Message from the Chair

I sat down to write this message when I realized that it’s my last one as Chair of the Committee on the State Regulation of Securities. Where has the time gone? So much has happened. So much has changed. And somethings, thankfully, have stayed the same.

So, what has happened? For those of us filing with the states pursuant to Reg. D, Rule 506 offerings, we now have the ability to file electronically via the EFD. Thanks to everyone at NASAA for their hard work and dedication to make this system something truly valuable to filers and the states alike.

The states have adopted new rules and procedures regarding Crowdfunding as well as Reg. A+ offerings. A special shout out goes to Faith Anderson of Washington State for her hard work and dedication in making Reg. A+ a functional way to raise funds for smaller issuers on the state level.

As a Committee, we have become more streamlined and, in the process, able to work more collaboratively with our friends at NASAA and the states and territories. We have gone from over 20 subcommittees to five. Those five subcommittees mirror both the SEC and NASAA regarding enforcement, broker/dealer, investment advisor, corporate finance, and education. Thanks to the heads of each of those subcommittees for leading the charge in each of those areas.

When I took the helm 3 short years ago, the regulatory world was a vastly different place. We now have two camps that have distinctly different views as to how our world should interact with issuers, investors, and regulators. It seems one group would prefer a more robust regulatory framework while the other prefers no framework at all. Needless to say, each side has its flaws - and its virtues. We, as a committee, must work together with regulators and industry to ensure that we balance the ever-present scale of investor protection and capital formation. That being said, we still have to consider investor empowerment of which investor protection is an element, but which provides far greater ability for investors to choose what to invest in and how to do so.

One issue that has been of particular concern and which we, as a committee, have helped raise as an issue is financial elder abuse. As you all know, we have supported efforts to make broker/dealers and industry aware of this very real threat. I have been fortunate enough to work with several people including Judy Shaw, immediate past president of NASAA, as well as members of the ABA Committee on Law and aging to help get the word out. To that end, our committee is sponsoring a CLE which provides two hours of ethics credits and goes into the many ways seniors can be victimized by scamsters. It never ceases to amaze me the depths to which some will go to deprive the elderly of their hard-earned retirement income. Shameful as it is, we need to admit that this problem exists and will continue to grow as the elderly population grows. Recently, a fellow who is not quite elderly was the victim of a bank fraud. Someone was able to forge a replica of his checks and nearly made off with a fair amount of money. Luckily that fellow was alerted to what was happening and shut down his account. Several days later the person who alerted this fellow about the fraud tried to cash the check himself which shocked the bank as well as the owner of the bank account.

In what can only be seen as incredibly bad timing, this fellow then got the usual
scam call from the "IRS" stating that the "IRS" had been trying to reach him and, since they were unable to do so, would be filing suit. Now we all know that this is a scam, but in the moment this fellow called his wife and accountant to alert them that he was being sued by the "IRS". It was only upon hearing himself say this to his accountant that he realized it was a scam. While he was relieved, he felt foolish for almost falling for this well-known scam. And yet this shows that even those of us who are sophisticated about such matters can, in the right circumstances, lose perspective and, once defrauded, could easily become a victim again. The point of the story is that with the incidence of financial fraud increasing daily, we have to remain ever vigilant. The elderly don't stand a chance when we realize that a younger person can be easily victimized as well. The difference is that for the elderly, such victimization can result in losses that cannot be recouped. In some instances, the result has been the suicide of the elderly victim as they realized that they had lost everything. This would sound needlessly dramatic if it wasn't, in fact, reality. I urge you all to learn as much as you can about financial elder abuse and its warning signs. Make your clients aware of the seriousness of this issue. Don't assume that it is someone else's problem.

Finally, I would like to thank two more people who have made my tenure a true pleasure. The first is Shane Hansen. Shane, thanks for your wit and wisdom during the transition. I would have been lost without your never ending guidance.

The second person I want to thank is Richard Alvarez. He is our new chair and I can't thank him enough for taking charge. He has been my vice-chair these last three years and as such has been a tremendous source of knowledge as well as much needed perspective. No one can lead this committee in a vacuum. He has also been a good friend through good times and bad. Needless to say, I will be standing by to return the favor.

So, as I ride off into the sunset, (cue the music from Blazing Saddles), please know that I plan on being an active member of the committee and offer my perspective to practitioners and regulators alike if asked.

Martin A. Hewitt
Chair, State Regulation of Securities Committee

Everyone has a Role in Protecting Against Cyberattacks

By Joseph P. Borg

Cybersecurity is a top priority for the North American Securities Administrators Association (NASAA) and its members - the state, provincial and territorial securities regulators in the United States, Canada and Mexico.

The steady drumbeat of news of cyberattacks, hacks and data breaches, including the recent "Petya" and "WannaCry" ransomware cyberattacks, has commanded the attention of financial regulators at all levels of government, the financial services industry, and investors both here and abroad.

NASAA's Cybersecurity Committee, works closely with members throughout North America, as well as with other financial regulators and industry, to identify specific cyber threats and develop strategies to protect our financial infrastructure.

This effort is informed, in part, through NASAA's participation on the U.S. Treasury Department's Financial Banking and Information Infrastructure Committee (FBIIIC), an 18-member committee of federal and state organizations in the financial regulatory community. As NASAA's representative to FBIIIC, I know firsthand that there will be greater coordination on cybersecurity issues and cyber threats going forward.
In his remarks to open NASAA's June 23, 2017 Cybersecurity Roundtable in Washington, D.C., NASAA President and Minnesota Commissioner of Commerce Mike Rothman called cyberattacks "one of the greatest threats globally to our financial sector."

Last year alone, the number of U.S. data breaches reached an all-time high, totaling 1,093, up 40 percent from the 780 breaches reported in 2015, according to the Identity Theft Resource Center. A new report from Juniper Research predicts criminal data breaches will cost businesses a total of $8 trillion over the next 5 years. This report also forecasts that the number of personal data records stolen by cybercriminals will reach 2.8 billion this year and 5 billion in 2020.

Another study, by specialist insurer Hiscox, found more than half of businesses surveyed in the United States, the United Kingdom and Germany were ill-prepared to deal with cyberattacks. Larger U.S. firms were targeted more often than others, with 72 percent experiencing a cyberattack in the last 12 months. The study also found that the financial impact of cyberattacks was felt the greatest by smaller firms, which, also appeared to be more complacent than larger firms in their response to these attacks. Nearly one-third of smaller firms that had previously experienced cyberattacks indicated they planned no changes to their security measures.

Three years ago, NASAA conducted a survey of 440 small and mid-sized registered investment adviser firms in nine states to help regulators better understand the technology and data practices of state-registered investment advisers. The survey asked how these advisers communicate with clients; and what types of policies and procedures these advisers maintained. The pilot project also focused on specific uses of technology and websites, with a goal of understanding the safeguards used by state-registered investment advisers to protect client information; to inform state examination programs; and to identify national cybersecurity trends relevant to state-registered investment advisers.

The NASAA survey found 4.1 percent of responding firms indicating they had experienced a cybersecurity incident and even fewer, 1.1 percent, indicating they had experienced theft, loss, unauthorized exposure, or unauthorized use of or access to confidential information. These results could indicate that the firms responding to the survey rarely are the targets of cyberattacks. On the other hand, they could just as well signal the existence of a lack of awareness that such incidents have in fact occurred. Examiners from state securities agencies currently are conducting a series of coordinated examinations of small- and mid-sized investment advisers to assess in part current cybersecurity practices and procedures, as well as to gain insight into the current cyber threat level among state-registered investment advisers.

Information from the coordinated examinations also will help inform NASAA's consideration for the need of a possible model cybersecurity rule for state-registered investment advisers. It is important that financial firms and professionals have the tools and information they need for cybersecurity and also essential to have the proper regulatory expectations and guidance in place for these advisers.

The results of the coordinated examinations will be presented during the Investment Adviser Forum at NASAA's 2017 Annual Conference, September 24-26 in Seattle, Washington. During the forum, NASAA's Investment Adviser Section also is expected to address tools to help smaller firms perform an assessment of their cybersecurity readiness.

No securities firm or investment adviser of any size can afford the loss in client trust - much less financial losses - that will result from a serious cybersecurity failure. And no investor should have his or her personal information compromised. When you protect your firms you are protecting your customers.
Communicating with regulators also is critical in identifying threats early and helps inform how businesses and law enforcement should respond. Cybersecurity requires a collaborative approach involving regulators and industry, while recognizing that there are similarities and differences in the size, structure and operations of the various firm models. State securities regulators will continue to develop resources to help regulators and industry members understand and address cybersecurity issues.

Education and awareness are two tools to help ensure that we are all better prepared against cyberattacks. Cybersecurity and cyberattacks are an issue for firms regardless of size and business model. Everyone within your firm - from the front desk to the C-suites - has a role to serve in mitigating your firm's risk from cyber events.

*The writer gratefully acknowledges the expertise of NASAA Executive Director Joey Brady and Director of Communications Bob Webster for their assistance with this article.*

### New Rules Under The Colorado Securities Act Now Effective

**By Herrick K. Lidstone, Jr.**


**Rules Governing Exemptions from Registration of Securities**

- C.R.S. § 11-51-308(1)(B)(l) provides an exemption for non-issuer transactions in securities which are listed in recognized securities manuals. Rule § 51-3.9 identified a list of manuals for which the non-issuer transaction was available. In the amended rules:
  - Standard & Poor's Standard Corporation Descriptions was removed, and
  - OTC Markets Group Inc. (with respect to securities included in the OTCQX and OTCQB markets) was added.

- C.R.S. § 11-51-308(1)(p) provides exemptions from registration for securities being issued under certain SEC regulations. Rule § 51-3.13 now includes a state exemption from registration for offerings made under Tier 2 of federal Regulation A and Section 18(b)(3) of the Securities Act of 1933. The new rule also updates initial filing requirements and submissions for any Reg A Tier 2 offerings, adds provisions allowing for additional twelve-month period renewals of Reg A Tier 2 offerings, and adds provisions allowing for amendments to increase the amount of securities offered under Reg A Tier 2.

**Crowdfunding in Colorado**

- When the Colorado Crowdfunding Act ("CCFA") was adopted in 2015 ((H.B. 15-1246; amended H.B. 16-1049), it limited offerings to $1,000,000 (or $2,000,000 if audited financial statements were available for the issuer). C.R.S. § 11-51-308.5(3)(a)(XI) prohibits the crowdfunding exemption from being used in conjunction with other exemptions from registration under the CSA when offerings are part of a "single plan of financing." Rule § 51-3.24(K) defines the term "single plan of financing" lists factors to be considered when determining whether offers and sales
should be regarded as part of a single plan of financing in a manner very similar to Rule 502(a) of Regulation D - providing clarity to the CCFA.

- As originally adopted, the CCFA required that offerings be made in accordance with SEC Rule 147 for intrastate offerings. In October 2016 the SEC adopted an additional rule for intrastate offerings, Rule 147A. Rule § 51-3.24(L) expanded the CCFA to include offerings under federal Rule 147A.
- Federal Regulation CF (crowdfunding) is now available. While securities issued under the federal Rule (enacted pursuant to the JOBS Act of 2012) are "covered securities" and thus exempt from state review, states can require informational filings and payment of a fee. Rule § 51-3.31 imposes a filing requirement, the ability to renew a filing after twelve months, and a filing fee for federal crowdfunding offerings.
- Unfortunately, crowdfunding has not yet been successful under the CCFA, and the Colorado Securities Commissioner is planning an interest group meeting in October 2017. For more about the issues under the CCFA, see Crowdfunding in Colorado Is Not Working - A Solution Proposed available at https://ssrn.com/abstract=2933748.

Electronic Delivery of Offering Documents and Signatures

- The Colorado rules, through the addition of § 51-3.32, now allows for delivery of offering documents over the Internet and allows for use of electronic signatures.

Broker-Dealer Regulation -- Business Brokers and M&A Brokers and Cybersecurity Practices

- Colorado has Rule § 51-2.1.1(B) exemption business brokers dealing in a closely-held corporation with no more than a single buyer from the broker-dealer registration requirements of the CSA found in C.R.S. § 11-51-401. In the new rules, the Commissioner added Rule § 51-3.33 defining and exempting merger and acquisition brokers ("M&A Brokers") from the CSA's licensing requirements provided the M&A Broker limits its activities as described in the new rule.
- Colorado has now adopted Rule § 51-4.8 which imposes general guidelines for reasonable cybersecurity practices, and mandates a number of specific practices on broker-dealers doing business in Colorado. Brokers must now protect "confidential personal information," "establish and maintain written procedures reasonably designed to ensure cybersecurity," incorporate cybersecurity in annual risk assessments, use of secure (encrypted) email and dual factor authentication, and disclose to clients the risk of using electronic communications. These rules are less prescriptive than the rules recently adopted by the New York Department of Financial Services which impose obligations on most national broker-dealers. Compliance with the NYFDS rules likely equal compliance with the Colorado rules.

Investment Adviser Rules

- C.R.S. § 11-51-401(1.5) prohibits a person from acting as an investment adviser or an investment adviser representative in Colorado unless licensed or exempt from licensing. To provide greater definition to the licensing requirement, the new rules include Rule § 51-4.3(J)(IA) which discusses four acts or practices which require licensing as an investment adviser and compliance with statutes and rules pertaining thereto. The rule now makes it clear that
  - Lawyers, accountants, engineers or teachers are subject to licensing if the investment advice they render is not "solely incidental to the professional's regular professional practice with respect to clients."
  - Broker-dealers and broker-dealer agents must be licensed if, for a
fee, the broker-dealer or broker-dealer agent "provides investment advice to clients if the investment advice is not solely incidental to the conduct of business as a broker-dealer or broker-dealer agent."

- Insurance agents who, for a fee, provides investment advice to a client, must be licensed as an investment advisor or investment advisor representative. There is no "solely incidental" exception.
- Others (not described above) must be licensed as investment advisers or investment adviser representatives if they advertise or hold themselves out as a provider of investment advice, if they publish an article which (for a fee) gives investment advice based upon the specific investment situations of clients, or receive a fee from an investment adviser for customer referrals.
  
- The new rules add § 51-4.4(J)(IA) which increases the obligations on a person applying for licensing as an investment adviser representative if the person has unpaid FINRA arbitration awards.
  
- The new rules update the books and records requirements for licensed investment advisers in Rule § 51-4.6(A)(19)(IA) and now requires an annual review and certain supervisory procedures.
  
- New Rule § 51-4.11(IA) discusses requirements and conditions for a private fund advisers to exempt themselves from investment adviser licensing requirements, including imposing further requirements for exemption for private fund advisers who advise at least one (3)(c)(1) fund that is not a venture capital fund.
  
- New Rule § 51-4.12(IA) requires investment advisers to engage in business continuity and succession planning in the case of a loss of, or relocation of an office, or the death of the adviser.
  
- New Rule § 51-4.13(IA) requires that investment advisers must maintain a positive net worth of from $10,000 to $35,000, depending on various factors discussed in the rule. Investment advisers with discretionary authority or custody who do not meet the minimum net worth requirements must also maintain a surety bond.
  
- New Rule § 51-4.14(IA) imposes cybersecurity requirements on investment advisers similar to the requirements imposed on broker-dealers discussed in Rule § 51-4.8, above.
  
- New Rule § 51-4.15(IA) requires that any licensed investment adviser who wishes to charge a fee based on a share of the capital gains or the capital appreciation of the funds or any portion of the funds of a client must comply with 17 CFR § 275.205-3. The federal rule only permits the use of such fee if the client is a "qualified client" as defined therein.

### Conduct of Hearings by the Colorado Securities Board and the Office of Administrative Courts

- The new rules update and add to Chapter 6 which governs procedures for hearings conducted by the Colorado Securities Board and the Office of Administrative Courts. The rules include provisions discussing:
  - Hearings on orders to show cause why a cease and desist order should not enter under C.R.S. § 11-51-606(1.5) [Rule § 51-6.3, amended and reorganized];
  - Hearings on the denial, suspension or revocation of a registration statement and the denial or revocation of exemption from registration under C.R.S. § 11-51-310 [Rule § 51-6.4, a new rule addressing the described issues]; and
  - Hearings on the denial of an applicant or suspension, revocation, censure, limit or other conditions on the securities activities of a broker-dealer, sales representative, investment adviser or investment adviser representative under C.R.S. § 11-51-410 [Rule § 51-6.5, a new rule addressing the described issues].
Concentration Limits in Non-Traded REITs

By Deborah S. Froling

After meetings with various representatives of the non-traded industry, NASAA proposed, in July 2016, to amend its Statement of Policy Regarding Real Estate Investment Trusts ("REIT SOP") to include a concentration limit for investors. The proposed amendments to the REIT SOP would require the sponsor to propose a minimum concentration limit which the administrator would review in light of the particular circumstances of the program. However, unless the administrator determined that a lower or higher standard would be required, the concentration limit would be 10% of the investor's liquid net worth. Liquid net worth was defined "as that portion of net worth consisting of cash, cash equivalents, and readily marketable securities." The concentration limit would not be applicable to "accredited investors" as defined under Rule 501 of Regulation D. The 10% limit for each investor would include not only the program being registered but also programs of its affiliates and other non-traded REITs.

In addition, the prospectus would be required to disclose that the sponsor and each person selling shares on behalf of the sponsor had the responsibility to "make every reasonable effort to determine that the purchase of [shares met] the concentration standard … based on information provided by the [shareholder] regarding [its] financial situation and investment objectives."

Comments from industry on the proposed amendments to the REIT SOP were not supportive based on the following objections:

(1) "One size fits all" approach is not appropriate for optimal portfolio construction;

(2) While the proposed amendments to the REIT SOP seemed to include a "uniform" standard, it was within the discretion of each state administrator to determine the appropriate limit which could be higher or lower than 10%;

(3) The inclusion of a REIT's affiliates and other non-traded REITs was overly broad and could ensnare other programs that would be inappropriate to include within the limitation; and

(4) "Liquid net worth" was not an appropriate measurement for purposes of calculating the concentration limit.

Source: ADISA comment letter dated September 12, 2016.

Following the receipt of comments from various industry participants, the proposed REIT SOP amendments are currently on hold with no timetable for any further action.

Drafting BDC Guidelines

NASAA is exploring drafting BDC guidelines to be used for reviewing the increased number of non-traded BDCs coming into the market. Currently, the states are using a combination of the Omnibus Guidelines as well as certain other generally applicable guidelines in reviewing the BDCs attempting to register. The Omnibus Guidelines are of limited assistance in connection with the BDC programs given the regulatory scheme required by an Investment Company Act of 1940 regulated product. The work is being spearheaded under the Business Organizations and Accounting project group of the Corporation Finance Section. There is currently no timetable for draft guidelines to be available.

Summary of Significant Rulemakings and Proposed Rulemaking Since January 2017
By Andrew Stephenson

The last few years has seen significant rulemaking activity at the state level in response to changes in federal law brought about by the Jumpstart Our Business Startups Act of 2012 and associated rulemakings by the Securities and Exchange Commission. Below is a snapshot of significant rulemakings at the state level from January 2017 through the first week of July 2017. The editors at the Blue Sky Bugle encourage state regulators to share updates on their rulemaking activity with the State Regulation of Securities Committee email list at BL-STATEREGS-request@mail.americanbar.org.

New Jersey:

Corporate Finance - (Jan. 3, 2017) In a Notice of Statutory Construction, the NJ Bureau of Securities clarified that an individual who represents an issuer in New Jersey in an offering under Tier 2 of Regulation A, is required to registered with the Bureau as an agent. See, http://www.njconsumeraffairs.gov/Adoptions/secnotice_01032017.pdf.

Washington


North Carolina


Maine


Idaho


Texas

Corporate Finance - (Feb. 17, 2017) The TX State Securities Board proposed to amend its intrastate crowdfunding exemption to permit the use of segregated accounts in lieu of an escrow account. Comments were accepted through March

Settling the securities case administratively - Do I have to pay the investor?

By Rick Slavin

It is hard not to applaud securities regulators who can get thieves and fraudsters to give up their ill-gotten gains to the victims of their crimes. The United States Securities and Exchange Commission has for years made large fines and disgorgement a function of the remedies it seeks from wrongdoers. Recently, the United States Supreme Court imposed limitations on the amount of disgorgement and civil money penalties a court can impose on a defendant. Both Kokesh v. SEC, No.16-529, slip. Op. June 5, 2017 (addressing a five year limit on disgorgement) and Gabelli v. SEC , 568 US 442 (2013) (imposing a five year limitation on civil money penalties) applied the five year statute of limitations to the SEC's attempt to impose a fifteen year disgorgement formula in the Kokesh case.

These decisions were the result of contested court cases. Certainly the SEC has for years negotiated disgorgement with defendants in the context of Consent Agreements. These agreements were not administrative but were part of injunctive actions in Federal District Court required to be approved by a judge.

Interestingly in 1990 the SEC first received authority to seek civil monetary penalties for securities law violations in the Securities Enforcement Remedies and Penny Stock Reform Act, 15 U.S.C. §77t(d). There is no specific statutory authorization for the imposition of disgorgement.

Settlement of cases at the state level; administrative disgorgement or restitution

My recent experience with disgorgement or restitution at the state level is generally administrative. While the existence of disgorgement statutes under state securities laws varies from state to state, regulators have recently been requiring such a remedy in administrative settlements. The dynamics of settling a case with state securities regulators involves some different considerations from a case which winds up in a Federal District Court for final disposition.

While most states have the ability to bring civil actions against wrongdoers through attorneys general or by referring cases to local or statewide prosecutors, the preferred remedy is to settle administratively with the regulator. This route provides a number of potential advantages over an unpredictable adversarial proceeding: (1) it avoids an adversarial court proceeding which may not turn out well for the defendant and, similarly, might give the regulator a ruling it did not desire based on differing interpretations of the law; (2) it avoids on the record statements in a court proceeding; (3) it allows for a consent order or similar administrative order which allows the respondent to "neither admit nor deny" wrongdoing; (4) it allows the parties to negotiate the language of the formal document and negotiate a penalty which works for both sides; and (5) it avoids an administrative hearing which all too often may involve reduced burdens of proof, limited rights of appeal without de novo review, agency employees as hearing officers, and other less than desirable risks.

It is certainly not fair to say that every administrative proceeding involves the risks
detailed above, but if any exist at all, a settlement certainly makes sense. A settlement often requires the respondent to agree to a fine and other sanctions such as the hiring of independent compliance consultants, heightened supervision of employees, and other protections against wrongdoing. A not insignificant remedy which regulators have increasingly imposed is disgorgement or restitution. In other words, without the payment of funds to investors, no settlement.

On its face, what better service can a regulator provide for an investor than to recover money spent in a bad investment. A problem arises, however, when there is insufficient proof of wrongdoing at the settlement stage, a dispute over the facts, or a misunderstanding of the facts which prompts a regulator to insist on a payment to investors. In a case where the respondent has decided it makes no sense to choose a hearing because of the potential pitfalls outlined above, the respondent has a difficult choice and the regulator has a distinct advantage in imposing his or her desired terms. Does the respondent pay the investor even though he thinks the investor is not entitled to repayment or disgorgement of gains?

If, practically, the respondent wants to avoid a hearing, there is little choice. The regulator's unilateral decision controls the day. With such an opportunity for an unfair outcome, the regulator must act carefully to insure that the restitution order or disgorgement order is justified. Investor protection is certainly the traditional role of the regulator; however, that role can only be played if the result is a fair outcome. Allowing arbitrators or courts to determine whether compensation is appropriate avoids the potential for a regulator to get it wrong.

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