MESSAGE FROM THE CHAIR

By: MARTIN A. HEWITT

It has been far too long since the Blue Sky Bugle has been published and I hope that this edition will put it back on a regular schedule.

In any event, so much has happened since the last edition of the Blue Sky Bugle and here seems the right place to look at some of the highlights of the past year or so.

Elder Financial Abuse

The fight against financial elder abuse has been a hot topic for many years, but more and more regulatory developments have put the fight into better focus. I can’t think of anyone who has not heard of someone close to them or their extended family and friends
who has not fallen victim to financial elder abuse. This can take the form of a nefarious registered representative of a broker-dealer, a cold call from the faux “IRS” stating that if the recipient of the call does not provide a credit card to pay an outstanding tax balance a warrant for that person’s arrest will be issued immediately, or numerous other scams. While most of us understand when we see a scam, there are those who, because of either age and/or illness are not so fortunate.

Among many recent developments in the fight against these abuses is NASAA’s Model Act to Protect Vulnerable Adults from Financial Exploitation which was posted on the NASAA website on January 22, 2016. This model act is for jurisdictions (state and territorial), considering legislation, regulation, or rulemaking that will provide resources to regulators to monitor potential financial abuse. The important point here is that regulators cannot do it alone and that we as a legal community are in an excellent position to address the issue of financial elder abuse with our clients (e.g., issuers, broker-dealers, and investment advisors).

Uniform Securities Act of 2002

After many years of relative stagnation, several states have adopted or are in the process of adopting the Uniform Securities Act of 2002; recent adopters include New Hampshire (effective on January 1, 2016) and Wyoming (effective July 1, 2017). Alaska is currently in the process of seeking legislative approval to enact the Uniform Securities Act of 2002.

Electronic Filing Depository

1 Delayed effectiveness. The following Act sections will take effect on July 1, 2017:

- Section 1 on definitions, federal agency citations, and electronic records/signatures; and
- Section 2 on exempt securities and transactions, including a new intrastate crowdfunding exemption.

The following Act sections take effect immediately, thereby allowing the Secretary of State to begin preparing for the transition to the new Act:

- Section 3 on securities registration (by coordination and qualification) and federal covered security notice filings;
- Section 4 on broker-dealers, agents, investment advisers, investment adviser representatives, federal covered investment advisers, and filing fees; and
- Section 5 on fraud and liabilities.

After years of eager anticipation, NASAA announced the long awaited Electronic Filing Depository (“EFD”) on December 15, 2014. As many of you know, EFD is an online system that allows issuers to submit a Form D, pursuant to Regulation D, Rule 506, to the various states. The system quickly gained popularity and exceeded 10,000 filings by August 5, 2015. Needless to say, it has grown precipitously since then.

It is important to note that what makes EFD so effective are the people who created and run it. They have been helpful in terms of occasional technological hiccups as well as their willingness to work with industry to make the EFD ever more effective and user friendly.

It should be noted that as of April 2, 2016, there are 44 states where one can file electronically through the EFD. Of those states five (Colorado, Iowa, Montana, New Jersey, and New Mexico), require filing through the EFD. To find more information please click here.

Crowdfunding and Reg. A+

Crowdfunding, a new and exciting area appears to be in a constant state of flux. A child of the JOBS Act, it seems that the term Crowdfunding means different things to different people. Perhaps it is a “beauty is in the eye of the beholder” kind of thing. In any event, many states have developed a regulatory framework for these offerings with other states working on such frameworks.

At the present time 30 jurisdictions have adopted specific intrastate Crowdfunding exemptions either by legislation, regulation, or administrative orders. A good resource regarding state crowdfunding efforts is available at NASAA’s Intrastate Crowdfunding Directory.

Available since last summer, Reg. A+ is another child of the JOBS Act. As such its goal is to provide a mechanism for smaller public offerings to come to market.

Reg. A+ has two separate “tiers”. Tier 1 offerings are smaller offerings of up to $20,00,000 and are subject to state regulation. Tier 2 offerings are for offerings of up to, but no more than $50,000,000. Currently, there is ongoing litigation between the SEC and the states of Massachusetts and Montana over whether
Tier 2’s preemption of state registration regulation is valid.

While each state has its own state filing requirements, for those issuers that desire multistate registration there is a coordinated review program based out of Washington State. Coordinated review is intended to facilitate and streamline the registration process. For more information please see NASAA’s Coordinated Review Program for Regulation A Offerings.

Thus far there have been approximately 60 issuers that have filed Regulation A+ offerings with the Securities and Exchange Commission (“SEC”). Of those 60 issuers, approximately 12 have filed with FINRA because a FINRA member is participating in the distribution of securities for these issuers. Of the dozen FINRA filers there have been approximately 2 (as of this writing), which have received a No Objection Letter (“NOL”) from FINRA. An NOL is required for such offerings to receive final approval from the SEC.

Concentration Limits for Alternative Investments

NASAA is currently working on developing concentration limits for direct investments, such as business development companies and real estate investment trusts. NASAA’s concern is that people should not take undue risk in a particular investment class. At the present time NASAA is looking at a 10% limitation of an investor’s liquid net worth as the maximum that can be invested in a particular investment class. While the goal, investor protection, is essential, many in the legal community have proposed alternatives. NASA held meetings with various individuals, including lawyers and issuers in order to get the broadest range of thought on this subject. While the nature of any such limit has yet to be carved in stone, all stakeholders continue to have discussions with NASAA. The give and take between NASAA and the various stakeholders has been robust and enthusiastic with many more discussions to come.

State Exemptions for Private M&A Brokers

As I like to often say about one issue or another, the states are all over the map on this one. After the SEC’s M&A Brokers No Action Letter, dated January 31, 2014 (revised: February 4, 2014), the states developed the NASAA Model Rule Exempting Certain Merger & Acquisition Brokers (“M&A Brokers”) From Registration. While this rule is similar to the SEC’s M&A No Action Letter, it more closely resembles legislation currently winding its way through Congress.

The reason I say that states are all over the map on this issue is because some states already have rules in place while others exclude M&A Brokers by definition, and still others are contemplating the model rule. This is an area of both great interest and great uncertainty because of the panoply of conflicting guidance on both the federal and state level.

Finders

Last, but certainly not least, are the latest developments regarding finders. The Private Placement Taskforce has been working on this issue for approximately 16 years or so. During that time there have been many attempts to figure out how to bring finders into the light of day and also rid the industry of those finders who are less than reputable.

Once again, things seem to be heating back up and hope springs eternal. Several lawyers have been in discussion with the SEC, NASAA, and FINRA. While it is slow going, there is progress being made. It is a far more complicated topic than one would first think; therefore, the delays and setbacks are not unexpected.

Final Thoughts

I would like to thank all of the contributors to this issue of the Blue Sky Bugle. As you can see, much has happened since the Blue Sky Bugle was last published. Each of these topics are worthy of future articles -- which is a not so gentle hint that we are always looking for content here at the main offices of the Blue Sky Bugle. If you would like to submit an article, please e-mail me at Hewitt@mheittlaw.com.
AN INTERVIEW WITH JUDITH SHAW, ESQ.
ADMINISTRATOR, MAINE OFFICE OF SECURITIES
By: Sigmond D. Schutz, Esq.
Preti Flaherty, LLP
By: John Duval, Sr.
Securities Arbitrator and Litigation Consultant

The following is an interview with Judith Shaw, the current president of North American Securities Administrators Association (NASAA). I would like to thank the authors (Sigmund D. Schutz and John J. Duval, Sr.) for sharing this interview with the readers of the Blue Sky Bugle. I would also like to thank Judith Shaw for taking time from her busy schedule to speak with Messrs.' Schutz and Duval.

What’s on the mind of the Maine top securities regulator as she assumes the presidency of the North American Association of Securities Administrators (“NAASA”) as of September 2015? On August 25, 2015, Sigmund D. Schutz, Maine’s only member of the Public Investors Arbitration Bar Association, and John Duval, Sr., a securities arbitrator and litigation consultant, had an opportunity to sit down with Judith Shaw, Administrator of the Maine Office of Securities, to find out what the Maine Office of Securities does, what Shaw hopes to accomplish as President of the North American Association of Securities Administrators, her path to that position, steps her office has taken to protect senior citizens, issues surrounding crowd funding, and other topics.

What Is The Maine Office Of Securities?

SS Can you give us a sense of the scale of the Office of Securities?
JS Absolutely. There are 16 of us altogether including myself. When I first came to the office our examination and audit functions as well as our investigative functions were handled by the same people and one of the first things that I decided was that that needed to change. In my view, examination and audit is all about partnership and compliance. Investigation is about getting to the bottom of something that has occurred and potentially taking enforcement action. The individuals performing the examination function focus solely upon compliance. We have two individuals who do that. Both for broker dealers and state licensed investment advisors. The examination function is performed by five very talented investigators, overseen by our general counsel, Carla Black.

SS How many examinations or audits do you perform a year?
JS We perform somewhere between 15 and 20 examinations or audits per year. We try to keep investment advisors on a regular schedule because we’re the only game in town for them. What we try to do is within six months to a year of a firm being licensed we go out and do an audit. Then we try to go out and see them again every three to five years. Clearly, somebody who has custody of assets is going to see us a little more frequently than somebody who doesn’t.

SS How many investigations do you typically have ongoing?
JS On average, our investigators carry between 15 and 20 open cases at any moment. Those cases can run from the gamut from administrative enforcement cases against a licensee all the way up through criminal investigations, including Ponzi schemes. We extradited an individual not too long ago who had been involved in a Ponzi scheme and was sentenced to 19 months. We have a case that involved an insurance agent who encouraged an elderly individual to invest in a fictitious real estate investment in Wisconsin. The insurance agent did no diligence whatsoever. Had he done a simple Google search he would have seen that the person raising money for the real estate investment had just gotten out of federal prison for securities fraud. The insurance agent convinced his client to sell an annuity to put into the fictitious real estate investment. The investor lost all of their money.

SS Does the Office of Securities coordinate with the Bureau of Insurance?
JS We do, absolutely. It’s very important. We are seeing more and more securities and insurance regulators coordinating their efforts. The Office of Securities has a
Memorandum of Understanding with our Bureau of Insurance so that we have a very formalized process to make sure that nobody is going to fall through the cracks. If we are initiating an investigation of a securities professional, who also holds an insurance license, we’re going to notify the Bureau of Insurance and coordinate any efforts and likewise they do the same for us. We also meet on a regular basis to go over any cases. We are concerned about professionals getting rid of their securities licenses to go out and attempt to hang out in insurance land or vice versa.

JD Does your office have any dollar threshold for screening investor complaints?

JS Absolutely not. There are 1.33 million people in Maine and I’m responsible for every single one of them. I understand the concept of thresholds, particularly at the federal level, but what we need to appreciate is the fact that the markets are on Wall Street but all of those investments, the stocks, bonds, mutual funds – they are sold on Main Street. Every single investor on Main Street is my responsibility and I’m not going to turn anyone away for being too small.

SS You assumed the presidency of the North American Association of Securities Administrators (“NAASA”) in September 2015.

JS What initiatives for NAASA do you have in mind?

One of the things that I’m hoping to accomplish as NAASA president is increased collaboration with our federal counterparts, both the Financial Industry Regulatory Authority (“FINRA”) and the Securities and Exchange Commission (“SEC”). There are ways in which the states can collaborate more with FINRA. We do a lot already. There are communications through NAASA that happen with FINRA on a regular basis on all sorts of issues. For example, FINRA discloses information on registered broker-dealers, including qualifications, employment, and complaints. How can we make those disclosures an even more valuable resource to investors? I will be strongly encouraging both FINRA and the SEC to continue to find ways not just at the national level but at the regional level for all of the states to be able to continue to work and coordinate with them.

SS What other priorities can we expect NAASA to pursue?

JS We will continue to pursue senior issues. The time is right. It is the single most important issue facing all regulators, but certainly securities regulators. It is an issue that we can all speak with one voice. We know that Senator Collins has done a wonderful job at chairing the Senate meeting committee along with Senator McCaskill in bringing issues forward around financial exploitation. It was a great honor to be able to testify before her committee earlier this year.

Background And Career Arc

JD How did you get hooked on becoming a lawyer?

JS My mother was a legal secretary for a wonderful, brilliant attorney, Walter Sage, who believed that the legal profession was a service profession. She worked for Walter for 60 years. He would take payment in potatoes or chickens or whatever anyone had available. He taught me the importance of wanting to help people and provide a service. He told me if I ever felt I was not helping people, if I was not providing a service, that would be the time when I would need to move on and find another profession. It really was a meaningful conversation to a very impressionable young 10-year-old.

JD 10 years old? Wow. So, then you went to high school where?

JS I graduated from Fort Fairfield High School in Aroostook County. Something I carry with me is that amazing County ethic that people talk about. The work ethic just really carries me forward. And, from there I attended the University of Maine at Orono. I got a degree in political science with an
emphasis as well in psychology, which I think has served me well to understanding people in this profession. I left Maine to follow my former spouse in his career and ended up in New Jersey and got my law degree in Delaware from Widener School of Law, a law school with corporate focus - retired DuPont general counsel as professors, for example. That caused me to take a little different look at law, looking at it more from an organizational perspective, if you will.

SS When you moved back to Maine you joined the Attorney General’s Office?

JS I did. I moved back to Maine in 1992 after spending about 5 years after I graduated law school at the New Jersey Election Law Enforcement Commission. First, as Associate Legal Director and then Chief of Investigations. I moved back to Maine after the birth of my first son, joined the Attorney General’s Office and spent the majority of my time at the Attorney General’s Office representing the Bureau of Insurance. From there in 2001, I joined the Bureau of Insurance as Deputy Superintendent. I spent about 7 years there and then moved over in November of 2008 to my current role.

Protecting Seniors

SS You testified before Senator Collins’ committee in February of this year about the Office of Securities’ Senior Safe Program?

JS Senior Safe is just a wonderful program. It took us about two years to create it. The process was so important – to interview people from banks and credit unions to find out what are the barriers that you face every day to identifying and reporting what you believe to be cases of financial exploitation. It is so important to identify these issues early on because one of the things we know is that elder financial exploitation does not travel alone. It is almost always accompanied by some form of elder abuse or self-neglect as well. So it is an opportunity in my view to create a community safety net for our elderly. The Senior Safe training program includes training for front line bank tellers, training for compliance and supervisory personnel. It includes a consumer brochure and very specific resource tools. There is a teller card – a two-sided teller card they actually keep at their station. It has some red flags for elder abuse and financial exploitation on one side and the other side gives them a decision tree – what do I do about it - and a similar card for higher level staff.

One of the key components we have been able to implement is to have two points of entry into state government for reporting. If a financial institution believes someone may be incapacitated as defined under Maine law, they can contact Adult Protective Services. If they are not sure they think maybe the person doesn’t meet that definition, our office agreed to step up and be the other point of contact. So we receive these reports, we’ve developed a working relationship with Adult Protective Services as well as community-based services like legal services for the elderly and area agencies on aging to get some much-needed community services. That’s that safety net I’m talking about. We have to partner and work together.

I’m aware of one situation where a credit union teller had an elderly person who one day a week, her social event was to go to the branch, and she wasn’t showing up any more and when the teller called her phone number she was told “Oh, she doesn’t live here anymore.” So Adult Protective Services had a welfare check done and the woman was taken to the emergency room. The doctor said another 24 hours and she would not have made it. So that is the value of this program.

Our investment education manager does a great job talking to the customer and saying “yes, you’ve been sending money to this fellow who says he has this home in
Maryland – it’s actually a gas station; here’s the Google earth picture,” and she actually does it in such a gentle, kind way, that it’s been effective in stopping the bleeding, stopping the flow of the money.

SS What do you say to attorneys who may have a client and there’s a concern that there may be financial exploitation?

JS One of the things we developed was this little card that legal professionals can take that gives them red flags, vulnerability and risk factors, resources in the area as well as some conversation starters. Our message to legal professionals is think about changes in that person’s life, if somebody is suddenly widowed, they are going to become more vulnerable. Think about what those red flags are. Are they suddenly not dressed quite as nicely as they usually are when they come to your office? And don’t be afraid to call us. Even if it’s just to say, what do you think I should do? We have many calls from banks and credit unions and investment advisors and brokers saying: “here’s the scenario – do you have any advice for me?” And we can work through it together.

JD I’ve got a case down in Long Island where an 80-year-old lady fell victim to a door-to-door salesman. After it was all over I asked her what are you going to do when somebody knocks on your door again – she said “I’m not answering it!”

JS You know, there’s so many challenges. We all, as we age, start to have cognitive decline. It’s just the nature of aging. What happens is seniors’ willingness to take risks increases. These are also people who may be isolated and lonely and trusting. One of the things we often tell our victims when they call us is let us put your number on the do-not-call list. One gentleman said: “oh please don’t do that – it’s the only call I get.” We have people who say I keep putting my number on the do-not-call list, but the scam artists keep calling. There are people who are not going to honor do-not-call lists. So now we are trying to encourage people to change their phone number. But that’s a tough sell. My mom has had the same phone number since she was 18 years old. She is not giving that up. So it’s really a challenge. The number one thing we need to make sure to do is communicating with our elder population is to communicate in a way that respects their independence and their dignity.

Ordering Restitution For Investors

SS Can the Office of Securities order restitution for investors?

JS Up until just a couple of years ago I could not administratively order restitution. We would have to file a civil suit. But the Legislature very graciously modified our statute to allow the Administrator to order restitution as part of an administrative order. Prior to that time we would do the best we could to negotiate with firms and individuals to get restitution by consent. However, we are not acting as counsel for any particular investor. We are not going to look at an investigation in the way you would, Sig, in representing and advocating for a client.

Fiduciary Duties

SS The U.S. Department of Labor has proposed a fiduciary duty rule for advisors on retirement plans. NAASA has made comments supporting that rule. Why does NAASA support that rule?

JS There should be a uniform fiduciary duty across the board. It is a very important investor protection. The Department of Labor is taking a positive step in that direction. I would like to see the SEC also move forward with an appropriate fiduciary duty rule for brokers as well. The fact of the matter is that there is a great deal of confusion when we speak to investors. They automatically believe that any financial professionals they deal with – be it an insurance agent, investment advisor, or broker-dealer – that they are all obligated to act in their best interests and so they are making decisions based upon that assumption. Nobody is disabusing them of that notion. They call themselves financial advisors, for crying out loud. How do they even tell the difference between an
investment advisor and a representative of a broker-dealer?

So why shouldn’t we protect investors and make sure that any conflicts are disclosed; that certain extreme conflicts cannot be waived, even if disclosed? We need to make sure that the public’s hard-earned money, the money they need to live, the money they need to pay their medical bills, that they need for retirement, or they need for their children’s education, is being managed in an appropriate way and in their best interest. We have historically and continue to encourage the SEC to move forward with having a fiduciary duty for all securities accounts as well – all retail accounts.

JD That’s a tough sell, isn’t it?

JS Everybody agrees that brokers should be operating in the best interests of investors. How you define that best interest is the rub.

Mandatory Disclosures

SS Is NAASA also working on a proposal to enhance disclosures around fees charged to customers?

JS Yes. NAASA had done a study and actually supplemented that with a survey of investors to see what level of confusion there was around miscellaneous fees in particular. What we found is that there is a great deal of confusion over what fees exist out there, that fees are not as transparent as they should be. It can be hard to find fee disclosure schedules on some websites, for example. NAASA has been working very diligently, and we are hopeful to have a product that will roll out at our annual conference at the end of September. It’s so important that people, as I said, be informed on all fronts, including with regard to fees. I can’t tell you how many complaints we get when somebody goes to transfer an account and they say: “Wait a minute – I had no idea it would cost me money to transfer my account. Why should it cost me money to transfer my account?” Those complaints can be short-circuited if there is appropriate up-front disclosure.

Arbitration Clauses

JD I see many cases where the customer would prefer to present a claim to a jury, but is required to submit to mandatory arbitration. What’s NAASA’s position on investor choice about the forum for dispute resolution?

JS We think that informed investors should be able to make informed decisions. Why are we taking this choice away from investors? If an arbitration panel is the right option, the investor should be able to go that route. We just think it’s wrong to take away investor choice. It is a key investor protection to be able to have options.

Looking Forward/Crowd Funding

JD What’s your message to the regulated community?

JS My message to the industry is that I really want them to think about how we can continue to be stronger compliance partners. Not all firms take the same approach to compliance. When I think about Maine, we strongly view ourselves as compliance partners. We actually had an investment advisor call and ask if we would come do an exam: “I know I’m not due yet, but could you come down and take a look.” That’s a great partnership to have. We want to work with the industry to identify those areas where we can beef up investor protection.

SS Is there anything on the horizon to make it easier for businesses to raise capital in Maine?

JS Absolutely. We have this new Maine crowdfunding rule. One of the things that I did after that law was passed was to form an advisory group that included some small businesses, people who counsel small businesses. We’ve developed some forms with their assistance. We’ll also look at ways we can expand electronic filing.

One of the misconceptions with crowd funding when we talk to small businesses, is
that they may think it’s just another kick-starter campaign. When you explain to them what it really means to give somebody equity in your business, and ask them whether they really want a hundred owners, we find that sometimes alternatives that already exist in Maine law better suit their needs. We are going to continue to work on that process to figure out not only how we can make crowd funding opportunities available and help implement them, but also how can we continue to get the word out there that Maine law already has capital-raising opportunities. To make capital raising affordable for the smallest of the small entrepreneurs in Maine requires our office to continue to work closely with businesses and their attorneys.

SS Maine’s approach to crowd funding is a bit different from other states in that investors can be from outside the borders of the state?

JS Yes, Maine is the only state that took the crowd funding approach that allows investors from outside the state. All the other states have relied upon the intrastate exemption. They are struggling with this idea that the theory of crowd funding is to reach out to the crowd on a broad basis, usually through the Internet. How do you do that if you have to stay within the borders of Vermont or Wisconsin or what have you? We are having conversations with our New England colleagues to see if there is some way that we can leverage a regionalized approach to crowd funding. NAASA is supportive.

JD Is NAASA involved in crowd funding?

JS The states have been right up front, including Maine, in the crowdfunding arena. NAASA has a wonderful clearinghouse on our website that you can take a look at that shows somewhere in the neighborhood of 24 states that have adopted crowd funding. Just as we know our investors, we know our small businesses and our entrepreneurs. All of the NAASA members have wonderful ideas. NAASA can help coordinate their efforts and leverage their resources in a way that’s going to help protect investors.

SS Maine – a rural state with an older population and lots of small businesses – is fortunate to have you bringing this state’s perspective to NAASA. Thank you very much.

JS Thank you.

BLUE SKY DEVELOPMENTS IN ARKANSAS
By: Professor Frances S. Fendler
University of Arkansas at Little Rock Bowen School of Law

The Arkansas Supreme Court and the Arkansas General Assembly have completed a one-two punch that potentially makes the work of Arkansas securities lawyers more challenging. First, in the recent case of Waters v. Millsap, 2015 Ark. 272, the Arkansas Supreme Court avoided an opportunity to adopt a principled test for the existence of a debt security in favor of an amorphous "all-factors" approach that now applies to all types of securities. Second, in Act 460 of 2013, the Arkansas legislature recast the private civil liability provision in the Arkansas Securities Act, which is based in part on section 410 of the Uniform Securities Act of 1956. In the process, the legislature deleted affirmative defenses formerly afforded to defendant sellers and purchasers.

A. Waters v. Millsap was a civil action brought by the Securities Commissioner against three unregistered brokers for selling unregistered, non-exempt promissory notes in the amount of $2 million. The notes were for a term of one year, represented loans made for specific real estate projects in the United Kingdom, bore a fixed rate of interest, and were secured by collateral. Most of the money was never repaid. The defendants denied that the notes were securities.

The trial court granted summary judgment to the defendants, ruling that the notes were not securities under the risk capital test first articulated in Smith v. State, 587 S.W.2d 50 (Ark. App. 1979), which the trial court ruled was the exclusive test for the presence of a security under Arkansas law. The elements of the Smith
test are "(1) the investment of money or money's worth; (2) investment in a venture; (3) the expectation of some benefit to the investor as a result of the investment; (4) contribution towards the risk capital of the venture; and (5) the absence of direct control over the investment or policy decisions concerning the venture." Id. at 52. The Commissioner appealed, arguing that the Smith test was not exclusive and urging the Arkansas Supreme Court to adopt the family resemblance test of Reves v. Ernst & Young, 494 U.S. 56 (1990), as determinative for the classification of notes as securities. The Arkansas Supreme Court agreed that the Smith test is not exclusive but rejected the invitation to adopt the Reves family resemblance test for notes. After reviewing several of its previous decisions, the court held that the presence of a security of any kind--necessarily including stock, bonds, investment contracts, and other kinds of instruments and interests included in the Arkansas Securities Act's laundry-list definition of "security"--should be determined by examining all of the facts surrounding the transaction. The court refused to adopt the family resemblance test of Reves, "because all of these factors are embraced within our flexible, all-inclusive [all-factors] test." Similarly, the factors embraced by the Smith risk capital test are potentially relevant in identifying a security. The court then disposed of the case before it by reversing and remanding the case with instructions that the trial court "consider all factors surrounding the transaction," including "the sophistication of the parties, a factor that is prominent in this court's prior cases." Notably, the court accepted the Commissioner's position that the existence of a fixed rate of interest does not dictate the conclusion that no security is present.

The Millsaps all-factors test is not a test at all. Apart from its reference to the sophistication of investors and its general nod towards Reves and Smith, the court doesn't explain what makes a fact relevant to the determination of what is a security or what weight to accord to whatever facts are presented. Presumably, facts found to be significant in earlier decisions will continue to be relevant. These include whether the transaction amounts to the sale of a business; whether the claimed securities are traded on a market; how the purchaser accounts for the income he received; the type of profit the purchaser expects, long-term appreciation or a fixed amount of interest (although after Millsaps, the latter factor should not conclusively establish non-security status); whether the profit the purchaser expects depends on the earnings of the business (notably, in Millsaps it was stipulated that the borrower's obligation to repay the loan was not based on the financial performance of the borrower's endeavor, so this factor is not determinative); whether the transaction is commercial in nature; and whether there is a risk-reducing factor, such as collateral (again, given the facts in Millsaps, this is not determinative).

By its "all-factors" approach, the court leaves it to the ingenuity of counsel in each case to identify facts and argue their relevance or irrelevance. While it is understandable that the court would not want to hobble its ability to provide relief to unsophisticated people who may be fleeced by slick operators, its no-test "test" leaves business people (and the lawyers who counsel them) no way to predict whether their ventures may collapse because an investor sues for rescission on the theory that what he received was a unregistered, non-exempt security. By contrast, although federal case law on what is a security is not free from uncertainty, the federal tests for "stock," "notes," and "investment contracts" are principled and offer some degree of predictability, and to that extent reduce transaction costs in financing desirable business growth and development.

B. Section 23-42-106 of the Arkansas Code is the only provision in the Arkansas Securities Act granting a private cause of action for investors to recover for regulatory violations or for misrepresentations. It grants aggrieved purchasers a cause of action against their sellers and aggrieved sellers a cause of action against their purchasers (the causes of action extend to certain secondary actors, as well). Prior to 2013, the defendants in misrepresentation cases had the
affirmative defense that "he or she did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.")

In Act 460 of 2013, the Arkansas legislature amended the statute to create a private cause of action against investment advisers for regulatory violations and for fraud. Evidently wanting to streamline the wording of the statute, thedrafter rewrote it. In the process, the affirmative defenses described above were converted to elements of the plaintiffs' causes of action. Now, a buyer aggrieved by a misrepresentation may recover "if the buyer does not know of the untruth or omission and meets the burden of proof that he or she did not know, and in the exercise of reasonable care could not have known, of the untruth or omission." The conversion in the case of an aggrieved seller is even clearer. Redundantly, the statute says that a purchaser is liable to a seller if "the seller does not know of the untruth or omission and meets the burden of proof that the seller did not know, and in the exercise of reasonable care could not have known, of the untruth or omission." Thus, under the amended statute, a defendant seller or purchaser who was not negligent, who perhaps may himself have been deceived about the facts, is liable unless he can make out some other defense, such as, for example, immateriality, statute of limitations, or rescission offer.

The author believes that these changes were inadvertent. It is to be hoped that the legislature will eventually amend the statute again and reinstate the affirmative defenses.


Overview

Those convenient “clouds” of electronically stored or accessed data and personal information also contain “lightning” that can strike unprepared investment firms and their clients. Criminal enterprises behind these attacks have become more sophisticated and often involve domestic or foreign organized crime syndicates, foreign nationals and even foreign governments—no longer just techno-geeks and petty thieves.

A 2014 pilot survey by state securities regulators found that 4.1% of state-registered investment advisers had experienced a cybersecurity incident and 1.1% had experienced theft, loss, or unauthorized exposure or misuse of confidential information. Cybersecurity experts (including cybersecurity consulting firms marketing their services) believe the “hit rate” is likely higher. With the U.S. government, the Securities and Exchange Commission (SEC), the North American Securities Administrators Association (NASAA), the Financial Industry Regulatory Authority (FINRA), and news media sounding sirens of cyber threats, do not be caught unawares sleeping under a tree when the lightning strikes at your firm and your clients.

Connectivity is Convenient but Risky

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Today you need more than gates, guards, and guns to prevent criminals from getting away with the firm’s and clients’ identities or cash. Email, computers, laptops, tablets, internet-based information access or storage, smartphones, internet-connected hardware and related software, flash drives, wireless communications—all the “modern conveniences”—create ample opportunity for a tech-savvy intruder to monitor, gain access to, and misappropriate confidential information. Smartphone applications like “Swipe” and “Swift Key” include seemingly helpful features that “learn” and adapt to your (bad) typing habits by tracking your every key entry on their remote file servers—convenient, yes, but the person with access to that remote file server can potentially see every password and ID you type. Frequently, hi-tech platforms and data aggregators gather, store, and allow access to both clients’ and the firm’s own confidential personal information. Access to client information and emails can later be translated into highly convincing identity theft schemes. The days of physical computer tapes, CDs, DVD, and manual data back-ups are largely gone—replaced by more reliable third-party “cloud” servers and systems. However, today’s remarkable connectivity and convenience through networks, the internet, and the digital cloud create cyber vulnerabilities.

Firms are susceptible to various kinds of cyber threats, some more serious than others. Unencrypted laptops, tablets, smart phones, and similar devices are easy targets if lost or mislaid, particularly if not password-protected. Unencrypted email is easily intercepted, especially when email addresses are stolen from other sources, such as “big box” retailers. How often have you forgotten your password to personally access a website and simply clicked to have it emailed to you—are you the only person receiving it? Many consumer-grade file-sharing websites and systems are not designed with strong cybersecurity protections. These file-sharing systems may be simple and cheap—great for personal photo sharing—but may not be suitable for the type of confidential personal, financial, and business data transmitted and stored by financial services firms.

Malware, “digital worms”, and “key-logging” software are commonly spread through e-mail, spurious applications and program updates, “Trojan horse” file attachments, and visiting infected websites. Phishing emails continue to be a common attack strategy. There are cyber threats to the computer operating systems you use to conduct daily business—not just your own systems, but also third-party systems and websites you rely upon to serve your clients. A “botnet”—short for robot network—is an accumulation of compromised computers (called “zombies”) manipulated by a central computer or “controller.” Botnets have the ability to overload webservers, to steal data, and may be difficult to detect. Distributed denial of service (DDoS) attacks can stall business operations for hours or even longer—your website or third-party websites you rely upon to monitor portfolios or enter trades. These attacks have been used to extort “ransom” from the web host in exchange for resumed operations. In the meantime, you may be unable to access or use the website.

Cyber-related Regulations

Assessing and planning for cybersecurity risks has become a high regulatory priority among securities regulators. On September 15, 2015 the SEC Office of Compliance Inspections and Examinations (“OCIE”) issued a release, Cybersecurity Examination Initiative, summarizing its examination priorities, which will involve more testing to assess implementation of firm procedures and controls. OCIE’s focus will include: governance and risk assessment, access rights and controls, data loss prevention, vendor management, training, and

incident response. The release includes a sample of OCIE’s requests for information and documents.

The SEC and FINRA have brought enforcement cases against firms for cybersecurity-related compliance failures. Firms have been cited for inadequate written policies and procedures, failing to enforce such policies and procedures, failing to conduct periodic self-assessments of cybersecurity-related procedures, and failing to respond to self-identified deficiencies. For example, on September 22, 2015, the SEC issued a press release announcing the settlement of an enforcement action against R.T. Jones Capital Equities Management, Inc. The SEC alleged that the firm failed to adopt any written policies and procedures to ensure the security and confidentiality of personally identifiable information (PII) of approximately 100,000 individuals, including thousands of the firm’s clients, and protect it from anticipated threats or unauthorized access. According to the SEC’s order the firm’s web server was attacked in July 2013 by an unknown hacker who gained access and copy rights to the data on the server. No indications of a client suffering financial harm as a result of the cyber-attack were yet reported. The SEC’s order finds that R.T. Jones violated Rule 30(a) of Regulation S-P under the Securities Act of 1933. Without admitting or denying the findings, the firm agreed to cease and desist from committing or causing any future violations of Rule 30(a) of Regulation S-P and agreed to be censured and pay a $75,000 penalty. Concurrently, the SEC issued an Investor Alert: Identity Theft, Data Breaches and Your Investment Accounts.9

Privacy and Safeguarding Rules

Important privacy regulations derive from the Financial Services Modernization Act of 1999, more commonly called the Gramm-Leach-Bliley (GLB) Act.10 The GLB Act directed the SEC,11 the Federal Trade Commission (FTC),12 and the federal bank regulatory agencies to adopt consumer privacy regulations. The FTC does not examine state-registered investment advisers, but may respond to client complaints and referrals from state securities regulators.

SEC Regulation S-P, Privacy of Consumer Financial Information, applies to SEC-registered broker-dealers and investment advisers. Regulation S-P implemented sections of the GLB Act and the Fair Credit Reporting Act (FCRA) for entities registered with and regulated by the SEC. SEC Rule 30 (Safeguarding Rule) requires registrants to “adopt written policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information.”

State-registered investment advisers are covered by the FTC’s Privacy of Consumer Financial Information rule. The FTC’s rule is more rigorous than the SEC’s Regulation S-P. Notably, it requires state-registered firms to “develop, implement, and maintain a comprehensive information security program that is written in one or more readily accessible parts and contains administrative, technical, and physical safeguards that are appropriate to your size and complexity, the nature and scope of your activities, and the sensitivity of any customer information at issue.”

SEC – CFTC Identity Theft “Red Flags” Rules

As the name implies, the federal identity theft rules direct covered firms to take steps to prevent losses caused by identity theft through unauthorized account orders or access, including

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impersonations. The SEC and the Commodities Futures Trading Commission (CFTC) jointly adopted rules implementing identity theft “red flags” and guidelines under the Fair and Accurate Credit Transactions Act of 2003 (FACTA), which amended the Fair Credit Reporting Act (FCRA). The SEC’s version is Regulation S-ID, Section 248.201, and the CFTC’s version is Subpart C, Section 162.30, both titled Duties Regarding the Detection, Prevention, and Mitigation of Identity Theft (Red Flags Rules). The SEC-CFTC Red Flags Rules apply to SEC and CFTC registrants; the FTC’s Red Flags Rule applies to state-registered investment advisers.

Generally, the Red Flags Rules require a covered financial institution to develop, implement, and administer a written identity theft prevention program. The program’s purpose is to detect, prevent and mitigate identity theft in connection with the direct or indirect opening or maintenance of a covered account.13

**FINRA Cybersecurity Rules and Guidance**

FINRA’s website provides cybersecurity guidance and resources for brokerage firms.14 FINRA has provided guidance about cybersecurity issues, including risks related to wireless fidelity (Wi-Fi) and remote access networks.15 Accordingly, a broker-dealer’s written supervisory and control procedures must address compliance with the SEC’s Safeguarding and Red Flags Rules under FINRA Rules 3110, 3120, and 3130.

Cybersecurity and identity theft prevention measures intersect in FINRA Rule 3110(c)(2). This rule requires brokerage firms to have policies and procedures to address safeguarding customer funds and securities; transmittals of funds (e.g., wires or checks, etc.) or securities from customers to third party accounts; from customer accounts to outside entities (e.g., banks, investment companies, etc.); from customer accounts to locations other than a customer’s primary residence (e.g., post office box, “in care of” accounts, alternate address, etc.); and between customers and registered representatives, including the hand-delivery of checks. Policies and procedures must also build controls around changes of customer account information, including address and investment objectives changes and validation of such changes. These are among the leading circumstances surrounding identity theft losses.16

**State Breach Notification Laws**

Forty-seven states require security breach notifications.17 Firms must report identified data breaches to all affected customers and, typically, to government authorities. Requirements do vary significantly by state and are not preempted by federal law. Twenty-nine of those laws contain exceptions or safe harbors for firms that are subject to, and/or comply with federal privacy laws and related rules promulgated by their federal regulator. However, the SEC has not adopted breach notification requirements, so its rules likely do not preempt state laws. Forty-seven states have also enacted “security freeze” laws that allow customers to freeze their credit reports in the event of a security breach. The national credit reporting agencies charge for security freezes, likely an expense of the firm whose cybersecurity was breached. Firms with clients in multiple states will be subject to

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multiple state laws with differing reporting obligations.

**Business Continuity Planning and Disaster Preparedness**

Cyber-attacks on a firm or on a third-party vendor upon which the firm relies can have a devastating impact on normal operations so should be among the risks addressed in business continuity and disaster recovery planning. For example, “ransomware” is a flavor of malware restricting access to the computer system that it infects. The “infection” is then accompanied by extortionate demands for access to be restored. Ransomware may encrypt files on the computer’s hard drive, lock up the system, or simply threaten data erasure if the ransom is not promptly paid. Denial of service attacks are another form of business interruption. Cybersecurity risks intersect with recordkeeping requirements when books and records are stored or archived in the “cloud”. Specifically, if records are stored in electronic form it must be protected from alteration, loss, or destruction.18

**Cybersecurity Resources and Planning**

Commonly cited by cyber-industry experts, the National Institute of Standards and Technology (NIST), an agency of the U.S. Department of Commerce, released the first version of the Framework for Improving Critical Infrastructure Cybersecurity on February 12, 2014 (Framework). The Framework consists of voluntary standards, guidelines, and practices to promote the protection of critical infrastructure. The Framework is industry neutral, so relevant to all types of businesses. The NIST’s Computer Security Division published NISTIR 7621, Small Business Information Security: The Fundamentals, to help small businesses and small organizations implement the fundamental components of an effective information security program.

In addition, the Securities Industry and Financial Markets Association (SIFMA) published useful Guidance for Small Firms,19 including a Small Firm Cybersecurity Checklist. These resources are useful to all business models, not just broker-dealers. These resources will aid in your development of a firm-specific approach to cybersecurity risks as you develop policies, procedures, and a program to safeguard your clients’ and firm’s information.

So, how to get started? Each firm’s circumstances will be different, so each cybersecurity risk assessment and each program will be different, but here are some basic suggestions:

- **Muster an internal team.** It members should include IT, operations, compliance, and front-line and back-office representatives. Involve senior management. Identify gaps in expertise—likely technology—and engage outside support. Keep records of the team’s composition, meetings, and related activities.

- **Develop written cybersecurity and identity theft game plans.** Written records are critical in demonstrating your team’s efforts to regulators and courts. Set and update written priorities and progress reports.

- **The Red Flags Rules include specific guidance with helpful content.** FINRA created a template designed to help small firms develop and document their “red flags” program.

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18 For SEC-registered investment advisers, see Rule 204-2(g), 17 C.F.R. 275.204-3; state law imposes similar requirements on state-registered investment advisers. For broker-dealers, see SEC Rules 17a-3 and 17a-4, 17 C.F.R. 240.17a-3 et seq.

• **Start with the basics.** Identify the technology you are using to remotely connect to email and client information, including technology allowing clients’ remote access and assess its vulnerabilities—think about all office, home, and mobile devices. Install and update antivirus software, implement passwords and user IDs.

• **Revisit your plan when prompted by changes and periodically.** When employees, representatives, and third-party vendors change, change log-ins and user access rights. New offices, new employees and representatives, new services, new vendors, and new technologies should trigger a reassessment of related cybersecurity risks.

• **Password management.** Require and train all employees and representatives to use and periodically change passwords and user IDs on all electronic devices (e.g., computers, tablets, and other mobile devices).

• **Antivirus Software, “Patches”, and Encryption.** Install and update antivirus software on all electronic devices. Check for application updates and promptly install security “patches”. Install encryption software on files, emails, and mobile electronic devices.

• **Vendors.** Do your due diligence before contracting with “cloud” service providers. Beware of free “cloud” services for data storage, back-up, and file sharing.

• **Train and Educate.** Train employees and representatives, and educate clients, on common cybersecurity risks and defensive strategies.

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**FLORIDA ADOPTS AN M@A BILL—AS OF MARCH 31, 2016**  
*By: Don Rett*  
Borden Ladner Gervais LLP

During the recently concluded 2016 Legislative Session, the Florida Legislature adopted "An act related to merger and acquisition brokers". Florida's Governor signed this Bill on March 25, 2016, yet the Bill is not effective until July 1, 2016.

The Bill provides the following:

1. Florida's exemption for Exempt Transactions s.517.061 has been amended to make the following a transaction which does not require a filing in FL: The offer or sale of securities, solely in connection with the transfer of ownership of an eligible privately held company, through a merger and acquisition broker in accordance with s.517.12(22).

2. The Act goes on to explain what a "Merger and acquisition broker" is' see Section 2 of this Act, VERY IMPORTANT: Clients who may wish to avail themselves of an exemption from the registration of s. 517.12 (b/d; registered representative) must look at section (2(4)).

Conclusion: This submission represents observations of a very recently Bill passed in Florida. Other thoughts. This law recognizes that States like Florida do not distinguish between broker and dealer.
EDITORIAL
By: Martin A. Hewitt
Attorney at Law

As editor of the Blue Sky Bugle, I usually look forward to writing my editorial, but this is one editorial I imagined I would never have to write.

Patty Struck, Wisconsin Administrator of the Department of Financial Institutions, Division of Securities and former NASAA President, passed away unexpectedly just before Christmas. We were all shocked and saddened to receive this sad news.

I had just seen her and her husband Larry at the NASAA Conference in Puerto Rico and again in Washington last autumn. At each event she was full of life and enthusiasm. We spoke of future projects that the securities industry and regulators could work on collaboratively. One of her passions in the regulatory world was financial elder abuse. She was committed to protecting senior citizens from fraudsters seeking to leave these senior citizens penniless in what should be their golden years.

As for Patty’s place in the regulatory universe, she was always eager to solve problems and work with many of us regarding thorny regulatory matters. In fact, as Joey Brady, Executive Director of NASAA said so eloquently at Patty’s funeral service on January 9, 2015, “[r]espect for Patty’s knowledge and diplomacy extended beyond her fellow regulators to members of the securities industry as well. Upon being informed of her death a member of the industry wrote me a simple three word email – ‘I’m broken hearted’.”

She was a mentor to so many people in both the securities industry and to fellow regulators. Patty possessed that unique gift of making the person she was speaking with, even in the most crowded gathering feel like they were, the most important person in the room. That is a skill few of us possess. She was certainly one special person and her passing is a loss for all of us. She will be missed by family, friends, colleagues, and the securities industry.

At the end of the day, she led a full and wonderful life even if it ended far too soon.
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