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Private Placements in Florida After the National Securities Markets Improvement Act of 1996

by Jeff Mihm

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In October 1996, Congress preempted the ability of the states to substantively regulate private placements of securities conducted in accordance with Rule 506 under the Securities Act of 1933. The effect of this recent law—the National Securities Markets Improvement Act of 1996 (NSMIA)[1]—on private placements in Florida is illustrated by the following hypothetical:

The CEO of your small business client calls with a problem. A couple of years ago, she tells you, seven individuals (all located in Florida and all very wealthy) invested a total of $1.5 million in your client's business in exchange for shares of the corporation's stock. Upon questioning, you learn that no disclosure document or other notice was given to the investors. One of the seven investors is now complaining about the performance of the business. After consulting with his attorney, this investor claims he is entitled to the return of his investment. What, she asks you, should she do?

The answer depends on when the private placement occurred. For an offering occurring prior to the passage of NSMIA, the investor's counsel is right—the complaining investor (indeed, all seven investors) is entitled to rescind the sale of the securities and the return of his or her investment. After NSMIA, however, the result is turned on its head and your client should prevail against a claim to rescind the sale of the securities.

This article examines the state and federal securities laws applicable to this hypothetical. The first part of this article provides a general overview of the Florida Securities and Investor Protection Act (Florida Securities Act) and then describes the exemption for private placements in Florida, including the right of purchasers to rescind sales made pursuant to this exemption. This part also examines an often overlooked aspect of compliance with the Florida Securities Act—the possibility that the issuer or the persons selling the securities on behalf of the issuer may need to be registered as a "dealer" under the Florida Securities Act. The second part of this article reviews NSMIA and its preemptive effect on state regulation of private placements conducted in accordance with the federal safe harbor provided by Rule 506. The final part of this article reviews and answers the above hypothetical and concludes by arguing against any attempt to require an issuer placing its own securities in a Rule 506 offering to be registered as a "dealer" under the Florida Securities Act.

Florida Securities Act—A Primer for the Practitioner

As most practitioners know, every offer and sale of securities must comply with both the federal and state securities laws. On the federal level, this involves the Securities Act of 1933 (Securities Act) as administered by the Securities and Exchange Commission (SEC). In Florida, it involves the Florida Securities Act as administered by the Florida Department of Banking and Finance, Division of Securities and Investor Protection (the Florida Division of Securities).[2]

The statutory scheme of the Florida Securities Act (and most other states' blue sky laws) follows the statutory scheme of the federal laws: The security[3] offered for sale must either be registered with the state or qualify for an exemption from registration.[4] The registration process—both on the federal and state level—can be onerous, costly, and time consuming. In addition, registration of securities in many states, including Florida, is subject to "merit" review by the state regulators.[5] Under merit review, the state may refuse to register an offering upon a determination that the terms of the offering are not "fair, just or equitable."[6] As a result of the time and cost involved in the registration process, the first step in reviewing the application of the Florida Securities Act to a particular offering of securities is to determine whether an exemption from registration exists.

Exemptions from registration of a security offered in Florida fall into two classes—"exempt" securities, based on the nature of security being offered, and "exempt transactions," based on the nature of the transaction in which the security is offered.[7] Examples of exempt securities for which registration is not required include securities issued by certain governments, banks, specified nonprofit organizations, and others.[8] Since the types of exempt securities are exceptional and rarely applicable to the vast majority of offering by for-profit issuers, most issuers must look to the exempt transactions in order to avoid registering the securities to be offered for sale. Exempt transactions take many forms.[9] Some of the more commonly relied upon exempt transactions are for isolated sales by an individual, stock dividends or other distributions to security holders, sales to a sophisticated institution such as a bank, savings institution, insurance company, dealer, investment company, or qualified institutional buyer, sales by a Florida registered dealer, and sales under a stock option or other employee benefit plan.[10]

Private Placement Exemption in Florida

For corporations and other issuers of securities, the exemption[11] for the private placement of securities in Florida (private placement exemption) is likely the most relied upon of the exempt transactions. The private placement exemption allows an issuer to sell its securities to no more than 35 purchasers in any 12-month period without the need to register the securities with the Florida Division of Securities. The 35 purchaser limit does not include accredited investors,[12] purchasers who invest more than $100,000, or certain relatives or spouses of purchasers.[13] It also does not include any purchaser with whom the transaction was consummated outside the State of Florida.[14] For an offering to qualify for the private placement exemption, there cannot be any public advertising or general solicitation of the offering in Florida.[15]

The issuer must provide each purchaser in the private placement "with full and fair disclosure of all material information."[16] The issuer typically meets this disclosure requirement in one of two ways. The first is to provide prospective purchasers with access to the books and records of the issuer as well as the opportunity to ask questions of the executive officers of the issuer.[17] If this approach is taken, counsel for the issuer should ensure that, among other things, a representation to this effect is included in the subscription agreement for the offering. The second manner in which the issuer may meet its disclosure obligation under the private placement exemption is to provide the purchaser with a disclosure document, often referred to as an offering circular or private placement memorandum (PPM). Where feasible, the PPM should contain all of the information prescribed by the Florida Division of Securities in Fla. Admin. Code rule 3E-500.005. This rule, however, is simply a safe harbor; failure to include the information listed in the rule does not necessarily mean that the issuer has failed to give the purchaser full and fair disclosure of all material information.

Unlike most other states, the private placement exemption in Florida gives a purchaser the explicit right to rescind the sale of a security when sales are made to five or more purchasers.[18] A purchaser's right of rescission expires on the later of three days after the first tender of consideration is made by such purchaser to the issuer, or three days after the availability of the rescission privilege is communicated to the purchaser.[19] In order to toll the right of rescission, the issuer should advise purchasers of the availability of the right of rescission in the PPM or subscription agreement.[20] Care should be taken that the notice closely follows the statutory language. In *Barnebey v. E.F. Hutton & Co.,* 715 F. Supp. 1512, 1531 (M.D. Fla. 1989), a notice stating that a purchaser could void his subscription within three days of the submission of a subscription agreement was held to be insufficient because it failed to follow the specific statutory language noted above.

The payment of a commission or finder's fee to any person other than a registered dealer in Florida will prevent the issuer from properly claiming the private placement exemption.[21] Some issuers have attempted to avoid this requirement by characterizing the prohibited commission or finder's fee as an unrelated consulting fee or other type of payment. The Florida Division of Securities has issued a sternly worded warning to issuers about the consequences of such subterfuge:

The [Florida Division of Securities] is deeply concerned about the payment of fees to persons who are acting as dealers but are not registered as such when securities are offered and sold pursuant to Florida's private placement section. The practice of disguising or characterizing these fees as something other than a sales commission not only defeats the availability of the exemption, but also produces an enormous contingent liability for the issuer. Because of these ramifications, an issuer availing itself of the private placement section should be cautious about any fees that are paid to persons who may subsequently be deemed to be dealers, including such professionals as attorneys, accountants, and offeree representatives.[22]

Registration as a Dealer in Florida

As the Florida Division of Securities has warned, if a dealer (as defined broadly in F.S. §517.021(6)) is involved in the private placement, the dealer must be registered with the Florida Division of Securities pursuant to F.S. §517.12. Often, though, the issuer decides to place its securities without the benefit of a registered dealer (and thereby avoid paying a commission or other fee to the dealer). In such case, the securities are placed directly by the issuer through its officers and directors. An often overlooked aspect of an issuer's compliance with the Florida Securities Act (as well as the blue sky laws of other states in which offers and sales are made) is the possibility that the issuer as well as the person who sells the securities on behalf of the issuer may fall within the definition of a "dealer" under the Florida Securities Act and thus be required to be registered with the Florida Division of Securities as such.

F.S. §517.12 states that no dealer, associated person, or issuer of securities may sell any securities in or from offices in Florida or securities to persons in Florida from offices outside Florida unless the person is registered with the Florida Division of Securities. Issuers' counsel needs to review §517.12 and the definition of dealer,[23] associated person,[24] and issuer[25] in the Florida Securities Act to determine whether the issuer and the other participants in a particular offering need to be registered as with the Florida Division of Securities. Failure to register entitles the purchaser to a 30-day right of rescission if the purchaser still has the security or an action for damages if the security has been sold.[26] An issuer that is required to register under §517.12 may elect to register as an issuer/dealer under Fla. Admin. Code rule 3E-600.004. As part of the issuer/ dealer application, the issuer may register up to five associated persons (*e.g.,* officers and directors), who become exempt from the examination requirements that typically apply to associated persons. The registration process for an issuer/dealer in Florida is similar to registering as a dealer in Florida, including submitting a Form BD for the issuer and a Form U-4 and fingerprint card for each associated person.

Fortunately, from the perspective of the issuer conducting an offering in accordance with the private placement exemption in Florida, the issuer is provided with an exemption from registering as an issuer/dealer.[27] Likewise, the person offering the securities on behalf of the issuer in accordance with the private placement exemption is not required to register as a dealer

if such person is a bona fide employee of the issuer who has not participated in the distribution or sale of any securities in the last 12 months and who primarily performs, or is intended to perform at the end of the distribution, substantial duties for, or on behalf of, the issuer other than in connection with transactions in securities.[28]

Generally, offerings involving exempt securities or exempt transactions are also exempt from the dealer registration requirements of §517.12. An issuer, however, cannot assume that it is exempt from issuer/dealer registration simply because the particular offering is exempt from security registration. This point is explored below in the context of a private placement conducted in accordance with Rule 506 after the passage of NSMIA.

National Securities Markets Improvement Act of 1996

In October 1997, the Florida Securities Act was amended to exclude a whole new class of securities known as "federal covered securities" from the registration requirements of the Florida Securities Act.[29] This amendment was prompted by NSMIA. Enacted in October 1996, NSMIA dramatically reallocated the respective roles of the federal government and the states in practically all areas of securities regulation, including the regulation of broker-dealers, investment advisers, and mutual funds.

One of the most important consequences of NSMIA was the elimination of the authority of the states to substantively regulate four broad classes of securities. Specifically, the states may not "directly or indirectly, prohibit, limit or impose conditions, based on the merits of such offering or issuer," on the following "covered securities": 1) securities listed on the New York Stock Exchange, the American Stock Exchange, the NASDAQ National Market, and other stock exchanges identified by the SEC as having substantially similar listing standards; 2) securities issued by investment companies registered by the SEC under the Investment Company Act of 1940; 3) sales to "qualified purchasers" as defined by SEC regulation; and 4) securities issued in transactions exempt under: a) section 4(1) (for transactions by persons other than an issuer, underwriter or dealer) of the Securities Act for the securities of reporting companies under the Securities Exchange Act of 1934; b) section 4(4) (broker's transactions) of the Securities Act; c) section 3(a), not including securities of religious or charitable organizations, securities issued in intrastate offerings, and municipal securities offered in their home state; and (d) securities issued pursuant to the SEC's rules and regulations under §4(2) of the Securities Act.

Securities offered and sold in accordance with Rule 506 of Regulation D are considered "covered securities." This is because Rule 506 was promulgated by the SEC under §4(2) of the Securities Act.[30] Under Rule 506, the offer and sale of an unlimited amount of securities is exempt from federal registration provided there are no more than 35 unaccredited investors and the other requirements of Rule 506 and Regulation D are satisfied.[31] Like the Florida Private Placement exemption, the 35-person limit of Rule 506 does not include "accredited investors," which are defined in Rule 501(a) of Regulation D, and certain excluded purchasers, which are defined in Rule 501(e) of Regulation D. Each purchaser in the Rule 506 offering who is not an accredited investor must either alone or with his or her purchaser representative(s) have such knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of the prospective investment. If sales are made only to accredited investors, there is no specific disclosure document that needs to be furnished to such investors. If, on the other hand, sales are made to nonaccredited investors, the issuer must furnish investors with the information specified by Rule 502(b)(2). In addition, the offering must comply with the general conditions of Rules 501, 502, and 503. This includes prohibition on any general solicitation or general advertising of the offering, restrictions on the resale of securities sold under Rule 506, and filing of a notice of sales on Form D.

Although the states are now preempted from requiring the registration of, or otherwise imposing conditions on, "covered securities," they still retain their antifraud enforcement powers[32] and may continue to require notice filings, consents to service or process, and certain fees.[33] Since the Florida Securities Act does not require the filing of a notice or the payment of a fee in order to claim an exemption from registration, this latter provision has had no effect in Florida.

Effect of NSMIA on Rule 506 Offerings in Florida

In the hypothetical at the beginning of this article, a corporation sold $1.5 million worth of securities to seven investors. We assume here that all the wealthy investors were accredited under Rule 501 of Regulation D and that the other requirements for a Rule 506 offering have been satisfied. Of course, prior to NSMIA, the fact that the offering complied with Rule 506 was meaningless for purposes of the Florida Securities Act. Instead, the offering must have complied with the requirements of the Florida Private Placement Exemption. In the hypothetical, no notice was given to the seven investors, including notice of their three-day right of rescission under the Florida Private Placement Exemption.

Because the issuer failed to give the required rescission notice, the investors, prior to the passage of NSMIA, could have immediately demanded the rescission of the offering pursuant to F.S. §517.061. After NSMIA, however, the issuer's failure to provide the rescission notice has no effect. Since the offering complied with Rule 506, NSMIA preempts the authority of the state to substantively regulate the offering, including the three-day right of rescission previously afforded by the Private Placement Exemption.

In the hypothetical, the issuer did not register as an issuer/dealer under F.S. §517.012. As discussed above, an issuer that complies with the Florida Private Placement Exemption does not have to register as an issuer/dealer. There is, however, no corresponding exemption for issuers offering "federal covered securities." Does this mean, as some have suggested, that a Rule 506 offering in Florida must still comply with the requirements of the Florida Private Placement Exemption in order to avoid issuer/dealer registration? Stated differently, may an investor in a Rule 506 offering that does not otherwise

meet all the requirements of the Florida Private Placement Exemption claim the issuer violated the Florida Securities Act by failing to register as an issuer/dealer and, therefore, demand a 30-day right of rescission under §517.211?

While no court in Florida has yet addressed this issue, the answer should be an emphatic "no." NSMIA prohibits the states from, directly or indirectly, imposing any condition, based on the merits of the offering or the issuer, upon the offer or sale of any covered securities. Any attempt to impose issuer/dealer registration on an issuer in order to sell its securities in a Rule 506 offering would be an impermissible indirect condition on the offering and the issuer. The statutory language, as well as the principal purpose of NSMIA to reduce duplicative state and federal regulation, should prevent any attempt to back-door regulate a Rule 506 offering through issuer/dealer registration.[34] The Florida Legislature should clarify this ambiguity by amending §517.012(3) to exempt Rule 506 transactions (and other "federal covered securities" for which an ambiguity may exist) from the registration requirements of §517.012. In the meantime, the Florida Division of Securities should follow the recommendation of the North American Securities Administrators Association and extend the same treatment to the issuer (and its agents) in a Rule 506 offering as it does to the issuer (and its agents) in an offering exempt under the Private Placement Exemption.[35]

Conclusion

Counsel representing defrauded investors should be aware that the Florida Securities Act provides a three-day right of rescission to investors that purchase securities in a private placement to five or more persons in Florida. With the passage of NSMIA, however, this right of rescission (and the other provisions of the Florida Private Placement Exemption) no longer applies to private placements conducted in accordance with Rule 506 of the Securities Act. Nevertheless, issuers conducting a Rule 506 offering in Florida may wish to continue to offer and provide notice of the three-day right of rescission (and otherwise comply with the requirements of the Florida Private Placement Exemption) until it is settled that the issuer/dealer requirements of F.S. §517.012 do not apply to Rule 506 offerings. The Florida Legislature should clarify this ambiguity by amending §517.012(3) to exempt Rule 506 offerings from the registration requirements of §517.012.

[1] Pub. L. No. 104-290, 110 Stat. 3416 (1996).
[2] Fla. Stat. §517 *et seq.* The Florida Securities Act is supplemented by a series of regulations promulgated by the Florida Division of Securities. Fla. Admin. Code Ann. r. 3E-100.005 *et seq.*
[3] Fla. Stat. §517.021(18) lists stocks and bonds and 18 other examples of what is included in the definition of a security. Also included is an "investment contract" which the Supreme Court broadly defined in *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946) as a "contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." Unlike many states, neither the Florida Securities Act nor the regulations promulgated by the Florida Division of Securities expressly define an interest in a limited liability company as a security. Especially in the case of an offer of an interest in a "manager-managed" LLC to a large number of persons, counsel should review *Howey* and its progeny to determine whether the LLC interest could be deemed to be an investment contract. *See generally* Park McGinty, *Are Interests in Limited Liability Companies Securities?* 25 Sec. Reg. L.J. 121 (1997).
[4] Fla. Stat. §517.07(1).
[5] Fla. Stat. §517.081(7).
[6] Fla. Stat. §517.111(1)(i). For most securities registered with the SEC, the Florida Securities Act permits the securities to be registered "by notification" pursuant to Fla. Stat. §517.082. Securities registered by notification are not subject to merit review and a determination that the offering is "fair, just and equitable."
[7] Fla. Stat. §§517.051 and 517.061. Both types of exemptions in Florida are self-executing, meaning that there is no filing requirement with the Florida Division of Securities in order to claim the exemption. In any proceeding to determine the validity of the exemption, the burden of proof rests on the person claiming the exemption. *See also Weinberg v. Pennington,* 462 So. 2d 862, 863 (Fla. 3d D.C.A. 1985).
[8] Fla. Stat. §517.051.
[9] *See* Fla. Stat. §517.061 which lists 19 different types of transactions that are exempted from Florida's registration requirements.
[10] *See* Fla. Stat. §517.061.
[11] Fla. Stat. §517.061(11).
[12] Fla. Stat. §517.061(11)(b)(5). The definition of accredited investor under Fla. Stat. §517.061(11) refers to the definition of the same in Rule 501 of Regulation D promulgated under the Securities Act. *See supra* note 31 accompanying text.
[13] Fla. Stat. §517.061(11)(b).
[14] Fla. Admin. Code Ann. r. 3E-500.004.
[15] Fla. Stat. §517.061(11)(a)(2). *See* Fla. Admin. Code Ann. r. 3E-500.007.
[16] Fla. Stat. §517.061(11)(a)(3).
[17] Fla. Admin. Code Ann. r. 3E-500.005(5)(a) provides that an issuer shall be deemed to have given a purchaser access to material information if the purchaser is given access to: 1) all material books and records of the issuer; 2) all material contracts and documents relating to the proposed transaction; and 3) an opportunity to question the appropriate executive officers or partners.
[18] Fla. Stat. §517.061(11)(a)(5).
[19] *Id.*
[20] The following is an example of the Florida legend included in a private placement memorandum: In the event that sales of the securities offered hereby are made to five or more persons in Florida, all purchasers in Florida have the right to void the sale of the securities offered hereby within three days after the payment of the purchase price is made to the company, an agent of the company or an escrow agent.
[21] Fla. Stat. §517.061(11)(a)(4).
[22] Fla. Admin. Code Ann. r. 3E-500.006(2).
[23] Fla. Stat. §517.021(6).

[24] Fla. Stat. §517.021(2).
[25] Fla. Stat. §517.021(12).
[26] Fla. Stat. §517.211.
[27] Fla. Stat. §517.12(2).
[28] Fla. Stat. §517.021(6)(b)(6).
[29] Fla. Stat. §517.07(1).
[30] By contrast, Rule 504 and Rule 505 offerings are not considered "covered securities" because these rules were promulgated by the SEC under §3(b) of the Securities Act, not §4(2).
[31] *See generally* Randolph H. Elkins & Larry M. Meeks, *Regulation D,* 51-2nd C.P.S. (BNA).
[32] 15 U.S.C.A. §77(c)(1).
[33] 15 U.S.C.A. §77(c)(2).
[34] *See* Mark A. Sargent, *Blue Sky Mysteries of the National Securities Markets Improvements Act,* 25 Sec. Reg. L.J. 91, 97 (1997).
[35] *See* G. Philip Rutledge, *NSMIA...One Year Later: The States' Response,* 53 Bus. Law. 563, 565 (1998) (citing NASAA Interpretive Memorandum Regarding Issuer-Agent Licensing for Rule 506 Offerings (Nov. 27, 1996) (on file with The Business Lawyer, University of Maryland School of Law)).

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