ROBERT G. HUTCHINS - LEGAL BULLETINS

August 2008 - Who will Regulate Unregistered Securities Offerings under Rule 506?

In the US, most unregistered securities are offered and sold under Rule 506 of SEC Regulation D. Rule 506 provides a "safe harbor" for claiming the exemption from registration found in Section 4(2) of the federal Securities Act for "transactions by an issuer not involving any public offering." Regulation D also provides safe harbor exemptions for limited offerings complying with either of Rules 504 or 505, but Rule 506 offerings are favored for two reasons: there is no limit on the money that can be raised by them and since 1996 the states, nominally at least, have been preempted (prohibited) from regulating them.[1]

The problem that has emerged for Rule 506 issuers is that the "preemption" may be illusory. Traditionally, companies that wanted to raise capital by selling securities had to comply with both federal law and the law of each state in which the securities were offered. The result, particularly in a multi-state offering, was a regulatory quagmire that relatively few companies were willing, or financially able, to negotiate. To remedy this, the National Securities Markets Improvement Act of 1996 ("NSMIA") amended Section 18 of the Securities Act to "exempt" offerings of so-called "covered securities" from state regulation.[2]

Not surprisingly, the "covered securities" enumerated in NSMIA include securities authorized for listing on the NYSE, NASDAQ, or another national exchange with comparable listing standards and securities issued by registered investment companies. However, securities issued in a transaction that is exempt from registration under Rule 506 are also "covered."[3] As a result, when NSMIA was adopted it was widely assumed that the SEC was now the only public authority that could enforce Rule 506 on its own initiative. Accordingly, the federal district courts would be the proper judicial forum for challenging an enforcement action. A state had no right to review the offering documents in advance or require that the offering be registered. A

[1] See note 2 respecting the preemption. The maximum amount that can be raised under Rule 504 during any 12 month period is $1,000,000. The corresponding limit under Rule 505 is $5,000,000. The principle advantage of the two Rules is that purchasers need not be "sophisticated," as is the case under Rule 506. There are numerous disclosure and other requirements applicable to all Regulation D safe harbors. See, **www.hutchins-law.com/publications**, "Private Placements," Parts I-IV.

[2] See, Securities Act, Sections 18(b)(1), (2) and (4)(D). Under Sections 18(c)(2)(A)&(B), the states retain the right to receive notice of transactions in covered securities and to impose notice filing fees.

[3] See, Section 18(b)(4)(D), supra. "Covered" securities may eventually include those offered and sold to "qualified purchasers," but no definition of that term has yet been adopted. The SEC proposed initially that a "qualified purchaser" should mean an "accredited investor" as already defined in Regulation D, generally "insiders" with ready access to relevant information, individuals with a net worth of at least $1,000,000 or current income of at least $200,000 ($300,000 with spouse), entities with at least $5,000,000 in assets (if not specially formed to purchase the securities) and entities all of whose owners are accredited. Several states, including Washington, objected vehemently claiming the financial standards for accreditation were too low to be used as a threshold for eliminating state regulation. The standoff continues.

state court could determine whether an offering complied with the Rule only if the question arose between *private* litigants in a suit over which the court otherwise had jurisdiction.[4]

But NSMIA did not deprive the states of their right to enforce securities fraud claims under their own laws; nor did it specify what agency would decide in the first instance whether Rule 506 applied to an offering. That encouraged some states to sanction an issuer if they thought its offering did not comply either with the Rule or with its state equivalent. Left unchecked, that principle would again subject Rule 506 offerings to independent review by each state in which the offering was made, notwithstanding NSMIA's preemption.[5]

The early NSMIA case law favored issuers, but the recent trend is ominous. In 2002, a Florida district court ruled that securities offered "pursuant" to Rule 506 were "covered" under NSMIA. The offering was therefore exempt from challenge by Florida's securities authority, whether or not the issuer actually complied with the Rule. The explicit result was that mere reliance on the Rule (if in good faith, presumably) was sufficient to defeat state regulation. The Florida decision was followed in 2003 and 2006 by district courts in Minnesota and Oklahoma. The federal courts, it seemed, were resolving NSMIA's ambiguities in favor of unqualified preemption.[6]

Then, on December 26, 2006, the Ohio Court of Appeals decided *In re Blue Flame Energy Corp.*[7] Blue Flame had offered securities without registration to finance oil and natural gas drilling operations in Kentucky's Appalachian Basin. It filed a Form D with the SEC and with the Securities Division of the Ohio Department of Commerce in which it claimed an exemption from registration under Rule 506. Unfortunately, it also publicized the offering on its website.

The Ohio Securities Division sanctioned Blue Flame under state law alleging that Blue Flame had engaged in a prohibited general solicitation of Ohio investors by means of its website. Blue Flame challenged the sanction in the Ohio courts where it argued that, even assuming a general solicitation occurred, its offering was made in reliance on Rule 506. The offered securities were therefore "covered" under NSMIA and only the SEC had jurisdiction to determine whether the offering actually qualified under the Rule.

The trial court agreed with Blue Flame and overturned the sanction, but the Ohio Court of Appeals reversed. It concluded that NSMIA preempted only offerings that, *in fact*, complied with Rule 506 and that state courts were competent to determine the compliance issue.

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[4] In an enforcement action the regulating authority would allege that the issuer violated the registration requirement of Section 5 of the Securities Act or its state law equivalent. The issuer would defend on the basis of Rule 506.

[5] Section, 18(c)(1) provides that the states "…shall retain jurisdiction …to investigate and bring enforcement actions with respect to fraud or deceit…in connection with…securities transactions."

[6] See, *Temple v. Gorman* (S.D. Fla.2002), 201 F.Supp.2nd 1238; *Lillard v. Stockton* (N.D.Okla.2003), 267 F.Supp.2d 1081 and *Pinnacle Communications International, Inc. v. American Family Mortgage Corp.* (D.Minn.2006), 417 F.Supp2d 1073.

[7] 171 Ohio App.3d 514-Ohio-6892.

To explain its result, the Ohio Court engaged in an extensive discussion of the power of Congress to preempt state law under the "supremacy" clause of the US Constitution. The Court began by noting that Congress can exercise its power expressly (by stating its preemptive intent) or by implication (by adopting a statute that regulates an entire field or one that conflicts with state law). It then noted that neither NSMIA nor any other federal statute purports to occupy the entire field of securities regulation and that state courts are always competent to decide questions of federal law that affect controversies over which they have jurisdiction. Finally, the Court noted that, while NSMIA preempts state regulation of a Rule 506 offering expressly, it does so only if the offering "is" exempt under the Rule. That threshold question can be determined by the states.

Blue Flame has since been followed by various courts, including the federal Court of Appeals for the Sixth Circuit where Ohio is located. If that trend continues, all states may be encouraged to challenge any offering they believe is suspect. Unless such challenges are expressly prohibited by an amendment of NSMIA, or by a clarifying Supreme Court opinion, issuers must be prepared to submit to state review on demand.[8]

This is not a mere academic risk. Blue Flame Energy Corp. deliberately promoted its offering on its website, but innocent product advertising by an issuer engaged in a Rule 506 offering can also be construed as an unlawful "general solicitation" of investors. Rule 506 requires extensive, line item disclosure to any investors who are not "accredited." Accreditation can be difficult to verify and complex disclosure documents can be a gold mine for crusading regulators and the plaintiff's bar. If issuers must prove compliance with the Rule to gain preemption, NSMIA will become a toothless statute for them. Evaluation of the "proof" will be tantamount to a full review of the offering. If that review can be conducted by each state in which potential purchasers reside, issuers will again face the prospect of the duplicative, time consuming and expensive quagmire NSMIA was supposed to eliminate. Time will tell.

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8 See, e.g. *Brown v. Earthboard Sports USA, Inc.* et al 481 F.3d 901 (6th Cir. 2007) approving the *Blue Flame* rationale and summarizing the case law. In an opinion just handed down, the Minnesota Supreme Court reversed the Minnesota Court of Appeals (and disregarded the Minnesota district court decision in *Pinnacle Communications*) in favor of the *Blue Flame* reasoning. See, *Risdall v. Brown-Wilbert*, et al, Minn. Sup. Ct, A06-1233, July 31, 2008.