
THE BLUE SKY BUGLE

A Newsletter for Blue Sky Lawyers

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EVENTS CALENDAR

ABA BUSINESS LAW SPRING MEETING

The Committee and its Subcommittees will meet in conjunction with the 2009 Spring Meeting of the ABA Business Law Section at the Pan Pacific Vancouver Hotel Vancouver, British Columbia April 16-18, 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 the North American Securities Administrators Association Sheraton Hotel Denver, Colorado September 13-16, 2009

ABA BUSINESS LAW SPRING MEETING

The Committee and its Subcommittees will meet in conjunction with the 2010 Spring Meeting of the ABA Business Law Section Denver, Colorado April 22-24, 2010

ABA ANNUAL MEETING

The Committee and its Subcommittees will meet in conjunction with the ABA Annual Meeting of the ABA Business Law Section August 6-9, 2010

NASAA 2010 FALL CONFERENCE

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

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BLUE SKY BITS AND PIECES

By: *Ellen Lieberman*
Debevoise & Plimpton LLP

Richard G. Ketchum was named Chairman and Chief Executive Officer of the Financial Industry Regulatory Authority, Inc. (FINRA), succeeding new SEC Chair **Mary Schapiro**. Rick is also chairman of the World Federation of Exchanges' regulatory committee and previously served as Chief Executive Officer of NYSE Regulation, Inc., as first chief regulatory officer of the New York Stock Exchange, as General Counsel of the Corporate and Investment Bank of Citigroup Inc., as Presidents of the NASD

and The Nasdaq Stock Market, Inc., and as Director of the SEC's Division of Market Regulation. **Steve Luparello**, who had served as FINRA's Interim Chief Executive Officer, became Vice Chairman of FINRA's Board of Directors with oversight of FINRA's regulatory operations.

Other changes at FINRA include the naming of **Joseph Price**, who had been Vice President and Director of FINRA's Corporate Financing Department, as a Senior Vice President with responsibility for both the Advertising Regulation and Corporate Financing Departments. **Paul Mathews**, a FINRA Vice President, became the new Director of FINRA's Corporate Financing Department.

Martin A. Hewitt, Editor of the Blue Sky Bugle and Co-chair of our Subcommittee on NSMIA and Limited Offering Exemptions, has joined the firm of Lowenstein Sandler PC as Counsel in its Roseland, New Jersey office. Martin's practice is focused on blue sky law, FINRA issues, Regulation D and Rule 144A offerings, Section 16 reporting requirements and other securities law matters.

Deborah Froling, a partner in the Washington, D.C. office of Arent Fox, was honored by the National Association of Women Lawyers (NAWL), receiving the organization's Special Recognition Award for advancing the role of women in the legal profession. Deborah has served on NAWL's Executive Board for four years, as the Board's corresponding secretary for two years, and as editor of its *Women Lawyers Journal*. Deborah serves as our Committee's Liaison on TICs and Other Real Estate Related Securities Issues and Liaison to the NASAA Corporate Finance Section.

Erik R. Sirri, Director of the SEC's Division of Trading and Markets since 2006, is leaving the SEC in April 2009 to return to teaching; he was previously a finance professor at Harvard Business School and Babson College, and Chief Economist of the SEC from 1996 to 1999. Sirri implemented the SEC's new authority over credit ratings agencies, disclosure rules for municipal securities and Regulation SHO relating to share delivery requirements, as well as the establishment of central counterparties for over-the-counter derivatives. In February Deputy Director of the Division of Trading and Markets, **Robert L.D. Colby**, left the SEC after 27 years to join the law firm of Davis Polk & Wardwell. Also departing from the SEC, **Linda Chatman Thomsen** stepped down as Director of the Division of Enforcement and

was succeeded by **Robert Khuzami**. Khuzami most recently served as General Counsel for the Americas at Deutsche Bank AG and formerly for 11 years as a federal prosecutor with the United States Attorney's Office for the Southern District of New York with three years as its Chief of the Securities and Commodities Fraud Task Force. Enforcement actions led by Thomsen included the Enron investigation and resulting actions against a number of large financial institutions including Citigroup, JPMorgan Chase, and Merrill Lynch, auction rate securities market settlements, subprime and financial fraud cases, stock option backdating cases, and expanded enforcement of the Foreign Corrupt Practices Act including the recent Siemens settlement (which also involved cooperative enforcement with foreign regulators) and the "Oil for Food" cases.

FROM THE CHAIR – RANDOM RANTS AND RAVES

By: Alan M. Parness

Cadwalader, Wickersham & Taft LLP

More on Electronic Form D and Rule 506 Notice Filing Issues

As readers of the *Bugle* are well aware, the SEC has revised Regulation D under the Securities Act of 1933 (the "1933 Act"), so as to change Form D and require the mandatory electronic filing of that form through the SEC's EDGAR system, effective March 16, 2009. See SEC Securities Act Rel. No. 33-8891 ("Release 33-8891"), reprinted at 73 Fed. Reg. 10592 (Feb. 27, 2008). As reported *ad nauseum* via the Committee's Listserv, there seems to be no end to the glitches filers have encountered in filing their Form D's via EDGAR (whether due to the way the SEC's system is designed, due to the failure of filers to follow the SEC's instructions, or both). Further, despite the Item-by-Item Instructions in Form D and the release by the staff of the SEC's Division of Corporation Finance of updated "Compliance & Disclosure Interpretations" concerning Regulation D and Form D [see Sections 254-260, 655, 656, and 659 of the "Securities Act Rules" C&DIs (last updated Jan. 26, 2009), available from the SEC's website at www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm, and Section 130 of the "Securities Act Forms" C&DIs (last updated Feb. 27, 2009), available from the SEC's website at www.sec.gov/divisions/corpfin/guidance/safinterp.htm], there still appear to be interpretive issues

concerning how to respond to certain questions of the new electronic version of Form D. I'm reasonably confident, however, that filers will ultimately get used to the new system and how to respond to the new Form, the technical kinks resolved, and filings made in the fashion envisioned by the SEC.

While I'm optimistic about the future of electronic Form D filings on the SEC side, I'm not overly encouraged by the developments to date on the state side. Reiterating my last column for the *Bugle*, Part I.B.3 of Release 33-8891, *Id.* at 10593-10594, discussed the prospects that the electronic filing of Form D will "promote uniformity and coordination between federal and state securities regulation," and the potential creation of a "one-stop filing" system for Form D with the SEC and the states. However, the SEC clearly proceeded with its plans for an electronic filing system before the states could set up their counterpart system. Further, since neither the SEC nor the Financial Industry Regulatory Authority ("FINRA") leaped at the opportunity to set up and maintain a system for the states, the states, working through the North American Securities Administrators Association ("NASAA"), are reportedly working at creating their own electronic system to receive filings and collect fees on behalf of the individual states, in similar manner to the CRD and IARD systems maintained by FINRA for broker-dealer, agent, investment adviser, and investment adviser representative registrations with the states. According to a chart of committee assignments at NASAA Reports (CCH) ¶ 221, Michael Stevenson of Washington state and Jack Herstein of Nebraska are co-chairs of NASAA's "Regulation D Electronic Filing Committee," charged with the responsibility of establishing the state system.

Unfortunately, the March 16, 2009 due date for mandatory electronic Form D filings with the SEC has come and gone, with no report of any real progress in creating a state filing system. Further, I believe that full state participation cannot be assured until each state has confirmed that its applicable laws and rules authorize filings and payment of filing fees through such a system, something that I suspect will not be achieved any time soon, particularly if legislative action is deemed necessary, given the fact that certain state legislatures seem to meet on a sporadic basis and securities law amendments don't seem to be high priority items, and as further evidenced by the dilatory manner in which rules are adopted by certain states.

While some states have adopted or proposed rules, orders, or policy statements to deal with the new electronic Form D regime, I note that there is little uniformity to such actions, and I've seen or heard reports from Committee members of inconsistent practices among the states, such as: (1) accepting the built-in consent to service of process in electronic Form D, or insisting that issuers continue to file a separate Form U-2; (2) accepting a copy of electronic Form D with an electronic signature, or insisting on receiving a manually-signed copy; (3) requiring issuers to file the Appendix pages from the now-repealed paper version of Form D (such a requirement would appear to be clearly preempted by 1933 Act § 18(c)(2)(A) once an issuer has converted to electronic filing status or has only filed in electronic format with the SEC); and (4) asking issuers to separately state the date of first sale in the particular state.

Unfortunately, there also appear to be some states that persist in asking all Rule 506 filers to submit copies of their offering materials (such requests phrased in terms of a demand or a request for "voluntary" compliance), a practice that should be clearly preempted by reason of 1933 Act § 18(c)(2)(A), so long as Rule 506 issuers' offering materials are not filed with the SEC and there is no legitimate basis for an investigation of the offering in accordance with the state-preserved antifraud authority under 1933 Act § 18(c)(1). I believe the legislative history of the amendments to 1933 Act § 18 by the National Securities Markets Improvement Act of 1996 ("NSMIA") makes clear that a state may not use its authority under § 18(c)(1) to engage in "fishing expeditions" to review offering materials, and that any such activities are proscribed by 1933 Act § 18(a). In this regard, I offer special kudos to David Weaver, General Counsel of the Texas State Securities Board, who has embarked on a crusade to encourage uniformity among the states in their handling of Rule 506 notice filings.

Irrespective of filing problems on the state level since the advent of electronic Form D, I also note that the states, acting through NASAA, have cranked up the volume in their ongoing battle against NSMIA preemption, with Rule 506 offerings a particular target. Thus, for example, see the remarks by Fred Joseph, NASAA President, at a January 29, 2009 news conference, reprinted at NASAA Reports (CCH) ¶ 18,184 at p. 17,630:

Even though [Rule 506] securities do not share the essential characteristics of the other national securities offerings addressed in NSMIA, Congress nevertheless blocked the states from subjecting them to regulatory review even where the promoters or broker-dealers have a criminal or disciplinary history. These offerings also enjoy an exemption from registration under federal securities law, so they receive virtually no regulatory scrutiny. As a result, Rule 506 offerings have become the favorite vehicle under Regulation D, and many of them are fraudulent.

Although Congress preserved the states' authority to take enforcement actions for fraud in the offer and sale of all "covered" securities, including Rule 506 offerings, this power is no substitute for a state's ability to scrutinize offerings for signs of potential abuse and to ensure that disclosure is adequate before harm is done to investors.

In light of the growing popularity of Rule 506 offerings and the expansive reading of the exemption given by certain courts, NASAA believes the time has come for Congress to reinstate state regulatory oversight of all Rule 506 offerings by amending the Securities Act of 1933.

There is no doubt that there are some fraudulent Rule 506 offerings, as there are fraudulent offerings sold pursuant to other exemptions from the 1933 Act and Blue Sky laws, as well as fraudulent offerings registered under the 1933 Act and Blue Sky laws. However, while I can't attest to conducting my own statistical survey, I take issue with Mr. Joseph's characterization that "many" Rule 506 offerings are fraudulent. First, it seems odd to me that a real crook would want to file a Form D and thereby put the SEC and state regulators on notice of a fraudulent offering, thereby creating the potential for an inquiry into the deal. Rather, I would guess that many, if not most, of the fraudulent offerings Mr. Joseph is speaking of actually operated "below the radar," with the issuer making no regulatory filings, and perhaps, at best, giving lip service to compliance with Rule 506 in its offering materials, without ever really attempting to comply with the Rule. If the NASAA folks could provide real statistics to support their position as to how many notice filings they received for Rule 506 offerings which proved to be fraudulent, I'd like to see that proof.

Second, Mr. Joseph's claim to the contrary, since certain principals and promoters of a Rule 506 issuer, as well as its placement agents, must be identified in Form D, the states have always had the opportunity to run a background check through the CRD, Google, or any other database to determine whether any of those persons had a "criminal or disciplinary history," and, upon discovering any such "history," could have used their authority under 1933 Act § 18(c)(1) to investigate and pursue the issuer for fraud if it is determined that the particular individual's nefarious history was material to investors and wasn't disclosed to them. While the presence of a principal, promoter or placement agent of an issuer with a criminal or disciplinary history is not a per se disqualification from use of Rule 506 or reliance on "covered securities" status under 1933 Act § 18(b)(4)(D) [compare Rule 505(b)(2)(iii) of Regulation D], a determination that the failure to disclose any such person was an omission of a fact material to investors could result in loss of the Rule 506 exemption by reason of non-compliance with the disclosure requirements of Rule 502(b) of Regulation D, in turn leading to loss of state preemption and claims for sale of unregistered securities under both the 1933 Act and applicable Blue Sky laws (to say nothing of claims under antifraud provisions).

Since NASAA seems to be pressing for a return to the good old pre-NSMIA days, I note that, historically, pre-NSMIA, most states had (and most continue to have) at least one form of private placement exemption from registration in their statutes and/or rules, with a wide variety of disparate conditions, including a requirement to make a pre-offer or pre-sale filing to perfect the exemption. While a number of such exemptions included an obligation to submit copies of offering materials for review, from my experience (which I grant may not be typical of all filers), few states ever examined or commented on such materials or otherwise raised questions about the terms of the offering or the promoters or placement agent involved, at most focusing on whether the applicable state forms were properly completed and the applicable filing fee paid, and perhaps confirming that the offering materials included an idiosyncratic state legend or disclaimer mandated by the particular exemption (frankly, considering that these were exemption filings, and not registrations, the states did, in fact, handle these filings appropriately!). It was this convoluted, time-consuming, and expensive process (and, remember that the costs of Blue Sky compliance typically are paid by the issuer, meaning that investors are

ultimately footing the bill) that was a driving force behind the inclusion of Rule 506 offerings as “covered securities” in NSMIA, particularly because of the detrimental effect this lack of uniformity among the states had on small businesses attempting to raise capital. In this connection, it is somewhat ironic that, subsequent to the enactment of NSMIA, NASAA endorsed the 2002 version of the Uniform Securities Act, Section 202(14) of which includes a simple self-executing exemption for a private offering by an issuer to not more than 25 purchasers in the state during any 12 consecutive months (excluding from the numerical limit certain institutional investors covered by the Section 202(13) exemption).

Finally, while a number of old state private placement exemptions included so-called “bad boy disqualifications,” in most cases premised on the “Uniform Limited Offering Exemption,” reprinted at NASAA Reports (CCH) ¶ 6201, I believe that a determined fraudster or even a careless issuer could deliberately or inadvertently circumvent such provisions by failing to perform the due diligence necessary to identify any “bad boys,” or, having done so or otherwise being aware of any such persons, by simply not identifying those persons or the disqualifying events in their pre-offer or pre-sale filings with the states. Further, this process will not stop a person with a clean record and whose first Rule 506 offering is his entrée into badboydom. Given such possibilities, can the states really provide any assurance that reinstating “bad boy disqualifications” for Rule 506 issuers, or some other form of pre-offer or pre-sale vetting process, will truly prevent use of the exemption by future Bernie Madoff wannabes? In any event, I still believe that the real crooks out there generally don’t file anything with the SEC or any state, so that reimposing a more arduous filing process will by and large penalize the honest and compliant issuers.

STANDING IN THE BREACH—STATE LAW REQUIREMENTS WHEN A CUSTOMER DATA BREACH OCCURS

By Shane B. Hansen and Jordan Paterra
Warner Norcross & Judd LLP

Safeguarding the customer information in your firm’s possession is not just a good business practice, it is

required under federal law and related rules.¹ One year ago, the Securities and Exchange Commission (“SEC”) published for comment proposed amendments to Regulation S-P, Privacy of Consumer Financial Information and Safeguarding Personal Information,² that would expand upon those requirements and impose specific obligations upon firms when a breach of their data security occurs.³ The SEC’s adoption of these requirements is not an “if,” but a “when.” The federal banking regulators jointly adopted the Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice that is applicable to banks in March 2005.⁴ Safeguarding customer information and preventing identity theft are among the SEC’s and FINRA’s regulatory priorities for 2009.⁵ Firms are presently grappling with their implementation of the “Red Flag” rules, effective May 1, 2009, promulgated by the Federal Trade Commission⁶ which are generally applicable across industry boundaries.⁷ But your challenges do not end with federal privacy laws and related rules.

Forty-four states have filled a perceived gap in consumer protection by requiring notification of

¹ Gramm-Leach-Bliley Act, 15 U.S.C. § 6801, et seq.; *see also* Financial Privacy Act, 12 U.S.C. § 3401, et seq.; Fair Credit Reporting Act, 15 U.S.C. § 1681, et seq.; the Health Insurance Portability and Accountability Act of 1996, Public Law 104-191; and 2 Richard L. Fischer, *The Law of Financial Privacy* § 5.01 (2007).

² Part 248 – Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Personal Information, Release Nos. 34-57427; IC-28178; IA-2712; File No. S7-06-08 (3-4-08).

³ For a discussion of the SEC’s proposed amendments, *see* NSCP Currents, April/May 2008, *The Price of Protecting Privacy—Proposed Regulation S-P Amendments*, by Shane B. Hansen.

⁴ *See* www.occ.treas.gov/consumer/Customernoticeguidance.pdf.

⁵ *See* FINRA’s 2009 exam priorities letter at <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p118113.pdf> and the SEC’s CCO Outreach National Meeting Agenda at <http://www.sec.gov/info/bdccc outreach.htm>.

⁶ The FTC and the federal banking regulators issued joint regulations implementing Sections 114 and 315 of the Fair and Accurate Credit Transactions Act of 2003 (FACT Act) www.ftc.gov/os/fedreg/2007/november/071109redflags.pdf.

⁷ For broker-dealers, *see* FINRA Regulatory Notice 08-69 *Fair and Accurate Credit Transactions Act of 2003*. Besides banking institutions, the term “financial institution” includes “any other person that, directly or indirectly, holds a transaction account . . . belonging to a consumer.” 16 CFR 681.2(b)(7); 15 U.S.C. § 1681a(t).

security breaches under various circumstances.⁸ Twenty-nine of these state laws contain exceptions or safe harbors for firms that are subject to, and/or comply with, federal privacy laws and related rules promulgated by their primary federal regulator.⁹ The contours of these exceptions and safe harbors vary among the states and some appear to depend upon the SEC's final adoption of rules requiring security breach notifications. Fifteen states' laws do not contain exceptions or safe harbors based on compliance with an SEC rule. Forty-seven states have enacted "security freeze" laws allowing customers to freeze their credit reports in the event of a security breach.¹⁰

State security breach statutes impose similar, yet somewhat inconsistent, obligations on firms for reporting data breaches.¹¹ If a firm services customers in multiple states, then it will be forced to follow differing state laws and reporting obligations to different customers—a daunting task when a firm may service customers in many or all fifty states. Many, many questions arise once you start digging into these state breach notification laws. Federal privacy laws and related rules do not preempt these state laws.

Does your firm have to report data breaches?

The first question should be an easy one, yet, even with this threshold question, different states require different persons to report data breaches. California was among the first to address these

issues.¹² A majority of states follow California's reporting approach, which requires any firm that conducts business in California to report a data breach if that firm owns, licenses, or maintains data that is covered by the law ("covered data"). Some states have added their own spin to California's approach. They require any person, whether or not conducting business within the state, to report a data breach if that person owns, licenses, or acquires covered data regardless of where the individual described in the data resides if the state has any basis to assert its jurisdiction.¹³ Other states are more clearly focused on protecting their own citizens and require a data breach to be reported if the person owns or licenses computerized data that includes personal information of an individual residing in the state.¹⁴

Several states also require that "data collectors" or any person that, for any purpose, handles, disseminates, or otherwise deals with nonpublic personal information report data breaches.¹⁵ Some states require any person that deals with personal information to report a data breach.¹⁶ Hence, more than one state's law may apply and more than one person with responsibility for the data (a "covered person") may have a reporting obligation for the same data breach.

What is "personal information"?

State breach notification statutes defining "personal information" have an assortment of terms affecting the scope of breach notification requirements. The California statute is the model for most states. The California statute defines "personal information" as a combination of a first name, or first initial and last name, in combination with any one or more of the following data elements, when either the name or data elements are not encrypted: social security number; driver's license number or state

⁸ See National Conference of State Legislatures website for a list and links with the states at: <http://www.ncsl.org/programs/lis/cip/priv/breachlaws.htm>. States with no security breach law include Alabama, Kentucky, Mississippi, Missouri, New Mexico, and South Dakota.

⁹ The following 15 states' breach notification laws do not contain an exception or safe harbor for compliance with federal law or related rules governing data breaches: California, District of Columbia, Georgia, Illinois, Louisiana, Montana, New Jersey, New York, North Carolina, North Dakota, Ohio, Oklahoma, Texas, Vermont, and Washington. See also New York City ordinances.

¹⁰ http://www.consumersunion.org/campaigns/learn_more/003484in_div.html (last visited March 10, 2009).

¹¹ See, for example, *Navigating Some Uncertain Waters in Michigan's New Security Breach Notification Law*, Norbert F. Kugele and James Placer (July 2007) at: http://www.wnj.com/nfk_privacy_and_data_security_law_journal_article_july_2007/

¹² Cal. Civ. Code §§ 1798.80-1798.84 (2007 Supp.). California was the first state to create an agency devoted to consumer privacy issues, the California Office of Information Security and Privacy Protection, on the Internet at http://www.oispp.ca.gov/consumer_privacy/default.asp.

¹³ See, e.g., Ark. Code Ann. §§ 4-110-101 to -108 (2007 Supp.).

¹⁴ See, e.g., Md. Code Ann., Com. Law § 14-3501 to -3508 (2007 Supp.).

¹⁵ See, e.g., 815 Ill. Comp. Stat. 530/1 to /30 (2007 Supp.); Vt. Stat. Ann. tit. 9, § 2430 to -2435 (2006).

¹⁶ See, e.g., Mass. Gen. Laws 93H § 1-6 (2007); 2007 Or. Laws 759.

identification number; or account number, credit or debit card number in combination with any required security code, access code, or password permitting access to an individual's financial account. California has amended this definition to also include medical and insurance information. California does not consider "personal information" to include any information available to the general public from federal, state, or local government records.¹⁷ Other states expand their definition to include the following as "personal information": medical information; middle name; or information sufficient to perform identity theft.¹⁸ Some states follow California and do not consider publicly available information as "personal information," while other states do not have such an exception in their definitions.¹⁹

Does your firm have an affirmative obligation to protect data?

Depending on the state in which your firm does business, or where your customers reside, your firm may have an affirmative obligation to protect data.²⁰ States vary in this affirmative obligation. California does not impose an obligation to protect data while other states require reasonable measures to protect against unauthorized access, while still other states require reasonable security measures and an affirmative obligation to destroy customer records after use.²¹ Some states do exempt financial institutions (not always defined the same way) from an obligation to use reasonable measures to destroy

customer records after use,²² but federal law and related rules impose similar obligations.²³

What constitutes a breach?

The way a state statute defines "breach" of data and what the statute requires of a firm once a breach has occurred often leads to inconsistent reporting obligations for a firm. A data breach in one state may not be a data breach in another state. As a result, a firm would have to report what one state defines as a data breach to customers only of that state, when, in actuality, the data breach could have impacted more customers in different states. Firms may choose to report data breaches to some customers in some states, even when not required, for simplicity and consistent treatment of all customers.

Again California serves as the model for many states. California defines a "breach" as the unauthorized acquisition of computerized data that compromises the security, confidentiality, or integrity of personal information maintained by a firm.²⁴ This approach focuses on the recipient, rather than the loss of data by the firm or its agents. As a variation of the California model, some states define a breach as access and acquisition of covered data that is reasonably likely to cause substantial economic loss to an individual or is not likely to cause reasonable harm after an investigation.²⁵ Other states require that the breach be a "material" compromise of the data in combination with an unlawful acquisition by the recipient.²⁶

Does it matter that your data is in paper or electronic formats?

A majority of states require covered persons to report breaches involving unencrypted computerized personal information or a variation of this type of data.²⁷ Other states apply a broader approach to covered data, requiring persons to report data breaches not only of computerized personal

¹⁷ Cal. Civ. Code §§ 1798.80-1798.84 (2007 Supp.).

¹⁸ See, e.g., Ark. Code Ann. §§ 4-110-101 to -108 (2007 Supp.); Fla. Stat. ch. 817.5681 (2006); Ga. Code Ann. §§ 10-1-910 to -912 (2007 Supp.).

¹⁹ See, e.g., Ark. Code Ann. §§ 4-110-101 to -108 (2007 Supp.).

²⁰ See, e.g., Code of Massachusetts Regulations at 201 CMR 17.00, "Standards for the Protection of Personal Information of Residents of the Commonwealth," effective in three stages starting on 1/1/2009, issued under Massachusetts General Laws chapter 93H, which addresses information security breaches.

²¹ See, e.g., Haw. Rev. Stat. §§ 487N-1 to -4 (2007 Supp.); Md. Code Ann.; Com. Law § 14-3501 to -3508 (2007 Supp.) (requiring reasonable measures to protect against unauthorized access); Ark. Code Ann. §§ 4-110-101 to -108 (2007 Supp.); Mont. Code Ann. § 30-14-1704 (2007); Nev. Rev. Stat. § 603A.220 (2007 Supp.) (requiring reasonable security measures and an affirmative obligation to destroy customer records after use).

²² See, e.g., Tex. Bus & Com. Code Ann. § 48.103 (2007 Supp.); Utah Code Ann. § 13-44-101 (2007 Supp.).

²³ Financial Privacy Act, 12 U.S.C. § 3401, et seq.; Fair Credit Reporting Act, 15 U.S.C. § 1681, et seq.; Gramm-Leach-Bliley Act, 15 U.S.C. § 6801, et seq.

²⁴ Cal. Civ. Code §§ 1798.80-1798.84 (2007 Supp.).

²⁵ See, e.g., Ariz. Rev. Stat. § 44-7501 (2007 Supp.); Ark. Code Ann. §§ 4-110-101 to -108 (2007 Supp.).

²⁶ See, e.g., Fla. Stat. ch. 817.5681 (2006).

²⁷ Cal. Civ. Code §§ 1798.80-1798.84 (2007 Supp.).

information, but computerized data transferred to a different medium, such as paper; and other states also require data breach notification even of written, drawn, spoken, visual, or electromagnetic information.²⁸ States also differ with respect to whether breach notification is required when the data is in an unencrypted form or when encrypted with an encryption key. Some states require persons to report all forms of breached data.²⁹

What notification is required?

After a breach has occurred, California requires a firm to notify a California resident whose unencrypted personal information was, or is reasonably believed to have been, acquired by an unauthorized person.³⁰ Other states do not have such a state specific notification law requirement. Where a breach has occurred, some states require firms to notify “affected individuals,” with no limit as to whether the individuals reside in a specific state.³¹ Some state statutes do not require notification if there is no reasonable likelihood of harm to customers after an investigation, while other states require firms to notify customers upon discovery or knowledge of a breach regardless of its potential impact on them.³²

How quickly does your firm have to report?

State statutes also determine the timeliness in which your firm must notify your customers. Although California requires you to notify your customers in the most expedient time possible and without unreasonable delay, generally within 10 days, California also allows your firm to delay if a law enforcement agency determines that the notification would impede a criminal investigation.³³ Other states do not require the “most expedient time possible” while others allow for a delay of notification to restore the integrity of the data

²⁸ See, e.g., Haw. Rev. Stat. §§ 487N-1 to -4 (2007 Supp.); Ind. Code §§ 24-4.9-1-1 to -3-4 (2006).

²⁹ See, e.g., Mass. Gen. Laws 93H § 1-6 (2007)

³⁰ See, e.g., Cal. Civ. Code §§ 1798.80-1798.84 (2007 Supp.); Mich. Comp. Laws § 445.71 (2007 Supp.).

³¹ See, e.g., Ariz. Rev. Stat. § 44-7501 (2007 Supp.).

³² See, e.g., Ark. Code Ann. §§ 4-110-101 to -108 (2007 Supp.); Col. Rev. Stat. § 6-1-716 (2007 Supp.); Fla. Stat. ch. 817.5681 (2006); (not requiring notification if there is no reasonable likelihood of harm to customers after an investigation); 815 Ill. Comp. Stat. 530/1 to /30 (2007 Supp.) (require businesses to notify customers upon discovery or knowledge of a breach regardless of its potential impact on them).

³³ Cal. Civ. Code §§ 1798.80-1798.84 (2007 Supp.).

breached computer system to prevent the risk of further unauthorized access before making the announcement.³⁴ Wisconsin requires a “reasonable time” not to exceed forty-five days after learning of the breach. Wisconsin takes into consideration the number of notices and the method in which a firm can notify customers.³⁵ North Carolina requires notification without unreasonable delay, consistent with legitimate needs of law enforcement and consistent with any measures necessary to determine sufficient contact information, scope of breach and restore the reasonable integrity, security, and confidentiality of the data system.³⁶ On the other hand, Maryland also requires that notification be sent to its Office of Attorney General prior to communicating with affected consumers, which posts these notifications on its website.³⁷

Who can sue your firm for failure to comply with data breach statutes?

State statutes take three different approaches with regards to who can enforce the state data breach statutes. The first approach is that injured customers themselves can bring civil actions against your firm.³⁸ The second approach is that the state statute specifies certain government entities to enforce the statutes, such as the state attorney general or designated state departments.³⁹ The final approach is a blend of the first two, where both private and state enforcement may bring actions against persons that fail to comply with the state data breach statutes.⁴⁰

Some states offer a safe harbor for compliance with other states’ statutes.

Despite conflicting, overlapping, or contradictory state data breach statutes, some states offer safe harbors recognizing that other states’ laws may also apply and some recognize that firms may

³⁴ See, e.g., Col. Rev. Stat. § 6-1-716 (2007 Supp.).

³⁵ See, e.g., Wis. Stat. § 895.507 (2006).

³⁶ See, e.g., N.C. Gen. Stat. § 75-65 (2007).

³⁷ Maryland Personal Information Protection Act, MD Stat. Ann. § 14-3504. See <http://www.oag.state.md.us/idtheft/businessGL.htm>.

³⁸ See, e.g., Cal. Civ. Code §§ 1798.80-1798.84 (2007 Supp.); Minn. Stat. § 325E.61 (2007 Supp.); Tenn. Code Ann. § 47-18-2107 (2007 Supp.).

³⁹ See, e.g., Ariz. Rev. Stat. § 44-7501 (2007 Supp.); Me. Rev. Stat. Ann. tit. 10, §§ 1346 to 1350-A (2007 Supp.); 2007 Or. Laws 759.

⁴⁰ See, e.g., Haw. Rev. Stat. §§ 487N-1 to -4 (2007 Supp.); N.H. Rev. Stat. Ann. §§ 359-C:19 to :21 (2007 Supp.).

implement a more protective approach to data breaches. The California statute deems that a firm has complied with the data breach statute if a firm maintains their own notification procedures as part of an information security policy that is consistent with California's timing requirements.⁴¹ Colorado's statute excepts firms that already comply with federal or state laws that require security breach notification procedures.⁴² Delaware has the same exception and also excepts broadly those persons that maintain their own notification procedures.⁴³

Once a breach has occurred, can customers freeze their credit report file?

Once a data breach has occurred, 47 states and the District of Columbia have enacted security freeze laws which allow customers to freeze their credit report file. Security freeze laws prohibit a credit reporting agency from releasing information from a file without "the express authorization of the consumer."⁴⁴ State security freeze laws also vary widely as to who may enact the security freeze, if there is an exception for insurance, how much the security freeze costs, whether a customer can lift a security freeze for a specific party, and whether there is a charge to lift the freeze for a specific period or a specific party. States have two approaches as to whom the security freeze laws cover. The first approach taken by a minority of states is to allow only identification theft victims to use the freeze laws.⁴⁵ The second approach allows any consumer to use the security freeze laws when there has been a data security breach.⁴⁶ States take a varied approach as to charges for freezes and lifting of the freeze for a period of time or indefinitely. States also take a varied approach as to whether it will allow a customer to lift a freeze for a specific amount of time or for a specific party.

⁴¹ Cal. Civ. Code §§ 1798.80-1798.84 (2007 Supp.).

⁴² See, e.g., Col. Rev. Stat. § 6-1-716 (2007 Supp.); Me. Rev. Stat. Ann. tit. 10, §§ 1346 to 1350-A (2007 Supp.).

⁴³ See, e.g., Del. Code Ann. tit. 6, §§ 12B-101 to -104 (2005).

⁴⁴ 2 Richard L. Fischer, *The Law of Financial Privacy* § 5.07 (2007).

⁴⁵ See, e.g., Ark. Code Ann. §§ 4-110-101 to -108 (2007 Supp.); Kansas Stat. §§ 50-7a01 to -7a04 (2007 Supp.).

⁴⁶ See, e.g., Cal. Civ. Code §§ 1798.80-1798.84 (2007 Supp.); Conn. Gen. Stat. § 36a-701b (2007 Supp.); Del. Code Ann. tit. 6, §§ 12B-101 to -104 (2005).

What should your firm do?

For most firms, it is probably not an "if" but a "when" the security breach occurs. Planning for the event will improve your response time, which may help you mitigate the potential damages resulting from a data breach. The first step is to understand your federal and home state's security data breach notification and freeze laws, as well as the state laws where your customers reside. Your firm must understand these laws in order to know what type of data is covered under the statute, when a reportable breach has occurred, and what type of reporting regimen the state requires of your firm.

You need to assess the data security risks facing your firm and analyze where and how a breach could occur. Consider everything from high tech to low tech possibilities. This process will be most effective if you organize a working group of knowledgeable employees in your firm who understand your technology and data storage systems and processes, as well as paper copies of your books and records.

After identifying the risks, develop a plan to address and manage those risks. Periodically review and update your risk assessment, particularly when you make significant changes to your computer systems and business processes that involve customer data. These records will be requested by the SEC and/or FINRA during the examination process. Also, remember that these are ordinary business records that are discoverable in litigation, so you should consider involving your legal counsel in this self-assessment process.

Depending on the size and complexity of your firm, consider organizing a standing "SWAT Team" of employees in your organization who understand your technology and data storage systems and processes. Your SWAT Team should meet and develop several hypothetical data breach mock drills with scenarios to help you think through and develop written procedures to respond when the real thing occurs.

These planning exercises, together with the related documentation, will help you create a comprehensive data security breach notification system. With a system in place, your firm may be able to take advantage of the safe harbors created by many, but not all, of the state laws that regulate these circumstances. Most importantly, by taking these steps your firm may be able to better protect your

customers and your reputation and, hopefully, avoid regulatory enforcement proceedings.

SOME LESSONS LEARNED (THUS FAR)

By Bob Boresta
Winston Strawn LLP

As we work ourselves out of this financial crisis we have gained some insight into what we can do to prevent future generations from experiencing the same problems. As we might expect, some of the lessons that we have learned are not new but instead confirm basic lessons that we should have learned before now.

Lesson One – Spelling – Be wary of unpronounceable acronyms, such as CDS and CSE. There is a good reason that these letter combinations do not exist in common English usage – they are too hard to say, and even harder to understand. Once they are created, they grow to gargantuan proportions that wreak havoc all around.

Lesson Two – Math – There is a reason that we have both natural numbers and integers. Natural numbers (0, 1, 2, 3...) are used for counting. Integers include natural numbers and their negatives. When making assumptions for computer modeling in areas such as housing prices, investment returns, etc., integers and not just natural numbers should be used since (as we have learned) housing prices, investment returns, etc. may not remain in positive territory.

Lesson Three – Reading – This lesson cannot be over-emphasized – Read before you sign and certainly before you invest. Do not hand over your life savings to the money-manager-guy at the country club because other people say that he never lost money for his clients.

Lesson Four – Homework – Please re-read lesson three above. Before investing it is essential to do *your own homework*. Research and ask questions about prospective investments. Conduct your own diligence and do not just rely on the assumption that someone else did their homework, whether that someone is a major institution or your neighbor.

Lesson Five – History – Bubbles always burst: there was the Tulip Bubble (Holland 1634-1637); the South Sea Bubble (U.K. 1711); the Panics of 1792, 1873, and 1907, the 1929 Stock Market Crash; the 1987 Stock Market Crash (following the junk bond

craze); the Asian Financial Crisis (1997); The Ruble Crisis and Long Term Capital Management (1998); the Dotcom Bubble...

Lesson Six – Adult Supervision – Some adult supervision at a macro level is required. Federal Reserve Chairman Ben Bernanke said that to prevent a repeat of the risks that built up in the banking system, the U.S. must have a powerful overarching regulator. While we leave to others to determine the level and scope of the supervision necessary, suffice it to say that (even if we were all capable of fending for ourselves as described above) as individuals we do not have the ability to monitor systemic risk in our economy; for that we need a referee to ensure that everyone plays the game fairly and that the risk level is manageable for its participants.

WHAT MIGHT IT MEAN FOR A FINANCIAL PLANNER TO BE A FIDUCIARY UNDER CERTIFIED PLANNER BOARD CONDUCT RULE 1.4?

By: Keith Loveland
Attorney at Law

Rule 1.4 currently states:

"A certificant shall at all times place the interest of the client ahead of his or her own. When the certificant provides financial planning or material elements of the financial planning process, the certificant owes to the client the duty of care of a fiduciary as defined by CFP Board."

On March 30, 2009, the Board of Directors ("Board") of Certified Planner Board of Standards proposed technical corrections to its Standards of Professional Conduct ("the Code"). The Board has proposed that Rule 1.4 read as follows:

"A certificant shall at all times place the interest of the client ahead of his or her own. When the certificant provides financial planning or material elements of financial planning, the certificant owes to the client the duty of care of a fiduciary as defined by CFP Board."

The Terminology section of the Code defines "Fiduciary" as follows:

"One who acts in utmost good faith, in a manner he or she reasonably believes to be in the best interest of the client."

No change in the definition of fiduciary has been proposed by the Board. The comment period ends April 29, 2009.

Many CFP certificants ask me ‘what specifically must I do to demonstrate adherence to the fiduciary duty of care?’

For CFP certificants who are either registered investment advisers (“RIA”) or are investment adviser representatives (“IAR”) of an RIA, the federal law requires them to adhere to a fiduciary standard of conduct. For CFP certificants who are neither RIAs nor IARs, but who hold themselves out as financial planners, financial advisers, financial counselors (or some similar description), Minnesota Statute 45.026 (for example) requires them to adhere to a fiduciary standard of conduct. In other words, act like an investment advisor. But what does that mean, specifically, they ask.

Most often, I direct them to the website www.fi360.com. There they can view Prudent Practices for Investment Advisors. The 20+ prudent practices are grouped within 4 steps – Organize, Formalize, Implement, and Monitor. In my opinion, seven of the prudent practices are especially important for the demonstration of acting with a fiduciary duty of care. Six of the seven are within the Formalize step, and they are listed below.

Practice SA-2.1 - An investment time horizon has been identified for each client.

Practice SA-2.2 - A risk level has been identified for each client.

The level of risk the client’s portfolio is exposed to is understood, and the quantitative and qualitative factors that were considered are documented. A “worst-case” scenario has been considered, and it has been determined that the portfolio has sufficient liquidity to meet short-term (less than five years) obligations.

Practice SA-2.3 - An expected, modeled return to meet investment objectives has been identified.

Practice SA-2.4 - Selected asset classes are consistent with the identified risk, return, and time horizon.

Practice SA-2.5 - Selected asset classes are consistent with implementation and monitoring constraints.

Practice SA-2.6 - There is a written investment policy statement (“IPS”) which contains the detail to define,

implement, and manage the client’s investment strategy.

The six practices listed above, if followed, provide a CFP certificant with demonstrable evidence that a fiduciary duty of care was followed within the financial planning engagement.

The seventh practice is especially relevant in the post-Madoff era. Within Step Three – Implement, Practice SA-4.1 states: The investment strategy is implemented in accordance with the required level of prudence.

Practical criteria for making real this prudent practice is that the CFP certificant has a due diligence procedure for selecting investment options exists, and that the due diligence process is consistently applied.

The Prudent Practices for Investment Advisors suggests that each investment advisor follow a due diligence procedure prior to allocating any client money to an outside money manager. Suggested areas of due diligence inquiry include, for example, minimum track record, holdings consistent with style, correlation to style or peer group, performance relative to assumed risk, as one would expect. In my opinion, in addition to the above inquiries, CFP certificants should assess the custodial arrangements and examine regulatory oversight of the outside money manager.

Following prudent practices should go a long way towards demonstrating that a CFP certificant placed the interest of the client ahead of his or her own, and acted in utmost good faith, in a manner he or she reasonably believes to be in the best interest of the client.

FLORIDA UPDATE

By Donald A. Rett

Late in 2008, Don Saxon, Commissioner, resigned his position. Owen (“Alex”) Hagar, who had been the Deputy Commissioner, is now the Acting Commissioner. In December, 2008, Division Director, Richard (“Ric”) White resigned, and has been replaced by Acting Director, Michael B. Gross, Esq. Florida had approximately sixty people apply for the Commissioner’s vacancy. While the list of applicants has been severely trimmed, a Commissioner has not been appointed.

In other relevant news, the Florida legislature is currently considering “...the most important

securities legislation to be considered in decades...”; the text of the proposed legislation has substantial support in the Executive and Legislative branches of FL government. The more important aspects are the following:

1. Loss of Securities Licensure for losing an Arbitration: The Bill, which is being studied by the Florida House and Senate, as originally proposed, would authorize the revocation, denial, restriction or suspension of the license of any b-d, I/A, associated person or branch office if the licensee “loses” an arbitration. Currently, this language appears to have been amended out from the House version.
2. Under the Senate version, Florida’s Office of Financial Regulation (“OFR”) would be entitled to immediately suspend the registration of any b/d, I/A, branch office or associated person failing to provided the OFR “within thirty days after a written request” ANY of the records required to be submitted by OFR regulations. The House version is substantially identical.
3. Statutes of Limitations would become applicable to enforcement actions initiated by Florida’s OFR, although the periods vary from the House and Senate versions.
4. It is proposed that the Florida Attorney General’s Office (the "AGO") should be empowered to sue for violations of Florida’s securities anti-fraud provisions, for injunctions, restitution, civil penalties and other remedies, whenever the AGO’s office has reason to believe that any person is in violation of such anti-fraud provisions. Apparently, the OFR is supposed to tender “approval” prior to action by the AGO.

The House provision is at CS/HB 484, while the Senate version is at SB 1126.

LESSON LEARNED: THE NEW ELECTRONIC FORM D

By Kristi Nickles
Fredrikson & Byron, P.A.

January began with a question: “Do you have time to work on a Blue Sky project?”

I quickly replied, “Sure,” without a clue on what dangers lurk ahead.

The transaction involved complicated factors including multiple issuers and states. This meant each issuer needed to be named on each Form D as they were all affiliated companies co-issuing each security in a complex reorganization transaction. I cringed at the thought of preparing and filing ten separate Form Ds in seventeen states, but remembered the new electronic Form D allows for listing all the issuers on one form. Suddenly, I no longer dreaded coordinating 170 filings and life seemed good. Unfortunately, there were dark clouds on the horizon.

My days were soon filled with obtaining Edgar codes for each of my ten issuers. I spent days on the phone with SEC Edgar support, searching chat rooms for tips, and emailing colleagues for advice. As the days went by, I began to fear direct Edgar filing and decided to choose a vendor’s software that would provide a safety net, which included a technical assistance team to fix problems.

As I merrily began to enter all the CIK and CCC codes, issuer data, addresses, related persons, and deal data, my confidence started to soar. It was soon time for the test filing and with a happy heart, I bravely hit the “Test File” button.

“SUSPENDED.” Oh no, rejected 66 times, which meant there were 66 suspension errors in the first electronic Form D test filing. After several days of working with technical support to decipher and fix the suspension messages, I finally achieved a successful test filing.

The filings occurred before the mandatory March 16 date. In an effort to be proactive with each paper state filing, I included an originally signed and notarized Consent to Service. Each of the cover letters described how many investors there were in each particular state and the date of first sale. Most states accepted the sole filing fee for one Form D filing. Even though this was a Rule 506 Regulation D offering, some states called and asked for a copy of the offering documents out of “curiosity”; a sentiment not commonly expressed by blue sky regulators. A few states asked for ten separate filing fees – one for each issuer.

From this experience, I have come up with the following tips on how to make this process go more smoothly:

-
1. Get your codes early. Some applications are processed with lightning speeds, others take close to a week.
 2. It is important to be much more proactive and take steps to identify potential offerings or issuances well before the March 16 deadline. Prior to March 16, it was possible to prepare the Form D, obtain signed copies, and get the SEC and state filings out within a day or two. This is no longer the case.
 3. Perhaps most importantly, if in doubt, check with the state to find out. My research has shown that about half will accept the built in Consent to Service and the rest want a paper Consent to Service. Some want the equivalent information contained in the old state appendix pages, some want original signatures, some take the SEC as-filed conformed copies. Most states say they will be reevaluating their positions in the near future and to be sure to check back.

The bottom line is that confusion still reigns, which means it is important to continually educate yourself and lawyers on this new process. It seems even state securities regulators are not always sure of the new rules, as I had a state regulator tell me that the mandatory filing date was moved back to sometime in April. In the near future, I will keep hoping that the states establish some conformity, but until they do, I will be sure to give myself the extra time I need to work with the new electronic Form D.

EDITORIAL

By: Martin A. Hewitt
Lowenstein Sandler PC

Why are there private securities offerings? It seems like such a simple question and yet there are those who believe that they exist for one reason and one reason only, which is to take advantage of unsuspecting, unsophisticated, widows and orphans. While it is true that there are con artists in every area of our lives, from home improvement “specialists” to purveyors of various gadgets and gizmos on late night television, most home improvement specialists provide homeowners with the ability to maintain and improve their largest investment, while there are some gadgets and gizmos which actually serve innovative functions making our lives safer or at least more efficient or more entertaining.

Most issuers of securities in private transactions are, in fact, not the con artists mentioned above, but rather are entrepreneurs who are at the core of innovation in various areas including technology and medicine. There are those issuers that are part of this process by creating various funds (either hedge or private equity) (“Funds”) that in turn invest in such entrepreneurs. These Funds are able to attract far greater numbers of investors and investment dollars than the smaller entrepreneurs, but they are an integral part of the entrepreneurial process.

With the ire of the media and politicians, the investing public has jumped on the band wagon of increased regulation for private offerings. While there is certainly a need for regulation, the method and manner is of critical importance. In the rush to regulate we cannot go overboard and make the process so onerous as to choke off the supply of funds required by entrepreneurs as they try to grow their businesses.

What is the correct type and amount of regulation? No one person (be it the politician, regulator, practitioner, or layman) has all the answers; however, the first steps include understanding who has to be regulated, for what purpose, by whom, and in a manner that does not drag down the ability of entrepreneurs and start-up companies in their ability to raise capital.

The one thing that is knowable is that whatever regulation rises from the ashes of the current economic meltdown, it must be carefully shaped in consultation with regulators and practitioners so that the twin goals of investor protection and investor education are reached with as close to surgical precision as possible. Now is not the time for any one group to go down a road alone which effects so many issuers and individuals without the input of all affected parties.

To shift topics, the editors of the Blue Sky Bugle would like to thank the many contributors to the current edition. There are many new contributors including Jordan Pattera (a student from Wayne State University Law School), Keith Loveland, and Kristi Nickles who are all contributing for the first time. We encourage them to contribute in the future as well!

Please note that the next deadline for the Blue Sky Bugle is July 4, 2009. If we can be sure of nothing else in securities law it is that the fireworks will continue and we need as many contributors,

including practitioners, regulators, and paralegals to provide their unique perspectives as we grapple with the challenges of shaping regulations for the 21st Century.



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