, and there is no guarantee that our independent auditor will accept the guidance OCA does offer. We continue to believe that the approach gives us the greatest likelihood of being able to complete our financial statements and bring our SEC filings current as expeditiously as possible.

10 See letters from Philip M. Arlen, M.D., President & Chief Executive Officer, Neogenix to Neogenix Shareholders regarding the filing and facts underlying the filing. www.neogenix.com

11 Letter from Philip M. Arlen, M.D., President & Chief Executive Officer, Neogenix to Neogenix Shareholders (Feb. 5, 2010).

12 Under Section 29(b) of the Exchange Act, (15 U.S.C. § 78cc(b) (2012)), contracts entered into in violation of the Act may be rendered void. Courts have used this statute to declare void securities transactions entered into with unregistered broker-dealers. State law rescission rights may exist even where the unregistered finder did not contract directly with investors.
“As a result of the pending SEC inquiry, the significant potential rescission liability and the inability to present audited financial statements, we have been unable to raise funds.”

The upshot is that the company decided to sell itself to another entity owned by Neogenix shareholders and to declare Chapter 11 bankruptcy.

Maybe, at long last (see the list of my publications on the subject, the SEC will at last pull up its socks and institute a practical alternative … broker / dealer lite. Stay tuned.

EDITORIAL

By: Martin A. Hewitt
Attorney at Law

As another year ends, one full of natural disasters and man-made follies, it is time to take both a look back and a look forward at what we have and have yet to accomplish in the wonderful world of Blue Sky law. This past year we have seen the implementation of the Investment Adviser Switch; further rulemaking under The Dodd-Frank Act; and of course, the JOBS Act with all the excitement it has generated for practitioner and regulator alike. And there is no doubt that this next year will be one in which we will surely contend with continued man-made financial disasters brought to you by our friends on Capital Hill.

This leaves us with a simple question. Where do we go from here? Certainly the answers are not to be found with our elected officials. They seem to have scant understanding of the world in which we all live. Let’s refer to this as the real world. And when I write “we” I mean all of us - practitioner, regulator, issuer, investor, broker/dealer and investment adviser. In speaking with colleagues in each of these areas, I believe the answer is that we all have to work through this together. While each of us has our own unique perspective, it is the amalgamation of perspectives and insights that will give us the most realistic and workable set of rules by which we can all help our economy – such as it may be next year. The puzzle to solve is simple enough. We need to find a way for issuers to raise funds that ought to help create jobs, while protecting the investor at the same time. The key is provide a means by which issuers can raise funds without spending more time on compliance than on running a business, while at the same time ensuring the integrity of the marketplace. If we can figure out that puzzle, balance the scale so to speak, then prospective investors will have the confidence to invest.


13 Unregistered Finders articles/links

• http://www.thedeal.com/magazine/2010/05/consequences_of_violating_section_29/print/
  “Consequences of violating Section 29,” May 10, 2010.
• Unregistered Finders: The SEC Begins Enforcement Actions (8/4/2009),
• Private Equity Alert - Unregistered Finders - The Last Chapter? (6/9/09),
• Mandatory Registration of Finders as Private Placement Brokers: SEC Action On The Way (Part 1)
  (1/11/07),
• Mandatory Registration of Finders as Private Placement Brokers: SEC Action On The Way (Part 2)
  (1/16/07),
• Unregistered Finder; Can Issuer's Counsel Participate in the Deal? (6/1/06),
• Can You 'Find' Capital: NASD Action vs. John Hancock (5/13/03),
• Finder's Keepers? (9/30/00),
• Business Brokers Not Required to Register as Brokers,
• Mandatory Registration of Finders: ABA Task Force Report,
• ABA Report and Recommendations of the Task Force on Private Placement Broker-Dealers, 2006,
• Bartlett, "ABA Task Force Urges the SEC to Promulgate 'Broker Dealer Lite:' Registration
That is all we need to do. Simple? OK, perhaps not. But the only way we can come closer to balancing that scale is to engage in a robust dialogue among the parties. Time is of the essence, not just because of the unrealistic deadlines set by politicians, but because there is an urgency to move the economy forward through job creation that will, most likely, not be addressed adequately in Washington.

So I end with an invitation to our friends at NASAA, the SEC, FINRA, issuers, and investors, to join in the discussion. The solution will not be found in a vacuum. Perhaps one place to start that dialogue is right here in the *Blue Sky Bugle!* This has been a tough year for the *Blue Sky Bugle*. While I can’t thank the authors that contribute timely content for these pages, there is plenty of room for others to express themselves here, and I encourage you to take time to write a few pages regarding your thoughts and perspectives on what is truly needed in our regulatory world. We can’t leave this to those inside the Beltway. It is up to each of us.

Happy New Year!

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.

Clear sailing over the ocean blue - mah © 2012
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Published by the American Bar Association Section of Business Law
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