'EXCUSE ME, WHILE I KISS THE [BLUE] SKY': COMMON STATE SECURITIES LAW CONSIDERATIONS APPLICABLE TO U.S. PRIVATE OFFERINGS BY CANADIAN ISSUERS

Smarter Way to Cross Blog Archives
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The wires have hit. You've just closed a multijurisdictional offering and delivered a great result for your client. As visions of a raucous post-closing party with your client enter your mind (or perhaps just visions of a good night's sleep!), U.S. counsel interrupts your reverie with a reminder that your client's Form D and associated blue sky filings are due within 15 days. Say what? Do you really have to make these filings, and what in the world are "blue sky laws" anyway? Although not quite as colorful and catchy as a Jimi Hendrix song, blue sky laws can leave you in a purple haze if not carefully considered. Let's explore this often-overlooked topic in further detail.

Introduction

U.S. capital markets and capital formation activities are regulated by a patchwork of overlapping federal and state regimes. Each offer and sale of securities must be registered federally under the U.S. Securities Act of 1933, as amended (the Securities Act), unless an exemption from registration is available. There also exist corresponding registration requirements and possible exemptions at *each* of the fifty states, the so-called blue sky laws.* Once a decision has been made to offer or sell securities to residents of a given state, an analysis must be undertaken to determine the legal obligations imposed by the blue sky laws of each such state.

One preliminary caveat: the registration requirements of state blue sky laws are pre-empted by the federal securities rules if the offered securities are "covered securities" pursuant to the U.S. National Securities Market Improvement Act of 1996 (the NSMIA). Among the categories of "covered securities" are:

1. Securities that are listed on certain national securities exchanges,
2. Securities sold pursuant to Rule 506 of Regulation D of the Securities Act, and
3. Securities of reporting companies sold under Rule 144A of the Securities Act.

Although offerings of covered securities are exempt from state registration and qualification requirements, states may still require notice filings and the payment of filing fees with respect to offerings of covered securities. However, if the offering does not involve a covered security, there is no federal pre-emption, and the state registration rules and exemptions must be analyzed in greater detail. What follows is a brief road map of the blue sky process under three private deal structures: a Regulation D offering, a Section 4(a)(2) private placement, and the emerging "Regulation A+" exemption. Whenever securities are being offered to U.S. residents, U.S. counsel should be engaged at an early stage in the offering to lay out the possible ramifications of proceeding down any of these paths.

Scenario 1: A Regulation D Offering Pursuant to Rule 506 of the Securities Act

As discussed in a previous blog post, a Regulation D Rule 506 offering is one of the most common methods of raising money from U.S. investors due to its flexible structure. A typical Regulation D offering pursuant to Rule 506 of the Securities Act involves the sale of restricted securities by an issuer solely to "accredited investors" followed by the filing of a Form D with the SEC within 15 days of the first sale of the securities. The Form D discloses certain basic details of the offering (you can access the form here). Since securities sold pursuant to Regulation D Rule 506 are also "covered securities," state registration requirements are pre-empted; however, many states do require a notification filing and filing fee if Regulation D Rule 506 offerings are made its residents.

There is no fee for an issuer to file the Form D with the SEC. States that require a notice filing generally piggyback off the federal Form D and require an issuer to send a signed copy of this form to their securities regulator along with a prescribed fee. As part of this filing, some states will also require an issuer to include a consent to service of process in the state.

As New York attorneys, our ears always perk up whenever we hear that New York State investors comprise part of an offering, as it is in some ways an outlier to the general rules discussed here. New York's attorney general requires issuers in Regulation D transactions to make certain filings with its regulator *before the commencement of the offering* to New York residents. Some commentators, including the New York State Bar Association, have pointed out that these onerous obligations may violate both the letter and the spirit of the NSMIA pre-emption for covered securities, which would preclude New York State from requiring filings beyond the post-sale notices and associated fees required in other states. New York's Office of the Attorney General has not accepted this position, and the matter has not been conclusively settled. Issuers who are contemplating a sale of securities to residents of New York State should consult a qualified New York securities law attorney well in advance to discuss these requirements.

Scenario 2: Private Placement Under Section 4(a)(2) of the Securities Act

Securities may also be sold under the general federal private placement exemption of Section 4(a)(2) of the Securities Act. Because such securities do not enjoy the benefit of being exempt from state registration requirements as covered securities, a state-by-state survey of available exemptions from state registration should be performed for each state in which the investors are resident. Given the limited, non-public nature of Section 4(a)(2) private placements conducted outside Regulation D, many states have some form of self-executing "limited offering exemption" that is applicable to this type of private placement. States that have adopted the *Uniform Securities Act of 2002* provide this self-executing exemption for single issuances of securities where a) not more than 25 purchasers are present in such state during any 12 consecutive

months; b) no general solicitation or advertising is used; c) no commission or other remuneration is paid, directly or indirectly to a person other than a registered broker dealer for soliciting a prospective purchaser in the state; and d) the issuer reasonably believes that all the purchasers in such state are purchasing for investment. If these criteria apply to the private placement, the exemption is "self-executing" in that no filing or other action is required in such a state. Some states have modified this Model Act to require payment of a few while other states (like California) may require the filing of a short form in analogous offerings.

If the issuer will be placing securities directly with investors, a further consideration is to verify that both the issuer and its officers and employees are exempt from registering as a "broker-dealer" or "agent" in the relevant states. It is common for states to have an "Issuer-Agent Exemption" whereby representatives of the issuer are exempt from such registration if the individual is not compensated (e.g., does not receive commission or similar transaction-based compensation) in connection with his/her participation in the securities transaction. Once again, the regulations vary by state, and it may require a detailed survey to nail down the relevant exemption.

Scenario 3: The Emerging Practice of Regulation A+

In another recent blog post, I explored the new exemption provided by amendments to Regulation A, colloquially called "Regulation A+." Pursuant to this exemption, Canadian and U.S. companies may engage in a "mini public offering" with no investor accreditation and the sale of unrestricted securities. Tier 1 offerings under Regulation A+ do not preempt state blue sky laws. Although states are working to facilitate a streamlined clearance of Regulation A+ offerings, this lack of preemption may be a hurdle in the broader acceptance of this exemption for the time being. Additionally, some states have even challenged the federal preemption of blue sky laws under tier 2 offerings under Regulation A+, so developments in this area bear watching.

Frequently-Asked Questions:

Q: My client has just concluded a securities offering to U.S. accredited investors in reliance on Regulation D. What are the ramifications of failing to file a Form D?

A: It used to be the case that securities lawyers took a lax approach to the Form D. So long as the other aspects of Regulation D were met, many took the view that the exemption was validly fulfilled and dismissed the Form D as a technical filing that the SEC used to gather information. This view found favor with publicity-shy emerging companies that did not want to disclose any public details of their newly consummated offerings. After all, Form Ds are publicly available on the SEC's EDGAR website and disclose certain information that some companies may prefer not to reveal such as the amount being raised, the compensation paid to brokers and dealers and the identity of the company's directors and executive officers. This is no longer the accepted view.

Although the SEC has clarified that the failure to file a Form D does not result in a blown exemption (a catastrophic outcome for an issuer!) and does not invalidate the NSMIA preemption of state-level registration, the SEC could take action against the issuer and seek to have the issuer enjoined from future use of Regulation D under Rule 507. If the violation is willful, it could also constitute a felony. Moreover, the SEC's position does not necessarily control how state

securities regulators and courts will view any omission. Certain state regulators view the filing of Form D as a requirement for a valid Rule 506 exemption. For these state regulators, a Form D filing is effectively a prerequisite for offered securities to receive the benefit of preemption of state registration and qualification requirements as covered securities under NSMIA.

Q: What are the consequences of failing to make a state level filing?

A: Assuming we are speaking of a covered security, the SEC holds that NSMIA preemption is not lost if an issuer fails to make the required notice filing with a state. Once again, this view is not binding on how a state regulator may act. Many states take opposite views (which may or may not hold up to judicial scrutiny if enforced and subsequently challenged) and may issue fines or stop orders for late or missed filings. Additionally, future investors or acquirers conducting diligence may pose questions as to whether all required filings had been made by the issuer and query the possible consequences of any delinquency. Issuers need to be diligent in making all required securities filings when conducting private placements!

**This colorful moniker is generally attributed to the ostensible targets of U.S. depression-era securities regulation – hucksters who would purport to sell shares in the very blue sky above us, if left to their own devices and without regulation.*