
THE BLUE SKY BUGLE

A Newsletter for Blue Sky Lawyers

Published by the ABA Committee on State Regulation of Securities

Volume 2008, Number 2, July/August 2008

EVENTS CALENDAR

ABA ANNUAL MEETING

The Committee will meet in conjunction with the
2008 Annual Meeting of the ABA
August 8-11, 2008
New York, New York

COMMITTEE MEETING

Monday, August 11, 2008
10:30 a.m.-12:30 p.m.
Grand Hyatt at Grand Central Station
Chrysler Room, Mezzanine Level

COMMITTEE DINNER

Monday night, August 11, 2008, 7:30 p.m.
Carmine's Restaurant
200 West 44th Street;
contact Benjamin L. Nager, Sidley Austin LLP
212-839-8755, bnager@sidley.com, by August 4,
2008, pre-registration with Ben required

MCLE PROGRAM CO-SPONSOR

*Securities Arbitration Practitioners'
Perspectives on the System*
Sunday, August 10, 2008
10:30 a.m.-12:30 p.m.
Grand Hyatt at Grand Central Station
Julliard & Uris Conference Level
Program Chair: David N. Jonson, K&L Gates LLP

MCLE PROGRAM CO-SPONSOR:

*Public and Private Initiatives on
Hedge Funds and Their Regulation*
Monday, August 11, 2008
2:30-4:30 p.m.
Grand Hyatt at Grand Central Station
Empire State Ballroom A, Ballroom Level
Program Chairs:
Paul Roth, Schulte Roth & Zabel LLP;
Jeffrey Tabak, Weil, Gotschal & Manges LLP

NASAA 2008 FALL CONFERENCE

The Committee and its Subcommittees will meet in
Conjunction with the Annual Meeting of the North

American Securities Administrators Association
Caesars Palace Hotel
Las Vegas, Nevada
September 14-16, 2008

COMMITTEE MEETING

Monday, September 15, 2008
10 a.m.-12 noon
Caesars Palace Hotel, Pompeian Room

SUBCOMMITTEE MEETINGS

Enforcement
Sunday, September 14, 2008
5:00-5:30 p.m.
Caesars Palace Hotel, Capri Room

Employee Plan and Other Exempt Securities
Monday, September 15, 2008
5:00-5:30 p.m.
Caesars Palace Hotel, Capri Room

NSMIA and Limited Offering Exemptions
Tuesday, September 16, 2008
8:00-9:00 a.m.

Caesars Palace Hotel, Pompeian Room
(joint program with Paralegals regarding Form D)

Liaisons to State Administrators
Tuesday, September 16, 2008
5:00-6:00 p.m.

Caesars Palace Hotel, Capri Room

ABA BUSINESS LAW SPRING MEETING

The Committee and its Subcommittees will meet in
conjunction with the 2009 Spring Meeting of
ABA Business Law Section
at the Pan Pacific Vancouver Hotel
Vancouver, British Columbia
April 16-19, 2009

ABA ANNUAL MEETING

The Committee and its Subcommittees will meet in
conjunction with the ABA Annual Meeting
Hyatt Regency Hotel
Chicago, Illinois
July 30, 2009 – August 4, 2009

NASAA 2009 FALL CONFERENCE

The Committee and its Subcommittees will meet in conjunction with the Annual Meeting of North American Securities Administrators Association
Adams Mark Hotel
Denver, Colorado
September 2009

NASAA 2010 FALL CONFERENCE

The Committee and its Subcommittees will meet in conjunction with the Annual Meeting of North American Securities Administrators Association
Hawaii
September 2010

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BLUE SKY BITS AND PIECES

By: *Ellen Lieberman*
Debevoise & Plimpton LLP

First and foremost, it is with great pride and pure delight that I announce the birth of my granddaughter, **Paloma Sophia Passeri**, born on May 31, 2008 in Los Angeles to Andrea Lieberman and Vince Passeri, 5lb., 15oz., 18¾ inches and absolutely beautiful. She will be a bi-coastal baby and is expected to be in residence in New York for August and part of September, to travel to Paris for the fabric shows and to Mexico for her uncle’s

wedding in October, and generally to gallivant around the world with her stylist, fashion and jewelry designer mommy and her cinematographer daddy. By the time she goes to kindergarten she should have accumulated lots of frequent flier miles. Grandma is on cloud nine!

And another new arrival! **Nelson S. Ebaugh**, who practices at Nelson S. Ebaugh, PC in Houston, Texas, and his wife are the proud parents of **Neal Alexander Cathal Ebaugh**. Neal was born on June 30, 2008, at 8:58 a.m. At birth, he weighed 9 pounds and was 21¼ inches long. (Maybe we could make a match!)

On May 5, 2008, Commissioner **Paul Atkins** announced his departure from the Securities and Exchange Commission (SEC) effective upon the swearing in of his successor. A Commissioner for six years and, before that, a partner at PricewaterhouseCoopers, Atkins was at times a dissenting voice to the majority of his colleagues, calling for more protection for investors, more transparency, greater cost-benefit analysis with respect to SEC rules—and speaking out against more regulation to the mutual fund and hedge fund industries. Atkins was a Republican member of the SEC nominated by President Bush. The President nominated, and the Senate on June 27 approved, **Troy Paredes**, a Washington University Law School professor, as his successor. Paredes will serve through June 2013.

President Bush also nominated, and on June 27 the Senate approved, **Elisse B. Walter** and **Luis Aguilar** to the two vacant Democratic seats on the SEC. There are a number of potential initiatives that apparently have been awaiting a full complement of Commissioners before the SEC acts, ranging from proxy access to revised Regulation D. Walter’s term will run until June 5, 2012 and Aguilar’s until June 5, 2010. Walter, a long-time regulator, has most recently been Senior Executive Vice President, Regulatory Policy & Programs at FINRA and, before that, General Counsel of the Commodity Futures Trading Commission and Deputy Director of the SEC Division of Corporation Finance. Aguilar, a securities lawyer, is a partner at McKenna, Long & Aldridge LLP in Atlanta, Georgia, and before that practiced at other national law firms, and served as General Counsel of INVESCO and as a staff attorney at the SEC.

It is reported that Commissioner **Christopher Cox** will leave the SEC, regardless of presidential election results, in January, so the only current Commissioner

whose term will continue through 2009 will be **Kathleen Casey**, who joined the SEC less than two years ago. The SEC in the next year will likely face a host of critical issues, including regulatory reform which may emanate from the executive branch and/or be imposed by Congress, globalization, and the repercussions of the subprime mortgage and credit meltdown crises.

Wayne Stumpfer, who was California's Deputy Corporations Commissioner for Enforcement and Education, will head the SEC's Office of Investor Education and Outreach within its recently expanded Office of Investor Education and Advocacy.

David A. Markowitz became Bureau Chief of New York's Investment Protection Bureau as of April 7, 2008, where he is overseeing the investigation of investment banks and credit-rating agencies. Previously he served as an assistant director in the New York branch of the SEC where he prosecuted and obtained a \$247 million settlement in an early fraud case for short selling in pipe transactions and where he charged specialist firms at the New York Stock Exchange with unlawful proprietary trading. Markowitz succeeds **Matthew Gaul**, who had been appointed by previous attorney general, Eliot Spitzer, now the ex-governor of New York. Gaul also serves as special counsel to the New York State Commission to Modernize the Regulation of Financial Services chaired by **Eric Dinallo**, New York's insurance superintendent and Gaul's predecessor as Bureau Chief.

Colleen Monahan has been named as Deputy Commissioner of the Office of Legislation and Policy in the California Department of Corporations. She is a graduate of the University of California, Berkeley and the University of California, Davis School of Law.

Cora M. Alston, Chief of Securities Registration at the Securities Division of the Tennessee Department of Commerce and Insurance, will be retiring as of August 15, 2008. After 34 years working for the government, with 33 of those years at the Department, Cora will assume a full-time ministry at Faith Church Incorporated, where she has previously been a part-time pastor.

Another 33-year veteran, **Steven G. Kagan**, Securities Examiner in the Rhode Island Securities Division, is retiring as of August 31. He expects to stay busily engaged in a variety of activities, many

involving public service including acting as a museum docent and helping to feed the hungry.

The Utah Division of Securities has named a new Director, **Keith M. Woodwell**, who took office on June 30. He previously served in the U.S. State Department, both domestically and abroad, served as associate general counsel to the Utah Legislature for five years and practiced law with the firm of Kesler & Rust, concentrating on government regulatory law and commercial litigation. He succeeds **Wayne Klein**, who has joined Lewis B. Freeman & Partners as a principal and is leading that firm's new downtown Salt Lake City office.

Keith Paul Bishop, the Committee's California liaison, joined the law firm of Allen Matkins Leck Gamble Mallory & Natsis LLP as a partner on July 14, 2008. His office will be in Irvine, California and his practice focuses on federal and state securities laws, corporate law, investment adviser and financial services regulation, and California administrative law. He previously served as Managing Partner in the firm of Buchalter Nemer, as Commissioner of Corporations for the State of California, Deputy Secretary for Business Regulation, General Counsel to the California Business, Transportation & Housing Agency, and Interim Savings and Loan Commissioner for the State of California, and as a member of the California Senate Commission on Corporate Governance, Shareholder Rights and Securities Transactions. Active within the California State Bar and the Orange County Bar Association, he also has been an adjunct professor of law at Chapman University Law School, and has authored treatises and articles and appeared as a speaker on corporate and securities law issues. Keith will be a panelist on Public and Private Initiatives on Hedge Funds and their Regulation, a program the Committee is sponsoring (with other Business Law Section Committees) at the ABA Annual Meeting on August 11.

David Jonson (our Liaison on Arbitration) and **F. Daniel Bell, III** (who is also a former NASAA President) inform us that their firm of Kennedy Covington Lobdell & Hickman, L.L.P. merged effective July 1, 2008 with K&L Gates LLP, with the merged firm retaining the latter name. The merger has created a firm of more than 1,700 lawyers in 28 offices located throughout the United States, Europe and Asia, including the largest Carolinas presence of any global law firm.

Andrew Pagliughi, formerly of Dewey & Leboeuf LLP, has relocated to Simpson Thacher & Bartlett LLP, where he joins **Mark Lab** in the practice of blue sky law. **Sean Cotton**, formerly of Simpson Thacher & Bartlett LLP, has moved back to his home state of Michigan, where, I am told, he will serve as General Counsel to an HMO.

James A. Klimek has announced the opening of his office for the practice of blue sky, securities and corporate law in Indianapolis, Indiana. Jim is a former Chief Counsel to the Indiana Securities Division.

A new slate of Committee leaders will take office after the ABA Annual Meeting in August 2008. With great appreciation to those who are stepping down after distinguished service as Committee officers, and those who have agreed to continue their service in the new ABA term, the new slots are being filled as follows:

- Committee Chair **Alan M. Parness**, Cadwalader Wickersham & Taft LLP, stepping up from his current slot as Committee Vice-Chair.
- Committee Vice-Chair **Michele Audrey Kulerman**, Hogan & Hartson LLP, taking on yet another function in addition to her role as Co-Chair of the Employee Plan and Other Exempt Securities, which she heads with **Peter Danias**, Kaye Scholer LLP.
- Secretary **Carmen A. Gaspero, Jr.**, Katten Muchin Rosenman LLP, who recently did yeoman's work as the sole presenter of our MCLE Young Lawyer's Forum program in Dallas this Spring.
- Chair of the Subcommittee on Publications **Martin A. Hewitt**, Cadwalader Wickersham & Taft LLP.
- Vice-Chair of the Subcommittee on Publications **Jennie Getsin**, Ropes & Gray LLP.
- Chair of the Subcommittee on Direct Participation, Commodities and Hybrid Securities **Benjamin L. Nager**, Sidley Austin LLP, stepping in for **Alan Parness**.
- Co-Chair of the Subcommittee on NSMIA and Limited Offering Exemptions **Martin A. Hewitt**, who will head the Subcommittee with **Mike Liles, Jr.**, Karr Tuttle Campbell. Martin is

stepping in for **Kathleen G. Duggan**, Cahill Gordon & Reindel LLP.

- Co-Chairs of the Subcommittee on International Securities **Kenneth G. Ottenbreit**, Stikeman Elliott LLP and **Guy P. Lander**, Carter Ledyard & Milburn LLP, stepping in for **Ellen M Creede**, Cleary Gottlieb Steen & Hamilton, and **Paul G Findlay**, Borden Ladner Gervais LLP.
- **Deborah Schwager Froling**, Liaison to NASAA Corporation Finance Section Arent Fox PLLC, stepping in for **E. Marlee Mitchell**, Waller Lansden Dortch & Davis LLP, and Liaison to the Section Committee on Meetings, stepping in for **Benjamin L. Nager**, Sidley Austin LLP, in addition to her role as Liaison on TICs and Other Real Estate Related Securities Issues.
- Liaison to the Committee on Diversity of the ABA Section of Business Law, **Della P. Richardson**, Carter Ledyard & Milburn LLP, stepping in for **David C. Wang**, Holland & Knight LLP.

Those whose service will continue (in addition to the continuing Co-Chairs noted above) are:

- Co-Chairs of the Subcommittee on Broker-Dealers and Investment Advisors **Martin R. Miller**, Willkie Farr & Gallagher LLP, and **David M. Katz**, Sidley Austin LLP.
- Chair of the Subcommittee on Enforcement **R. Michael Underwood**, Fowler White Boggs Banker, and Vice-Chair **Richard Slavin**, Cohen and Wolf, P.C. Rick has also volunteered to serve as a member and our Committee's liaison to a new Joint Task Force that committees of the ABA Section of Business Law are establishing (including the Committee on State Regulation of Securities) to address current anti-money laundering and anti-terrorism initiatives currently under consideration, including but not limited to a possible AML regime for beneficial ownership in various types of business entities and placing responsibility for AML compliance on lawyers as well as others who take part in the establishment of such entities.
- Co-Chairs of the Subcommittee on Liaisons to State Administrators **Donald A. Rett** and **Shane B. Hansen**, Warner Norcross & Judd LLP.

- Co-Chairs of the Subcommittee on The Uniform Securities Act (2002) **Philip Alan Feigin**, Rothgerber Johnson & Lyons LLP, and **Lynn D. Naefach**, Wachovia Securities.
- Liaison to NASAA Ombudsman **F. Lee Liebolt, Jr.**
- Liaison to NASAA Broker-Dealer Section **Melanie A. Jenkins**, Citigroup Global Markets, Inc.
- 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 **Tamara K. Salmon**, Investment Company Institute.
- Liaison on Regulation D Electronic Filing Issues **Gary M. Emmanuel**, Reitler Brown & Rosenblatt LLC.
- Liaison on Variable Annuity Issues **Peter J. Anderson**, Sutherland Asbill & Brennan LLP.
- Liaison to NASAA Enforcement Trends Project Group **Andrew Kandel**, Cerberus Capital Management, L.P.
- Liaison on Arbitration **David N. Jonson**, K&L Gates LLP.
- Liaison to the Committee on Pro Bono of the ABA Section of Business Law **Judy F. Zybach**.
- Member of the Board of Editors of The Business Lawyer **G. Philip Rutledge**, Bybel Rutledge LLP.

Still open is the position (and if you are interested in becoming involved, do contact Alan Parness) of Liaison to the Section Committee on Membership.

Website. Do become a regular visitor to our Committee website. Access it via a Google search for *ABA state regulation securities* (it should be the first site that pops up), by going to <http://www.ababusinesslaw.org/r/staterregs/>, or by marking the site as one of your favorites. What's available once you get there? A current list of planned meetings and events, contact information for Committee leaders and members, back issues of meeting books, the Blue Sky Bugle, Subcommittee reports, Committee comment letters, and CLE

Program materials, listserv archives; and links to a helpful list of other securities-related sites.

Recent comment letters from our Committee include a letter with the Committee on Federal Regulation of Securities to the SEC addressing proposed amendments to Form ADV and Part 2 delivery requirements (June 18, 2008), letters to New Jersey (June 18, 2008) concerning revisions of their securities rules and Washington (April 8, 2008) relating to their proposals for new electronic Form D, and to NASAA officers (June 27, 2008 and March 2008) as to Rule 701 compensatory benefit exemptions, and (March 18, 2008) as to options, warrants and rights for exchange-listed securities. Each of these is posted on the Committee's website. The Committee is currently working, with the Committee on Federal Regulation of Securities, on a letter to the SEC addressing its proposals with respect to equity indexed annuities.

Meetings and Events. The Committee held a luncheon event, in person and by conference call, on June 26, 2008. The luncheon was graciously hosted by **Charles S. Gittleman** of Shearman & Sterling LLP. The discussion guided by Charles and by **F. Lee Liebolt, Jr.**, included an update from **Alan Parness** of Cadwalader Wickersham & Taft LLP on new state rule proposals (including those of Hawaii and Minnesota whose new Uniform Securities Act recently became effective; from **Gary Emmanuel**, Reitler Brown & Rosenblatt LLC, on electronic Form D, from **Keith Bishop**, Allen Matkins Leck Gamble Mallory & Natsis LLP, on *People v. Cole*, 3A Blue Sky L. Rep. (CCH) par. 74,672, from **Mark Lab**, Simpson Thacher & Bartlett LLP, on FINRA developments, and from **Peter Danias**, Kaye Scholer LLP, on non-uniformity of state benefit exemptions. In light of our discussion on the latter issue, I then forwarded to **Don Saxon**, NASAA's Ombudsman, our Committee's prior letter to the head of NASAA's Corporation Finance Section related to state exemptions for Rule 701 offerings, with the hope that the Ombudsman will encourage states to make their exemption more uniform.

The Committee on State Regulation of Securities will next meet on Monday, August 11, 2008, 10:30 a.m.-12:00, at the Grand Hyatt at Grand Central Station in New York City, Chrysler Room Mezzanine Level, at the ABA Annual Meeting. **David Weaver**, General Counsel to the Texas State Securities Board and a member of NASAA's Corporation Finance Section, and New York state regulator **David A.**

Markowitz, Chief of the Investment Protection Bureau, will join us. We will have a Committee dinner 7:30 Monday night, August 11 at Carmine's Restaurant, 200 East 44th Street, and ask that you contact **Benjamin L. Nager**, Sidley Austin LLP (212-839-8755, bnager@sidley.com), to let him know prior to August 4 if you expect to attend and how many will be in your party, and to send him a \$90 check prior to August 7 to cover your dinner, wine, beer, tax and tip.

The Committee is co-sponsoring two MCLE programs as follows: Securities Arbitration – Practitioners' Perspectives on the System on Sunday, August 10, at 10:30 a.m.-12:30 p.m., Grand Hyatt Julliard & Uris Conference Level, Program Chair: **David N. Jonson**, K&L Gates LLP; and Public and Private Initiatives on Hedge Funds and their Regulation on Monday, August 11, 2008 2:30-4:30 p.m., Grand Hyatt Empire State Ballroom A, Ballroom Level, which **Andrew Kandel** of Cerberus Capital Management, L.P. helped put together with **Rita Molesworth** of Willkie Farr & Gallagher LLP, **Paul Roth** of Schulte Roth & Zabel LLP, and **Jeffrey Tabak** of Weil, Gotshal & Manges LLP. For your information, Dialogue with the Director will be Monday morning 8:00 a.m.-9:30 a.m. Empire State Ballroom E, FINRA Corporate Finance 9:30-10:30 a.m. (immediately before our meeting in Park Avenue Room Mezzanine Level), and Private Placement Broker Task Force 12:30 p.m.-1:30 p.m. (immediately after our meeting in the same room as our Committee meeting).

Following our August meeting, the Committee will again meet, in conjunction with the NASAA Annual Meeting, in Las Vegas from 10:00 a.m.-12:00 p.m. Monday, September 15 at Caesars Palace Hotel. The NSMIA and Limited Offering Exemptions Subcommittee will meet from 8:00 a.m.-9:00 a.m. on Tuesday morning September 16 in a joint program with the Paralegals to discuss revised SEC Form D and SEC and state filings. Other Subcommittee meetings will be held as follows: Sunday evening September 14 5:00-5:30 p.m. (Subcommittee on Enforcement); Monday evening September 15 5:00-5:30 p.m. (Employee Plan and Other Exempt Securities), Tuesday evening September 16, 5:00-6:00 p.m. (Liaisons to States). Tentatively, all ABA meetings will be held in the "Capri Room," except for the general Committee meeting and the NSMIA Subcommittee meeting, which will be held in the "Pompeian Room."

Free MCLE. Did you know that, as a member of the ABA Section of Business Law, you can receive six hours of free CLE annually? The Section produces a series of six teleconferences annually (every other month) called BLT Live CLE Teleconferences, and they cover a wide range of topics. These sessions are free for the first 250 Section members to enroll in each session, and registration fees are deeply discounted for members after that. Your issue of Business Law Today should let you know what teleconferences are in the works and how to access them, or check the Section website.

FROM THE CHAIR – WHAT'S NEW IN THE BLUE SKY WORLD

By: Ellen Lieberman
Debevoise & Plimpton LLP

It seems fitting to use the Bugle to blow Taps for my stint as Chair of the Committee on State Regulation of Securities, which comes to an end in mid-August. Those with long memories and long histories in the practice of blue sky law may recall that I conceived and published the Bugle (and served as its editor, chief author and chief cook and bottle washer) for a number of years until the reins were handed over to Bruce E. Johnson and later to Martin Hewitt. The Bugle has become a fixture on the blue sky scene and blue sky law, notwithstanding the death knells sounded at the time of NSMIA, has continued to be a dynamic area of practice.

Three years as Committee Chair have passed quickly, and I thank all those who contributed with substantive comments, breaking news, attendance and participation at meetings, willingness to write reports and articles and comment letters, to organize and participate in CLE programs, to host luncheons and share the latest blue sky developments and gossip. The participation of so many makes it worthwhile – and a real community effort. As someone we all know once said – It takes a village. . . . I am delighted to know the Committee's stewardship will be in the excellent hands of Alan Parness whose work ethic and intellectual capacity are legend. I know that, under his leadership, the Committee will maintain and enhance its utility to the blue sky community and its public prominence.

While it's been a busy three years in the world of securities law, it looks as if things are just beginning to heat up. On the horizon are new electronic Form D, final revised Regulation D rules from the Securities and Exchange Commission (SEC), movement on the federal front to address the issue of private placement broker registration (or exemption), state regulatory and statutory changes including additional states adopting the 2002 Uniform Securities Act, the subprime mortgage and credit market meltdowns, attacks on mandatory securities arbitration – and then potentially cosmic events such as those envisioned in the Treasury Blueprint.

Subprime Mortgage and Credit Market Meltdowns – State and Federal Actions, and the Treasury Blueprint. State regulators are looking at **subprime mortgages** and a host of problems resulting from the current credit market meltdown. For example, press reports indicate that Andrew Cuomo, New York's Attorney General, in addressing subprime mortgages, has received from Clayton Holdings Inc., a firm that underwriters hire to check the quality of loans used for securitization, copies of its reports, generally showing these mortgage loans to be outside of normal bank lending criteria. Cuomo may then be able to use this information under New York's Martin Act if registration statements for these collateralized securities did not provide full disclosure. The press also reported that Cuomo had reached a settlement with Moody's Investors Service, Standard & Poor's, and Fitch Ratings, which would allow the rating firms to avoid possible sanctions under the Martin Act for their prior actions with respect to subprime mortgages in return for implementing increased disclosure about their ratings and a new fee structure going forward; the new fee structure may be beneficial to the rating agencies, since they could earn additional fees for preliminary work reviewing debt and mortgage-backed securities and not just for issuing final credit ratings. The press reports that Connecticut Attorney General Richard Blumenthal has also been investigating the rating firms. On another front, Cuomo has negotiated a settlement with Freddie Mac and Fannie Mae governing future appraisal procedures in mortgage loan origination so that lenders who assign loans to underwriters to be used for securitization will not be able to pressure appraisers into overstating their appraisals. California and Illinois attorneys general have both brought actions against Countrywide Financial Corp., the largest of the mortgage originators. Federal authorities are also paying attention to subprime mortgages, with reports

indicating both the SEC and the FBI are investigating mortgage originators, including Countrywide.

NASAA reports that several states are also investigating **auction-rate securities** (ARS), where investments of funds are subject to auction to reset interest rates every month or other specified period of time. Where the credit markets have dried up, as is currently the case, the auctions may not be successful and investors may be unable to access their funds. State regulators have been fielding numerous complaints focusing primarily on broker sales practices, including questions about material omissions or misrepresentations, and supervisory issues. The states are working through a nine-state ARS Task Force (Florida, Georgia, Illinois, Massachusetts, Missouri, New Hampshire, New Jersey, Texas and Washington) chaired by Bryan Lantagne, Director of the Massachusetts Securities Division. On June 26, Massachusetts Commonwealth Secretary William Galvin filed an administrative complaint against UBS Securities and UBS Financial Services alleging fraud and dishonest conduct in the retail sale of ARS newspapers; newspapers reported on July 31 a settlement agreement requiring UBS to repurchase \$3.4 million of ARS sold to municipalities and pay \$1 million including \$250,000 to be allocated to the municipalities. On July 17, Missouri regulators conducted a "special inspection" (which newspapers also described as a raid) of Wachovia Securities seeking documents and records on sales practices with respect to ARS. On July 25, New York Attorney General Andrew Cuomo filed a civil action against UBS Securities LLC and UBS Financial Services Inc, and has issued a number of subpoenas to other firms selling ARS. The press reported that a number of ARS class action lawsuits had also been launched in which broker-dealer violations of securities laws and SEC regulations for failure to adequately disclose investment risks are alleged (ARS may have been promoted as cash equivalents). In addition, the SEC and FINRA are conducting preliminary investigations – the SEC has issued a number of sweep letters and FINRA has sent out its own survey, seeking information about holders of ARS.

With both **federal and state regulators** looking at subprime mortgages and ARS, it's interesting to take note of a recent paper that compared the aggressiveness of federal vs. state regulators, at least with respect to past debacles. The paper by Eric Zitzewitz, an Associate Professor of Economics at

Dartmouth College, available at <http://www.dartmouth.edu/~ericz/eliot.pdf>, examined approximately 20 market timing and late trading cases between 2003 and 2007. Among his findings, settlements jointly negotiated by the New York Attorney General (under the stewardship of then-Attorney General Eliot Spitzer) and the SEC were considerably more favorable to shareholders than those negotiated by the SEC alone and New York's more aggressive involvement was actually a factor in the larger settlements. Recent news reports also suggest that, although Andrew Cuomo's stewardship in New York has been effective, some say more effective, in reforming industry practices, it has focused less than the Spitzer administration on levying large fines on corporate and financial transgressors.

In the midst of the meltdown on March 31, 2008, the Treasury Department proposed its **Blueprint** for Financial Regulatory Reform, available at <http://www.treas.gov/press/releases/reports/Blueprint.pdf>, which would overhaul the entire U.S. financial regulatory system by, in the long term, having three distinct objectives-based regulators. One would have prudential regulatory authority over all types of financial institutions, generally assuming the role of the Office of the Comptroller of the Currency and the Office of Thrift Supervision and addressing risk management issues. A second regulator, likely the Federal Reserve Board (FRB), would regulate market stability. The third regulator would regulate business conduct, including financial products and consumer protection, with responsibility for federally chartering and licensing insured depository institutions, insurance institutions and financial service providers and setting standards that would apply to both federal- and state-chartered institutions. The business conduct regulator would cover many but not all of the current functions of the SEC and the Commodity Futures Trading Commission (CFTC) and some functions as well of the FRB and Federal Trade Commission. While states would retain legislative and enforcement authority with respect to state-chartered institutions, because of the preemptive effects of federal standards that would apply, state authority would likely be minimal even with respect to state-chartered institutions, and even more minimal with respect to federal-chartered institutions. Two additional entities would also be created, one responsible for corporate finance regulation assuming some authority currently held by the SEC such as oversight of corporate disclosure, corporate governance, and accounting, and the second entity

would be a federal governmental insurer generally taking on responsibilities of the FDIC.

The Blueprint also proposes as an intermediate step combining the SEC and the CFTC, a concept that has been floating around for years, and having the merged entity operate on a principals-based philosophy more in the manner of how the CFTC, rather than the SEC, currently operates. Treasury also recommended as an intermediate step that Congress harmonize the regulation of broker-dealers and investment advisers who offer similar services to retail investors and that, like broker-dealers, advisers be subject to an SRO.

The Blueprint is actually not intended as a response to the immediate credit market problems but instead is intended to address longer-term issues discussed in numerous reports over the last year concluding the U.S. may be losing its competitive position in the international capital markets as a result of our cumbersome, some think antiquated, regulatory system. In response to the Blueprint, however, some questions have been raised about whether the FRB (which would be a key regulator under the Blueprint) should be viewed more as a cause of the credit market crisis due to its free market philosophy, rather than as a cure for the economy's ailments. Is the FRB a cause of the credit market crisis? Presumably, a cottage industry of scholarly studies, books and articles will be spawned in the search for the definitive cause of the current meltdown. The FRB, by way of the Securities Exchange Act of 1934, was given responsibility for regulating how much credit could be extended by financial institutions to permit the purchase of securities on margin, and the SEC was given the task of enforcing this. To the extent margins were a factor in the speculative bubble, some commentators have noted that the FRB did not take strong actions to curb margin rates. On the other hand, the impact of margin rates has dissipated in recent years with derivatives, to a large extent, becoming a substitute for margin leverage. So was derivative trading reined in? The answer is generally no in part because there was no clear line of authority to do so with a split in regulation of derivatives between the SEC and the CFTC compounded by the split in oversight of the two agencies between different Congressional committees. So, although the Blueprint suggests realigning the regulators, commentators have suggested that alone will not be enough to prevent the next economic crisis, unless the government also acts to dampen speculation and

leverage in the capital markets through regulation of both the derivative markets and the margin rates.

Another casualty of the credit meltdown was the fall of investment bank, Bear Stearns. After that occurred, **Representative Barney Frank** (D-MA), Chairman of the House Financial Services Committee, called for tougher and broader regulations of the financial system, for giving the FRB or a new regulator the power to oversee the activities of major financial players, regardless of whether they are banks, securities firms or hedge funds, and indicated that investment banks, as well as commercial banks, should perhaps be required to hold cushions against financial losses. Frank also suggested that, in return for new access to direct borrowing from the FRB (granted to JPMorgan Chase with respect to its acquisition of Bear Stearns), investment banks might be subject to new powers granted to its new regulator (perhaps the FRB or perhaps some other entity) enabling the regulator to curb risky practices in order to protect the integrity of the financial system. The Committee is holding hearings beginning in July on the Bear Stearns implosion and systemic risks.

SEC Chairman Christopher Cox agreed with the Blueprint that financial services regulation in the United States is too balkanized, but urged Congress to look at proposals for integration carefully, and said his support for an SEC-CFTC merger would depend entirely on how it would be accomplished. In the meantime, the SEC and CFTC have entered into a Memorandum of Understanding establishing a regulatory liaison, providing for more sharing of information and setting out principals for review of new derivative securities. The SEC and FRB also entered a Memorandum of Understanding on July 7 to provide more cooperation with respect to the sharing of information and overlapping supervisory responsibilities – the SEC regulates investment banks, but the FRB has authority over federally-chartered banks, some of which are owned by investment banks. Under the terms of the Memorandum, the SEC and FRB would expect to meet at least quarterly to identify, discuss, and share information as to banks' and investment firms' financial condition, risk management systems, internal controls and capital, and liquidity and funding resources. Senate Banking Committee Chairman Christopher Dodd (D-CT) and Ranking Member Richard Shelby (R-AL), in a June 27 letter, however, told Cox, FRB Chairman Ben Bernanke, and Treasury Secretary Henry Paulson not to

implement any Memorandum of Understanding because "it is Congress's role to determine if and how any alterations to our financial regulatory system should be undertaken."

Chairman Cox has also asked a House appropriations panel for separate line-item funding of the SEC's program to supervise the five largest Wall Street investment banks on a consolidated basis (taking into account that the function of banks has expanded since passage of the Gramm-Leach-Bliley Act). His call for more funding for the consolidated supervision was echoed by former SEC chairmen, David Ruder and Arthur Levitt, Jr., who, along with Erik Sirri, director of the SEC's Division of Trading and Markets, also urged a Senate banking subcommittee to pass federal legislation that would clearly define and mandate the SEC's authority to examine these consolidated entities and impose standards requiring them to have risk controls. Cox has also asked the House appropriations panel for separate line-item funding for expanded oversight of nationally recognized statistical rating organizations (NRSROs). He indicated the NRSROs played a contributory role in the subprime mortgage and credit market meltdown. The SEC was given extensive authority to oversee NRSROs effective 2007. On June 16, 2008, the SEC proposed new rules for NRSROs relating primarily to disclosure and conflicts issues both generally and in particular for structured finance products. On June 25, the SEC proposed to revise its own rule references to credit ratings to distinguish those relating to structured finance products from those relating to other debt securities to take into account their different underlying risks.

NASAA responded negatively to the Blueprint, with NASAA President Karen Tyler stating: "In our response to Treasury's request for comments on regulatory restructuring last year, NASAA's position was, and continues to be, unambiguous: the existing regulatory system, as it pertains to the securities markets, needs no fundamental restructuring. The focus of state securities regulators is clear and singular: investor protection must remain the centerpiece of the securities regulatory system."

Hedge Funds. In April 2008, government and industry leaders made public a set of voluntary "best practice" rules for hedge funds based on principals and guidelines developed in 2007 by the President's Working Group on Financial Markets. Among the suggestions, some from asset managers and some from investor groups: better disclosure, risk

management, and valuation (particularly of hard-to-value financial products such as complex derivatives), better assessment of the suitability of particular investments for investors, fiduciary duties for the hedge fund manager, and enhanced compliance, conflict-of-interest management, and business practices such as a written code of ethics. While the proposals were well received in a number of quarters, that reaction was not universal. Richard Blumenthal, the Attorney General of Connecticut – home to a large number of funds – said hedge funds are too big to remain outside mandatory rules and that non-binding best practices or voluntary guidelines are not sufficient.

SPACs. On May 6, 2008, the SEC approved proposed New York Stock Exchange rule changes to permit the listing of special purpose acquisition companies (SPACs) on the New York Stock Exchange. SPACs raise capital to pay for an as yet undetermined and unidentified acquisition to be completed within a specified period of time and, if not accomplished, the money is returned to investors. On April 18, 2008, The NASDQ Stock Market LLC filed a similar proposal to permit SPACs to list on the Nasdaq. News reports indicate that all SPACs that had been listed on an exchange were listed on the American Stock Exchange (approximately 70), and close to half as many traded over the counter. I note that NASAA is addressing the subject of SPACs at its training session for state regulators in July.

Equity-Indexed Annuities. On June 25, the SEC issued rule proposals (a comment letter with the Committee on Federal Regulation of Securities is in the works) with respect to equity-indexed annuities, a topic that NASAA has had on its front burner for several years. The SEC's proposed rule would clarify the status of indexed annuities under the federal securities laws and would apply on a prospective basis to contracts issued on or after the effective date of the rule. In an equity-indexed annuity, generally, the issuer is an insurance company that provides a guarantee of a particular interest rate and a guarantee against loss of some or all of an investment, and also permits the investor to earn additional interest based on a securities market index. Those indexed annuity contracts under which the amounts payable by the insurer will more likely than not exceed the amounts guaranteed under the contract will be viewed as not being "annuity contracts" or "optional annuity contracts," and so they would not be exempt from federal securities registration under Section 3(a)(8) of the Securities

Act of 1933; the SEC rationale is that the contracts should be treated as securities because the majority of the investment risk will be borne by the individual purchaser, not the insurer. The SEC is also proposing to exempt insurance companies from filing reports under the Securities Exchange Act of 1934 with respect to such securities if the insurer and securities are subject to state insurance regulation and the securities are not publicly traded.

NASAA, which has long believed that equity-indexed annuities should be treated as securities, is concerned that the products are complex, often entail long accumulation periods and high surrender charges, and may not be suitable investments for, and may be deceptively marketed to, some investors, particularly senior citizens. Of course, the treatment of these products by the SEC is not controlling for purposes of blue sky law, although regulation by the SEC may influence state decisions and state enactments. The SEC has long treated variable annuities as securities, while the states remain split on that front and whether to treat variable annuities as securities has been a bone of contention and a stumbling block in a number of jurisdictions that otherwise might have moved forward in adopting the 2002 Uniform Securities Act.

Public Alert: Unregistered Soliciting Entities, or PAUSE. The SEC in April launched a web site posting information received about questionable e-mail and phone securities solicitations. The information is obtained from investor complaints, foreign regulators and other sources and investors can utilize this as an additional tool to avoid scams when considering a proposed investment. The information can be found at <http://www.sec.gov/investor/oiepauselist.htm>. The web page provides details about unregistered soliciting entities that are soliciting U.S. investors or claim to be registered in the U.S., and also fictitious governmental agencies and international organizations associated with soliciting entities.

Three years is both an eternity and only a moment in time. While much has transpired, and (however one may define the term) "progress" has been made on many fronts, old issues tend to morph into new issues, new issues give rise to new problems, and new problems call for new approaches and new solutions. And so the work continues.

Thank you again for your support and your contributions. Please continue to participate as the blue sky world continues to focus on the mundane as well as the potentially cosmic events on our horizon.

JUDGE ALLOWS OREGON BLUE SKY CLAIM AGAINST NEW YORK FIRM

By: John English, Summer Associate
Cadwalader, Wickersham & Taft LLP

Imagine the horror of a law firm in New York that represented a hedge fund in Delaware being liable in Oregon to a plaintiff named Houston. That horror may not be imaginary enough for Seward & Kissel, LLP (“Seward & Kissel”), a New York law firm that has been sued for allegedly aiding securities fraud in contravention of Oregon’s Blue Sky law.

Seward & Kissel represented Wood River Partners, LP (“Wood River”), a Delaware-based hedge fund. Wood River had offices in California and Idaho. A high net-worth individual named Howard Houston, an Oregon resident, invested \$2.75 million in Wood River based on representations Wood River made in its offering documents. In those documents, Wood River stated that its investments would be diversified so that not more than ten percent of its portfolio would be invested in any one security. Unfortunately, within six months of Mr. Houston’s initial investment, Wood River had invested sixty-eight percent of its portfolio in EndWave, a technology company. One month later, when EndWave’s stock lost about half of its value, Mr. Houston lost his \$2.75 million investment in Wood River.

Mr. Houston sued Seward & Kissel in U.S. District Court for the Southern District of New York. He alleged that Seward & Kissel materially aided the fraudulent sale of securities in contravention of Oregon Securities Law sections 59.115(1)(b) and 59.135(1), (2), and (3). Mr. Houston specifically alleged that Seward & Kissel aided the fraudulent sale by drafting, editing, reviewing, and approving Wood River’s offering documents and other marketing materials. Seward & Kissel filed a motion to dismiss, claiming that Oregon’s Blue Sky law was preempted by the National Securities Market Improvement Act of 1996 (“NSMIA”). Furthermore, Seward & Kissel argued before Judge Harold Baer, Jr., that applying Oregon’s Blue Sky law to a New York law firm that represented a Delaware hedge fund would violate the “Dormant Commerce Clause”

of the U.S. Constitution. Judge Baer denied Seward & Kissel’s motion to dismiss.

By denying Seward & Kissel’s motion to dismiss, Judge Baer held that state securities fraud statutes are not preempted by federal law. *Houston v. Seward & Kissel, LLP*, No. 07cv6305(HB), 2008 WL 818745 (S.D.N.Y. 2008). Judge Baer also held that the Dormant Commerce Clause does not prevent a state from holding an out-of-state law firm liable for aiding a fraudulent securities transaction. *Id.* Judge Baer did not address the underlying merits of Mr. Houston’s claim pursuant to Oregon’s Blue Sky law. However, the finding of no federal preemption, the denial of the Dormant Commerce Clause claim, and law firms’ potential liability pursuant to state Blue Sky laws are each sufficient to make the watchful securities law practitioner anxious.

Federal Preemption

Seward & Kissel argued that NSMIA expressly preempted Oregon’s Blue Sky law as it applied to the Wood River offering. Furthermore, if Oregon law was not expressly preempted, Seward & Kissel argued that it was at least impliedly preempted by NSMIA because it conflicted with NSMIA’s objectives.

Congress enacted NSMIA to give the federal government exclusive regulatory power over the national securities markets. NSMIA broadly preempts many state Blue Sky laws that would otherwise regulate “covered securities.” Covered securities include, among other things, securities that are traded on a national exchange and securities that are exempt from registration under federal law. The Wood River offering was a covered security because it was exempt from registration pursuant to Securities and Exchange Commission Regulation D.

NSMIA expressly preempts state law that would regulate covered securities’ offering documents. 15 U.S.C. § 77r(a)(2). Seward & Kissel argued that, because Mr. Houston’s Blue Sky claims were based on representations made in Wood River’s offering documents, the claims were expressly preempted by NSMIA. Judge Baer disagreed, stating on the contrary that Congress expressly intended that states retain their traditional regulatory authority over securities fraud. Indeed, NSMIA provides that “any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud.” *Id.* § 77r(c)(1). Judge Baer did not consider Seward & Kissel’s assertion that it

was not defending against a state investigation or enforcement action but a private lawsuit.

Seward & Kissel alternatively argued that NSMIA impliedly preempted Oregon's Blue Sky law because it conflicted with NSMIA's objective, which is to improve efficiency and consistency in the regulation of the national securities markets. Seward & Kissel contended that, by extending liability beyond sellers, Oregon's Blue Sky law created uncertainty for issuers' law firms, which must comply with different standards depending on the state in which a security is sold. Therefore, Seward & Kissel reasoned, Oregon law conflicted with NSMIA's objective to improve efficiency. Judge Baer disagreed with the claim of conflict preemption, stating that there is no conflict between the anti-fraud provisions of Oregon's Blue Sky law and NSMIA because NSMIA relates only to registration and disclosure requirements. The Judge added that there was no field preemption of Oregon law, because Congress did not intend to occupy the entire field of securities regulation.

The Dormant Commerce Clause

Seward & Kissel also claimed that Mr. Houston's case should be dismissed because Oregon's Blue Sky law violated the Dormant Commerce Clause and the protections it affords interstate commerce. Seward & Kissel argued that Oregon's Blue Sky law violated the Dormant Commerce Clause because it: (1) improperly regulated commerce that occurred in other states; and (2) impermissibly burdened interstate commerce.

The Dormant Commerce Clause prohibits a state from regulating commerce that occurs entirely outside of the state. Seward & Kissel argued that Oregon's Blue Sky law regulated commerce that occurred entirely outside of Oregon, because it exposed an out-of-state law firm to liability for the in-state actions of its client. Indeed, in *Anderson v. Carden*, the Oregon Court of Appeals held that a law firm's liability pursuant to Oregon's Blue Sky law was not contingent on its own violation of any law. 934 P.2d 562, 566 (Or. Ct. App. 1997). Instead, the out-of-state law firm's liability was contingent on the in-state violation of the seller. *Id.* Therefore, Seward & Kissel reasoned that Oregon law exposed it to liability not for its own actions within Oregon (because there were none), but for the actions of Wood River. In other words, Oregon was regulating commercial activity that took place entirely outside

of Oregon – namely, Seward & Kissel's representation of Wood River. Seward & Kissel said that this regulation violated the Dormant Commerce Clause because it interfered with the authority of New York to regulate the conduct of lawyers practicing in New York. Seward & Kissel noted to Judge Baer that New York law does not burden lawyers with a duty to police their clients or disclose information about them to third parties. In fact, New York professional ethics rules normally prohibit lawyers from disclosing information about clients. Therefore, Seward & Kissel sought dismissal of the complaint because Oregon's regulation of completely out-of-state commerce was constitutionally improper.

Furthermore, Seward & Kissel argued that Oregon's Blue Sky law was unconstitutional because the burden it imposed on interstate commerce exceeded its claimed benefit. *See Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970). First, Seward & Kissel claimed that extending liability to law firms advising in the sale of securities was of minimal benefit. Seward & Kissel thought the benefit minimal because victims of securities fraud could obtain sufficient recourse through causes of action brought pursuant to other Oregon securities statutes, Oregon common law, and federal law. Second, Seward & Kissel stated that Oregon's Blue Sky law was unduly burdensome upon interstate commerce because it could cause out-of-state lawyers to avoid clients that might sell securities in Oregon. Seward & Kissel noted that lawyers have little control over where securities are sold and usually have little to do with the solicitation of investors, marketing of securities, and actual sale of securities. Therefore, Seward & Kissel claimed that Oregon's Blue Sky law would have an unconstitutionally adverse impact on the national securities market by stifling private securities offerings.

Judge Baer disagreed with both of Seward & Kissel's Dormant Commerce Clause arguments. First, Judge Baer held that Oregon's Blue Sky law did not impermissibly regulate completely out-of-state commerce because it only applied to the in-state sale of securities. Specifically, the Judge said the transaction addressed by Oregon law was Wood River's furnishing of documents to Mr. Houston at his Oregon home, not Seward & Kissel's representation of Wood River in New York. Judge Baer added that the Dormant Commerce Clause did not even apply because Congress has recognized state power to hold service providers liable for aiding fraudulent securities sales. In addition, Judge Baer

stated that Oregon’s Blue Sky law was not unique and was actually based on the Uniform Securities Acts. Regarding Seward & Kissel’s undue burden argument pursuant to *Pike v. Bruce Church*, Judge Baer again found Oregon’s Blue Sky law constitutional. Judge Baer stated that there is no violation of the Dormant Commerce Clause where a state regulation has the same effect in-state as it does out-of-state. Finding no preemption or Dormant Commerce Clause violation, Judge Baer denied Seward & Kissel’s motion to dismiss.

Blue Sky Liability for Aiding Securities Fraud

Judge Baer did not address the underlying merits of Mr. Houston’s Blue Sky claim against Seward & Kissel because the Judge was only ruling on a motion to dismiss for unconstitutionality. However, the most troubling issue raised in this case for the average securities law practitioner is whether a law firm can be liable for aiding its client’s sale of securities if the client’s subsequent conduct renders the sale fraudulent.

Seward & Kissel allegedly aided Wood River in drafting its offering documents. Mr. Houston alleged that Wood River’s offering documents contained a material misrepresentation – namely, that Wood River would limit its investment in any one security to ten percent of its total portfolio. However, that statement was not a misrepresentation at the time it was drafted, unless Wood River never intended to limit its investments to ten percent, a fact Seward & Kissel would not likely know anyway. Instead, the statement regarding diversification did not become a misrepresentation until after it was drafted, when Wood River invested more than ten percent of its portfolio in EndWave.

Oregon Securities Law section 59.135(2) prohibits untrue statements of material fact in connection with a securities sale. Section 59.115(1)(b) states that a person is liable to the purchaser of a security if the person violated section 59.135(2) and fails to prove a reasonable lack of knowledge that the statement was untrue. Section 59.115(3) states that every person who participates in or aids the sale is also liable unless they prove a reasonable lack of knowledge of such violation. A law firm that prepares legal materials for a securities offering materially aids the sale of securities. *Adams v. Am. Western Securities, Inc.*, 510 P.2d 838, 844 (Or. 1973).

At first glance, Oregon law might appear to vastly broaden securities fraud liability. Indeed, it exposes

law firms to liability for aiding a security sale if someone else makes a false statement in Oregon in connection with that sale. However, Seward & Kissel can still avoid liability if it proves a lack of constructive knowledge. Oregon’s Blue Sky law provides a burden-shifting mechanism for those alleged to have aided a fraudulent securities sale. Instead of requiring Mr. Houston to prove that Seward & Kissel knew that statements made in the offering documents were false, Oregon’s Blue Sky law requires Seward & Kissel to prove that it did not know the statements were false. Seward & Kissel must raise its reasonable lack of knowledge as an affirmative defense.

In this case, Wood River’s principal, John Whittier, had previously pleaded guilty to federal securities law violations. In his allocution, Mr. Whittier admitted that he lied to Seward & Kissel about Wood River’s investments. This evidence might help Seward & Kissel satisfy its burden of proving lack of constructive knowledge. However, even if lied to and without actual knowledge, Seward & Kissel can still be liable if it recklessly ignored sufficient “red flags” to make its lack of knowledge unreasonable. *See In re Charter Communications, Inc.*, No. 02cv1186, 2004 WL 3826761, at *14–15 (E.D. Mo. 2004).

Impact

NSMIA’s savings clause preserves states’ authority “to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions.” 15 U.S.C. § 77r(c)(1). At issue is whether NSMIA’s savings clause allows states to regulate out-of-state law firms any time their issuer-clients commit securities fraud. Practitioners arguing that states may not hold out-of-state law firms liable for aiding fraudulent securities transactions might cite the specific reference to brokers and dealers in NSMIA’s savings clause. Furthermore, the savings clause provides that *states* retain the right to bring enforcement actions, but Mr. Houston’s claim against Seward & Kissel was a private lawsuit. In addition, many practitioners would argue that Oregon’s Blue Sky law conflicts with NSMIA’s objectives because it promotes uncertainty for law firms by broadly exposing them to liability. These practitioners would claim that contrary to Judge Baer’s holding, NSMIA preempts attempts by states like Oregon to regulate out-of-state

law firms merely because they assisted a client in drafting offering documents.

If Blue Sky laws like Oregon's are upheld, law firms' broad exposure to liability in different states would burden interstate commerce. Therefore, such laws violate the Dormant Commerce Clause unless the burden on interstate commerce does not outweigh the laws' putative benefit. The benefit of exposing law firms like Seward & Kissel to liability is outweighed by the resulting chilling effect on legal representation in connection with securities sales. Also, victims of securities fraud have sufficient access to relief without holding law firms liable. Law firms are rarely in a position to prevent fraud. Wood River's securities sales became fraudulent only after Seward & Kissel's representation had all but ceased. Blue Sky laws similar to Oregon's would also violate the Dormant Commerce Clause if they regulated completely out-of-state commerce. Liability pursuant to Oregon's Blue Sky law is based entirely on the actions of the seller, Wood River. *Anderson*, 934 P.2d at 566. Seward & Kissel was not exposed to liability for anything it did in Oregon; it is only potentially liable because it represented Wood River, which took place outside of Oregon. Therefore, many practitioners would argue that states like Oregon violate the Dormant Commerce Clause by exposing out-of-state law firms to liability for assisting a client in drafting offering documents.

By finding Oregon's Blue Sky law constitutional, Judge Baer allowed Oregon to broadly expose actors with even attenuated connections to fraudulent securities sales to liability. However, Oregon law does not provide strict liability for lawyers that aid the sale of securities just because the sale turns out to be fraudulent. Instead, Oregon law shifts the burden to the lawyers to prove they reasonably lacked knowledge of the fraud. Although law firms are not strictly liable, this burden-shifting mechanism is quite onerous in itself. Still, in cases like Seward & Kissel's, this burden might not be impossible to satisfy. Unless Wood River never intended to limit its investments to ten percent of its portfolio, the offering documents were not untrue at the time Seward & Kissel aided Wood River in drafting them. The representations in the offering documents were only made untrue by Wood River's subsequent failure to adhere to its standards. At that point, Seward & Kissel may have had little or no contact with Wood River. Therefore, Seward & Kissel should be able to show it lacked knowledge of the falsity of the statements. By allowing Seward &

Kissel to avoid liability by proving it reasonably lacked knowledge of the fraud, Oregon's Blue Sky law does not place upon lawyers an affirmative duty to police their clients.

Conclusion

Judge Baer allowed Mr. Houston to proceed with his Oregon Blue Sky claim against Seward & Kissel for allegedly aiding the fraudulent sale of securities. In doing so, Judge Baer held that Oregon law was neither preempted by NSMIA nor unconstitutional pursuant to the Dormant Commerce Clause. This holding allows Mr. Houston to proceed with his claim against Seward & Kissel without alleging scienter, but readers who practice securities law should postpone their run to the hills. Many practitioners and, possibly, other courts would disagree with Judge Baer's holdings regarding constitutionality. Assuming Oregon's Blue Sky law is constitutional, Seward & Kissel can avoid liability by proving its reasonable lack of knowledge as an affirmative defense. Pursuant to Judge Baer's interpretation of the law, lawyers should consider potential state liability in connection with clients' fraudulent securities sales.

A FEW INTERESTING STATE BROKER-DEALER CASES

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

Three recent court decisions concerning broker-dealers should be of interest to Blue Sky lawyers.

State v. Casper

In *State v. Casper*, No. M2006-02538-CCA-R3-CD, 2008 WL 2648954 (Tenn. Crim. App. July 3, 2008), a copy of which opinion is available for free download at <http://www.tsc.state.tn.us/opinions/tcca/PDF/083/caspermoopn.pdf>, the appellant was convicted of acting as an unregistered broker-dealer in violation of Sec. 48-2-109 of the Tennessee Securities Act (the "TSA"), by reason of his offer and sale of preferred stock of a Florida company (supposedly in an offering pursuant to Rule 506 of SEC Regulation D) through "Olde South Trust," a company which he owned. While the appellate court reversed and dismissed the convictions due to the state's failure to introduce sufficient evidence to prove that appellant acted "willfully" so as to support a criminal conviction, parts of the decision are

somewhat confusing as to the availability of exceptions and exemptions from broker-dealer registration under the TSA. For example, as set forth at page 3 of the opinion, one of the state’s witnesses testified that:

[T]rust companies are characterized as “Institutional Investors” in Tennessee. Institutional Investors as a group are excluded from the definition of broker-dealers. In other words, employees and agents of trust companies or Institutional Investors that are operating in a lawful manner are exempt from registration requirements.

While that’s a correct statement of the law, another of the state’s witnesses testified that Olde South Trust was not registered as a regulated trust company with the Department of Commerce and Insurance (see page 2, footnote 1), so one would have thought that the state would have argued that, despite its name, Olde South Trust should not be deemed a “trust company” within the meaning of TSA § 48-2-102(9), and therefore could not qualify as an “institutional investor” within the scope of the exception from the definition of “broker-dealer” in TSA § 48-2-102(4)(C). There’s also no indication that any evidence was introduced whether Olde South Trust had a net worth in excess of \$1 million, as required by of “Institutional Investors” under TSA § 48-2-102(9).

Also somewhat strange is testimony by another of the state’s witnesses to the effect that “An agent selling a Regulation D 506 security does not have to be registered in the State of Tennessee as a broker-dealer or agent.” There does not appear to be any specific exemption under the TSA from broker-dealer or agent registration for sales of securities in Rule 506 offerings, particularly in this case, where it appears that the issuer paid commissions to Olde South Trust for sales of its securities, and Olde South Trust in turn paid commissions to appellant and at least one other salesperson (it appears that appellant and the other salesperson were licensed insurance agents in Tennessee, but never bothered registering under the TSA). Thus, it’s curious why the state didn’t indict Olde South Trust for acting as an unregistered broker-dealer, and the appellant for either acting as Olde South Trust’s unregistered agent or as an unregistered broker-dealer in his individual capacity. (In a separate civil matter, the appellant enter into an “Agreed Order” with the Tennessee Department of

Commerce and Insurance, admitting that he had engaged in the offer and sale of unregistered securities without being registered as a broker-dealer or agent of a broker-dealer, surrendered his insurance license, and agreed to cooperate with the state in its investigation of another individual.)

Karsner v. Lothian

In *Karsner v. Lothian*, No. 07-7080, 2008 WL 2727402 (D.C. Cir. July 15, 2008), a copy of which opinion is available for free download at <http://www.oag.state.md.us/Securities/Actions/2008/JRK08.pdf>, a customer commenced an arbitration proceeding against her broker-dealer, charging the broker-dealer had induced her to make unsuitable investments and had negligently managed her account. The complaint was settled prior to the arbitration hearing, and following the settlement, the arbitration panel dismissed the customer’s claims with prejudice and recommended expungement of the arbitration proceeding from the broker-dealer’s record on the Central Registration Depository (the “CRD”). The broker-dealer then filed a petition with the federal district court to confirm the award, naming the customer and the NASD as respondents; the NASD notified NASAA of the proceeding, and NASAA in turn notified the Maryland Securities Commissioner, who moved to intervene in that proceeding in order to oppose the expungement. The district court denied the Commissioner’s motion to intervene and confirmed the award, including the expungement. On appeal, the D.C. Circuit reversed, and held that the Commissioner could intervene in the proceeding, and remanded the case to the district court to consider the Commissioner’s failure to appeal the lower court’s confirmation order, as well as whether the arbitration panel’s *recommendation* of expungement was an “award” subject to judicial confirmation under the Federal Arbitration Act. Accordingly, it’s not clear now whether or not the complaint will actually be expunged from the broker-dealer’s record.

BNY Investment Center Inc. v. Bacchus

The *Karsner* decision should be contrasted with the decision in *BNY Investment Center Inc. v. Bacchus*, No. 109678/07, 3A Blue Sky L. Rep. (CCH) ¶ 74,715 (NY Sup. Ct. June 13, 2008). *Bacchus* entailed a court proceeding to confirm an arbitration award recommending expungement of all references to a customer complaint from the CRD record of one of three respondents in an arbitration proceeding. In

this case, the customer had entered into a settlement agreement in which she agreed that this particular respondent had no involvement in the transaction underlying the claims, and that the complaint should accordingly be expunged from the respondent's CRD record. While permitting the New York Attorney General to intervene, the court denied the Attorney General's motion opposing the expungement, finding that the arbitration panel's decision satisfied the requirements of NASD Rule 2130, which governs expungement proceedings, that there was no evidence that the respondent was involved in any wrongdoing, and there was a substantial basis in the record for the panel's expungement recommendation. The court noted that the Attorney General also questioned whether the arbitrators' expungement recommendation was subject to judicial confirmation, on the basis that it wasn't an "award," but the court rejected that argument since the Attorney General presented no authority for that point. The court also rejected the Attorney General's arguments that the arbitration panel failed to make detailed findings of fact and that CRD records were official records subject to record retention requirements.

As regards the *Karsner* and *Bacchus* cases, it should be noted that NASAA has taken a strong stance in opposition to the manner in which expungement proceedings are handled by arbitration panels pursuant to NASD Rule 2130, so it is anticipated that other state securities administrators may seek to intervene in such proceedings or court proceedings to confirm arbitration decisions permitting expungement, with NASAA's encouragement and support (NASAA filed an amicus curiae brief in the *Karsner* case). As evidence of NASAA's position, it submitted a comment letter on April 24, 2008 to the SEC, available for download at <http://www.nasaa.org/content/Files/Release%20No34-57572SR-FINRA-2008-010NASAA.pdf>, regarding proposed amendments to FINRA's Codes of Arbitration Procedure as regards requests for expungement relief (see SEC Rel. No. 34-57572, File No. SR-FINRA-2008-010). In this proposal, which was still pending as of July 23, 2008 (copies of FINRA's original proposal and subsequent submissions are available for download from <http://www.finra.org/RulesRegulation/RuleFilings/2008RuleFilings/P038135>), FINRA is seeking to adopt new Rules 12805 and 13805 of the Code of Arbitration Procedure so as to require arbitrators considering an expungement request to:

- hold a recorded hearing session by telephone or in person;
- provide a brief written explanation of the reasons for ordering expungement;
- in cases involving a settlement, review the settlement documents to examine the amount paid to any party and any other terms and conditions of the settlement; and
- assess forum fees for hearing sessions held solely for the purpose of considering expungement against the parties requesting the relief.

In its comment letter, NASAA expressed its support for all of FINRA's proposals. NASAA objected, however, to the proposal's failure to address substantive issues, as opposed to procedural ones. Thus, NASAA claimed that the proposal failed to provide guidance as to the proper application of expungement or the actual meaning of the standards for expungement under Rule 2130, and recommended that the rule include a presumption against expungement, on the basis that it is an extraordinary remedy and isn't appropriate in all circumstances. NASAA also questioned the authority of arbitration panels to award expungement relief to third parties not participating in the arbitration or who had been dismissed from the case, to expunge state court proceedings, or to expunge customer complaint information in the absence of underlying arbitration.

PROPOSED AMENDMENT TO FOREIGN BROKER-DEALER RULE CARRY BLUE SKY IMPLICATIONS

By: Robert A. Boresta

The Securities and Exchange Commission (the "SEC") has proposed for comment changes to the rule governing the activities of foreign broker-dealers in U.S. markets that would liberalize the rule in a manner that would have implications under state securities or blue sky laws.

Rule 15a-6 under the Securities Exchange Act of 1934, as amended (the "Exchange Act") ("Rule 15a-6") provides a safe harbor from broker-dealer registration under the Exchange Act for foreign broker-dealers that conduct business with certain U.S. institutional investors in compliance with the rule. Under the current rule, foreign broker-dealers are permitted to furnish research, or induce or attempt to induce the purchase or sale of any security by a

“major U.S. institutional investor” or “U.S. institutional investor” provided that the foreign broker-dealer effects any transactions resulting from such activity through a registered broker-dealer in accordance with the conditions set forth in Rule 15a-6.

The SEC proposes to replace the categories of a “major U.S. institutional investor” or “U.S. institutional investor” with a single category – “qualified investor.” The primary distinction between a “major U.S. institutional investor” and a “qualified investor” is the threshold value of assets or investments owned or invested and the inclusion of natural persons. As a result, under the proposal, the threshold would decline from that of institutional investors that own or control greater than \$100 million in total assets to include, among others, all investment companies registered with the SEC under Section 8 of the Investment Company Act and corporations, companies, or partnerships that own or invest on a discretionary basis \$25 million or more in investments.¹ In addition, under the proposed rule, natural persons who own or invest on a discretionary basis not less than \$25,000,000 in investments would be included.² However, an important caveat concerning the use of the qualified investor standard to solicit and/or effect trades with U.S. persons is the application of U.S. state securities or blue sky laws.

Under the laws of most U.S. jurisdictions, a broker-dealer is generally defined to mean a person engaged in the business of effecting transactions in securities for the account of others or for the person’s own account. There is an exclusion in most jurisdictions for a person that does not have a place of business in the jurisdiction and only effects transactions with certain institutions. Generally, under most state laws, there is no exclusion for persons that solicit or effect transactions in securities with natural persons, regardless of the natural person’s investment portfolio. Thus, if adopted as proposed, a foreign broker-dealer that proposes to

effect transactions with natural persons under the rule would have to first assess whether it would have to become registered as a broker-dealer prior to soliciting or effecting transactions with any natural persons.

Another proposed change to Rule 15a-6 with state law ramifications is that of doing away with the so-called “chaperone arrangements” in the current rule. The SEC has proposed two alternative approaches to replace the chaperone provisions that require persons associated with a foreign broker-dealer to be accompanied by an associated person of a U.S. registered broker-dealer during in-person visits with U.S. investors. The proposed rule also would eliminate the current requirement for an associated person of a U.S. registered broker-dealer to participate in communications between foreign associated persons and U.S. investors, whether oral or electronic. Specifically, the proposed rule would not limit a foreign broker-dealer’s ability to have unchaperoned communications, both oral and electronic, with qualified investors, as part of a transaction subject to certain conditions. In addition, the proposed rule would provide that a foreign associated person may conduct unchaperoned visits to qualified investors within the United States, provided that transactions in any securities discussed during visits by the foreign associated person with qualified investors are effected pursuant to one of the alternative exemptions because these transactions would be viewed as being solicited.

Whether a foreign associated person’s stay in the United States would qualify as a “visit” for purposes of the proposed rule would be a facts and circumstances determination based on factors including, but not limited to, the purpose, length and frequency of any stays. The SEC proposes to interpret a “visit” as one or more trips to the United States over a calendar year that do not last more than 180 days in the aggregate. The purpose of this proposed limitation regarding visits is to prevent foreign broker-dealers from essentially maintaining a permanent sales force in the United States, thereby allowing such foreign broker-dealers to conduct a U.S. based broker-dealer business, without being registered as a broker-dealer with the SEC. However, since most state securities laws require the registration of persons with a place of business in their state that conduct broker-dealer activities, whether the business is with institutions or individuals, should foreign broker-dealers, whether

¹ The definition of qualified investors includes (but is not limited to) corporations, companies, partnerships and natural persons with at least \$25,000,000 in investments; banks; savings associations; brokers, dealers and their associated persons (other than natural persons); insurance companies; registered investment companies and certain entities exempt from the definition of investment company; certain trusts and employee benefit plans (other than IRAs); governments, political subdivisions, agencies and instrumentalities with at least \$50,000,000 in investments; foreign banks and governments; and multinational and supranational entities, and their agencies and instrumentalities.

² Section III.A., Proposing Release.

intentionally or inadvertently, maintain places of business within the meaning of a state's laws to facilitate visits of foreign associated persons, they could be subject to broker-dealer registration. Accordingly, foreign broker-dealers should consider whether they are maintaining a "place of business" in any United States jurisdiction when their associated persons conduct regular visits to a jurisdiction.

Similarly, under most state blue sky laws an "agent" is defined to mean an individual, other than a broker-dealer, who represents a broker-dealer in effecting or attempting to effect purchases or sales of securities. If adopted as proposed, foreign associated persons that visit the United States on behalf of a foreign broker-dealer relying on this exemption, may themselves be subject to agent registration or broker-dealer registration under applicable state blue sky laws.

In conclusion, if Rule 15a-6 is adopted as proposed foreign broker-dealers relying on the rule would need to consider the application of blue sky laws that in many U.S. jurisdictions, could require that they register as broker-dealers.

THE TEXAS SUPREME COURT'S CURIOUS APPROACH TOWARDS AIDING AND ABETTING

By: Nelson S. Ebaugh, P.C.

Federal courts have been hopelessly split on the minimum level of scienter necessary to prove aiding and abetting liability under the federal securities laws. For instance, some federal courts simply require proof of recklessness. Other federal courts, however, are not satisfied with mere recklessness. Instead, they require proof that the aider and abettor possess "general awareness by the aider and abettor that his role was part of an activity that was improper." This split regarding the requisite scienter is not limited to just these two positions. Among federal courts, there are at least four minimum levels of scienter that have been articulated in the aiding and abetting context. To this date, the United States Supreme Court has not resolved this multifaceted split among the federal courts.

All states periodically refer to federal court opinions construing the federal securities laws for guidance in interpreting their own blue sky laws. Consistent with this approach, in *Sterling Trust Company v. Adderley*, 168 S.W.3d 835 (Tex. 2005), the Texas Supreme Court looked to federal court opinions for guidance

to decide what should be the minimum level of scienter necessary to prove aiding and abetting liability under the Texas Securities Act (the "TSA"). However, due to the multifaceted split among the federal courts on the subject, the Texas Supreme Court issued an unusual, and arguably mistaken, opinion in *Adderley*.

In *Adderley*, the Texas Supreme Court held that to prove aiding and abetting liability under the TSA, "the alleged aider must possess a 'general awareness that his role was part of an overall activity this is improper.'"³ In other words, the alleged aider must possess "general knowledge" that his role was part of an overall activity this is improper. Knowledge is a higher mental state than is required by the express language of the TSA. The TSA provides that "reckless disregard for the truth or the law," a lower mental state, is sufficient to establish scienter in the aiding and abetting context.

The Texas Supreme Court did not engage in a meaningful analysis when it held that the general awareness standard should be applied to the TSA in lieu of less stringent standards of scienter articulated by the federal courts. Instead, the Texas Supreme Court simply adopted the standard that it believed had been embraced by "most" of the federal courts. But, as explained below, it is not clear that the standard chosen by the Texas Supreme Court had been adopted by most of the federal courts.

In addition, assuming that the standard embraced by the Texas Supreme Court had been adopted by most federal courts, that does not mean that the standard should have been applied to the TSA. The Texas Supreme Court should have weighed the pros and cons supporting each standard and made a decision on the relative merits of each standard rather than on what most federal courts have done. If it had done so, the Texas Supreme Court would likely have held that reckless disregard, alone, is sufficient to satisfy the scienter element for aiding and abetting liability.

A. Background of the TSA's Aiding and Abetting Provision

To fully appreciate the unusual nature of the *Adderley* decision, it is essential to understand the unique development of the TSA's aiding and abetting provision.

³ *Adderley*, 168 S.W.3d at 842 (quoting *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761, 780 (3d Cir. 1976)).

In 1963, Texas amended the TSA to adopt, almost verbatim, the portion of the Uniform Securities Act of 1956 (the “Uniform Act”) that imposed civil liability upon primary violators of the securities laws. Although the Uniform Act contained an accompanying aiding and abetting provision, Texas declined to adopt this provision. In fact, for years the TSA did not expressly provide for aiding and abetting liability.

1. Adoption of Aiding and Abetting Provision

In 1977, Texas amended the Texas Securities Act (the “TSA”) to include an aiding and abetting provision.⁴ Because the Texas legislature was concerned with the Texas Supreme Court’s liberal construction of secondary liability under the TSA, Texas refused to adopt the Uniform Act’s aiding and abetting provision.⁵ Instead, Texas adopted an aiding and abetting provision that was much narrower in scope than the Uniform Act’s aiding and abetting provision.

Texas’ aiding and abetting provision requires proof of scienter in order to establish liability.⁶ The Uniform Act does not contain such a requirement. Under the Uniform Act, a person is strictly liable for aiding and abetting liability unless he can “sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist.”⁷

2. Borrowing the Definition of Scienter for Aiding and Abetting from Federal Courts

In the early to mid 1970s, many federal courts required proof of scienter to establish primary

liability under section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. These courts generally identified the requisite scienter as “intent to defraud, reckless disregard for the truth, or knowing use of some practice to defraud.”⁸ For the most part, the TSA’s aiding and abetting provision contains the same phrases. Presumably, the Texas legislature borrowed this language from the federal courts for the TSA’s aiding and abetting provision. The TSA’s aiding and abetting provision reads: “A person who directly or indirectly with intent to deceive or defraud or with reckless disregard for the truth or the law materially aids a seller, buyer, or issuer of a security is liable . . . jointly and severally with the seller, buyer, or issuer, and to the same extent as if he were the seller, buyer, or issuer.”⁹

To establish primary liability under the Uniform Act, the plaintiff does not have to prove scienter.¹⁰ The same is true under the TSA.¹¹ In fact, courts have described the TSA’s primary liability provision as imposing strict liability.¹² In this regard the Uniform Act and the TSA are in harmony.

As mentioned above, however, the Uniform Act and the TSA are in not in harmony as far as each Act’s respective approach towards aiding and abetting liability. Instead, aiding and abetting liability under the TSA follows the approach of the federal courts. As a consequence, civil liability under the TSA is a hybrid of the Uniform Act and the federal securities law.

B. The Confused State of Aiding and Abetting Liability in the Federal Courts

Federal courts have never agreed upon the minimum level of scienter that is required to prove aiding and abetting liability under the securities laws.¹³ And to

⁴ Tex. Rev. Civ. Stat. Ann. art. 581-33, Comment—1977.

⁵ In *Brown v. Cole*, the Texas Supreme Court held that a person could be liable under the TSA if he served as “any link in the chain of the selling process.” 155 Tex. 625, 291 S.W.2d 704, 708 (1956). “The Committee drafting section 33F as part of the 1977 revision intended that the provisions of Section 33F would control the broad implications of *Brown v. Cole* regarding the collateral defendants covered by section 33F.” Hal M. Bateman, *Securities Litigation: 1977 Modernization of § 33 of the Texas Securities Act*, 15 HOUS. L. REV. 839, 853 (1978) (citations omitted).

⁶ Tex. Rev. Civ. Stat. Ann. art. 581-33, Comment—1977 (Section 33F(2) of the TSA “makes a material aider liable equally with the violator, but only if the aider has the requisite scienter, i.e. intent to deceive or defraud, or reckless disregard.”).

⁷ Uniform Securities Act of 1956 § 410(a).

⁸ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n. 12, 96 S.Ct. 1375, 47 L.Ed. 2d 668 (1976).

⁹ Tex. Rev. Civ. Stat. Ann. art. 581-33F(2).

¹⁰ Uniform Securities Act of 1956 § 410(a).

¹¹ *Herrmann Holdings Ltd. v. Lucent Techs. Inc.*, 302 F.3d 552, 563 (5th Cir. 2002) (“[A]n article 581-33 claim does not require scienter.”).

¹² *Sterling Trust Co. v. Adderley*, 119 S.W.3d 312 (Tex. App.—Fort Worth 2003) *rev’d on other grounds*, 168 S.W.3d 835 (Tex. 2005) (“Under the strict liability provisions of sections 33(A)(2) and (B), a plaintiff may recover against a seller without proof that the seller knew or should have known of the untruth or omission on which the plaintiff’s claim is based.”).

¹³ Matthew L. Mustokoff, *Proving Scienter in SEC Aiding and Abetting Cases; Courts Apply Tougher Standard in Recent*

date, the United States Supreme Court has not addressed the issue. Consequently, as far as aiding and abetting liability goes, there are at least four different versions of scienter under the federal securities laws.¹⁴ Most of these versions provide that some form of recklessness will support the requisite scienter needed.¹⁵ But, under at least one version, recklessness alone is insufficient to prove aiding and abetting liability.¹⁶

The federal courts that aren't satisfied with proof of recklessness, demand proof of a higher mental state. They demand that the alleged aider possess as least a "general awareness" of the primary violation before imposing aiding and abetting liability. Awareness of wrongdoing is synonymous with knowledge of wrongdoing.¹⁷

C. Texas' Appellate Courts Mirror the Confusion in the Federal Courts

Just as the federal courts have been split on whether recklessness alone can qualify as scienter for aiding and abetting purposes, so were Texas's intermediate courts for a while.¹⁸ At least one of Texas' intermediate courts did not require proof of general awareness to demonstrate an aider's scienter.¹⁹ However, several other Texas appellate courts required proof of the aider's general awareness of the underlying violation before imposing liability under the TSA aiding and abetting provision.²⁰ Consequently, the same split that had been playing out for years in the federal courts began playing out in the Texas courts.

D. The Texas Supreme Court Decides the Issue

In *Sterling Trust Company v. Adderley*, 168 S.W.3d 835 (Tex. 2005), the Texas Supreme Court resolved

Decisions, INSIGHTS: THE CORPORATE & SECURITIES LAW ADVISOR (May 1, 2006).

¹⁴ Kevin R. Johnson, *Liability For Reckless Misrepresentations and Omission Under Section 10(b) of the Securities Exchange Act of 1934*, 59 U. CIN. L. REV., 667, 685-95 (1991).

¹⁵ *Id.*

¹⁶ Mustokoff, *supra* note 11.

¹⁷ *Howard v. SEC*, 376 F.3d 1136, 1142 (D.C. Cir. 2004).

¹⁸ *Adderley*, 168 S.W.3d at 840 (observing the split amongst the Texas intermediate appellate courts).

¹⁹ *Id.*

²⁰ *Id.*

this split among Texas' intermediate courts. Relying heavily upon federal cases that have addressed aiding and abetting liability under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, the Texas Supreme Court held that proof of the aider's "general awareness" of the underlying violation is necessary to establish aiding and abetting liability under the TSA.²¹

1. It Is Unclear Whether Most Federal Courts Required Proof of General Awareness

The *Adderley* opinion, however, lacked a meaningful analysis to reach this conclusion. The Texas Supreme Court based its holding largely on the assumption that "most" of the federal courts in 1977 required proof of general awareness to prove aiding and abetting liability.²² That was the extent of its analysis in deciding the difficult question about whether recklessness alone may suffice to establish aiding and abetting liability under the TSA.

Such an important issue deserved a more thorough analysis than this. Moreover, it is not even clear that most federal courts require proof of the aider's general awareness of the underlying violation. At least one commentator has claimed that most federal courts do not require proof of "general awareness."²³ Another has implied as much.²⁴

²¹ *Id.* at 842.

²² *Id.* at 840.

²³ Johnson, *supra* note 12, at 689-90. *But see* Don J. McDermott, Jr., Note, *Liability for Aiding and Abetting Violations of Rule 10b-5: The Recklessness Standard in Civil Damage Actions* 62 TEX. L. REV. 1087, 1096 (1984) ("[M]ost of the circuits have followed *Coffey*" which requires proof "that the defendant had a general awareness that his role was part of an overall activity that was improper."); Cheryl L. Pollak, Note, *Rule 10b-5 Liability after Hochfelder: Abandoning the Concept of Aiding and Abetting*, 45 U. CHI. L. REV. 218, 236 (1977) ("The mental state issue most consistently mentioned in the cases is the secondary defendant's knowledge of the principal's wrongdoing.").

²⁴ Robert S. De Leon, *The Fault Lines Between Primary Liability and Aiding and Abetting Claims Under Rule 10b-5*, 22 J. CORP. L. 723, 726 (1997) ("For aiding and abetting claims, plaintiffs [before *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 114 S. Ct. 1439, 128 L. Ed. 2d 119 (1994)] were only required to plead (1) a violation of Rule 10b-5 by another party; (2) knowledge or reckless disregard of the violation by the aider and abettor; and (3) substantial assistance by the aider and abettor in the achievement of the violation.").

2. Public Policy Arguments For and Against the Requirement of General Awareness

In the end, it really should not have mattered whether or not most of the federal courts have adopted the general awareness standard in lieu of recklessness. Instead, it would have been better if the Texas Supreme Court had made a decision by carefully evaluating the pros and cons of the recklessness standard versus the general awareness standard. Unfortunately, most federal courts omit this analysis.

Federal courts tend to simply state in a conclusory fashion that the general awareness standard is, or is not, required without explaining the basis of their holding.²⁵ Therefore, it was not all that surprising when the Texas Supreme Court likewise failed to significantly delve into the public policy arguments for and against the general awareness standard.

In an opinion drafted by Judge Friendly, the Second Circuit of the U.S. Court of Appeals set forth a compelling reason for the application of the recklessness standard.²⁶ In that opinion, the Second Circuit observed: “‘In our complex society the accountant’s certificate and the lawyer’s opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar.’ . . . a lawyer, no more than others, can escape liability for fraud by closing his eyes to what he saw and could readily understand.”²⁷ In *Adderley*, the Texas Supreme Court never considered this rationale in support of the recklessness standard. Perhaps if it had, it would have paused before adopting the general awareness standard. After all, the TSA should be construed to protect investors.²⁸ Judge Friendly’s articulation of the recklessness standard would have protected investors without placing an undue burden on accountants and lawyers.

²⁵ Johnson, *supra* note 12, at 686.

²⁶ *SEC v. Frank*, 388 F.2d 486 (2nd Cir. 1968).

²⁷ *Id.* at 489 (citations omitted).

²⁸ “[B]ecause article 581–33 [of the TSA] is remedial in nature in the civil context, it ‘should be given the widest possible scope.’ *Flowers*, 472 S.W.2d at 115; *Anheuser–Busch*, 934 S.W.2d at 708. We are to construe the Texas Securities Act ‘to protect investors.’ TEX. REV.CIV. STAT. ANN. art. 581-10-1(b) (Vernon Supp. 2001).” *Texas Capital Securities Inc. v. Sandefer*, 58 S.W.3d 760, 775 (Tex. App.—Houston [1st Dist.] 2001, pet. denied). See also *Aegis Ins. Holding Co. v. Gaiser*, No. 04-05-00938-CV, 2007 WL 906328 (Tex. App.—San Antonio, March 28, 2007).

Many federal courts, if not most federal courts, have adopted the following definition of recklessness:

[R]eckless conduct may be defined as a highly unreasonable [act or] omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.²⁹

This standard would have been an excellent choice for the Texas Supreme Court to have adopted in *Adderley*. But unfortunately, the Texas Supreme Court did not even acknowledge this standard in its opinion. This recklessness standard is consistent with the recklessness language expressly provided for in the TSA. In addition, as noted by at least one commentator, “in many cases it will be virtually impossible for a plaintiff to show that an alleged aider and abettor had actual knowledge of the primary violation.”³⁰ This definition of recklessness protects aiders and abettors that are simply negligent, but would allow recovery against aiders and abettors that have a mental state higher than mere negligence. Again, the TSA is to be construed to protect investors.

Federal courts have advanced at least one argument in support of the general awareness standard. But, this argument was not brought up in the *Adderley* opinion. The Fifth Circuit has stated that: “Without these limitations [i.e. the general awareness requirement], the securities laws would become an amorphous snare for guilty and innocent alike.”³¹ Echoing the same sentiment, the D.C. Circuit has stated that the general awareness element of aiding and abetting liability was “designed to ensure that innocent, incidental participants in transactions later found to be illegal are not subjected to harsh . . . penalties.”³² No question about it, it would be wrong to subject a truly innocent person to aiding and abetting liability. But, if a person recklessly disregards a likely fraudulent transaction, that person is not completely innocent. Such individuals should

²⁹ McDermett, *supra* note 21, at 1102. See also Johnson, *supra* note 12, at 689-90.

³⁰ McDermett, *supra* note 21, at 1113.

³¹ *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 97 (5th Cir. 1975).

³² *Investors Research Corp. v. SEC*, 628 F.2d 168, 177 (D.C. Cir. 1980).

be liable as aiders and abettors under federal law and the TSA.

As noted in the above paragraph, the Fifth Circuit and the D.C. Circuit had at one time required proof of general awareness to prove aiding and abetting liability. But, these two Circuits have since relaxed, or entirely abandoned, the general awareness requirement. In *Akin v. Q-L Investments, Inc.*, 959 F.2d 521, 526-527 (5th Cir. 1992), the Fifth Circuit held that an accountant may be liable as an aider and abettor if he “has furnished substantial and non-routine services but is not consciously furthering primary violations by his client.” In *Howard v. SEC*, 376 F.3d 1136, 1143 (D.C. Cir. 2004), the D.C. Circuit held that “[a] secondary violator may act recklessly, and thus aid and abet an offense, even if he is unaware that he is assisting illegal conduct.” The Texas Supreme Court relied heavily on precedent from the Fifth and D.C. Circuits in support of its holding that general awareness must always be proven.³³ Perhaps the Texas Supreme Court would not have imposed the general awareness requirement if it had been aware of the Fifth and D.C. Circuit’s relaxation of this requirement.

3. Mistaken Reliance of Federal Precedent

Unfortunately, when it issued its opinion in *Adderley*, the Texas Supreme Court labored under an incorrect understanding of the level of scienter that the SEC must prove in aiding and abetting cases. In *Adderley*, the Texas Supreme Court stated that “SEC actions still require ‘a general awareness by the aider and abettor that his role was part of an activity that was improper.’”³⁴ In support of this statement, the *Adderley* court quoted a phrase from *Howard v. SEC*, 376 F.3d 1136, 1142 (D.C. Cir. 2004). However, *Howard* does not stand for the proposition that the Texas Supreme Court claims it does. In fact, *Howard* stands for a position that is directly contrary to the Texas Supreme Court’s position.

In *Howard*, the D.C. Circuit expressly held that the SEC is *not* required to prove that the aider had a

general awareness that his role was part of an improper activity. According to the *Howard* court:

A secondary violator may act recklessly, and thus aid and abet an offense, even if he is unaware that he is assisting illegal conduct. . . . “[E]xtreme recklessness” may support aiding and abetting liability. “Extreme recklessness” – or as many courts of appeals put it, “severe recklessness” – may be found if the alleged aider and abettor encountered “red flags,” or “suspicious events creating reasons for doubt” that should have alerted him to the improper conduct of the primary violator, or if there was a “danger . . . so obvious that the actor must have been aware of the danger.”³⁵

It is disappointing that the Texas Supreme Court was not aware of the true holding in *Howard*. If it had been, the Texas Supreme Court may have thought twice before adopting the general awareness standard in such a conclusory fashion. The *Howard* court’s version of recklessness would have been a much more appropriate standard to apply to the TSA’s aiding and abetting provision than the general awareness standard.

4. Inappropriate Reliance on Federal Precedent

Finally, the Texas Supreme Court failed to acknowledge a significant difference between aiding and abetting liability under the TSA as opposed to aiding and abetting liability under the federal securities law. The TSA expressly provides that aiding and abetting liability may exist if the aider possesses any one of the following mental states: intent, knowledge, or recklessness. For private litigants, there has never been a comparable provision under Section 10(b) of the Securities Exchange Act of 1934 or Rule 10b-5. Instead, aiding and abetting liability under Section 10(b) and Rule 10b-5 has always been an implied cause of action, with its contours defined by the federal courts. Consequently, upon its codification, the TSA’s aiding and abetting provision had no analog in Section 10(b) or Rule 10b-5. For this reason alone, a more appropriate decision may have been made if the Texas Supreme Court had refrained from looking to the federal courts for guidance in interpreting the TSA’s aiding and abetting provision.

³³ In *Adderley*, the Texas Supreme Court often cited to *Woodward v. Metro Bank of Dallas*, 522 F.2d 84 (5th Cir. 1975) to support its decision. In *Adderley*, Texas Supreme Court also cited to several D.C. Circuit Court opinions as persuasive authority: *Investors Research Corp. v. SEC*, 628 F.2d 168 (D.C. Cir. 1980); *Graham v. SEC*, 222 F.3d 994 (D.C. Cir. 2000); *Howard v. SEC*, 376 F.3d 1136 (D.C. Cir. 2004).

³⁴ *Adderley*, 168 S.W.3d at 847 n.2.

³⁵ *Howard*, 376 F.3d at 1143.

Finally, it was inappropriate for the Texas Supreme Court to graft a requirement to the TSA that the legislature clearly did not intend to exist. If the Texas legislature had intended a general knowledge requirement, it certainly had the ability to include it in the TSA's aiding and abetting provision. After all, some federal courts had adopted a general awareness standard before Texas amended the TSA to include an aiding and abetting provision. But the fact that Texas did not do that speaks volumes.

E. Conclusion

Instead of holding that general awareness is required to prove aiding and abetting liability, the Texas Supreme Court should have held that reckless disregard, alone, suffices as scienter for aiding and abetting liability. As demonstrated above, the rationale for such a standard outweighs the rationale for the general awareness standard. Hopefully, when given the opportunity to consider the issue again, the Texas Supreme Court will follow the lead of the Fifth and D.C. Circuits and relax, or entirely abandon, the general awareness requirement as these federal courts have done.

FLORIDA TIGHTENS LAWS ON SUITABILITY OF ANNUITY SALES TO SENIORS

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On June 30, 2008, Florida Governor Charlie Crist signed into law as Chapter 2008-237, Laws of Florida (CS/CS/SB 2082), the "John and Patricia Seibel Act." Named after a Venice, Florida couple in their 80s who were sold \$600,000 worth of annuities that could not be touched without large penalties for 15 years,³⁶ the new law significantly modifies the Florida Insurance Code with regard to sales of life insurance and annuities.

THE "FREE LOOK" PROVISION

An early version of the Seibel Act would have expanded the "free look" provision of Section 626.99(4)(a), Fla. Stat., for purchasers of annuities who are 75 or older, from the current 10 days to one year. Industry opposition defeated this proposal.³⁷

³⁶ J. Liberto, *State CFO Wants Tougher Rules on Annuities*, St. Petersburg Times, April 18, 2008.

³⁷ Florida Securities Dealers Association, *Florida Review* (May 12, 2008) at 3.

Because an annuity contract cannot be provided prior to its purchase, the "free look" is intended to avoid requiring purchasers to rely solely on agents' representations about the contract's terms. Florida formerly required that consumers be allowed to read and review such contracts and to cancel the purchase for an unconditional refund within 10 days after receiving the contract. The final version of the bill, which is effective January 1, 2009, dropped the age requirement and expanded the free look period in all cases from 10 to 14 days.³⁸

Life insurance policies can avoid the "free look" requirement if prospective purchasers are given "a buyer's guide and a policy summary" prior to the insurer's acceptance of an initial premium or premium deposit. Prospective purchasers of all annuities, no longer just fixed annuities, must be given the buyer's guide and contract summary required by the NAIC.³⁹ In addition, all annuity purchasers must have the right to an unconditional refund "for a period of at least 14 days."

AGENT REGULATION

Persons licensed to solicit or sell life insurance in Florida on and after January 1, 2009, must complete a minimum of three hours continuing education in life insurance and annuity suitability.⁴⁰ Licensees are also required to inform the regulator of their telephone number or e-mail address and to keep this information current or face a \$500 fine.⁴¹

Although it has not been a matter of doubt in Florida, Section 11 of the Seibel Act amends Section 627.805, Fla. Stat., to provide that Florida's securities regulator, namely the Office of Financial Regulation ("OFR"), "shall regulate the sale of variable and indeterminate value contracts" as securities. As a result, life insurance agents in Florida must be registered as associated persons of a securities dealer in order to sell variable annuities (or any other insurance product deemed a "security") "in or from offices in this state."⁴²

³⁸ Ch. 2008-237, Fla. Laws, Section 8.

³⁹ National Association of Insurance Commissioners.

⁴⁰ Ch. 2008-237, Fla. Laws, Section 3.

⁴¹ Ch. 2008-237, Fla. Laws, Section 4.

⁴² Section 517.12(1), Fla. Stat. Notably offers and sales of equity indexed annuities would receive similar treatment should Florida adopt the approach proposed by the U. S. Securities and Exchange Commission in its Release No. 33-8933 (June 25, 2008), which denies classification of most such annuity contracts as insurance.

UNFAIR INSURANCE TRADE PRACTICES

Florida Chief Financial Officer Alex Sink, head of the Florida Department of Financial Services (“DFS”), of which OFR and the Office of Insurance Regulation (“OIR”) are autonomous units, expressed disappointment that the legislation failed “to make it a felony to intentionally deceive a senior into an inappropriate annuity product.”⁴³ In a press release commending passage of the bill, she pledged not to rest “until we are able to put unscrupulous agents that prey on our seniors behind bars.”⁴⁴ CFO Sink wanted to designate certain violations of the insurance code to be felonies because DFS claimed Florida state attorneys are reluctant to initiate criminal prosecutions of misdemeanor offenses.⁴⁵ This fails to recognize, however, that fraudulent sales of variable annuities and any other insurance products deemed “securities or investments” are already felonies under Section 517.302(1), Fla. Stat. in the Florida Securities and Investor Protection Act. Moreover, under current law such crimes are predicate offenses under RICO⁴⁶ and subject to the highly punitive “alternative fine” provision of Section 517.302(3), Fla. Stat.

Furthermore, by this enactment, especially in combination with Chapter 2008-66, Laws of Florida (CS/CS/SB 2860), the “Homeowner’s Bill of Rights Act,” Florida has significantly increased penalties for violations of the Florida Unfair Insurance Trade Practices Act.⁴⁷ For example, an insurer can now face an administrative fine of \$40,000 for a single willful violation up to an aggregate fine of a quarter of a million dollars, instead of \$20,000 and \$100,000 respectively under current law. After the effective date of the Seibel Act, insurers might face even greater administrative penalties for offenses against senior consumers under new powers granted OIR to order rescission.⁴⁸

⁴³ Press Release: Statement by CFO Sink on the Legislature’s Passage of The Annuity Fraud Bill (May 2, 2008). <<http://www.myfloridacfo.com/PressOffice/ViewMediaRelease.asp?ID=2930>>

⁴⁴ *Ibid.*

⁴⁵ Florida Senate Bill Analysis and Fiscal Impact Statement for CS/SB 2082, prepared by staff of Banking and Insurance Committee (March 19, 2008) (hereafter “Staff Analysis”) at 6.

⁴⁶ Racketeer Influenced and Corrupt Organizations Act, Sections 895.01-895.08, Fla. Stat.

⁴⁷ Section 626.9521, Fla. Stat.

⁴⁸ Ch. 2008-237, Fla. Laws, Section 9, amending Section 626.5445(5)(a), Fla. Stat. *See* Note 30 *infra*.

Agents are also subject to increased fines for specified violations: \$5,000 for each non-willful violation (increased from \$2,500), up to a maximum aggregate amount of \$50,000 (increased from \$10,000).⁴⁹ Willful violations can be punished administratively by a fine of \$30,000 for each offense (increased from \$20,000), up to a maximum aggregate amount of \$250,000 (increased from \$100,000).⁵⁰ The disparity between insurers and agents is caused by Section 6 of the Seibel Act, which provides that if another law is enacted in the 2008 legislative session that creates greater fines in Section 626.9521, Fla. Stat., the greater fines will supersede increases made in this law. Although judicial construction may be required, this section appears to be triggered only with regard to insurers subject to the Homeowner’s Bill of Rights Act (Chapter 2008-66, Laws of Florida, CS/CS/SB 2860).⁵¹

The prohibited practices punishable by these enhanced penalties are “twisting,” “churning” and two new offenses created by the Seibel Act.⁵² “Twisting” is prohibited by Section 626.9541(1)(l), Fla. Stat. It involves use of misrepresentations, incomplete or fraudulent comparisons or material omissions to sell insurance or to induce other actions. “Churning” is prohibited by Section 626.9541(1)(aa), Fla. Stat. It occurs when a policyholder is fraudulently induced to use the value of existing insurance to purchase another product from the same insurer, when this increases compensation of the agent, but does not benefit the policyholder. The definition of “twisting” is unchanged by this law, but the definition of “churning” at Section 626.9541(1)(aa), Fla. Stat. is amended to prohibit specifically “indirect churning.” This occurs when a policy is surrendered and the resulting funds are used to purchase both an immediate and a deferred annuity, thus creating a double commission for the agent.⁵³

The two new offenses are, first, unlawful use of designations. A new subsection (ff) of Section 626.9541(1), Fla. Stat. prohibits agents from falsely implying they possess special skills or qualifications

⁴⁹ Ch. 2008-237, Fla. Laws, Section 5.

⁵⁰ *Ibid.*

⁵¹ Ch. 2008-237, Fla. Laws, Section 7.

⁵² Ch. 2008-237, Fla. Laws, Section 5.

⁵³ Staff Analysis at 7.

through use of titles and bogus designations.⁵⁴ Use of bona fide licenses and designations is permitted. Submission of false signatures on an application or policy-related document is prohibited in new subsection (ee).⁵⁵ Because the practice of submitting false signatures to an insurer is already illegal as forgery, which is punishable as a felony,⁵⁶ this new offense is punishable as a third degree felony. Twisting, churning and the other new offense are first degree misdemeanors.⁵⁷

SENIOR SUITABILITY

Section 626.4554, Fla. Stat. was created in 2004 as Florida's enactment of the NAIC "Senior Protection in Annuity Transactions Model Regulation."⁵⁸ A "White Paper on Annuities" prepared by DFS on March 5, 2008,⁵⁹ strongly implied that enactment was ineffective. It reports that during fiscal year 2006-2007, DFS opened 351 investigations related to annuity transactions, a 41% increase over the 2005-2006 period. The White Paper further reports 260 new annuity-related investigations opened in the first eight months of fiscal year 2007-2008, a projected cumulative increase of 58% since the senior suitability statute took effect on July 1, 2004.

The NAIC model enacted in Florida was intended to create standards for recommending the purchase or exchange of annuities to consumers who are 65 or older. The thrust of the Seibel Act is to replace a subjective standard, namely that agents and insurers must have "reasonable grounds" for recommending annuities to seniors, with an objective standard. The former law was asserted to thwart prosecution because clear and convincing evidence was required, not to prove that a particular transaction was suitable for a senior consumer, but whether the agent reasonably believed it was.⁶⁰ To accomplish

replacement of the subjective standard with an objective one, the Seibel Act amends Section 626.5445(4)(a), Fla. Stat. to state that an insurer or agent must, in recommending purchase or exchange of an annuity to a senior consumer, have "an objectively reasonable basis for believing the recommendation is suitable." The new law also specifies the minimum information that must be obtained from the consumer and requires use of a form to be promulgated by the regulator. Should the consumer refuse to provide the required information, the agent or insurer must, before execution of a transaction, obtain verification of such refusal from the consumer, again on a form to be promulgated by the regulator. In transactions concerning replacement or exchange of an annuity, a comparison must be provided on a prescribed form, including a written statement of the basis for the recommendation, disclosure of the possibility of tax consequences and other "overall advantages and disadvantages to the consumer if the recommendation is followed."⁶¹

An effort was made in the 2008 legislative session to expand application of the senior suitability statute to all life insurance products. That effort failed, but some language of the Seibel Act retains traces of the effort. A few references to "policies" appear among descriptions of annuity contracts. A definition of "annuity contract," once intended to complement a definition of "life insurance contract," has been added to the statute, but appears to have no effect. Former law defined "annuity" as a fixed annuity or a variable annuity. The new law replaces this definition with "annuity contract," defined as a fixed annuity, a variable annuity or an "equity indexed annuity."⁶² Because equity indexed annuities are fixed annuities, it is unclear how the Legislature intended this amendment to change the law.

The Florida Governor and Cabinet, sitting as the Florida Financial Services Commission, are authorized to begin rulemaking to implement the Seibel Act, including to promulgate the statutory forms, on June 30, 2008. The senior suitability provisions, Section 9 of the law, will become effective 60 days after the last such rule is adopted or on January 1, 2009, whichever is later.⁶³

⁵⁴ Ch. 2008-237, Fla. Laws, Section 7. This law should be considered in conjunction with OFR's proposed Rule 69W-600.0133, Florida Administrative Code, restricting use of "senior-specific certifications and professional designations" in securities transactions. Florida Administrative Weekly, Vol. 34, No. 25 (June 20, 2008).

⁵⁵ *Ibid.*

⁵⁶ Sections 831.01 and 831.02, Fla. Stat.

⁵⁷ Ch. 2008-237, Fla. Laws, Section 5.

⁵⁸ Section 146, Ch. 2004-390, Fla. Laws.

⁵⁹ Florida Department of Financial Services 2008 White Paper on Annuities (March 5, 2008) by Roxanne Rehm, Assistant General Counsel.

⁶⁰ Staff Analysis at 5.

⁶¹ Ch. 2008-237, Fla. Laws, Section 9.

⁶² *Ibid.*

⁶³ Ch. 2008-237, Fla. Laws, Section 12.

SENIOR SUITABILITY SAFE HARBORS

Like the former senior suitability statute, the new law contains a specific disclaimer of any private right of action to enforce its provisions.⁶⁴ In addition, the following language was enacted as a new subsection (c) in Section 626.5445(1), Fla. Stat.:

Nothing in this section shall subject an insurer to criminal or civil liability for the acts of independent individuals not affiliated with that insurer for selling its products, when such sales are made in a way not authorized by the insurer.⁶⁵

This may be a significant safe harbor, but the Legislature's intent in its enactment is unclear. Does it mean Florida intends to relieve insurers of their obligation at Section 626.5445(4)(d), Fla. Stat. to "ensure that a system to supervise recommendations . . . is established and maintained"? Does the "criminal or civil liability" from which insurers are protected by this language include administrative enforcement by OIR? How, for example, is this safe harbor to be read in conjunction with the simultaneously enacted new power of OIR at Section 626.5445(5)(a), Fla. Stat., to order rescission when "any senior consumer [is] harmed by a violation of this section by the insurer or the insurer's insurance agent"? The constitutionality of this new power of OIR will need to be tested. Without question, it exceeds any administrative authority given the regulator under Florida's securities laws. Section 517.191(3), Fla. Stat. only authorizes OFR to seek a similar remedy in securities cases from a court.

Another safe harbor is provided at Section 626.5445(8), Fla. Stat. for agents who are registered associated persons of members of FINRA.⁶⁶ Unfortunately, this provision is also unclear. The former law did not refer to membership in FINRA or registration in the securities industry. Anyone who could demonstrate compliance with NASD rules as they existed on January 1, 2004, was deemed to have satisfied the senior suitability statute with regard to variable annuities. Nevertheless, the Seibel Act does not change current law, which preserves the authority of DFS to discipline insurance agents and agencies

⁶⁴ Ch. 2008-237, Fla. Laws, Section 9.

⁶⁵ *Ibid.*

⁶⁶ Financial Industry Regulatory Authority (formerly National Association of Securities Dealers or NASD); Ch. 2008-237, Fla. Laws, Section 9.

and that of OIR to discipline insurers "to enforce the provisions of this section." Presumably, this means persons charged with having violated the senior suitability statute, with regard to variable annuities, can defend themselves by asserting their compliance with the applicable FINRA rule, but the regulator can rebut such a defense.

Application of the safe harbor provision at Section 626.5445(8), Fla. Stat. is expanded in the Seibel Act from variable annuities to all annuities. At the same time, however, the new provision is available only to persons "registered with a member of [FINRA]." Such persons may also be insurance agents, but it seems unlikely this immunity could ever be available to an insurance agency or to an insurer. Of course, agents who are not also registered to sell securities can no longer avail themselves of this provision. Also, because the suitability determination required by FINRA does not apply to products that are not securities, it is unclear whether the attempt to expand the safe harbor beyond variable annuities has any effect. Combining this new language with the existing "saving clause" for jurisdiction of DFS and OIR suggests Florida has significantly restricted availability of this safe harbor.

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SUITABILITY AND DISCLOSURE DEVELOPMENTS IN ANNUITY SALES IN TEXAS⁶⁷

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Regulators and Legislators have recently been focusing on the burgeoning sales in annuities, focusing on whether high commissions, rather than investor suitability, drive sales. This has resulted in recent major developments in Texas and nationally. First, the SEC recently approved FINRA's (formerly the NASD) new rules relating to variable annuity suitability and the supervision of variable annuity sales. Second, a recent statute passed by the Texas Legislature effective January 1, 2008 applies suitability requirements to all individually

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recommended annuity sales and requires specific disclosures in annuity sales.

But first, some background is needed. A fixed annuity pays out a defined return on investment for an indefinite period, usually the life of the insured, and is not based on the performance of any investments. A variable annuity pays a return on investment based on the performance of subaccounts managed by investment advisers and has multiple other features and benefits. An equity-indexed annuity pays a defined return on investment, but may provide a limited upside based on the performance of an investment index. It has no subaccounts and no selected investments. Variable and equity-indexed annuities are complex contracts that typically require long holding periods for liquidation without penalties. They can also carry higher costs and higher commissions than other investments. Annuities carry tax deferral benefits.

According to the Insurance Information Institute, in 2006, insurers sold \$160.6 billion of variable annuities and \$75.6 billion of fixed annuities. Variable annuities now hold almost \$1.4 trillion in assets. Since 2002 variable annuity sales are up 37.74% and fixed annuity sales are down 26.82%. Equity-indexed annuities have also been growing. In 2006, the ten largest producers of this product sold almost \$21 billion of equity-indexed annuities.

The regulation of the sale of annuities may fall into both securities and insurance regulatory regimes, which are vastly different. Securities regulatory regimes traditionally have imposed investor suitability requirements over the distribution channel and insurance regulatory regimes generally have not had suitability requirements. Further, under federal law, variable annuity sales have fallen under securities regulation while fixed annuity sales have fallen under state insurance regulators. Finally, arguments persist about the appropriate regulatory regime for equity-indexed annuities, and the SEC has not made a final decision about its general jurisdiction over the sale of equity-indexed annuities. First, FINRA asked the SEC to evaluate whether equity-indexed annuities are securities. Second, SEC Rule 151 may provide a safe harbor from securities registration for the sale of equity-indexed annuities. That rule exempts from securities regulation those annuities that are 1) registered with a state insurance administrator; 2) have the insurer assume the investment risk; and 3) not primarily marketed as investments. Third, at least one court has ruled that

equity-indexed annuities are not securities (*Malone v. Addison Insurance Marketing, Inc., et al.* 225 F. Supp. 743 (W.D.Ky 2002)). Finally, equity-indexed annuities sold by a registered securities broker-dealer would still be subject to suitability evaluations under broker-dealer rules.

One particular suitability concern for annuities involves switching, in which a salesman switches the customer's annuity, gets another large commission, and may cause the customer to pay early liquidation penalties. A second suitability concern involves placing annuities in tax-deferred accounts such as individual retirement accounts. In that case, the annuity's tax deferral benefit would generally be meaningless. Other suitability concerns involve carrying costs, holding periods, and allocations in variable annuity subaccounts.

For Texas brokers, two major developments in annuity sales have recently occurred. First, after three years of gestation, the SEC has approved FINRA's new sales and supervisory rules for the sale of variable annuities. Some of these rules will be effective May 5, 2008. Second, last session the Texas Legislature for the first time passed suitability rules for all annuity sales. Those laws became effective January 1, 2008.

FINRA's New Annuity Sales and Supervision Rules

FINRA's new variable annuity sales rule, Rule 2821, goes into effect on May 5, 2008. Rule 2821 has multiple provisions. It will create new suitability obligations, principal review and approval requirements, and supervisory and training requirements tailored specifically to variable annuity transactions that will be in addition to other NASD general rules on these topics.

Rule 2821 applies to the purchase or exchange of variable annuities and the customer's initial subaccount allocations. It will not generally apply to reallocations or subsequent premium payments, or when the purchase or exchange occurs within a tax-qualified employer-sponsored retirement or benefit plan. But, Rule 2821 will apply if a broker recommends a variable annuity to an individual plan participant.

Rule 2821 will require that a broker have a reasonable basis to believe that the transaction is suitable for the customer in order to recommend a variable annuity purchase or exchange. It will also

require principal review and approval before transmitting to the insurer within seven business days of the sale, and require training specifically tailored to variable annuity sales. Finally, the SEC made a technical change to the Net Capital Rule, Rule 15c3-1 which states that during the time the broker-dealer is holding a customer check for a variable annuity purchase pending principal approval and transmission, it will not be deemed to be holding customer funds for the purpose of the net capital rule.

The rule will require that broker-dealers generate a great amount of paperwork for each variable annuity sale and the detailed list of suitability review requirements will provide fodder for claimant attorneys in arbitrations. The broker-dealer and the insurer will undoubtedly require that all the required information be thoroughly documented and it will likely take many pages. Also, broker-dealers will need to provide extensive training to their sales force to make sure that brokers understand the new rule and the broker-dealers procedures used to comply with the rule.

Rule 2821 is an add-on suitability determination rule. The general suitability requirements of Rule 2310 still apply.

Rule 2821 Broker Requirements

First, Rule 2821 requires that brokers make reasonable efforts to obtain, at a minimum, the following information from the prospective customer before recommending a variable annuity:

- Age;
- Annual Income;
- Financial Situation and Needs;
- Investment experience;
- Investment objectives;
- Intended use of the variable annuity;
- Investment time horizon;
- Existing assets (including investment and life insurance holdings);
- Liquidity needs;
- Liquid net worth;
- Risk Tolerance;
- Tax status; and
- Such other information reasonably used or considered in recommending annuities to customers.

Because brokers will need to be able to demonstrate, often years later, to principals, FINRA and SEC

examiners, and arbitration panels that there was a reasonable basis for the recommendation, brokers will need to obtain this information in writing and in great detail. Some of these items may include checking boxes, but other items, such as existing assets, use of a variable annuity, and liquidity needs will likely need more detailed written explanation. Also, there is a new provision of the Texas Insurance Code (further explained below) which will require that the broker obtain a detailed list of all of the customers' other life insurance policies and annuities.

What does "reasonable efforts" mean? It means get it in writing. Principals and compliance departments face personal supervisory liability from FINRA for approving annuity sales and are unlikely to sign off on these sales based on assertion that the customer did not want to provide the requested information but still wanted to purchase an annuity.

Once this required information has been obtained, the broker must start making disclosures about the recommended product. Under Rule 2821 the broker and the broker-dealer must have a reasonable basis to believe that the customer has been informed, in general terms, of variable annuities various features, including:

- Potential surrender period;
- Potential surrender charge;
- Potential tax penalty if customers sell or redeem variable annuities before reaching age 59½;
- Mortality and expense fees;
- Investment advisory fees;
- Potential charges for and features of riders;
- The insurance and investment components of variable annuities; and
- Market risks.

This disclosure requirement combines both general annuity issues and items that are variable depending on the particular annuity recommended. This means that broker-dealers should create their own general annuity features disclosure document and also provide the insurer's disclosure summary. The broker will also need to be able to document that these disclosures were actually delivered with time enough for the customer to review. There will be a recital of these disclosure agreements signed by the customers, but it may also be wise to provide a copy of these disclosures during the initial meeting when the customer information is gathered. Broker dealers should also expect SEC and FINRA examiners to

focus on policies and proof relating to delivery of these required variable annuity disclosures.

After gathering information and providing disclosure, the broker is only one step away from being able to recommend a variable annuity. But, it is a big step. The broker must run all the customer's needs and the features of the various products through the suitability prism using a detailed list of factors provided by Rule 2821. The general suitability requirements of Rule 2310 also remain in effect. Rule 2821 requires the broker to evaluate if the customer would benefit from at least some of the annuity features, including:

- tax deferred growth;
- annuitization; or
- a death or living benefit.

The reference to tax deferred growth means that brokers should be cautious about recommending variable annuities for qualified accounts.

The next step in the suitability determination is to review the subaccount allocations, riders, and product enhancements to determine if all of these items are consistent with the customer's needs as stated in the information gathered from the customer.

Finally, variable annuity exchanges have additional requirements and will be a hot button item for regulators and claimant arbitration attorneys for the next several years. If the transaction is an annuity exchange, the suitability determination will take into consideration whether:

- The customer would incur a surrender charge;
- The customer would be subject to commencing a new surrender period;
- The customer would lose existing benefits, such as mortality and expense fees, or charges for riders and similar product enhancements;
- The customer would benefit from the product enhancements and improvements; and
- The customer's account had another variable annuity exchange within the preceding 36 months.

If there was another variable annuity exchange within the previous 3 years, FINRA and SEC examiners will undoubtedly view those transactions as red flags and seek excruciatingly exact details about them. As is standard at many firms today, from a compliance perspective exchanges will require a written acknowledgement of these issues by the customer.

Detailed broker notes about the various discussions of these issues will also be a crucial part of the record.

Rule 2821 Principal Requirements

So, after going through all these requirements, the broker finally hands the transaction off to his or her principal. Rule 2821 now requires a principal to review and approve the transaction before sending the variable annuity paperwork to the insurer for processing no later than seven business days after the customer signs the application. In December 2007, FINRA announced that it is reconsidering the required timing of the principal review, so annuity principal review time limits have yet to be finally determined. Rule 2821 also requires that the principal only approve the transaction "if there is a reasonable basis that the transaction would be suitable based on the factors" listed above. This standard appears to require that the principal conduct a new suitability review for the customer and not just a review of the broker's suitability analysis. Rule 2821 places principals squarely in the line of fire. Reliance on what the broker told them does not appear to be much of a mitigating factor if the variable annuity was subsequently determined to be unsuitable. Rule 2821 also requires that the principals sign their approvals or disapprovals and that the broker-dealer document these reviews.

If the principal disapproves the transaction, Rule 2821 allows for the customer to be informed of the reason for disapproval. If the fully-informed customer still wants to pursue the variable annuity transaction despite being educated about the reasons for principal disapproval and affirms that to the principal, the principal may authorize the processing of the transaction as a not recommended transaction.

Rule 2821 Broker-Dealer Supervisory Requirements

Rule 2821 requires that broker-dealers have supervisory procedures specific to the rule beyond the general supervisory procedures required by Rules 3010, 3012, 3013, and 3110. First, Rule 2821 requires a special statistical review of variable annuity exchanges by broker. Broker-dealers will be required to implement systems where exchanges can be easily tracked by broker, and probably by office code. The rule requires broker-dealers to have "surveillance procedures" to discover if each of its brokers has levels or frequencies of variable annuity exchanges that "raise for review whether such rates of exchanges evidence conduct inconsistent with the

applicable provisions of this Rule, other applicable rules, or of the federal laws.” Second, Rule 2821 requires broker-dealers that their policies and procedures to include corrective measures to address inappropriate exchanges and broker conduct in connection with those inappropriate exchanges.

Finally, Rule 2821 requires that broker-dealers “develop and document specific training policies and programs” for the brokers and principals involved in recommending and approving variable annuity transactions to comply with this rule. Fundamentally this means that broker-dealers should provide mandatory training to these persons on Rule 2821 and its new suitability requirements and procedures. A broker or principal who fails to complete training in Rule 2821’s requirements should not engage in or approve variable annuity transactions until they have completed the training.

Delay in Principal Review and Supervisory Systems Rule

On April 17, 2008, FINRA announced that it was delaying the effective date of the principal review and supervisory system provisions of Rule 2821 until 180 days after changes to the rule have been approved by the SEC. This means that the effective date for the special principal review and supervisory systems for variable annuities will likely go into effect in the first half of 2009. The revisions will likely address what rules to apply to broker-dealers, such as solely on-line broker-dealers, that do not make any recommendations, permit the deposit of the customer’s funds for the annuity purchase in a suspense account at the insurance company pending principal approval, and modify the seven-day principal review requirement. But, the *de novo* principal suitability review and supervisory systems requirements will likely remain substantively unchanged.

Exception to Net Capital and Prompt Transmittal Rules

The seven-day principal review period in Rule 2821 caused the NASD and SEC to provide exceptions to several other rules. NASD Rule 2330 prohibits improper use of customer funds and NASD Rule 2820 requires the prompt transmittal of the variable annuity application and purchase payment. Consequently, Rule 2821 creates an exception to these rules. A broker-dealer may now hold a variable annuity application and a non-negotiated customer check for up to seven business days while

completing its Rule 2821 review without violating Rule 2330’s use of customer funds requirements or Rule 2820’s prompt transmittal requirement. Because FINRA is reconsidering the seven-day period in Rule 2821, the details may change in the future.

The SEC also amended the net capital rule, Rule 15c3-1 for those broker-dealers who do not carry customer funds or securities (i.e. those firms with less than a \$250,000 mandatory net capital.) Rules 15c3-1 and 15c3-3 provides that a firm need not create a customer reserve account if it “promptly transmits” checks or securities to third parties which means that the transmission or delivery of the check needs to be made by noon of the next business day after the receipt of those funds or securities. The SEC has amended its rules to exempt Rule 2821’s principal review period from its “promptly transmits” requirements. The SEC has required that the broker-dealer transmit the check no later than noon of the day following the date that the registered principal completed the review of the variable annuity transaction. The broker-dealer must also keep copies of the check and record the date the check was received and when it was transmitted to the insurance company or returned to the customer.

Suitability, Disclosure and Recordkeeping for Annuity and Life Insurance Switches Under New Texas Statutes

Under Texas state law all annuities have been governed by the Texas Department of Insurance. The Texas Securities Act specifically excludes registered annuity contracts, thus depriving the Texas Securities Commissioner and courts enforcing the Texas Securities Act from direct authority over annuities. Section 4.A of the Texas Securities Act specifically excludes from the definition of “security:” “any . . . annuity contract . . . issued by an insurance company subject to the supervision or control of the Texas Department of Insurance when the form of such policy or contract has been duly filed with the Department.”

Last session, the Texas Legislature passed two bills impacting the sale of annuity contracts and required suitability in annuity sales for the first time. These bills gave enforcement duties to the Texas Department of Insurance and did not provide private causes of action.

Annuity Suitability – HB 2761

First, HB 2761 creates a suitability requirement in the sale of annuities made after January 1, 2008. It adds Chapter 1115 to the Texas Insurance Code and applies to agent-recommended fixed, variable, and equity-indexed annuities, provided that the annuity was individually solicited. The chapter's applicability does not depend on whether the annuity was a group or individual annuity. *Texas Insurance Code §§1115.002(2) and 1115.003(a)*. Chapter 1115 exempts advertisements and other direct responses if no information was collected from the customer, contracts used to fund employee benefit or welfare plans covered by ERISA, 401(k) and similar plans, and government and church plans, nonqualified deferred compensation arrangements by the employer or plan sponsor, litigation or claim settlements, and prepaid funeral benefits. *Texas Insurance Code §1115.003(b)*.

Chapter 1115 requires that, before executing a recommended annuity purchase, the agent (or the insurer in a direct sale) must make reasonable efforts to obtain the purchaser's financial status, tax status, investment objectives, and other relevant information. Then the annuity recommended by the agent (or the insurer in a direct sale) must have "reasonable grounds for believing that the recommendation is suitable" for that purchaser based on the purchaser's other insurance, their investments, and financial situation and needs. *Texas Insurance Code §§1115.051(a) and (b)*. The "reasonable grounds" standard is based on the agent's (or insurer's if direct sold) actual knowledge at the time of the recommendation. *Texas Insurance Code §1115.051(d)*. The agent (or the insurer if direct sold) is absolved from responsibility if the purchaser refused to provide the relevant information, provided incomplete or inaccurate information, or entered into a non-recommended annuity transaction. *Texas Insurance Code §§1115.051(c)*. Finally, compliance with FINRA suitability rules will meet Chapter 1115's requirements for variable annuity recommendations. *Texas Insurance Code §1115.054*. But, compliance with FINRA record-keeping requirements does not necessarily fulfill the Chapter 1115's record-keeping requirements.

The actual knowledge and reasonable basis provisions will mean that compliance will be process-driven. The gathering of information and the reasonable basis for the recommendation will need to be well-documented. In light of this, Chapter 1115

also requires maintaining a detailed compliance system in connection with recommended annuity sales, including written procedures and periodic reviews of the agents' and insurers' records to detect patterns indicating unsuitable annuity sales. *Texas Insurance Code §§1115.052(a) through (c)*. Agents and insurers may contract with third parties to establish and maintain the compliance system, but must reasonably inquire as to whether the third party is fulfilling its duties and take reasonable actions to enforce the third party's contractual compliance duties. This reasonable inquiry requirement can be fulfilled by an annual certification or periodically selecting other third parties to review the first third party's compliance work. *Texas Insurance Code §1115.052(d)*. The review procedures shall be "reasonable under the circumstances" and do not require the review of all agent-solicited transactions or the extension of these compliance controls beyond recommendations of annuity products. *Texas Insurance Code §§1115.052(e) and (f)*. Insurers can request compliance certifications from their agents. *Texas Insurance Code §1115.053*.

Chapter 1115 requires that agents and insurers maintain records of annuity recommendations and the information used as the basis for the recommendations for five years. *Texas Insurance Code §1115.055*.

Chapter 1115 specifically states that it shall not be construed to create a private cause of action. It can only be enforced by the Texas Department of Insurance which can impose administrative sanctions and penalties and require that insurers and agents take specific corrective actions. *Texas Insurance Code §§1115.101 and 1115.102*. Although there is no private right of action, other states that previously adopted annuity suitability requirements have been aggressive in enforcing these provisions. Minnesota, particularly, has established a track record of annuity suitability actions under insurance law:

- Pacific Life Insurance Company – \$950,000 penalty – April 2005;
- Conseco Insurance – \$2.5 million penalty – April 2006;
- Met Life Investors USA Insurance Company – \$250,000 – December 2006;
- American Investors Life Insurance Company – \$1.4 million penalty – August 2007;
- Allianz Life Insurance Company of North America – Restitution to up to 7,000 purchasers and a \$500,000 fine – October 2007

- American Equity Investment Life Insurance Company – \$125 million in restitution and \$250,000 fine – February 2008; and
- AmerUs/American Investors – lawsuit filed in Hennepin County, Minnesota – February 2008.

Although Chapter 1115 authorizes no private right of action, the new recordkeeping requirements for the sale of each recommended annuity may provide fodder for litigators seeking other insurance-related causes of action, including damages actions for “an unfair or deceptive act or practice in the business of insurance.” *Texas Insurance Code §541.151*.

Annuity Disclosures – HB 2762

Second, HB 2762 adds Chapter 1114 to the Texas Insurance Code. Chapter 1114 generally provides that insurance agents and companies produce detailed compliance and disclosure paperwork to customers considering paying for a new annuity or life insurance policy with financing or proceeds from a previous annuity or life insurance policy. These switching transactions have been a special concern for regulators.

Chapter 1114 is a detailed disclosure-based, not a suitability-based regime. It provides that agents must submit a statement signed by both the agent and the applicant as to whether the proposed insured has existing policies or contracts as part of the application for a new life insurance policy or annuity. If the applicant states that there are existing policies or contracts, the agent must present the applicant with a required notice approved by the Insurance Commissioner that lists all the life insurance policies and annuities the applicant proposes replacing, the name of the insured or annuitant, and whether that policy will be used as a financing source for the new policy or contract. The applicant and agent both must sign the notice and attest that the notice was read aloud to the applicant or the applicant waived reading. The notice must be left with the applicant. If the notice is presented to the applicant via the Internet, the insurer must mail the applicant a copy of the notice within three business days of receiving the application. The agent must also leave with the applicant all sales materials used in presenting the new life insurance policy or annuity. *Texas Insurance Code §1114.051*.

On December 27, 2007, the Texas Insurance Commissioner issued new rules mandating that an insurance customer be read or waive reading a notice about replacing annuities or life insurance policies.

28 TX Admin Code §3.9504. The Commissioner also issued a mandatory notice for direct response consumer notices. *28 TX Admin Code §3.9505*. Any variations from these notices must be pre-approved by the Texas Department of Insurance. *28 TX Admin Code §3.9506*.

Chapter 1114 also imposes duties on insurance companies selling the replacement policy or annuity. The selling insurer must:

- Tell its agents about the Chapter 1114 notice and disclosure requirements and incorporate these requirements into all relevant training manuals;
- Provide each agent with a written statement on whether and under what circumstances it will accept applications for replacement policies;
- Review the “appropriateness” of each replacement policy;
- Implement procedures to ensure that the insurer meets these provisions;
- Implement procedures to detect replacement transactions involving policies or annuities issued by that insurer in considering new applications, regardless of whether the agent or applicant has disclosed the existence of that previous policy. *Texas Insurance Code §1114.052(a) – (c)*; and
- Provide notice of the proposed replacement to the original life insurer. *Texas Insurance Code 1114.053(c)*.

The Texas Department of Insurance has yet to issue regulations defining terms such as “appropriateness.” But, that term may lead to something similar to a suitability review requirement. However, the statute provides a large loophole to the “appropriateness” determination. If the agent tells the insurer that the replacement transaction is consistent with the insurer’s written statement on the circumstances under which it will accept applications for replacement policies, then the insurer need not review the “appropriateness” of the transaction. The statute appears to say that the insurer can rely entirely upon the agent’s representation. But, the Texas Department of Insurance may require something more than taking the agent’s blanket representation at face value.

Chapter 1114 also requires insurers to generally monitor their agents’ sales of life insurance policies and annuities and be able to produce records detailing:

- Each agent’s life insurance replacements, including financed purchases, as a percentage of the agent’s total annual life insurance sales;
- Each agent’s number of policy lapses by the agent as a percentage of the agent’s total annual life insurance sales;
- Each agent’s annuity replacements, including financed purchases, as a percentage of the agent’s total annual annuity contract sales;
- Number of transactions that are unreported replacements of existing life insurance policies or annuity contracts detected by the insurer’s required monitoring system; and
- Replacement life insurance policies and annuities indexed by agent and previous insurer.

Chapter 1114 requires that insurers maintain these records for at least five years. *Texas Insurance Code §1114.052(d)*. The new statute also requires that insurers “ascertain” that the sales materials and illustrations used in replacement life insurance policy and annuity sales are “complete and accurate for the proposed policy or contract” and that the insurer maintains these records for five years. *Texas Insurance Code §1114.052(g) and (h)*. The insurer has some further compliance requirements for customers who come from “direct response solicitations” which include endorsers or sponsors and all forms of advertising. *Texas Insurance Code §§1114.002(2) and 1114.055*.

Finally, Chapter 1114 imposes certain duties on the insurers who issued the policies or annuities being replaced. Upon receipt of a notice of replacement by the insurer issuing the replacement life insurance policy or annuity, the previous insurer must provide a notice to the policy or contract owner about the owner’s right to receive information about the existing policy and contract values. The notice must include an in force illustration or a policy summary. *Texas Insurance Code §1114.054(c)*. The previous insurer must also provide the customer with a notice stating that “the release of policy values may affect the guaranteed elements, nonguaranteed elements, face amount, or surrender value of the policy from which the values are released.” *Texas Insurance Code §1114.054(d)*. These previous insurers must also preserve for five years all received replacement notifications received from the insurers issuing the replacement life insurance policies or annuities. *Texas Insurance Code §1114.054(b)*.

Chapter 1114 provides that the failure of insurers and agents to comply with its provisions “constitutes a

violation of Chapter 541 and is subject to sanctions and penalties as provided by that chapter.” *Texas Insurance Code §1114.101(a)*. Note that this language omits the word “damages.” Chapter 541 of the Texas Insurance Code provides that the Texas Department of Insurance can bring administrative actions for violations of the Texas Insurance Code’s provisions that can lead to sanctions and penalties. It also provides for a private cause of action for “damages.” *Texas Insurance Code §541.151*. This means that the Chapter 1114 does not create any claims for general damages by reference to Chapter 541. But, in litigation a plaintiff’s attorney could well argue an insurer’s failure to comply with Chapter 1114’s notice requirements is generally indicative of an “unfair method of competition or an unfair or deceptive act or practice in the business of insurance.” *Texas Insurance Code §541.151*.

Chapter 1114 also provided that, “if it is determined that the requirements of this chapter have not been met,” the insurer issuing the new life insurance policy or annuity shall provide the policy owner an in force illustration, policy summary, or available disclosure document and the required notice regarding replacements. *Texas Insurance Code §1114.001(c)*. The statute did not say who was required to make that determination. In any event, the only remedy provided for that violation to the policy owner is the requirement that the policy owner receive the required disclosures and notice.

The Texas Department of Insurance may seek extensive administrative remedies for violations of Chapter 1114. In addition to the penalty and sanction provisions of Chapter 541, the Texas Department of Insurance can seek to revoke or suspend an agent’s license or certificate of authority and forfeit commissions or other compensation paid to an agent. *Texas Insurance Code §1114.102(a)*. Violations that were material to the sale may also lead to an order requiring payment of restitution, restoration of the policy or contract values, and interest payments. *Texas Insurance Code §1114.102(b)*.

In connection with both recommended annuities and life insurance policy and annuity switches, it should be noted that if these activities are done by a FINRA-registered broker-dealer, the purchaser may have claims to enforce under FINRA suitability rules applicable to the broker-dealer and these new record-keeping requirements could provide ammunition for such claims.

FROM THE OTHER SIDE OF THE DESK

By: Sue Noble, Paralegal Specialist – Blue Sky/Securities
Bingham McCutchen LLP

One who asks a question is a fool for five minutes; one who does not ask a question remains a fool forever. Ancient Chinese Proverb

We learn more by looking for the answer to a question and not finding it than we do from learning the answer itself. Lloyd Alexander

When someone says, That's a good question, you can be sure it's a lot better than the answer you're going to get. Unknown

For you lucky readers who are not involved at all with private placements, the current “TOPIC A” is the SEC’s mandate for electronic filing of Form D, used by vast numbers of issuers to report sales of securities in reliance on SEC Regulation D. It would be entirely possible to fill up this column with nothing but questions, none of which would bear on TOPIC A, or to fill it up entirely with an incomplete list of questions that are solely related to TOPIC A. Both approaches seem equally unproductive.

Instead of asking questions and not answering them, I’m simply going to take this opportunity to let all of you know that among the many interesting presentations planned for the NASAA 2008 Fall Conference in Las Vegas (September 15-17) are at least two that should cast a good deal of light on TOPIC A. NASAA has graciously made space available to the paralegals and to subcommittees of the ABA Committee on State Regulation of Securities, and that space will be heavily utilized this year.

The Paralegal Roundtable, scheduled for 8:00 a.m. on Monday, September 15, will include (in addition to the ever-popular Year in Review) a presentation relating to conversion of “paper filers” to electronic filers (very briefly touched on in the Spring issue of The Blue Sky Bugle), and a report by a member of the NASAA Regulation D Electronic Filing Committee. Be the first on your block to find out the current status of the NASAA project!

In addition, the ABA Subcommittee on NSMIA and Limited Offering Exemptions and members of the Paralegal Roundtable will discuss electronic Form D and related issues in a joint meeting presently

scheduled for 8:00 a.m. on Tuesday, September 16. Participants are expected to include several paralegals, including the undersigned; Martin Hewitt and Mike Liles, the co-chairmen of the subcommittee; Gary Emmanuel, who coordinated responses and (with Carmen Gaspero) drafted the ABA Committee’s response to the Form D proposal; and last (but very far from least), Gerry Laporte, Chief of the SEC Office of Small Business Policy.

Participants, times and locations may be subject to change, so be sure to watch the NASAA web site for updated information. Better still, plan on attending the Conference and sharing your knowledge.

The views expressed in this article are those of the author and do not necessarily reflect those of Bingham McCutchen LLP.

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EDITORIAL

By: Martin A. Hewitt
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“It was the best of times, it was the worst of times; it was the age of wisdom, it was the age of foolishness; it was the epoch of belief, it was the epoch of incredulity; it was the season of Light, it was the season of Darkness; it was the spring of hope, it was the winter of despair; we had everything before us, we had nothing before us; we were all going directly to Heaven, we were all going the other way.” – Charles Dickens.

This quote was used in the last edition of the Blue Sky Bugle and it seems nothing and everything has changed since then. Today’s topic is what keeps practitioners awake at 3:00 A.M.

The obvious answer is the biggest cloud over otherwise Blue Sky which is the coming of electronic filing of Form D. There are many more questions than answers at this point. What do we tell our clients and when? Depending on by which date first sale is measured compliance will be problematic at best and fairly impossible at worst. Also, what are we as practitioners to do regarding filing with the SEC as well as any applicable states? As is well known by now, only one state – Washington – has even addressed the issue. Mechanically, there is no system in place by which filings can be made efficiently. On the federal, level filing electronically will be phased in over a six-month period starting on

a voluntary basis in mid-September of 2008 and becoming mandatory in mid-March 2009. Meanwhile, there is no indication that any of the 50 states or four territories will be able to accept electronic filings anytime during the remainder of this decade. The computer programmers will be hard pressed to roll out a coordinated electronic filing system within the foreseeable future. There are many more outstanding issues, but there are other 3:00 A.M. concerns to be addressed.

Perhaps one of the biggest concerns among practitioners is the attempt to respond to comment letters issued by states in a variety of situations only to find the author of a comment letter to be unresponsive regarding answers to such letters. There have been several instances reported by practitioners in which phone calls to regulators have not been returned and written responses ignored resulting in situations in which clients have been left in legal limbo. Communication is of paramount importance between practitioners and the states.

There is also concern that, from time to time, the opportunity to comment on pending regulatory matters has been severely diminished because either a state has not published such notices seeking comment or such notices have not been timely relayed by CCH. An efficient solution would be for such notices to be posted on the NASAA website on the release date or within a short period of time thereafter. Another possible solution would be to ask each state to forward the request for notice and comment directly to the listserv used by our Committee. If practitioners were provided ample opportunity to comment, the potential for unintended consequences would be greatly reduced which would greatly benefit the investing public.

Moving to other matters, we would like to thank the many contributors to this edition of the Blue Sky Bugle. In particular, John English, a summer associate at Cadwalader, Wickersham and Taft LLP has written a first rate article and we thank him for his efforts and wish him well as he returns to Seton Hall University School of Law and gets married on August 8, 2008. We would also like to congratulate Ellen Lieberman, both on the birth of her grandchild and on the completion of her successful three-year term as chair of the Committee. We look forward to the next three years under the leadership of Alan Parness.

Please note that we are always looking for articles for upcoming editions of the Blue Sky Bugle. The next

deadline is Halloween (October 31) and we hope that the spirit will move you to write an article. If so, please forward your articles to martin.hewitt@cwt.com.

Finally, as we do in every edition of the Blue Sky Bugle, we present below a timely photograph involving our Blue Sky community. Below is a picture of the latest Blue Sky Baby with her proud grandmother and outgoing Chair of the Committee, Ellen Lieberman.



Blue Sky Baby and Grandma

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