Private Offering Exemptions and Exclusions Under the New York State Martin Act and Section 18 of the Securities Act of 1933

By the Committee on Securities Regulation of the New York State Bar Association

This position paper was originally prepared for, and submitted to, the Office of the New York State Attorney General. The Committee on Securities Regulation of the Business Law Section of the New York State Bar Association ("Committee") is composed of members of the New York Bar, a principal part of whose practice is in securities regulation. The Committee includes lawyers in private practice and in corporation law departments. A draft of this position paper was circulated for comment among members of the Committee, and the views expressed in this position paper are generally consistent with those of the majority of the members who reviewed the position paper in draft form. The views set forth in this position paper, however, are those of the Committee, and do not necessarily reflect the views of the organizations with which its members are associated, the New York State Bar Association, or its Business Law Section.

Introduction

New York State's securities statute, Article 23-A of the General Business Law ("GBL"), known as the Martin Act, is unique among state securities laws in two important respects. First, the Martin Act does not require the registration of securities, other than securities sold in real estate offerings, theatrical syndications or intra-state offerings.[1] Instead, it requires some issuers to register as dealers in their own securities.

Second, the laws of every other state and the federal Securities Act of 1933 ("Securities Act") require the registration of all securities offerings, and then provide an exemption for non-public offerings if certain conditions are met. In contrast, the Martin Act requires registration (whether of brokers, dealers or special categories of offerings) only for offers and sales to, and purchases and offers to purchase from, the public. The Martin Act is silent with respect to private or non-public offerings, thus requiring no dealer registration filings, and no filing exemptions, for private offerings (other than intrastate offerings). The differences between the Martin Act and other state securities laws, particularly the first, have resulted in the use of registration and exemption forms and procedures that are unique among the states. Concerns about lack of uniformity are not academic. The capital markets in this country depend upon raising money in private placements, and New York is at the center of this market. Yet the manner in which the Office of the New York State Attorney General ("OAG") regulates private offerings exempt from registration under (a) § 4(2) of the Securities Act, the "classic" private placement exemption, and (b) Rule 506 of Regulation D under the Securities Act, the safe harbor exemption adopted by the Securities and Exchange Commission ("SEC") under § 4(2), is in conflict with the federal law and the laws of other states.

This paper addresses the regulation by the OAG of those offerings exempt from registration under either § 4(2) or Rule 506, and the application of the relevant provisions of the Martin Act and of § 18 of the Securities Act to those offerings. In the course of the following discussion, the Committee states several conclusions, which are summarized as follows:

(a) All offerings exempt under § 4(2) of the Securities Act, and all offerings exempt under Rule 506 ("Rule 506 offerings"), are excluded from the registration requirements of the Martin Act.

(b) An issuer that sells its own securities in New York exclusively to, from or through a bank, dealer or broker, whether on a firm commitment or "best efforts" basis, is excluded from the requirement to register as a dealer for that transaction.

(c) Section 18 of the Securities Act pre-empts New York State from requiring any filing with respect to securities offered under Rule 506, other than Form D (or a substantially similar form), a consent to service of process and a fee.

(d) Section 15(h) of the federal Securities Exchange Act of 1934 ("Exchange Act") pre-empts New York State from requiring federally-registered brokers to file the Further State Notice form (described in GBL § 359-e(8)) for securities offerings.

The Non-Public Offering Exclusion

GBL § 352-e requires the registration of certain real estate syndication offerings. Section 352-e provides that it is illegal "to make or take part in a public offering or sale in or from the state of New York" of real estate securities as defined in that section without filing a written offering statement or prospectus with the OAG (unless an exemption is available). Securities covered by § 352-e include interests in limited partnerships owning real estate or mortgages, shares in real estate investment trusts, cooperative apartment shares, condominium units and resort timeshare units.

GBL § 359-e requires the registration of dealers and brokers in securities. Section 359-e(1)(a) defines a dealer as including a person "engaged in the business of buying and selling securities from or to the public," and also a person "selling or offering for sale from or to the public within or from this state securities issued by it." Sections 359-e(2), (3) and (8) then require brokers or dealers to make certain filings (State Notice, broker or dealer registration statement and Further State Notice) if selling securities or offering securities for sale *to the public* within or from the State.

When the provisions of GBL § 359-e were substantially rewritten in 1959, the securities industry was concerned that New York State might interpret the term "to the public" differently than it was interpreted under federal law, which would result in a lack of uniformity and the risk of prosecution by the State for failure to register as a dealer or broker for offerings considered to be private offerings under the Securities Act. In response, the memorandum of Governor Nelson Rockefeller, dated April 22, 1959, approving L. 1959, c. 692, stated, in pertinent part:

> The bill will make appropriate exemption for situations not requiring regulation, including providing for exemptions for securities registered on a national securities exchange and for private placements of securities. In this latter connection it has been observed that there may be some ambiguity in the bill with respect to the scope of the exemption and the need for specific approval of the Attorney General in the case of limited offerings. I am confident that the underlying spirit of the Act will compel a determination that the bill is restricted in its application to situations tantamount to public offerings and will be administered in accordance with a philosophy comparable to that underlying the Federal Securities Act of 1933 which over the years has proven to be entirely workable. 1959 N.Y. Sess. Laws 1767 at 1768.

The cases in New York State courts interpreting the concept of public offering have consistently looked to federal case law interpreting the phrase "not involving a public offering" under § 4(2) of the Securities Act. *People v. Landes*, 84 N.Y.2d 655 (1994); *People v. Glenn Realty Corp.*, 106 Misc. 2d 46 (Sup. Ct. Spec. Term, N.Y. County 1980); *Puro v. Zimmerman*, N.Y.L.J. at 14, col. 3, April 18, 1977 (Sup. Ct.), *aff'd*, 61 A.D.2d 772 (1st Dep't 1978). The OAG itself has looked to federal law and rules in interpreting its statute; *see*, *e.g.*, Interpretive Opinion, 2A *Blue Sky L. Rep.* (CCH) *¶42,584* (December 6, 1994) (advising that issuers are not "dealers" if selling "'*private placements' as that term is understood under federal securities law*, solely to institutional investors described in the last sentence of New York General Business Law § 359-e(1)(a)" [emphasis supplied].

Rule 506 creates a safe harbor for non-public offerings under § 4(2) of the Securities Act. As the SEC makes clear in Preliminary Note 3 to Regulation D, while an offering satisfying Rule 506 will be deemed to be a non-public offering under § 4(2), Rule 506 is not the exclusive means for establishing a § 4(2) exemption. The Rule 506 exemption is not an exemption created by the SEC in the exercise of the authority given to the SEC to create exemptions under § 3(b) of the Securities Act, as are the exemptions under Rules 504 and 505. Rather, it is a determination by the SEC that offerings meeting the conditions of Rule 506 are not public offerings.

This determination by the SEC has been subsequently ratified by Congress in § 18(b)(4)(D) of the Securities Act, which preempts state registration requirements for securities sold in a transaction exempt from registration pursuant to "Commission rules or regulations issued under section 4(2)." At the time § 18 was amended by the National Securities Markets Improvement Act of 1996 ("NSMIA"), and at all times since, the only rule of the SEC describing an offering exemption and issued under § 4(2) has been Rule 506.

In *People v. Landes*, the Court of Appeals discussed the factors to be considered in determining whether an offering is public, looking for guidance to the decision of the Supreme Court in *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953). The decisive factor identified by the Supreme Court in *Ralston Purina* is whether investors have such access to material information about the offering and the issuer and its principals that they do not require a prospectus registered with the SEC. Rule 506 has built into it conditions designed to ensure that investors will have access to all material information about the offering. Rule 502, incorporated into Rule 506, requires that a disclosure document, meeting the requirements of specified SEC registration forms, be provided to all non-accredited investors. Accredited investors, a category that includes institutional investors and high net-worth and high income individuals, have the financial leverage to obtain the information they consider necessary to make the investment. Thus, the most important factor in *People v. Landes* is satisfied in all Rule 506 offerings. The other factors in *People v. Landes* are designed to test whether an offering is being made as part of a public distribution, but the conditions to Rule 506 ensure that these factors are satisfied as well. A Rule 506 offering may not be made using general advertising or general solicitation, and the resale of securities purchased in a Rule 506 offering is restricted.

Given: (a) that the cases in New York State interpreting the concept of public offering have looked to federal case law under § 4(2) of the Securities Act, (b) that the requirements of *People v. Landes* are satisfied by compliance with Rule 506, (c) the clear statement of legislative intent reflected in Governor Rockefeller's memorandum that the term "public offering" under the New York law should be interpreted consistently with the federal securities law, and (d) the clear statement of intent by Congress that Rule 506 should apply to state securities laws uniformly, we believe that all § 4(2) offerings and all Rule 506 offerings are non-public offerings under GBL §§ 352-e and 359-e. We further believe that the Attorney General should state publicly his agreement with that conclusion.

Because § 4(2) and Rule 506 offerings are non-public offerings under GBL §§ 352-e and 359-e, issuers are not required to file any form of notice or fee with the OAG. If New York State wishes to receive a notice and fee for § 4(2) and Rule 506 offerings, it must amend the Martin Act to require (or to permit the Attorney General to require) notice filings in non-public offerings.

The Exclusion for Offerings "to, from or through" a Bank, Dealer or Broker

GBL § 359-e(1)(a) excludes certain persons from the definition of dealer, stating, in part, that "[n]o person shall be deemed to be a 'dealer,' as defined in this subdivision, or a broker, as defined in subdivision (b), solely by reason of the fact that he is engaged in the business of (i) selling, offering for sale, purchasing or offering to purchase any security or securities to, from or through any bank, dealer or broker. . . ." The meaning of this provision is clear on its face. An issuer selling securities *to* an underwriter or underwriting syndicate in a firm commitment offering is excluded from the definition of dealer, and an issuer selling securities *through* a broker or group of brokers in a best efforts offering is likewise excluded from the definition of dealer. Although the OAG has recognized the exclusion for issuers selling in firm commitment offerings, to date it has not publicly recognized the equally valid exclusion for issuers selling through brokers in best efforts offerings. *See, e.g.*, "Broker-Dealer and Securities Registration Information Sheet, Part I(C), *CCH Blue Sky L. Rep. ¶42,573* (revised May 1993).

The intent of the New York State legislature to exclude issuers in both kinds of offerings is highlighted by the 1959 amendment to GBL § 359-e. Prior to that amendment, § 359-e, in relevant part, (a) encompassed only "dealers," not "brokers," (b) defined "dealer" as a person "who engages directly or through an agent in the business of trading in securities in such manner that as part of such business any of such securities are sold or offered for sale to the public in this state," (c) did not explicitly include issuers as a type of "dealer," and (d) contained exclusions for (i) "any sale or offer of sale to any person engaged in the business of acquiring securities for the purpose of resale to the public," and (ii) "any sale or offer of sale to a banker, to a dealer or to a corporation or to any syndicate or group formed for the specific purpose of acquiring such securities for resale to the public directly or through other syndicates or groups, or any sale or offer of sale upon the floor of any exchange to a broker in securities." GBL § 359-e (McKinney 1957, as amended by 1958 N.Y. Laws ch. 750, §§ 4-6).

Thus, the prior version of the statute excluded only sales *to* the designated persons, acting for their own account, and the 1959 addition of an exclusion for sales or offers *through* banks or brokers was a significant change. In particular, by excluding sales through brokers, who, by definition in GBL § 359-e(1)(b), are "engaged in the business of effecting transactions in securities for the account of others," the current exclusion must, by definition, apply to "best efforts" offerings, since a broker may only act in an agency capacity, not as a principal; *i.e.*, one cannot sell securities "to" a broker, but only "through" a broker. The rationale for the Legislature's amendment to expand the exclusion to also exclude sales through a bank or broker is that as long as a bank or registered broker is interjected between an issuer and public investors, there is no basis for also requiring the issuer to register as a dealer.

We realize there is a possibility that, in a best efforts offering, an issuer may sell some securities directly to the public and may, therefore, be a dealer. However, in best efforts offerings in which the issuer sells to the public *exclusively through a broker* (even if it sells directly to persons who are not banks, dealers or brokers in non-public offerings), the issuer is entitled to claim the exclusion from the definition of dealer. We also note the use of the disjunctive "or" introducing the clause following the "to, from or through" exclusion, rather than the conjunctive "and."[2] Thus it is clear that the issuer does not *also* have to be selling to a syndicate, corporation or group formed for the specific purpose of acquiring such securities for resale to the public in order to be entitled to the exclusion. A contrary interpretation would mean, among other things, that the 1959 amendment to the statute adding the word "through" would have served no purpose.

We believe that the Attorney General should publish advice confirming that issuers selling through brokers in best efforts offerings are excluded from the definition of dealer, as clearly provided by GBL § 359-e(1)(a). In the absence of such clarification, many issuers assume the unnecessary burden and expense of filing a Form M-11 issuer-dealer registration statement or a Form 99 issuer-dealer registration statement for covered securities offerings, compromising the privacy rights of the principals of issuers by doing so.[3]

Section 18 Preemption for Rule 506 Offerings

Section 18(a)(1) of the Securities Act, as amended by NSMIA in 1996, provides that no law, rule, regulation or order, or other administrative action of any State "requiring, or with respect to, registration or qualification of securities, or registration or qualification of securities transactions, shall directly or indirectly apply to a security that (A) is a covered security or (B) will be a covered security upon completion of the transaction." Section 18(b)(4)(D) provides that a security is a covered security in a transaction that is exempt from registration under the Securities Act under "Commission rules or regulations issued under Securities Act § 4(2), except that this subparagraph does not prohibit a State from imposing notice filing requirements that are substantially similar to those required by rule or regulation under § 4(2) that are in effect on September 1, 1996."

As discussed above, the only rule or regulation issued by the SEC under § 4(2) is Rule 506. The notice filing requirements in effect on September 1, 1996, were to file the first five pages (Parts A-D) of Form D within 15 days after the first sale of securities in the Rule 506 offering. *See* Rule 503 (Filing of Notice of Sales) and instructions to Form D.

It is clear that § 18 preempts the registration requirements under GBL § 352-e for real estate offerings made pursuant to Rule 506 (leaving aside the fact that under New York statutory provisions, such offerings are private offerings outside of the purview of § 352-e in any event). Section 18(a)(1) provides that no such registration requirement, whether of securities or of *securities transactions* shall apply, *directly or indirectly*, to a covered security. Thus, because of §18 preemption, New York State may not require the registration of issuers as dealers as a way of indirectly requiring registration of transactions in covered securities. All New York State could do (if it were permitted to do so under its statutory provisions) would be to impose notice filing requirements substantially similar to those required by Rule 503 and Form D.[4]

If the Martin Act permitted New York State to receive anything at all under GBL §§ 352-e or 359-e, it could receive only a fee, a consent to service of process and the first five pages (Parts A-D) of Form D together with the "State Signature" portion of page 6 of Form D, within 15 days after the first sale. In particular, New York may not require a notice filing before the first offer, nor may it require responses to questions 1-4 of Part E of Form D as regards information about disqualification under the provisions of Rule 262 of SEC Regulation A, undertakings to make other state filings, undertakings to provide offering materials and representations about familiarity with the Uniform Limited Offering Exemption provisions, as they are not part of the notice filing requirements of the SEC under Rule 506.

We note that information about disqualification under Rule 262 of SEC Regulation A, referenced in Part E on page 6 of Form D, was included in Part E of Form D purely for purposes of the state Uniform Limited Offering Exemption, which is no longer applicable to Rule 506 offerings. The Senate, House and Conference reports on NSMIA make clear that Congress did not intend to permit the states to use the enforcement powers reserved to them to "reconstruct in a different form the regulatory regime for covered securities that Section 18 has preempted." (See excerpts from reports attached as Appendix hereto.)

Section 15(h) Preemption of Further State Notice Filing

GBL § 359-e(8) provides that no dealer may sell or offer to sell securities to the public within New York State as principal or agent unless the dealer has filed a form known as the Further State Notice. The Further State Notice requirement is thus an operational reporting requirement for brokers or dealers.[5] For reasons discussed above, no Further State Notice should be required in any § 4(2) or Rule 506 offering, because such offerings do not involve the sale of securities to the public. To the extent that § 359-e(8) requires filing of a Further State Notice by broker-dealers registered under § 15 of the Exchange Act, that requirement is preempted in any case by § 15(h) of the Exchange Act. Section 15(h)(1) provides, in pertinent part, that

> [n]o law, rule, regulation, or order, or other administrative action of any State or political subdivision thereof shall establish capital, custody, margin, financial responsibility, making and keeping records, bonding, or financial or operational reporting requirements for brokers, dealers, municipal securities dealers, government securities brokers, or government securities dealers that differ from, or are in addition to, the requirements in those areas established under this title.

There is no equivalent to the Further State Notice under the Exchange Act. Since the requirement to file a Further State Notice is an operational reporting requirement for brokers or dealers that differs from, or is in addition to, the requirements established by the SEC and self-regulatory organizations like the NASD under the Exchange Act, §15(h) preempts the Further State Notice requirement, and registered brokers and dealers may not be compelled to file them.

We support the current efforts of the Attorney General to update and streamline its regulation of private offerings. The U.S. Congress has made it clear, through its amendment of Securities Act § 18 by NSMIA, that there is a national interest in reducing the regulatory burden on small business capital formation in connection with Rule 506 offerings. We believe that the Attorney General should take this opportunity to review its interpretation of the Martin Act, and to revise its filing requirements to comply with the provisions of NSMIA. We hope that this position paper assists in that process, and we would be pleased to make ourselves available for additional dialogue on the subjects discussed here.

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Endnotes

1. Section 23.03 of the New York State Art and Cultural Affairs Law requires registration of certain theatrical syndications, and GBL § 359-ff requires registration of intra-state offerings. Those registration requirements are not discussed in this paper, but we note that provisions of federal law preempting registration of real estate syndications apply equally to registration of theatrical syndications.
2. The full exclusion, contained in § 359-e(1)(a)(i), provides:

   > No person shall be deemed to be a "dealer," as defined in this subdivision, or a broker, as defined in subdivision (b), solely by reason of the fact that he is engaged in the business of (i) selling, offering for sale, purchasing or offering to purchase any security or securities to, from or through any bank, dealer or broker, or to or from any syndicate, corporation or group formed for the specific purpose of acquiring such securities for resale to the public directly or through other syndicates or groups.

3. Principals of issuers registering on Form M-11 are required to disclose their social security numbers and residence addresses, among other facts. Officers and directors of foreign companies, in particular, have long objected to disclosing their residence addresses for fear of kidnapping and assassination.
4. The power of Congress to preempt state laws in matters of interstate commerce, even where the state asserts its police powers, has been decisively settled. As the Supreme Court stated in *Hodel v. Virginia Surface Mining & Reclamation Assoc., Inc.*, 452 U.S. 264, 290-291 (1981), "A wealth of precedent attests to congressional authority to displace or pre-empt state laws regulating private activity affecting interstate commerce when these laws conflict with federal law. [Citations omitted.] Moreover, it is clear that the Commerce Clause empowers Congress to prohibit all—and not just inconsistent—state regulation of such activities. . . . This conclusion applies regardless of whether the federal legislation displaces laws enacted under the States' 'police powers.' The Court long ago rejected the suggestion that Congress invades areas reserved to the States by the Tenth Amendment simply because it exercises its authority under the Commerce Clause in a manner that displaces the States' exercise of their police powers."
5. If the Further State Notice were a transactional reporting requirement, it would be preempted by Securities Act § 18(b)(4)(D).

Appendix

Excerpts from Committee Reports on NSMIA Relating to Preemption of State Registration of Covered Securities

From Conference Report H. Rept. No. 104-684. September 28, 1996

With respect to securities offerings, the Managers have allocated regulatory responsibility between the Federal and state governments based on the nature of the securities offering. Some securities offerings, such as those made by investment companies, and certain private placements are inherently national in nature, and are therefore subject to only federal regulation. Smaller, regional, and intrastate securities offerings remain subject to state regulation. The Managers have preserved the authority of the states to protect investors through application of state antifraud laws. This preservation of authority is intended to permit state securities regulators to continue to exercise their police power to prevent fraud and broker-dealer sales practice abuses, such as churning accounts or misleading customers. It does not preserve the authority of state securities regulators to regulate the securities registration and offering process through commenting on and/or imposing requirements on the contents of prospectuses or other offering documents, whether prior to their use in a state or after such use.

From United States Senate Report No. 104-293. June 26, 1996

In both cases, the bill preserves state fraud authority. This preservation of authority makes clear that states would continue their role in regulating broker-dealer conduct whether or not the offering is subject to state review. The Committee believes that allowing the states to oversee broker-dealer conduct in connection with preempted offerings will ensure continued investor protection. As long as states continue to police fraud in these offerings, compliance at the federal level will adequately protect investors. In preserving this authority, however, the Committee expects the states only to police conduct—not to use this authority as justification to continue reviewing exempted registration statements or prospectuses. The Committee clearly does not intend for the "policing" authority to provide states with a means to undo the state registration preemptions. States will continue to receive notice filings and fees as specified to facilitate their antifraud efforts.

From House Report No. 104-622. June 17, 1996

Section 18(a) prohibits State governments from requiring the registration of, or otherwise imposing conditions on, offerings of "covered securities" as defined in Section 18(b), subject to Section 18(d), which preserves State authority to investigate and bring enforcement actions with respect to fraud or deceit (including broker-dealer sales practices) in connection with securities or securities transactions. Section 18(d) also preserves the authority of States to require notice filings and fees with respect to certain offerings, and to suspend the offer or sale of securities within a State as a result of the failure to submit a filing or fee. Section 18(a) also limits State governments from requiring the regulation or otherwise imposing conditions on offerings of "conditionally covered securities" as defined in Section 18(c). Section 18(a) specifically provides that States may not conduct merit reviews of these offerings. In addition, Section 18(a) prohibits States from placing limits or imposing conditions upon (including outright prohibition of) the use of offering documents with respect to such "covered securities" offerings, including advertising or sales literature used in connection with such offerings. It further preempts State regulation or other disclosure documents such as proxy statements and annual reports. In each case, the prohibition applies both to direct and indirect State action, thus precluding States from exercising indirect authority to regulate the matters preempted by Section 18(a). Also, in each case, the prohibitions are subject to the provisions of subsection (d). By extending the prohibition to indirect State action, the Committee specifically intends to prevent State regulators from circumventing the provisions of Section 18(a) that expressly prohibit them from requiring the registration of, or otherwise imposing conditions or limitations upon, offerings of covered securities. The Committee does not intend, however, that the extension of the prohibition to indirect actions by State regulators restrict or limit their ability to investigate, bring actions, or enforce orders, injunctions, judgments or remedies based on alleged violations of State laws that prohibit fraud and deceit or that govern broker-dealer sales practices in connection with securities or securities transactions.

* * *

Paragraph 18(d)(1) preserves specified State authority, pursuant to state law, consistent with Section 18. The relationship between Section 18(d) and Section 18(a) is especially important. The Committee intends to preserve the ability of the States to investigate and bring enforcement actions under the laws of their own State with respect to fraud and deceit (including broker-dealer sales practices) in connection with any securities or any securities transactions, whether or not such securities or transactions are otherwise preempted from state regulation by Section 18. It is the Committee's intent that the limitations on State law established by Section 18 apply to State law registration and regulation of securities offerings, and do not affect existing State laws governing broker-dealers, including broker-dealer sales practices. In preserving State laws against fraud and deceit, (including broker-dealer sale practice abuse), however, the Committee intends to prevent the States from indirectly doing what they have been prohibited from doing directly. The Committee intends that the authority that States retain over broker-dealers to allow the States to impose conditions on, or otherwise to regulate, offerings of securities. [sic] The legislation preempts authority that would allow the States to employ the regulatory authority they retain to reconstruct in a different form the regulatory regime for covered securities that Section 18 has preempted.

Thus, for example, Section 18 precludes State regulators from, among other things, citing a State law against fraud or deceit or regarding broker-dealer sales practices as its justification for prohibiting the circulation of a prospectus or other offering document or advertisement for a covered security that does not include a legend or disclosure that the State believes is necessary or that includes information that a State regulator criticizes based on the format or content thereof. The Committee intends to eliminate States' authority to require or otherwise impose conditions on the disclosure of any information for covered securities.