

# THE BLUE SKY BUGLE

A Newsletter for Blue Sky Lawyers

Published by the ABA Committee on State Regulation of Securities

Volume 2006, Number 2, August, 2006

## EVENTS CALENDAR

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The State Regulation of Securities Committee will meet in conjunction with the 2006 Annual Meeting of ABA Business Law Section to be held

August 6, 2006 (10:00 AM to 11:00 AM)  
at the Waikiki Beach Resort & Spa

2006 Annual NASAA Fall Conference  
September 17 through September 20, 2006  
Westin Horton Plaza, San Diego, California

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## PLAN FOR THE FUTURE

2007 Annual NASAA Fall Conference  
September 30 through October 3, 2007  
Seattle, Washington

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## BLUE SKY BITS AND PIECES

By Ellen Lieberman

Debevoise & Plimpton LLP (New York)

**Christine A. Bruenn**, after more than 18 years in government regulation, stepped down in March 2006 as Commissioner of Maine’s Department of Professional and Financial Regulation, a position to which she was named in May of 2005 after serving as Securities Administrator since 1997 and Acting Commissioner since July of 2004. At the same time in March Chris also stepped down from her position as NASAA’s Ombudsman. Chris, a former NASAA President, has become a partner at the firm of Bingham McCutchen LLP in its Portland, Maine, office, where she is representing, advising and consulting with clients on state and federal regulatory matters, including broker-dealer and investment adviser issues. **Michael Collieran**, previously a Maine Assistant Attorney General and a naval flight officer, became Maine Securities Administrator in August 2005.

**Lloyd P. LaFountain, III** is serving as Acting Commissioner of Maine’s Department of Professional and Financial Regulation. Mr. LaFountain continues to serve as the Superintendent of Maine’s Bureau of Financial Institutions, a position he has held since May 2005. He is also a former member of the Maine House of Representatives and engaged in the private practice of law. Stepping in as NASAA’s new Ombudsman is **Don Saxon**, Commission of Florida’s Department of Financial Services, Office of Financial Regulation.

**F. Lee Liebolt, Jr.**, formerly a Chair of the American Bar Association Committee on State Regulation of Securities and now practicing law at Harkins Cunningham LLP in New York, has graciously agreed to rejoin the leadership ranks of this Committee by serving as our Liaison to the NASAA Ombudsman. In that role he will be able to act as a voice to present our views, raise issues and generally let us know what the Ombudsman is doing on problems that concern our community. While folks are free to consult with the Ombudsman on their own, sometimes even on specific issues it’s helpful to have a person who is not part of the

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problem present it and help work on the solution. We appreciate Lee's offer to serve in that capacity.

**Melanie A. Jenkins**, Senior Vice President / Senior Regulatory Counsel, Citigroup Smith Barney, Compliance Regulatory Unit, is our Committee's Liaison to NASAA's Broker-Dealer Section. Melanie's efforts as our eyes and ears, and sometimes our voice, to NASAA's Broker-Dealer Section will complement the oversight and projects of our Subcommittee on Broker-Dealers and Investment Advisers co-chaired by Martin R. Miller, Willkie Farr & Gallagher LLP and a former Chair of this Committee, and David M. Katz, Sidley Austin LLP.

**Tamara K. Salmon**, Senior Associate Counsel of the Investment Company Institute has agreed to serve as our Committee's Liaison to NASAA Investment Adviser Section and to the Subcommittee on Investment Companies and Investment Advisers of the ABA Section of Business Law Committee on Federal Regulation of Securities. Tami's oversight and input will supplement the investment adviser segment of Marty Miller and David Katz's Subcommittee on Broker-Dealers and Investment Advisers, and will keep the Committee current on relevant issues relating to investment companies. Tami has long been a great resource to individuals who practice blue sky law, and we are happy to "institutionalize" her as a resource for the full Committee.

**Deborah Schwager Froling**, member of Arent Fox PLLC in Washington, D.C., has undertaken to serve as our Committee's Liaison on TICs and Other Real Estate Related Securities Issues. She has extensive experience in public and private offerings of debt, equity and convertible securities as both issuer's and underwriter's counsel, primarily for real estate companies, and in the tenant in common syndication industry. She will be able to represent the interests of the blue sky bar on these issues to relevant groups including NASAA and TICA, and will be able to keep the Committee abreast of developments in this area. Deborah has recently been honored with appointment to the National Association of Women Lawyers 2006-2007 Board of Directors.

**Peter Danias** of Kaye Scholer LLP has agreed to Co-Chair our Subcommittee on Employee Plan and Other Exempt Securities, with **Michele A. Kulerman** of Hogan & Hartson L.L.P., and we welcome his participation. Peter practices primarily in the areas of corporate law, securities transactions and Hart-Scott-Rodino antitrust compliance. He is admitted to the bar in New York and New Jersey and to the United States

Tax Court. The Subcommittee will renew its focus on non-uniform state requirements for securities offered under Rule 701 and would like suggestions from committee members about other securities exemption issues that should be addressed.

**G. Philip Rutledge**, Chief Counsel of the Pennsylvania Securities Commission for many years until his retirement in June 2004, long time active participant in NASAA, and a contributor to the last edition of the Blue Sky Bugle, has moved his practice of law. He is a founder and partner in Bybel Rutledge LLP, which will have several offices in Pennsylvania. Phil will work from the firm's Lemoyne, Pennsylvania, office.

**Preston DuFauchard** was named California Commissioner of Corporations effective June 12, 2006 by Governor Arnold Schwarzenegger. He was most recently Assistant General Counsel for Bank of America, supervising securities litigation related to mergers, investment banking and broker dealer operations and was previously a partner in Landels, Ripley and Diamond and Brobeck, Phleger and Harrison. He also serves as a director of the Legal Aid Society of San Francisco and as a judge pro tem for Alameda County Small Claims Court. In the press release announcing his appointment, he said "I share Governor Schwarzenegger's unrelenting commitment to enhance the business climate in California." He further stated that "I am truly honored to serve in this position to ensure the safety and soundness of our financial institutions and to also improve financial literacy programs aimed at helping California consumers achieve economic prosperity."

**William H. Mohr** has become Director of Compliance Programs at the Citigroup Operations & Technology, Global Compliance, Risk Management & Control Section. Bill had been Deputy Bureau Chief at the State of New York Law Department's Investor Protection and Securities Bureau and thereafter Assistant General Counsel of Datek Online Holdings Corp.

**Richard Barry**, Chief of Enforcement of the New Jersey Bureau of Securities, received the 2006 NASAA Enforcement Award. In two decades as Chief of Enforcement Barry led numerous investigations including investigations of penny stock fraud that involved the first use of the state's civil racketeering statute in a securities case, and its investigation of Robert Brennan, whose high-profile bankruptcy fraud trial, which led to his imprisonment in 2001, was a direct outgrowth of two separate civil matters brought by the New Jersey Bureau of Securities and the SEC. In the

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past two years, Barry led investigations resulting in settlement payments to New Jersey totaling \$68 million.

**William F. Reilly, Jr.** of the Bureau of Securities Regulation of Florida's Department of Financial Services, Office of Financial Regulation appeared and spoke at the Meeting of the ABA Section of Business Law Committee on State Regulation of Securities in Tampa on April 8, 2006. Also at the meeting was **Joseph P. Borg**, Alabama's Securities Commissioner and President-elect of NASAA.

On June 5, 2006 Securities and Exchange Commissioner **Cynthia A. Glassman** completed her term. She joined the Commission in January 2002 and served as Acting Chairman of the Commission during the summer of 2005. Prior to joining the Commission, she served 12 years at the Federal Reserve and 15 years consulting in the private sector. She received a PhD. in Economics from the University of Pennsylvania and taught economics at the University of Cambridge, England where she remains a member of their staff. During her term on the Commission she advocated for better disclosure and lately that Sarbanes Oxley requirements be scaled down--but not repealed--for small companies.

President Bush nominated **Kathleen L. Casey**, staff director of the Senate Banking Committee, to fill the Securities and Exchange Commission seat of Cynthia Glassman, and she was confirmed by the Senate and assumed office. After graduating from George Mason University Law School, Ms. Casey worked as chief of staff and legislative director for Senate Banking Committee Chairman Richard C. Shelby, of Alabama.

SEC Chairman Christopher Cox has appointed **Andrew "Buddy" Donohue** as Director of the agency's Division of Investment Management. Previously Donohue was Global General Counsel for Merrill Lynch Investment Managers; Executive Vice President, General Counsel, Director, and member of the Executive Committee for Oppenheimer Funds; Senior Vice President, General Counsel, and Director for First Investors Corporation; and a corporate and securities law partner with the firm of Kraft & McManimon (now McManimon & Scotland, LLC), a multi-practice firm for private and government clients based in Newark, N.J.

**Joseph P. Borg**, Director of the Alabama Securities Commission, and both Past President and President-Elect of NASAA, participated in March 2006 in an intergovernmental panel as part of the UN Eleventh Congress on Crime Prevention and Criminal Justice. Joe

will be only the second person in NASAA's 87 year history to twice hold the office of President.

In October 2005 **J. Randall McNeill** was appointed Deputy Director of the Alabama Securities Commission. Previously he was Deputy Attorney General and Chief Prosecutor for the Commission, and will continue in those roles and as Special Assistant U.S. Attorney.

Former Securities and Exchange Commission general counsel **Giovanni Prezioso** has returned to his former firm, Cleary Gottlieb Steen & Hamilton. Mr. Prezioso, a partner in Cleary's Washington, D.C., office from 1991 to 2002, when he joined the SEC, will return to that office. He was succeeded as SEC general counsel in January by former Latham & Watkins partner Brian Cartwright.

The NASD announced the promotion in March 2006 of **James S. Shorris** from Senior Vice President and Deputy Head of Enforcement to Executive Vice President and Head of Enforcement. Prior to joining the NASD, Shorris practiced securities law at several law firms, including Bingham McCutchen LLP and Choate, Hall & Stewart in Boston and at Morgan, Lewis & Bockius in New York. He was also Vice President, Counsel and Chief Compliance Officer for Allmerica Financial Corporation in Worcester, MA, Senior Vice President and Deputy General Counsel for Tucker Anthony Incorporated in Boston, and an Assistant District Attorney in the Manhattan District Attorney's Office for five years.

Shorris replaces **Barry R. Goldsmith**, who left the NASD after nearly 10 years to return to private practice as a partner in Gibson, Dunn & Crutcher LLP's Washington, D.C. office. Before joining the NASD, Goldsmith served as Chief Litigation Counsel for the Securities and Exchange Commission, where he had significant responsibilities, among other matters, for the SEC's landmark federal court cases against Drexel Burnham Lambert and Michael Milken, Ivan Boesky and Victor Posner.

In May 2006 **Douglas Shulman**, President of Markets, Services and Information, at the NASD was named its Vice Chairman. At the NASD since 2000, Shulman directed the restructuring in which the NASD spun off its market subsidiaries to focus on its mission as a regulator, led the negotiations for the sale of the NASDAQ Stock Market and the American Stock Exchange, and oversaw the launching of TRACE (NASD's real-time corporate bond market regulatory

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and information system) and modernization of NASD's technology systems.

Also in May 2006 **Elisse Walter**, NASD's Executive Vice President for Regulatory Policy and Programs was named Senior Executive Vice President. Walter directed NASD's efforts to improve regulation in the sale of mutual funds, oversees the Department of Corporate Finance and the Department of Advertising Regulation, and heads NASD's investor education efforts. Before joining the NASD in 1996, Walter served as General Counsel of the Commodity Futures Trading Commission (CFTC) and as Deputy Director of the Division of Corporation Finance of the Securities and Exchange Commission, and prior to that as an attorney in the private practice of law.

Also in May 2006 **Stephen Luparello** who serves as NASD's Executive Vice President for Market Regulation, was named to Senior Executive Vice President, NASD's regulation of broker-dealers. As head of the NASD Market Regulation Department, he has responsibility for oversight of trading on The NASDAQ Stock Market, the Over-the Counter equities market, and the corporate and municipal fixed income markets, and he is in charge of NASD's regulatory work for markets and exchanges in the United States, including the American Stock Exchange and the International Securities Exchange. Luparello came to the NASD in 1996 from the CFTC, where he served as Chief of Staff, and previously he was a legal counsel in the Division of Market Regulation at the SEC.

**Mary Badiak** has left her blue sky and related practice at Akin Gump Strauss Hauer & Feld LLP to assume the role of Associate General Counsel and Senior Vice President of Daiwa Securities America Inc. where her practice will cover all aspects of general securities matters. We wish her the best of luck in her new position.

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With deep regret we note the death in 2005 of **Susan Bialock Anderson**, formerly Deputy Director and General Counsel to the Alabama Securities Commission. She was memorialized by the Alabama Securities Commission as "a dedicated public servant whose outstanding services, vision, and loyalty will truly be missed." She was actively engaged in the American, Alabama, Birmingham and Montgomery County Bar Associations, the Board of Directors of the Alabama Eye & Tissue Bank and the First United Methodist Church of Montgomery. Born in 1953, she graduated law school

from Sanford University in Birmingham with a number one class ranking and went on to excel in private practice and government service. She is survived by her husband, James, and three children.

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## FROM THE CHAIR — EVENTS AND INTERESTING DEVELOPMENTS

*By Ellen Lieberman*  
Debevoise & Plimpton LLP

Tampa Meeting. We are off and running for the year, with a very successful ABA Section of Business Law Spring Meeting in Tampa.

Kudos to R. Michael Underwood, Squire, Sanders & Dempsey L.L.P., for a great job as Chair of the Program co-sponsored by our Committee in Tampa. Managing Parallel Proceedings in Securities Investigations panelists included Joseph P. Borg, Director of the Alabama Securities Commission and Chair-Elect of NASAA, Zachary W. Carter, Partner and Co-Chair of the White Collar Crime and Civil Fraud practice group at Dorsey & Whitney LLP in New York and former U.S. Attorney for the Eastern District of New York, David Nelson, Regional Director of the Securities and Exchange Commission in Miami, and Katherine A. Malfa, Vice President Enforcement at the NASD, with Michael E. Clark, Chair of the Criminal Laws Committee, partner at Hamel Bowers & Clark LLP in Houston, Texas, and former Assistant U.S. Attorney, Chief of the Criminal Division in the U.S. Attorney's Office for the Southern District of Texas, as moderator.

Our Committee meeting on April 8 was attended by, among others, Joe Borg and Richard A. White, Florida's Director of Securities and Finance Regulation.

Honolulu Meeting. The next meeting of the Committee is scheduled for Sunday, August 6, 2006, 10.00-11.00 a.m., in Milo II, 2<sup>nd</sup> floor, of the Waikiki Beach Resort & Spa, Honolulu, Hawaii, in conjunction with the ABA Annual Meeting, August 3-9, 2006. Aloha! And hoping to see many of you there. We have invited Hawaii securities regulators and the Committee's Liaison for Hawaii, David Reber of Goodwill Anderson Quinn & Stifel, to attend our meeting, and also Nathan T. Natori of the Hawaii Law Group who has been an active practitioner of securities law and a moving force in the recent passage by Hawaii of the Uniform Securities Act (2002). Bring your surfboard and hopefully there will be lots of sunshine and blue skies ahead.

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San Diego Meeting. Our final Committee meeting for this year will be held Sunday, September 17, 2006, 10:00 a.m.-12:00, in conjunction with the Annual Meeting of the North American Securities Administrators Association at the Westin Horton Plaza Hotel in San Diego, California, September 17-20, 2006. We are also scheduling some stand alone meetings of certain of our Subcommittees on Sunday and Monday, September 17 and 18: NSMIA and Limited Offering Exemptions, Enforcement, Broker-Dealers and Investment Advisors, Employee Plan and Other Exempt Securities, and The Uniform Securities Act (2002), and those meetings will be open for your attendance and participation. If surfing in Hawaii merely whetted your appetite, you'll have another opportunity in San Diego!

NASAA Corporate Finance Meeting. On April 19, NASAA's Corporate Finance Section was gracious enough to open up a portion of its meeting for an interactive conference call, which I arranged, and as a guesstimate about 30 people joined. Denise Voigt Crawford, Texas Securities Commissioner and Chair of the NASAA Section, discussed a number of issues of concern to NASAA, and ABA participants mentioned several issues of interest to practitioners. E. Marlee Mitchell, of Waller Lansden Dortch & Davis LLP and our Committee's Liaison to the NASAA Corporate Finance Section, is following up on one such issue with Randall E. Schumann, Legal Counsel for the Securities Division of the Wisconsin Department of Financial Institutions: whether state exemptions are available for warrants or options to purchase securities listed on the various tiers of NASDAQ, as it changes to a national securities exchange, and as it seeks "covered security" status for additional tiers. Michele A. Kulerman, Hogan & Hartson L.L.P. and Chair of our Employee Plan and Other Exempt Securities Subcommittee, is following up with Craig A. Goettsch, Iowa's Superintendent of Securities, on the lack of uniformity among the states in treatment of Rule 701 exempt securities.

NASD and Minnesota Commerce Department Annuity Roundtable. On May 5, 2006, the NASD and the Minnesota Department of Commerce sponsored an Annuity Roundtable to begin a dialogue on the current regulation of annuities by federal, state and NASD regulators and the regulatory framework under which annuity products are marketed and sold. Participants included securities and insurance regulators and industry executives who reached a consensus, according to a later press release, that "investors purchasing fixed, variable or equity indexed annuities should be comparably protected, regardless of which regulatory regime covers

the particular product they buy." The NASD and Minnesota regulators are forming working groups to compare regulatory standards in these areas: supervision, suitability, advertising, sales force training and disclosure requirements. Streaming video of the Roundtable is available at [www.nasd.com/annuityroundtable](http://www.nasd.com/annuityroundtable).

It is worth noting that the Uniform Securities Act (2002) and the 1956 version of the Uniform Securities Act allowed state by state determination as to whether variable annuity contracts issued by insurance companies (which are securities under federal law) should be excluded from the definition of "security." In most instances, variable annuities are issued by separate accounts of insurance companies, which are federally registered as investment companies, and thus would be "covered securities" under NSMIA and preempted from state securities registration requirements. Defining "security" under state law to include variable annuities, however, would have the effect of making those who sell them subject to broker and agent registration, and the sale subject to state antifraud provisions and state notice filing requirements.

NASAA Conferences. On May 9, 2006, NASAA held a Public Policy Conference focused on financial issues affecting baby boomers as they turn 60 and begin to retire. Securities and Exchange Commission Chairman Christopher Cox was the luncheon keynote speaker. Changes in the development and marketing of investment products and services to those about-to-be seniors were discussed, including problematic "free lunch" investment seminars. Coordinated federal and state initiatives aimed at preventing investment fraud of older Americans were highlighted. Using previous cooperative efforts among the Commission, Florida securities regulators and the NASD as a model, the new cooperative initiative will include targeted examinations to detect abusive sales tactics aimed at seniors, aggressive securities law enforcement in instances of fraud against seniors, and active investor outreach and education.

Following the luncheon, Don Saxon, Florida's Commissioner of the Office of Financial Regulation and NASAA's Ombudsman, presided at an open meeting in which problems and issues were aired, those of particular concern to the brokerage industry included clerical errors and expungement issues relating to disciplinary history in CRD records for broker-dealer agents, and burdensome document production requests.

On April 4, 2006, NASAA sponsored a NASAA Listens Forum focused on hedge funds and their increasing role

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in the portfolios of pensions and individual investors—with reference made to 2005 blowups of hedge funds run by Bayou Management and Wood River Capital Management and concerns expressed about the “so called” retailization of hedge funds.

ABA Committee Luncheon Meeting. The first of what we hope will be a continuing series of luncheon meetings held in person and by teleconference call was inaugurated on July 6, 2006, with Patricia D. Struck, President of NASAA and Wisconsin Securities Administrator as our guest speaker. F. Lee Liebolt, Harkins Cunningham LLP and our Liaison to the NASAA Ombudsman, helped organize the event. Alan M. Parness, Cadwalader, Wickersham & Taft LLP and Committee Vice Chair, graciously hosted the meeting.

Committee Comment Letter. Many thanks to Alan Parness who spearheaded our first comment letter, to the Securities and Exchange Commission in support of a rulemaking petition of the NASDAQ Stock Market to have its listed securities designated as “covered securities” under Section 18 of the Securities Act of 1933. As a Committee of the ABA Section of Business Law, we are in a position to submit comment letters to agencies of states or the federal government, and we were pleased to support this petition which was also supported by NASAA. Although it can be a somewhat cumbersome process, Alan has shown that submitting comment letters can be done. If there are issues on the state or federal level that you believe we should address as a group, let us know and we would hope you would want to pitch in and help with the drafting process.

Committee Liaisons and Officers. Getting involved is the name of the game. The more participation and the more feedback and dialogue, the more knowledgeable we, the Blue Sky community, can be with a real grasp of what’s happening out there in the states, districts and territories, and in the federal and global arenas. We thank, with great appreciation, the Committee’s Officers, Subcommittee Chairs and all of our many State Liaisons who are doing a great job in keeping us informed. We want to welcome to the ranks of Committee leadership several new Liaisons:

- E. Marlee Mitchell of Waller Lansden Dortch & Davis LLP as our Liaison to NASAA’s Corporate Finance Section
- F. Lee Liebolt, Jr., of Harkins Cunningham LLP as our Liaison to the NASAA Ombudsman

- Melanie A. Jenkins of Citigroup Smith Barney as our Liaison to NASAA’s Broker-Dealer Section
- Tamara K. Salmon of the Investment Company Institute as our Liaison to the NASAA Investment Adviser Section and to the Subcommittee on Investment Companies and Investment Advisers of the ABA Section of Business Law Committee on Federal Regulation of Securities.

We need input from ALL of you—send us hot news flashes to post on the listserv. Contribute to the next edition of the Blue Sky Bugle. Attend our meetings. Contact a Subcommittee Chair or Liaison to offer your services, or share information and issues. And if you would like to serve as Liaison to another arm of the ABA, NASAA or another relevant organization, let’s talk about it. This is YOUR Committee and we want you (and your firm) to be duly recognized.

Supreme Court Gives Broad Reading to SLUSA Preemption Provisions. In Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 126 S.Ct 1503, 164 L.Ed 2d 179 (2006), the Supreme Court gave a broad reading to the provisions of the Securities Litigation Uniform Standards Act of 1998 (“SLUSA”) that preempt state law claims in class action law suits to cover holders of securities who were fraudulently induced to retain securities. The Court did not limit the phrase “in connection with the purchase or sale of securities” only to purchasers and sellers of securities. The Court said “[t]he magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally traded securities cannot be overstated. .... The presumption that Congress envisioned a broad construction follows ... also from the particular concerns that culminated in SLUSA’s enactment ..., viz., ‘to prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives’ of the 1995 Act. .... Respondent’s preferred construction would also give rise to wasteful, duplicative litigation. .... The prospect is raised, then, of parallel class actions proceeding in state and federal court, with different standards governing claims asserted on identical facts. That prospect, which exists to some extent in this very case, squarely conflicts with the congressional preference for ‘national standards for securities class action lawsuits involving nationally traded securities.’”

California Superior Court Holds that Contents of Mutual Fund Prospectus are Preempted by NSMIA, Though States Retain Antifraud Authority. In People v. Edward

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Jones & Co., Cal. Super. Ct., Case No. 04AS05097, 5/25/06, the California Attorney General charged that failure by Edward D. Jones & Co. to make prospectus disclosure of cash and directed brokerage commissions of approximately \$300 million over a five-year period to market seven mutual funds, recommend them as buys and otherwise give them preferential treatment, was a violation of California blue sky law. The court, however, was “persuaded that the contents of a prospectus is subject to federal conflict preemption, although the state may bring enforcement actions.” The California Attorney General has indicated this decision will be appealed.

In an earlier case, California v. American Funds Distributors Inc., Cal. Super. Ct., BC330774, 11/22/05, and Capital Research and Management Co. v. Lockyer., Cal. Super. Ct., BC330770, 11/22/05, the same court reached a similar conclusion as to alleged violations of California blue sky law by American Funds Distributors Inc., the distributor, and Capital Research and Management Co., the investment manager, of American Funds, for failure to make prospectus disclosure of similar shelf agreements. “Such state-mandated disclosures, pursuant to the House Committee’s report and the intent of Congress, are directly barred by NSMIA.” This decision is currently being appealed.

Public Trust in Kansas. Kansas, having gone the Uniform Securities Act route, has now struck off on a frolic of its own. Effective July 1, 2006, registration of a broker-dealer, investment adviser or their respective representatives requires the Kansas administrator to find that the applicant and, if applicable, the officers, directors or partners of the applicant, are of sufficient character and reputation to warrant the public trust, and such person may be disciplined by the administrator on the grounds that the person lacks sufficient character or reputation to warrant the public trust. Kansas Uniform Securities Act, Sections 17-12a406 and 17-12a412.

Illinois Acts to End Atrocities and Terrorism in Sudan. Amendments to the Illinois Pension Code, which became effective this past January, put in place restrictions and certification requirements for companies that manage assets of an Illinois public pension fund or the Illinois public retirement system. From January 27, 2006, such manager may not loan or invest assets of the Illinois pension fund to a forbidden entity, as defined. Further, the manager will be required to certify that, beginning January 27, 2007, 60%, and then beginning July 27, 2007 100%, of the Illinois pension fund’s managed assets have not and will not be invested in

forbidden entities, and failure to certify will permit the fiduciary to void the investment. Generally these forbidden entities include the government of Sudan and its agencies and units, companies managed or controlled in whole or in part by Sudan and its agencies and units, companies organized or headquartered in Sudan, and certain companies identified (by the U.S. Department of Treasury Office of Foreign Asset Control or independent researching firms that specialize in global security risk) as sponsoring terrorist activities relating to Sudan. The legislation was prompted by genocide in the Darfur region of Sudan. Illinois Public Act 94-0079.

Texas Limited Finder Registration Proposal. The Texas Securities Board proposed amendments to its Rules §§115.1 and 115.3 and a new Rule §115.11 relating to securities dealers and agents. The proposal describes limited activities of certain persons, defines them as “finders” and provides a restricted form of securities dealer registration for such persons. Generally, a “finder” would be an individual who receives compensation for introducing an accredited investor to an issuer or an issuer to an accredited investor for the sole purpose of creating a potential investment in the issuer’s securities. The finder would be prohibited, among other things, from negotiating the terms of the investment, advising either the investor or the issuer about advantages or disadvantages of the investment, and participating in negotiating any of the terms of the investment. A finder could register as a restricted dealer and engage exclusively in the permitted activities permitted a finder. Waiver would be granted from securities examination requirements. Persons registered as general securities dealers could engage in finder activities under their general dealer license.

The intent of the proposal is to take a limited first step towards dealing with the private placement broker-dealer issue addressed by an ABA task force and recommended in concept by the Advisory Committee on Smaller Public Companies to the Securities and Exchange Commission. Among the comments submitted by practitioners to the Texas Securities Board, it was suggested that adoption of the rule be deferred pending a broader multijurisdictional resolution of the finder issue since otherwise a Texas finder registrant could be subjected to possible federal or other state enforcement proceedings, and to claims of possible rescission rights and disputed commission payments, because Texas registration might lend support to claimed violations of state or federal law.

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Advisory Committee on Smaller Public Companies. The Final Report of the Advisory Committee on Smaller Public Companies to the Securities and Exchange Commission was submitted to the Commission on April 23, 2006. While the report included a wide gamut of suggestions, many of which relate to implementation of Sarbanes Oxley, some recommendations may be of particular interest to the Blue Sky community including the following:

- Adopt a new private offering exemption from the registration requirements of the Securities Act of 1933 that does not prohibit general solicitation and advertising for transactions with purchasers not in need of all of the protections of registration under the Securities Act
- Relax prohibitions against general solicitation and advertising under Rule 502(c) of Regulation D utilizing the test the waters concept of Rule 254
- Spearhead a multiagency effort to create a streamlined NASD registration process for finders, M&A advisers, and institutional private placement practitioners
- Increase the disclosure threshold for Rule 701(e) from \$5 million to \$20 million
- Shorten the integration safe harbor from six months to 30 days

Define the term “qualified purchaser” and make NASDAQ Capital Market and OTCBB securities “covered securities” under NSMIA.

The full text of the Report is available at <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf>. If you are interested in NASAA’s comment letter, it is available at <http://www.sec.gov/rules/other/265-23/rastaples1692.pdf>.

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## **PROTECTING SENIORS FROM INVESTMENT FRAUD**

*By Patricia D. Struck*  
President, NASAA  
Wisconsin Securities Administrator

From the “Greatest Generation” to the “Baby Boomers,” seniors have worked hard to build both our nation’s economic prosperity and a lifetime’s worth of savings. State securities regulators are committed to using every resource available to ensure that the golden years of our nation’s seniors are not tarnished by investment fraud.

With the first ‘Baby Boomers’ turning 60 this year, my fellow state securities regulators and I share a deep concern that investment fraud among seniors could grow significantly. For years, we have been engaged in ongoing efforts to fight senior investment fraud through targeted, aggressive enforcement combined with financial education to protect investors from unscrupulous individuals. I am pleased that in recent months, federal regulators and others have joined us in our efforts.

Con artists have emerged from the side streets and back alleys to Main Street where older investors live. They know that retirees are living longer and are facing greater responsibility for their financial security. As a result, seniors are being flooded with pitches for investment seminars; many of them promising a free meal along with “little or no risk and higher returns.” Unfortunately, in many of the cases that we see, it’s just the opposite: high risk and no returns, just disastrous losses.

The current landscape facing senior investors is littered with slick schemes and broken dreams. In my own state of Wisconsin, for example, an elder in a Kenosha church operated a long-running Ponzi scheme that victimized a total of 117 friends, relatives, and mostly senior parishioners of more than \$6 million.

A survey by the North American Securities Administrators Association (NASAA) shows that nearly half of all investor complaints received by state securities regulators come from seniors and one-third of enforcement actions taken by state securities regulators involves senior investment fraud.

The NASAA survey also found that unregistered securities, variable annuities and equity-indexed annuities are the most pervasive financial products involved in senior investment fraud.

While my colleagues and I see a proliferation of troubling schemes involving unlicensed individuals promoting and selling unregistered securities to seniors, we continue to be concerned about the way in which variable and equity-indexed annuities are marketed and sold to seniors.

Our concerns with variable and equity indexed annuities are not about the products. These are legitimate and suitable investments for some, but they are unsuitable for many retirees; yet they are being pitched aggressively to seniors through investment seminars, where participants aren’t always told about high

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surrender charges for early withdrawals, the potential of exposure to market risk, and the steep sales commissions agents often earn when they move investors into these products.

We urge seniors to make sure they do business only with individuals licensed by their state securities regulators after they pass rigorous competency examinations.

NASAA also has developed an online Senior Investor Resource Center to help seniors protect themselves from investment fraud. The website is available on NASAA's website at: [http://www.nasaa.org/Investor\\_Education/Senior\\_Investor\\_Resource\\_Center](http://www.nasaa.org/Investor_Education/Senior_Investor_Resource_Center).

Today's senior investors are our parents, our teachers, and our coaches - the same people we looked up to in our childhoods. They deserve the same respect today. We must not tolerate their victimization by those who would profit from their lifetime's savings.

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**COMMITTEE SUBMITS COMMENT LETTER  
SUPPORTING NASDAQ RULEMAKING  
PETITION TO SEC**

*By Alan M. Parness*  
Cadwalader, Wickersham & Taft LLP

On April 3, 2006, the Committee submitted its first-ever comment letter to the Securities and Exchange Commission (the "SEC"), supporting a February 28, 2006 petition (the "Petition") filed by The Nasdaq Stock Market, Inc. ("Nasdaq"), requesting that the SEC amend Rule 146(b) under the Securities Act of 1933, as amended (the "Securities Act"), to designate securities listed on The Nasdaq Capital Market ("NCM") as "covered securities" for purposes of Section 18(b)(1)(B) of the Securities Act (the NCM has replaced The Nasdaq SmallCap Market). As noted in our letter, we felt it was important to amend Rule 146(b) to designate securities listed on the NCM as "covered securities" for purposes of Section 18(b)(1)(B), since, absent their designation as "covered securities," offerings of NCM-listed securities, and securities on par with or senior to such securities, would continue to be subject to oftentimes burdensome state regulation under Blue Sky law registration provisions, in addition to SEC registration under the Securities Act (and we noted that the costs of this dual regulatory scheme are ultimately borne by investors).

We noted Nasdaq's representations in the Petition and in Exhibits A and B thereto, as regards Nasdaq's adoption and rigorous enforcement of initial and continued listing standards for NCM issuers substantially similar to, and

in certain instances more stringent than, those imposed by the other markets the listed securities of which are now designated as "covered securities" pursuant to Section 18(b)(1) of the Securities Act and Rule 146(b) thereunder, and therefore we asserted that amending Rule 146(b) to designate NCM-listed securities as "covered securities" would be consistent with the SEC's mandate under Section 11A of the Securities Exchange Act of 1934, as amended, to assure fair competition among the exchanges. We also noted that the approval of the Petition would be consistent with the goals of the National Securities Markets Improvement Act of 1996, in which Congress, through the preemption provided by Section 18(b)(1) of the Securities Act, recognized that securities offerings by issuers of substantial size and means which met the quantitative and qualitative listing requirements of the national securities exchanges designated in that provision, as well as exchanges with comparable listing requirements, were offerings which are "national" in scope and best subject to uniform Federal regulation.

Further, we noted that, as reflected at page 8 of the Petition at footnote 42, the Board of Directors of the North American Securities Administrators Association ("NASAA") determined not to oppose the Petition. Given that NASAA, which historically has been a zealous defender of State authority over securities offerings, was not opposing the Petition, we submitted that such action lent great credence to the Petition. In this regard, NASAA also submitted a comment letter dated March 29, 2006 to the SEC, in which it affirmed its non-opposition to the Petition, but noted that the Petition illustrated certain deficiencies in the administration of listing and maintenance standards by the other major trading marketplaces the listed securities of which are presently "covered securities," and therefore recommended that the SEC undertake an "SRO Oversight Initiative."

Finally, although not specifically requested in the Petition, we recommended that the SEC amend Rule 146(b)(1), for the sake of clarity, to provide "covered securities" status not only to securities actually listed on the NCM and the other exchanges designated in Rule 146(b)(1), but also to securities which are "authorized for listing" on the NCM and the other exchanges. This would conform the Rule to the language of Section 18(b)(1)(B) of the Securities Act, and thereby resolve a theoretical issue as regards the need to effect Blue Sky registration filings in order to offer securities which have been authorized for listing on the NCM or one of the

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other exchanges designated in the Rule, pending their actual listing upon notice of issuance.

Copies of the Petition, as well as the comment letters submitted by the Committee and NASAA, are available on the SEC's website at <http://www.sec.gov/comments/4-513/4-513.shtml>.

Unfortunately, as of August 1, 2006, the SEC had taken no action in response to the Petition.

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## **STATUS OF HEDGE FUND REGULATION IN DOUBT**

*By Robert A. Boresta*  
Winston & Strawn LLP

On June 23 the U.S. Court of Appeals for the District of Columbia Circuit (the "Court") vacated the Securities and Exchange Commission's (the "SEC") Rule 203(b)(3)-2 and related rule amendments (together, the "Rule") which effectively requires many hedge fund managers to register as investment advisers under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). The Court found the Rule to be arbitrary and beyond the SEC's authority.

The full effect of the Court's decision has been delayed, as the Court, on its own motion, stayed the effectiveness of the decision until seven days after disposition of any appeal. Thus, if the SEC does not file a petition for rehearing by August 7, 2006 (45 days following the Court's decision), the earliest day that the Rule will be deemed vacated will be August 14, 2006. If the SEC petitions for rehearing, the disposition of the petition could take up to several months.

One early reaction to the Court's decision has been that certain members of Congress and at least one prominent state official have called for additional scrutiny of the hedge fund industry. Of particular interest to blue sky practitioners, Connecticut Attorney General Richard Blumenthal urged lawmakers to increase federal oversight of hedge funds or face the prospect of Connecticut and/or other jurisdictions stepping in to fill the void in regulation. Attorney General Blumenthal's comments have received significant media attention and have renewed focus on the debate over state versus federal regulation of securities.

### *Federal Preemption Limits What the States May Do*

The ability of state authorities to regulate hedge funds is limited by federal preemption. Most hedge funds are offered and sold to U.S. investors in reliance on the

exemption from registration which is afforded by Rule 506 of Regulation D, promulgated under the Securities Act of 1933, as amended (the "Securities Act"). The states are preempted from requiring registration of, or otherwise regulating the merits of offerings conducted pursuant to Rule 506 by Section 18 of the Securities Act. States retain the authority to regulate offerings of hedge funds for fraud, and to require that funds submit notice filings and fees to the states in which they are sold.

States also retain the ability to regulate hedge fund managers as investment advisers, provided that the managers are not registered with the SEC under the Advisers Act. The states may not require the registration, qualification, or licensing of SEC registered advisers, but retain the authority to bring actions against SEC registered advisers or their associated persons for fraud and deceit. States may also require SEC registered advisers to submit notice filings and fees to the states in which they conduct business.

The Advisers Act preempts state regulation of advisers who do not have a place of business in a state or who have five or fewer clients. However, where preemption ends, state regulation begins; a state such as Connecticut may require Connecticut based advisers to hedge funds who are not required to be SEC-registered to register with Connecticut. Connecticut's current approach follows that found in Advisers Act Section 203(b)(3) and Rule 203 (b)(3)-1 in counting advisory clients. However, should Connecticut change its policy, many advisers to hedge funds located in Connecticut could become subject to state registration.

### *Conclusion*

The net effect of the dual federal-state regulatory quilt is that states are not preempted from enacting laws or promulgating regulations that potentially could affect many hedge fund advisers. Should states attempt to enact legislation or adopt regulations that require advisers to register, the effect may be that such advisers would voluntarily submit to SEC registration (thereby avoiding state regulation) because of their greater familiarity with the federal regulatory scheme. In some cases, advisers may re-locate to another jurisdiction in the U.S. or abroad.

Undoubtedly, state regulators are likely to continue to have a voice in the ongoing debate as the future of hedge fund regulation in the U.S. continues to evolve. What that regulation shall consist of, and what the states' role will be, remains to be seen.

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## DOES AN INVESTMENT ADVISER ACTUALLY “SELL” SECURITIES? A FLORIDA TRIAL COURT SAYS “NO”

By Donald Rett

Law Office of Donald Rett

Earlier this year a Florida trial court addressed the issue of whether an investment adviser (“I/A”) actually “sells” securities.

The facts of the case were as follows. The customer and the investment adviser formed a relationship while both were non-residents of Florida. The investment adviser provided services through his own one-man firm which bore his name.

In 1998 the customer executed a one-page Power of Attorney (“POA”) whereby the customer gave the investment adviser’s company discretion over the customer’s account in order to implement a strategy. Prior to executing this 1998 agreement, two things had occurred: the respective parties moved to Florida, and Congress enacted the National Securities Markets Improvement Act (“NSMIA”) in 1996. (Practitioners will recall the initial confusion caused by NSMIA in the investment-advisor arena.)

The POA called for the I/A firm to be paid a percentage of assets under management; the actual execution of the orders was handled by an unaffiliated, registered associated person, at an unaffiliated, registered broker-dealer firm.

Prior to moving to Florida, the I/A and his firm had both been registered as investment advisers with the Florida Division of Securities and Investor Protection (“Division”). On an annual basis, his firm would send a single check to the Division, covering both his individual license and that of his I/A firm.

Post-NSMIA, the Division began to refund that dollar portion of the check which was applicable to his individual licensure. The manager of the I/A’s firm appears not to have questioned the refund; and, when the same incident occurred the following year, it seems no one contacted the Division to inquire why refunds were being made. According to the Complaint, the I/A representative’s individual license expired at the end of 1997 (while his firm continued to be registered).

At an undetermined time, the customer apparently became disenchanted with the services received. In 2003, the customer’s attorney filed a Complaint in a Florida circuit court. The Complaint, which was filed

solely against the individual, alleged a one-count violation of the Florida securities act, saying that the unregistered I/A rep sold securities without having an associated person’s license. The Complaint asked for rescissionary damages plus attorneys fees, as provided for in Florida’s securities law.

At the end of 2005, Plaintiff’s Amended Motion for Summary Judgment claimed damages of \$1,300,000, plus attorney’s fees.

Subsequently, defense counsel filed “Defendant’s Motion for Final Summary Judgment”, attaching an affidavit which I prepared. The affidavit referenced, among other sources, the legislative history of the major revision to Florida securities act which passed in 1978. Among other things, the 1978 legislative “Staff Report” said: “The most important distinction (in the definitional section of that amendment – DR) is the clarification between “dealer” and “investment adviser”. This distinction was not recognized under the prior law. A “dealer” is actively engaged in selling securities while an “investment adviser” provides advice concerning securities and is not involved in the actual sale of securities”. (e.s.)

(If you’ve read this far, you may not be surprised that I wrote those words for the Florida legislature in 1978.)

Following oral argument on the cross-motions, the court denied the customer’s motion for summary judgment. In granting defendant’s motion for summary judgment, the court wrote:“(u)pon consideration of the record evidence, the court finds that the defendant, an investment adviser, did not sell any securities to plaintiffs and as a result, the rescission provision of Florida Statute, Section 517.211(1) is inapplicable. The court finds that there exist no genuine issues of material fact in dispute”.

Bernard Sussman and Shirley Sussman v. Mark Hammer  
Twelfth Judicial Circuit (Sarasota County) Florida. Case #2003 CA 15310NC Decision: February 2006.

(During the last century, Don Rett was the Director of Florida’s Division of Securities, which is now known as the “Department of Financial Regulation”. He serves as Chair of the Committee’s sub-committee on “Liaison with Securities Administrators and NASD”. He was recently appointed by the Chair of the Florida Bar’s Business Law Section to be a member of “The Special Committee on the Florida Securities and Investor Protection Act”.)

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## THE STARRING ROLE OF NSMIA IN THEATRICAL SYNDICATIONS

Gary Emmanuel<sup>1</sup>

Beigelman & Associates, P.C.

### “Dirty Rotten Scoundrels”

While we may chuckle at the Max Bialystock type shenanigans in the “Producers,” for many years, legitimate theatre in New York was plagued by widespread abuse. Intensive investigations by the Attorney General’s office in the 1960’s uncovered practices ranging from undisclosed profiteering by producers to providing misleading and improvident offering literature to investors.

Faced with decreasing investor confidence, in 1964, New York, the theatre capital of the world, became the first and only State to enact legislation with the purpose of protecting the theatrical investor and the public from the results of such abuses. The regulatory framework governing New York theatrical syndications today can be found in Article 23 of the Arts and Cultural Affairs Law (“ACAL”), also known as the Theatrical Syndication Financing Act, and in the later promulgated Part 50 of Title 13 of NYCRR (“Theatrical Syndication Financing Rules”).

### “Ain’t Misbehavin’”

The cornerstone of the Theatrical Syndication Financing Act is Section 3 of Article 23.03 of ACAL which requires that all theatrical syndications must be conducted with the use of a prospectus or offering circular making full and fair disclosure of material facts pertaining to the theatrical venture.

The Theatrical Syndication Financing Act provides four principal means for compliance and it is instructive to briefly examine each of these means.

#### *Registration by Coordination*

The Theatrical Syndication Financing Act permits an effective prospectus filed with the SEC pursuant to the Securities Act of 1933, as amended (the “Securities Act”) or Regulation A to be used to solicit financing for a theatrical production. The prospectus must be filed

with the Attorney General’s office (together with certain other documents) prior to commencement of the offering.

#### *Intrastate Theatrical Offering*

A theatrical issuer may file an offering circular with the Attorney General’s office (which offering is similar to Regulation A offering circulars). Such circular must contain disclosure items included in Part 50.3 of Title 13 NYCRR (and Part 50.4 of Title 13 NYCRR if conducting a multi-production or blind pool offering).

Besides including items typical in non-theatrical Regulation A offerings, Part 50.3 requires disclosure of items such as the disclosure of a theatrical issuer’s right to abandon the production at any time, the amount of time it will take for investors to recoup their investment and risks to investors who authorize immediate use of their investment for preproduction and production purposes. In addition, a theatrical issuer must comply with additional requirements including a requirement that in a mini-maxi offering the minimum offering amount cannot be less than 75% of the maximum offering amount.

In practice, the intrastate theatrical offering has been rarely used and this was the case even before National Securities Market Improvement Act (“NSMIA”). In the years prior to NSMIA, if one was going to conduct a public offering, it made more sense for theatrical issuers to conduct a Regulation A offering (and register in New York by coordination) so that investors outside of New York could be solicited.

#### *Offerings using Investment Agreement*

Theatrical issuers conducting an offering of up to \$1,000,000 (other than multi-production or blind pool offerings) are exempt from providing investors with an offering circular as long as they set out in an investment agreement (e.g. limited partnership agreement), in easily readable print, all the terms of the offering. The investment agreement, together with other specific production related documentation, must still be filed with the Attorney General’s office for review prior to commencement of the offering.

Offerings using only an investment agreement must include certain disclosure items including a specific legend, information about the producers and amounts advanced to cover expenses. Additionally, Part 50.2 of Title 13 NYCRR mandates four specific items that must be included in every investment agreement (which is true for all offerings conducted under the Theatrical

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<sup>1</sup> Special thanks to Ronald Feiner (former Assistant Attorney General and Head of Theatrical Section of Bureau of Investor Protection and Securities in New York) and Mark Beigelman for their insightful comments.

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Syndication Financing Act) including specific details regarding the proposed production, a statement that all monies will be held in a special bank account in trust until actually used, a further statement that financial statements will be provided to investors in accordance with the requirements of ACAL, and the inclusion of special language and waivers if the investor approves use of its investment prior to capitalization.

#### *Waiver Offerings*

Compliance with the above requirements is no small feat for a theatrical issuer. Therefore, for offerings involving a limited number of persons within the close orbit of the producer, a special exemption known as the “waiver offering” is available for theatrical issuers. This exemption permits solicitation of investments from not more than 35 offerees (there can however be an unlimited number of accredited investors).

To qualify for this exemption there are minimal filing requirements with the Attorney General’s office and not surprisingly, in the pre-NSMIA years, this exemption was heavily relied on. However, it should be noted that this exemption is severely restricted by the small number of persons to whom offers can be made to as well as by the questionable application of this exemption if residents outside of New York are solicited.

#### **“Good Vibrations”**

For theatrical issuers, particularly those producing Off-Broadway productions, the time and expense of complying with the disclosure requirements of the theatrical syndication financing laws was too great and on the flip side the limitations on the waiver offering exemption too restrictive.

Therefore, the passing of NSMIA in 1996 provided much relief for theatrical issuers in the form of offerings conducted under the Rule 506 safe harbor. The combined effect of pre-emption of the registration and disclosure requirements of the Theatrical Syndication Financing Act (and other blue sky laws) together with the relative ease and low cost of a Rule 506 offering has resulted in Rule 506 becoming the most common means for conducting a theatrical offering.

#### **“Alive and Kicking”**

Nevertheless, New York’s jurisdiction over theatrical syndications under Rule 506 has not been completely overshadowed by NSMIA. Three principal areas remain where New York’s jurisdiction is still apparent, each of which is discussed below:

#### *Anti-Fraud Jurisdiction*

NSMIA specifically preserved a state’s authority to investigate and enforce instances of fraud. According to Section 5 of Article 23.03 of ACAL, it is unlawful in a theatrical syndication to (i) employ any device, scheme or artifice to defraud, (ii) willfully make any untrue statement of a material fact or to omit to state a material fact necessary in order to make such statement made, not misleading, and (iii) engage in any act, practice, or course of business which a person knows or reasonably should have known operates or would operate as a fraud or deceit upon any person. Coupled with this, the Theatrical Syndication Financing Act contains potent enforcement mechanisms that can be employed by the Attorney General to combat fraud.

Therefore, one could expect that in the appropriate circumstances, the Attorney General could activate its anti-fraud jurisdiction against a theatrical issuer even if such issuer was conducting an offering under Rule 506. Accordingly, practitioners of theatrical syndications would be well advised to utilize the relevant disclosure items of Part 50 of Title 13 NYCRR as a guideline as to what should be disclosed in a Rule 506 offering and to ensure to the extent possible that in a mini-maxi offering, the minimum offering amount is at least 75% of the maximum.

#### *Fund Segregation and Accounting*

In response to the financial improprieties that were uncovered during the investigations of the Attorney General during the 1960s, New York’s theatrical syndication laws contain a series of provisions designed to regulate the manner in which offering proceeds are maintained and financial accounting is handled. These include fund segregation rules requiring the maintenance of offering proceeds in a special bank account in trust until used for preproduction or production purposes or returned to the investor, requirements relating to the maintenance of books and records, and requirements to furnish investors and the Department of Law with financials (including “certified” statements where a specific exemption is not available). In addition, as mentioned earlier, all investment agreements must include fund segregation language informing investors that the offering proceeds will be held in a special bank account in trust and language notifying investors that financial statements will be provided in accordance with ACAL.

The Department of Law has taken the position that these provisions are free standing and survive NSMIA. The

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rationale for taking this position is apparently based on a view that the accounting and fund segregation provisions are neither unnecessary burdens nor duplicative of federal regulation and therefore continue to be applicable.

Certainly, the language that is supposed to appear in an investment agreement is prohibited by NSMIA because this is a condition upon the use of an offering document. With respect to the other provisions, the stated purpose of NSMIA was not only the avoidance of duplicative and unnecessary burdens but also to designate the Federal government as the exclusive regulator of covered securities. In fact, NSMIA carved out specific areas of residual State authority, none of which included the right to regulate accounting and fund segregation. Therefore, the Department of Law's continued insistence on regulating these matters is potentially an over extension of the State's jurisdiction. Nevertheless, given the uncertainty, theatrical issuers conducting Rule 506 offerings are better off complying with the fund segregation and accounting rules so as to avoid complications down the road.

#### *Form 99*

It is well known that the Department of Law takes the position that Form 99 together with the offering material used must be filed in a Rule 506 offering. Partly due to the unique history of theatrical syndication in New York and partly due to a belt and suspenders mentality, practitioners in this field regularly file Form 99, despite the complete lack of jurisdiction of the Department of Law to require such filing (See for example New York State Bar Association letter to the New York State Department of Law dated February 28, 1997). To the credit of the Department of Law, however, theatrical issuers are exempt from payment of the Form 99 filing fee in the implicit recognition of the budgetary restraints that theatrical productions operate under.

Putting the "requirement" to file Form 99 aside for a moment, the information requirements of Form 99 extend well beyond what is permitted by NSMIA. Specifically with respect to theatrical offerings, Form 99 requires information about the name, date and location of the proposed production. In addition, the theatrical issuer is required to notify the Department of Law within 10 business days of the first expenditure of investor funds and the date of the last public performance, if any, of the original production in New York. Given that Section 18(b)(4)(D) of the Securities Act requires notice filing requirements to be "substantially similar" to those in federal filing requirements, and there is nothing even

remotely similar in the federal filing requirements, the Department of Law has simply no grounds to inquire into such matters.

#### **"Pennies From Heaven"**

There are two points in the life of a theatrical issuer when infusion of a small amount of capital can make the difference between success and failure. The first is when a theatrical issuer first embarks on raising "front money" and the second is when the production has commenced its run and is in need of a production loan. Both situations present unique challenges for the theatrical issuer with NSMIA playing a fascinating role.

#### *Front Money*

Many theatrical productions begin with the raising of front money. Front money is a term of art used mainly in the entertainment industry to denote seed money used to start up an entertainment project. For theatre, front money is the first stage of financing raised in a theatrical syndication and it is used for preproduction purposes such as for the payment of the "option advance" to the authors and payment of key personnel such as a general manager and attorney.

A front money investor will typically be entitled to a pro-rata portion of the investor share (i.e. a limited partnership interest or membership interest) of the future revenue of the theatrical issuer plus a "kicker" in the form of a portion of the general partner's or manager's share of the future revenue of the theatrical issuer.

Investors who contribute front money to a theatrical production expose themselves to significant risks beyond the already high risks associated with theatrical syndications due to the fact that the front money will be spent during preproduction long before the theatrical issuer raises the rest of the funds necessary to mount the production.

In recognition of these added risks, the Theatrical Syndication Financing Rules regulate the manner in which front money may be raised. Not only do the Theatrical Syndication Financing Rules limit the purposes for which front money may be raised, but it also limits the number of front money investors. According to Part 50.1(q) of Title 13 of NYCRR, if the raising of front money is limited to no more than four people, then the theatrical issuer is exempt from registration under Part 50. However, if front money is raised from more than four people, then the theatrical issuer will have to conduct the offering in accordance with one of the four principal means of compliance

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described above. For this reason a convention has developed among practitioners in this field to limit front money investors to not more than four.

NSMIA plays an unforeseen role in relation to what has become known as the “front money exemption” leaving the status of this exemption essentially in limbo.

According to Section 18(a)(1) of the Securities Act, the registration and qualification prohibition of blue sky law extends to “covered securities.” However, at the time front money is raised the transaction is not conducted as a Rule 506 transaction (a covered security) and is therefore not subject to pre-emption.

Nevertheless, Section 18(a)(1) applies to another category of security: “a security that will be a covered security upon completion of the transaction.” Where a theatrical issuer raises front money and subsequently raises the rest of the financing under Rule 506, one may argue that a front money investment falls within the reach of Section 18(a)(1) subjecting the front money transaction to pre-emption. The rationale being that rather than viewing the front money as a discrete transaction, one views the front money as being integrated into the subsequent offering, together comprising the “transaction” referred to in Section 18(a)(1). Important to note here is that the front money is considered part of the overall financing being raised in the subsequent offering and, except for the “kicker” that is generally granted to the front money investor, the front money investor is usually treated in the same manner as all other investors as if he/she had invested at the same time as the other investors. Furthermore, the front money is interdependent on the subsequent offering since without it, a front money investor is left without any rights, other than perhaps a right of refund of unspent monies.

But can the front money actually be considered integrated into the subsequent offering? Though applied in very different circumstances, perhaps integration analysis can be of assistance.

According to the safe harbor provision of Rule 502(a), if the subsequent offering takes place more than six months after the front money transaction and no offers or sales of the subsequent offering take place within such six month period, then this achieves the unusual and undesirable result that front money will not be integrated into the subsequent offering.

However, if the subsequent offering takes place within six months after the front money transaction, then the

elusive five factor integration test comes into play, each of which is considered below.

- The first factor of the integration test, whether the sales are part of a single plan of financing, weighs in favor of integration since the front money is part of the overall financing for the mounting of a theatrical production and the subsequent offering is expressly contemplated at the time of the front money transaction.
- The second factor, whether the sales involve the same class of security, may or may not weigh in favor of integration. In one respect, the front money investment can be regarded as a type of preferred security because, as recalled above, the front money investor is usually entitled to a “kicker” in the form of an extra share of the revenue from the general partner or manager. However, in all other respects the front money investor is essentially treated in the same manner as an investor in the subsequent offering and this subcategory variation may be too de minimis to constitute a separate class of security.
- The third factor, whether the sales have been made at or about the same time, really depends on the particular circumstances of the offering, though it is not unusual for several months (and sometimes more) to lapse between the front money transaction and the subsequent offering.
- The fourth factor, whether the same type of consideration is being received, favors integration since both involve cash.
- The final factor, whether the sales are made for the same general purpose, most likely favors integration as offering proceeds for both the front money and the subsequent offering are used for mounting a theatrical production.

Though the application of the five factor test seems to point more in the direction of integration, this cannot be stated with any degree of certainty given the well documented difficulties in applying the test.

Yet there is another complication to add into the mix. Section 18(a)(2) which prohibits blue sky law from prohibiting, limiting or imposing any conditions on the use of any offering literature, applies only to “covered securities.” Unlike its counterparts in Section 18(a)(1) and (3), Section 18(a)(2) does not apply to a security that “will be a covered security upon completion of the

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transaction.” This could mean that even if front money is eventually considered to be covered by NSMIA, New York blue sky law may nevertheless govern the requirements as to what should be disclosed in a front money agreement. This however would be a strange result and most likely the result of a drafting error.

But let us assume for a moment that a front money investment definitively transforms into a covered security which is subject to pre-emption. If the rest of the financing is never raised or Rule 504 or 505 is relied on instead of Rule 506, then the security purchased by the front money investor does not ultimately transform into a covered security (Section 18(a)(1) of Securities Act is drafted in terms of “will be a covered security” and not “intended to be” or the like) and therefore, the front money exemption would not apply. The irony is that one cannot be certain when conducting a front money deal, that it will be subject to preemption, because this will only become apparent at a later time.

Accordingly, NSMIA has brought us full circle back to New York’s blue sky law; when handling a front money transaction it is simply best to comply with New York’s front money rules regardless of whether NSMIA will ultimately apply or not.

#### *Production Loan Financing*

With respect to production loan financing, NSMIA has potentially solved a long standing unresolved problem of the Theatrical Syndication Financing Act.

It is not uncommon for theatrical issuers to seek production loan financing after the production has begun its run. Generally, the financing is required to keep the production going as it struggles to break even in the hope that ticket sales will eventually pick up.

In return for the injection of cash, a lender of production loan financing is typically entitled to priority payment from production revenues plus profit participation to the extent there are any (from the general partner’s or manager’s share). Given the context of the transaction and the deal terms, there is little doubt that a production loan can be considered a “security” triggering the application of the securities laws.

In the pre-NSMIA years, the Theatrical Syndication Financing Act provided no redress. It would be totally impractical for a theatrical issuer, in dire need of emergency cash, to commence registration of the transaction. Similarly, the waiver offering exemption is unavailable since filing must be made with the Attorney General’s office before commencement of the first paid

performance and this type of production loan is obtained after performances commence. It is pertinent to point out also that glaringly missing from the Theatrical Syndication Financing Act is the isolated transaction exemption common in some other blue sky laws. Therefore, a theatrical issuer in such situation would be faced with the stark choice of either taking the risk of breaking the securities laws or closing the production.

Post-NSMIA, one may simply treat the production loan financing as a Rule 506 transaction, if structured properly, thereby pre-empting the potential breach of New York’s theatrical syndication laws. Unwittingly, Congress has come to the rescue of the theatrical issuer in perhaps its greatest hour of need.

#### **“The Times They Are A Changin’”**

Theatrical syndications in New York have come a long way since the 1960s thanks in large part to NSMIA which has swept away most of the broad regulatory framework of New York blue sky law that theatrical issuers were once subject to. In light of the overwhelming use of Rule 506 in theatrical syndications and as the costs of producing theatre continue to rise, challenges more familiar in corporate Rule 506 offerings such as restrictions on general solicitation and reliance on the finders’ exception become more acute. While these challenges remain the subject of much debate, as long as the theatrical issuer can convince investors to make the investment of their lifetime, the curtain continues to go up.

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#### **BLUE SKY LUNCHEON**

*By F. Lee Liebolt, Jr.*  
Harkins Cunningham LLP

Patricia D. Struck, NASAA President and Wisconsin Securities Administrator, was the guest of honor at a lunch meeting of the State Regulation of Securities Committee in New York City on July 6, 2006. More than 20 members of the Committee attended the meeting in person and another 30 members from around the country participated by conference call. Ellen Lieberman, Chair of the Committee, presided.

Ms. Struck, reminding us that she has worked with many of us over the years since starting her career as a regulator in 1982 in Wisconsin, shared her thoughts on the importance of cooperation and communication among fellow regulators. “The media loves to create the impression that there are disagreements,” Ms. Struck said, “but we know better.” Whether dealing with the

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SEC, NASD or other officials, Ms. Struck has always held to the principles of respect and collaboration.

Ms. Struck reviewed several of the significant issues that have arisen during her year of leading NASAA: the SEC's attempt to regulate hedge funds, sales of variable annuities, fairness of arbitration hearings, marketing of investments to seniors, viatical settlements, tenancies-in-common, licensing of finders, the report of the SEC Advisory Committee on Smaller Public Companies, Nasdaq's petition to have Capital Market (formerly Small Cap) securities designated as "covered securities," Chairman Cox's XBRL data-tagging project for mutual fund prospectuses, sales of security and insurance products to military personnel, and the appointment of Don Saxon as the new ombudsman at NASAA. Some of these issues and others were covered in the question-and-answer period that followed.

The lunch was hosted by Alan Parness, Vice Chair of the Committee, and held at the offices of Cadwalader, Wickersham & Taft LLP.

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## **EDITORIAL**

*By Martin A. Hewitt*  
Cadwalader, Wickersham & Taft LLP

As always, I would like to thank our many contributors for helping to make the current issue of the Blue Sky Bugle a success. The range of topics covered is truly amazing. More amazing are the topics that are currently in a state of flux and which could have a major impact on our community and our practice. In particular, Bob Boresta's timely piece highlights the complex world in which hedge funds and their counsel must navigate after the U.S. Court of Appeals for the District of Columbia Circuit vacated the Securities and Exchange Commission's ("SEC") Rule 203(b)(3)-2. Since this ruling, a small number of hedge fund managers have now terminated their registrations with the SEC. Time will tell whether or not this was a wise decision.

Other areas of interest in coming months will be the treatment of soft-dollars for 28(e) purposes; how WKSI take-downs will be treated by the NASD for purposes of filing on COBRA; and perhaps most relevant to our fellow practitioners, how many states will jump on the bandwagon and adopt the Uniform Securities Act (2002). Also of considerable interest will be the proposed new Texas Finder Rule which may become effective as soon as September 15, 2006 and which may cause repercussions that cannot – at the present time – be fully appreciated.

Needless to say there are many more areas that are near and dear to our community. The more participation that we all have in the process the better as exemplified by the Committee comment letter supporting a NASDAQ rulemaking petition to the SEC requesting that the SEC amend Rule 146(b) under the Securities Act of 1933, as amended, to designate securities listed on The National Capital Market as "covered securities" for purposes of Section 18(b)(1)(B) of the Securities Act as authored by Alan Parness.

It should be noted that there are many other ways to get involved and lend your name and your firm's name to this ever-changing area of the law. Of course the best contribution is to write an article for the Blue Sky Bugle. The articles need not be absolutely on point as to blue sky law, but need only discuss an area of law that impacts other blue sky attorneys or which casts new light on an area well known to fellow practitioners. For instance, this month's article by Gary Emmanuel entitled "The Starring Role of NSMIA in Theatrical Syndications" will prove to be a fascinating read for the majority of our community in that it is an application of blue sky law that most of us seldom see.

The next deadline for publication of the Blue Sky Bugle will be Halloween of this year. There is much going on that is truly scary in our chosen field of expertise; therefore, a timely article will be most appreciated. As many of you will notice, the length of time from deadline to publication has been reduced drastically. I would like to thank the current contributors for making this possible. In any event, I look forward to the Halloween deadline. While it really does not need repeating, there are myriad challenges ahead for practitioners of what we fondly refer to as the "so-called Blue Sky Laws" and your participation in bringing these challenges to this publication is an essential part of the exchange of important information.

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