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February 3, 2015

Understanding The NSMIA And Navigating State Blue Sky Laws- Part II

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The National Markets Improvement Act of 1996 (NSMIA)

Generally, an offering and/or sale of securities must be either registered or exempt from registration under both the federal Securities Act of 1933 ("Securities Act") and state securities laws. As a result of a lack of uniformity in state securities laws and associated burden on capital-raising transactions, on October 11, 1996, the National Securities Markets Improvement Act of 1996 ("NSMIA") was enacted into law.

The NSMIA amended Section 18 of the Securities Act to pre-empt state "blue sky" registration and review of specified securities and offerings. The preempted securities are called "covered securities." The NSMIA also amended Section 15 of the Exchange Act to pre-empt the state's authority over capital, custody, margin, financial responsibility, making and keeping records, bonding or financial or operational reporting requirements for brokers and dealers.

In Part I of this blog, I summarized the NSMIA pre-emption provisions. In this Part II, I discuss state blue sky laws.

In enacting the NSMIA, the legislature purposefully left certain securities as not covered and subject to the dual regulation of states and the federal government. Examples of securities that were specifically excluded from the NSMIA list of "covered securities" include (i) securities that trade on the over-the-counter market; (ii) Rule 504 offerings; (iii) Rule 505 offerings; and (iv) Regulation A offerings.

State Blue Sky Laws in General

Securities issued in transactions which are not covered securities, such as Regulation D Rule 504 and 505 offerings, Regulation A offerings, intra-state offerings, and registered direct or initial public offerings, must comply with state blue sky laws. In addition, the re-sale (secondary trading) of securities must either be pre-empted or comply with state blue sky laws.

Like the federal laws, state securities laws require registration or the availability of an exemption for the offer or sale of securities, and provide statutory exemptions from registration. In addition, every brokerage firm, individual registered representative of a brokerage firm, issuer and issuer representative must either be registered as, or exempt from, the broker-dealer registration requirements prior to selling securities. There are 54 U.S. jurisdictions, including all 50 states and 4 territories, each with separate securities laws.

Although many states have adopted the Uniform Securities Act of 1956 (the "Uniform Act"), or variations on such Act, state blue sky laws still differ greatly. Even in states that have identical statutes, the state's interpretations or focus under the statutes differ greatly. The most common areas of divergence among the states relate to:

Notice and filing requirements can be extremely different in terms of the amount of money required, the paperwork demanded, questions asked and the time to review and approve registration;

Standards of merit review – see discussion below on merit review standards. Different states can issue vastly different comments in different focus areas for the same issuer;

Length of comment periods – The amount of review time can be inconsistent from days in certain states to weeks and even months in others;

Suitability Standards;

Notice requirements for exempt offerings, even under the Uniform Limited Offering Exemption;

Required legends on offering materials;

Disclosure requirements can be varied, and some states will make the issuer sticker the offering with different disclosure items or put in language changing the meaning of some phrases;

Required forms in addition to the standard Form D in exempt offerings;

Treatment of offerings of asset-backed securities; and

Financial statement requirements – some states require audited financial statements and others do not.

Most states have some form of limited offering exemption based on either the number of offerees or purchasers, the dollar amount of the offering, or a combination of these limitations. Most states have a private offering exemption, many of which are substantially similar to the federal Section 4(a)(2). Many states have exemptions for offerings limited to accredited investors. Many states have adopted the NASAA's Uniform Limited Offering Exemption, which is similar to the federal Rule 506 exemption.

State Merit Review

Over 40 states apply a "merit review" approach to state registered offerings. In conducting a merit review, state regulators make a determination regarding the fairness of the offering to investors. A merit review is a substantive review of the issuer and the offering and is designed to prevent fraudulent or inequitable offerings. Common merit review topics include:

Discounted stock sales, including sales to insiders and promoters that are completed in close proximity to the offering at significantly discounted prices;

Affiliate transactions including loans. Loans to affiliates usually must be repaid before the offering, and affiliate transactions must be on arm's length terms;

Debt offerings will generally require sufficient cash flows to cover debt servicing charges and payments, and states may ask that a sinking fund be established or a trust indenture meeting the requirements of the Trust Indenture Act of 1939;

A state may require that the issuer agree to the impoundment of offering proceeds;

Options and warrants – the state may request limits on the number of outstanding options or warrants or may dictate the terms of exercisability (such as no less than 85% of market value); limits may be set on underwriter compensatory issuances;

Preferred Stock – states may require current and/or past net income to cover dividends or other obligations under preferred instructions; if the preferred stock is being offered, the state may require redemption provisions and other investor-friendly rights;

Promoter's equity investment – the state may require that a promoter's equity interest be more than 10% of the post-offering equity (i.e., ensuring the promoter is an affiliate and subject to affiliate resale restrictions);

Promotional shares – the state may require the escrow of shares or the reduction of the offering price where equity securities of a development-stage company have been issued to promoters and/or insiders for less than 85% of the offering price;

Selling expenses and selling security holders – states may limit the expenses to a percentage of the offering amount or require selling security holders to pay a pro rata share of offering expenses;

Unequal voting rights – states may prohibit or limit unequal voting rights;

Capitalization requirements – states may prohibit the issuance of any security except common equity for development-stage or less seasoned issuers; and

Specifying offering price – states may require that the offering price be related to book value, earnings history and/or industry price/earnings multiples or set other parameters on the offering price.

The NASAA has published Statements of Policy regarding merit standards both generally and for specific industries. Many states have either adopted such policies or refer to them as guidelines in their review process.

Blue Sky Laws and Secondary Trading

Only the secondary trading of securities that are traded on a national securities exchange is automatically preempted from compliance with state blue sky laws. The NSMIA preempts Sections 4(a)(1) secondary sales and 4(a)(4) broker transactions on behalf of customers, where the issuer is subject to the Exchange Act reporting

requirements. Section 4(a)(1), is a registration exemption for "transactions by any person other than an issuer, underwriter, or dealer." Section 4(a)(4) of the Securities Act of 1933 ("Securities Act") provides an exemption for broker-dealers when executing customers' unregistered sales of securities if, after reasonable inquiry, the broker-dealer is not aware of circumstances indicating that the customer would be violating the registration requirements of Section 5 of the Securities Act. Section 4(a)(4) is not, in and of itself, an exemption from registration. Section 4(a)(4) allows brokers to process the sale of unregistered securities where there is a valid exemption from such registration. Section 4(a)(4) generally works in conjunction with Section 4(a)(1), and the two together provide the basis for most secondary trading of securities on established trading markets.

The secondary trading of securities for issuers that are not subject to the SEC reporting requirements, including those that voluntarily report, or transactions that do not qualify under Sections 4(a)(1) or 4(a)(4) must satisfy state blue sky laws. If a security is not blue sky eligible in a given state, broker-dealers and investment advisers cannot give advice, solicit, distribute research or make recommendations to investors in that state.

It can be very difficult, if not impossible, to comply with blue sky laws for secondary trading in all 54 jurisdictions. The Manual's Exemption, discussed further below, provides some assistance in this regard. However, Alabama, Kentucky and Virginia have no exemption whatsoever for the secondary trading of non-reporting issuers' securities.

In a letter written to the SEC on March 24, 2014, arguing for blue sky preemption for Regulation A offerings, OTC Markets Group, Inc. ("OTC Markets") honed in on blue sky issues in general and specifically related to secondary trading. OTC Markets pointed out that "[T]he prohibition on advice and research in certain jurisdictions leaves investors uninformed of investment opportunities and risks, and, just as importantly, prevents investment professionals from advising their clients of the specific risks of investing in a security. Investors are left to determine the risks and potential benefits of an investment on their own, which runs counter to each jurisdiction's otherwise very worthy investor protection goals."

Even though a broker may not solicit or make recommendations, it can process unsolicited trades on behalf of a customer that requests it to do so. However, if that customer later claims that the broker recommended such a trade, that broker can be liable for damages. Accordingly, many brokerage firms simply refuse to process any trades for securities that are not blue sky eligible.

The OTC Markets letter to the SEC provides an excellent analysis of the lack of uniformity in blue sky laws related to secondary trading and in particular, the difficulty for a non-reporting issuer to satisfy such requirements. The letter poignantly points out that "[O]TC Markets Group is itself a non-SEC registered company that makes annual audited financial reports, quarterly and current information available to investors; has profiles published in both major securities manuals; and has worked at length with every jurisdiction to gain Blue Sky compliance. Despite our diligence, we have gained only 44 jurisdictions, which means we are not Blue Sky eligible to over 11% of the U.S. population."

The OTC Markets letter includes statistics related to blue sky compliance by companies trading on the OTCQB and OTCQX. OTC Markets reviewed 395 companies. Of the 395 companies, not a single one was in compliance with all jurisdictions and only 0.5% are in compliance for secondary trading in New Hampshire, California, Guam, Kentucky, Montana, North Dakota, Utah and Virginia. The statistics make clear the difficulties companies face in complying with blue sky requirements, and the obvious need for further federal intervention.

The Manual Exemption

The Manual Exemption is a state exemption for the secondary trading of securities. There are a total of 54 U.S. jurisdictions, including all 50 states and 4 territories, each with their own securities laws. Forty-four (44) of these jurisdictions offer a form of the Manual Exemption for the secondary trading of securities. Issuers that trade in states that do not have the Manual Exemption must satisfy a secondary trading exemption in other ways.

The Manual Exemption is an exemption for the secondary trading of securities where the issuer has a profile published in a recognized securities manual such as Mergent's or Standard & Poors, including specific enumerated information and financial statements. Some states require the filing of supplemental or additional information to

qualify for the Manual Exemption. Moreover, differing state statutory language is confusing and it is often difficult to determine whether a company has or is qualified for the Manual Exemption.

NASAA Regulation A Coordinated Review Process

Of the total 54 U.S. jurisdictions, including all 50 states and 4 territories, 48 participate in the Regulation A coordinated review process. The NASAA coordinated review process is well put together and seems to have a focus on both investor protection and supportive assistance for the issuer. An issuer elects to complete the coordinated review process by completing a Form CR-3b and submitting the application together with a copy of the completed Form 1-A and audited financial statements to Washington State by e-mail. The application contains a "check the box" for the states in which the issuer desires to qualify. Filing fees are mailed separately to each of the states.

A lead merit and a lead disclosure examiner are then appointed to manage the review process. If the issuer is not applying in any state with merit review, only a lead disclosure examiner is appointed. The filing goes through a review, comment and amendment process with the lead examiner issuing comment letters on behalf of all states.

The review process timing is relatively quick. Within three days of filing, an issuer receives a written receipt for the filing and a letter detailing the review process. Within ten days of the filing confirmation, the lead examiner drafts a proposed comment letter for the individual states to review and add to. The first comment letter must be delivered to the issuer within 21 days of filing.

The lead examiner schedules conference calls to discuss the comments and how the issuer can address the concerns. Moreover, the examiners make themselves available for discussion of comments and responses throughout the process, allowing for a type of cooperative relationship between the examiner and issuer. Issuers' comment responses are reviewed within five business days of receipt. If there are no comments, the offering will be cleared within 21 business days of filing.

The review standard itself is based on the NASAA Statements of Policy, which cover a wide array of topics—including, for example, impoundment of proceeds, loans and other material affiliated transactions, options and warrants, preferred stocks, promoter's

equity investment, promotional shares, specificity in use of proceeds, underwriting expenses, unsound financial condition and voting rights.

NASAA Coordinated Filing Program for Form D's associated with Regulation D, Rule 506

The NASAA offers a coordinated multi-state filing system allowing issuers to submit a Form D for Regulation D, Rule 506 offerings and pay-related fees to participating state securities regulators. The system is called the Electronic Filing Depository and is currently only available for Rule 506 Form D filings. Not all states participate with the system. Arizona, California, Connecticut, Delaware, Florida, Louisiana, Massachusetts, Michigan, Minnesota, New York, North Carolina and Oregon are not included. In addition to state filing fees, the NASAA charges a one-time $150 fee to use the system.

Closing

I am and remain an advocate of further federal preemption in all levels of registration and exemption requirements for the direct issuance and secondary trading of securities. Regardless of offer and sale preemption, the states retain jurisdiction over anti-fraud protections and the right and ability to investigate and prosecute fraud in any offering. They play an important role in this regard. I support allowing the federal government to control the disclosure process, including forms and review process, and continuing the combined efforts of both the states and federal authorities in policing, preventing and prosecuting fraud.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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