Editor's Note

The year 2018 is shaping up to be a year of change for securities law practitioners. But even with change, some things remain the same. In this short issue of the Blue Sky Bugle, Phillip Rutledge takes us on a walk through a re-write of the regulations adopted under the Pennsylvania Securities Act that became effecting on January 13, 2018. Our second piece looks at the Blue Sky issues impacting secondary trading of cryptocurrencies and digital securities tokens. These securities may be a new class of securities, but they still fit into existing regulatory frameworks.

Our second piece may be outdated sooner rather than later. On July 19, 2018, the North American Securities Administrators Association (NASAA) posted a request for public comment regarding proposed amendments the Uniform Securities Act to better account for digital information dissemination for secondary trading in securities. Comments on that proposal are due back by August 20, 2018. More information is available here.

Finally, I want to highlight that the Blue Sky Bugle is always open to submissions from practitioners. Past topics have included changes to state laws and regulations, analysis of court decisions, innovative applications of state law, editorial comments on practices by regulators, and more. If you have any questions about submissions, please contact me at andrew@crowdchecklaw.com.

PENNSYLVANIA RULE REVISIONS

By G. Philip Rutledge, Partner, Bybel Rutledge LLP

On January 13, 2018, a sweeping re-write of regulations adopted by the Pennsylvania Department of Banking and Securities ("PADOBS") under the Pennsylvania Securities Act of 1972 (the "1972 Act") became effective.

The most striking change in format is that all defined terms used in the 1972 Act regulations now appear in a single chapter at 10 Pa. Code, Ch. 102.021. This change was precipitated by the merger in 2012 of the Pennsylvania Securities Commission ("PSC"), an independent Commonwealth agency, into the Pennsylvania Department of Banking, an executive Commonwealth agency under the Governor's jurisdiction.

Whereas the PSC followed the format used by the U.S. Securities & Exchange Commission ("SEC") to define terms within specific regulations, all Commonwealth executive agencies are required to follow the format of a universal definition of terms. Therefore, practitioners must consult 10 Pa. Code, Ch. 102.021 in addition to the substantive provisions of any particular regulation. For the most part, the definitions previously appearing in separate regulations have been retained without significant changes.

Securities Offerings

Tax Opinion in Limited Partnership Offerings. The Most significant change
affecting securities offerings is the repeal of a requirement at 10 Pa. Code, Ch. 206.020 that a tax opinion or discussion of tax aspects prepared by an independent attorney, certified public accountant or other professional be filed with PADOBS in connection with a proposed offering of limited partnership interests by means of a registration by qualification under Section 206 of the 1972 Act. This repeal removes a significant impediment to issuers organized as limited partnerships that desire to make a Pennsylvania-only offering of securities.

Retroactive Registration of Securities. Revised 10 Pa. Code, Ch. 210.010 has been amended to reflect revisions made in Section 210 of the 1972 Act which expanded retroactive registration to any issuer that had an effective registration statement under Section 205 (registration by coordination) or 206 (registration by qualification) of the 1972 Act. This provision previously applied only to mutual funds and unit investment trusts.

Although Section 210 of the 1972 Act and Regulation 210.010 appear to impose payment of an additional filing fee for retroactive registration only on mutual funds and unit investment trusts, PADOBS may be reluctant to register retroactively securities of an issuer which has an effective registration statement under Section 205 or 206 of the 1972 Act if the issuer had not paid the maximum filing fee permitted under the 1972 Act.

Financial Intermediaries

Exemption for Private Fund Advisers. PADOBS has adopted the NASAA Model Rule on Private Fund Advisers at 10 Pa. Code, Ch. 302.070 which provides an exemption from registration under Section 301 of the 1972 Act for investment advisers exempt from registration with the SEC under Section 203(m) of the Investment Advisers Act of 1940, provided neither the adviser nor any of its advisory affiliates are subject to any disqualification set forth in Rule 262 of SEC Regulation A.

The utility of this exemption remains to be seen, particularly in light of the requirement that all Section 3(c)(1) funds advised by the adviser must incur the cost of providing annual audited financial statements to each beneficial owner of each fund. Individuals employed by or associated with an investment adviser exempt under this regulation are exempt from registration as an investment adviser representative.

Solicitor Exemption. PADOBS also adopted at 10 Pa. Code, Ch. 302.071 the NASAA model rule relating to exempting solicitors of investment advice from registration as investment adviser representatives if the solicitor (1) delivers a disclosure document relating to cash payment for client solicitation set forth in 10 Pa. Code, Ch. 404.012, (2) provides only impersonal investment advisory services and (3) is not subject to certain "bad actor" disqualifications described in Section 305(a) of the 1972 Act. Impersonal investment advice is the same as defined in SEC Rule 206(4)-3(d)(3) under the Investment Advisers Act of 1940.

Business Continuity and Succession Planning. A new regulation has been added at 10 Pa. Code, Ch. 304.071 which requires investment advisers registered with PADOBS to establish, implement and maintain written procedures relating to a
business continuity and succession plan and lists several topics which such procedures must cover. Particularly for sole proprietor investment advisers registered with PADOBS, this regulation imposes a legal obligation to formalize succession and continuity arrangements for their firms.

**Statute of Limitations for Dishonest and Unethical Practices.** To implement the change made to Section 305(a)(ix) of the 1972 Act by Act 52 of 2014, 10 Pa. Code, Ch. 305.019(b) was amended to provide a ten (10) year statute of limitations applicable to action taken by PADOBS to deny, suspend, condition, revoke any application or registration of, or censure, a broker-dealer, agent, investment adviser or investment adviser representative for engaging in dishonest or unethical practices in the securities industry or taking unfair advantage of a customer.

**Broker-dealers and Agents as Fiduciaries.** Although this provision has not been changed by this rulemaking, it is worth noting, given the current regulatory environment, that 10 Pa. Code, Ch. 305.019(a) states that "Every person registered under section 301 of the 1972 Act (which includes broker-dealers, agents, investment advisers and investment adviser representatives) is a fiduciary" (emphasis added) and shall act primarily for the benefit of its customers and observe high standards of commercial honor and just and equitable principles of trade in the conduct of their business."

**Senior Specific Designations.** 10 Pa. Code, Ch. 305.020 adopts the NASAA Model Rule on Senior Specific Certifications and Other Professional Designations which states that use of such designation in contravention of the prohibitions contained in the regulation constitute a dishonest and unethical practice in the securities business within the meaning of Section 305(a)(ix) of the 1972 Act and becomes a predicate for PADOBS to take administrative action against an applicant or registrant as permitted by that section.

**Statements of Policy**

The PSC had published a number of statements of policy which, as expressions of guidance, did not constitute regulations but nevertheless were codified at 10 Pa. Code, Ch. 604 for purposes of public disclosure. In this rulemaking, PADOBS removed these policy statements.

Provisions in some of the statements of policy had been incorporated into subsequent statutory or regulatory changes and continued publication made little sense. PADOBS argued that statements of policy should not be codified in an administrative code but appear on its web site as appropriate which was a practice followed by the Pennsylvania Department of Banking prior to its merger with the PSC.

The following statements of policy which previously appeared in 10 Pa. Code, Ch. 604 have been deleted:

- NASAA Statement Concerning Broker-Dealers, Investment Advisers, Broker-Dealer Agents and Investment Adviser Representatives Using the Internet for General Dissemination of Information on Products and Services;
- Submission of No Action letters;
- Imposition of administrative assessments;
- Denial of allegations; and
- Criminal referrals and investigation.

With respect to these statements of policy and, in particular, the above-referenced NASAA Statement, there was no expression by PADOBS in its rulemaking that it has withdrawn the effectiveness of these statements of policy. However, as a matter of good practice, practitioners should contact PADOBS staff if a client intends to rely on a particular statement of policy to determine if such statement of policy remains in effect.
TRADING CRYPTOCURRENCIES AND COMPLIANCE WITH BLUE SKY LAWS

By Andrew Stephenson, Partner, CrowdCheck Law LLP

While in many instances the origins of the term "Blue Sky" seems to directly apply to the market for initial issuance and trading of blockchain token offerings ("cryptocurrencies"), it is a fact that cryptocurrencies are here to stay, and are providing a source of capital for decentralized service providers. It is also a fact that the vast majority of cryptocurrencies are securities under state and federal law, and as securities they are subject to existing securities laws, no matter the novelty of the technology. One area of securities law that has not yet been publicly distorted (in contrast to the tortured interpretations of the Supreme Court's Howey opinion) is the application of blue sky laws to trading of cryptocurrencies. This article will briefly address the regulation of trading facilities, applicable blue sky regulations impacting the secondary market for cryptocurrencies, liability for non-compliance, and recent developments that may alter the business plans for some trading facilities.

Regulation of Securities Exchanges

As provided in Exchange Act Rule 3b-16, the SEC considers any person or entity that provides "a market place of facilities for bringing together purchasers and sellers of securities" and which:

(1) brings together the orders for securities of multiple buyers and sellers; and

(2) uses established, non-discretionary methods under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade

is acting in the role of a securities exchange and is required to register as such, or qualify for an exemption from registration. The rule clarifies that merely providing the trading facility constitutes non-discretionary methods. As such, the SEC Divisions of Enforcement and Trading and Markets released a public statement warning investors about unregistered cryptocurrency exchanges and has taken steps to enforce against violative actors.

In response, a handful of online cryptocurrency exchanges have registered, or begun undertaking the process to become registered as, or to acquire, alternative trading systems ("ATS"). As a registered ATS, such a trading facility would meet federal law requirements to act as a trading exchange for cryptocurrencies. ATS registration, however, does not relieve the trade participants from compliance with blue sky laws.

Blue Sky Laws Apply to Resale of Securities

The securities law axiom that all offers and sales of securities must be registered or exempt applies to resales as well as the initial issuance of securities. Fortunately, the average investor looking to resell securities in a one-off transaction does not need to register those securities for sale, but the resale must meet the terms of an exemption. The exemption most readily available for the seller would be the isolated non-issuer exemption, allowing an investor to resell securities that are not part of a distribution by the issuer. However, many states limit the number of transactions that may occur under this exemption per holder, restrict use by affiliates of the issuer, or restrict the use of public communications to resell the securities. Only 35 states have an unrestricted exemption for
isolated, non-issuer transactions. As such, holders of cryptocurrencies may fail to meet the terms of this exemption in many states if they undertake multiple transactions (even of different securities or tokens) in any given year.

Another exemption potentially available is the unsolicited broker transaction exemption. This exemption is available for investors that contact a broker, without being solicited, to purchase a particular security from an identified seller. Forty-five states have such an exemption in place. However, the exemption would not be available if the broker was required to solicit a counterparty to the transaction (the buyer), which may be necessary if there is limited volume in the trading of a particular cryptocurrency.

There is also the manual exemption. The manual exemption is available where there is current, public information about the underlying issuer reporting in a recognized securities manual. Forty-two states have this exemption on their books. The recognized securities manuals vary by state to state, and 24 states recognize that the manual exemption is available when current information is available on the SEC's EDGAR reporting system in the case of issuers reporting under the Exchange Act or Regulation A.

**Liability for Non-Compliance**

As participants in the offering, any broker-dealer or ATS that facilitates a secondary sale that does not meet the requirements of an available exemption may be held liable. States have broad authority to issue cease and desist orders, civil penalties, and even criminal penalties for violations of their respective securities laws.

For instance, under Section 25540 of California's Corporate Securities Law, willful violations of the state's securities act may result in criminal liable with fines of up to $1,000,000 and/or imprisonment of up to 1 year. Acts involving fraud have more significant penalties. It is likely that the state would not pursue criminal penalties against cryptocurrency exchanges that have taken the effort to register as an ATS, however, civil penalties and orders would still be available.

What is more likely to impact trading facilities and sellers is that any person who has purchased cryptocurrency through the trading facility, whether registered or not, in which there was no state law resale exemption available, will have a right to rescind the transaction. This creates the possibility of significant financial liabilities cropping up from time to time that could harm the trading facility's financial position.

**Exchange Registration and Potential Relief**

Currently, securities traded on certain national securities exchanges are not subject to blue sky laws covering the resale of those securities as a result of Section 18 of the Securities Act. As part of S. 2155 that was signed into law on May 24, 2018, Congress amended Section 18(b)(1) to no longer limit preemption to securities listed on certain national securities exchanges. Instead, securities listed on any exchange that meets the requirements for trading in the national market system would be eligible for preemption under Section 18. As such, certain trading facilities may determine that it would be advantageous to undertake registration as an exchange rather than an ATS, however expensive and burdensome such registration and ongoing compliance would be.

Many issuers of and investors in cryptocurrencies may believe they are operating in a new order based on cryptography, but much of what is occurring is already covered by existing securities laws. Those laws include state laws regulating the resale of securities, which includes cryptocurrencies. Certain participants in the space have undertaken the effort to register with the SEC as ATSs, but that is not the end of their regulatory obligations and they may find themselves liable to state governments or participants in their trading facilities for non-compliance.
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