STATE CORNER

California's Blue Sky Law Problems for Foreign Issues and Foreign Issuers

by Keith Paul Bishop

As a result of the enactment of the National Securities Markets Improvement Act in 1996 (NSMIA), state securities regulation of exchange traded issuers largely has become a thing of the past.[1] Indeed, many lawyers may view state securities laws as a concern only for over-the-counter companies and issuers engaged in private placements.[2] Consequently, they may not even think about the possible application of state blue sky statutes—especially when representing domestic issuers relying on Regulation S or large issuers traded on foreign stock exchanges. In fact, these issuers and persons trading in their securities may unwittingly run afoul of state blue sky laws. This article reviews some of these overlooked areas under California's Corporate Securities Law of 1968 (CSL) from the perspective of foreign issues and issuers.

Primary Offerings and Regulation S

Section 5 of the Securities Act of 1933 (Securities Act) by its terms applies to all offers and sales of a security involving interstate commerce or the use of the mails, unless an exemption is available.[3] Section 2(7) of the Securities Act defines the term "interstate commerce" to include "trade or commerce in securities or any transaction or communication relating thereto . . . between any foreign country and any State . . .".[4] Thus, the Securities Act's registration and prospectus delivery provisions as set forth in Section 5 could conceivably apply to virtually anyone, anywhere in the world.[5]

Keith Paul Bishop is a partner at Allen Matkins Leck Gamble Mallory & Natsis LLP in Irvine, CA, and an adjunct professor of law at Chapman University School of Law. He previously served as California's Commissioner of Corporations and Interim Savings & Loan Commissioner.

In 1990, the Securities and Exchange Commission (SEC) adopted Regulation S to establish nonexclusive safe harbors for extraterritorial offers, sales, and resales of securities.[6] Regulation S consists of nine preliminary statements and five rules. The guiding principle of Regulation S is set forth in Rule 901, which provides that for purposes of Section 5 of the Securities Act, the terms "offer," "offer to sell," "sell," "sale," and "offer to buy" are deemed to include offers and sales that occur *within* the United States and these terms do not include offers and sales that occur *outside* of the United States.[7] In other words, if an offer or sale is made outside of the United States, then it will not be subject to the registration or prospectus delivery requirements under the Securities Act. Rule 903 specifies when an offer or sale of securities by the issuer, a distributor, any of their affiliates, or anyone acting on their behalf occurs outside of the United States. Under Rule 903, two conditions must be satisfied in every case.

First, the offer and sale must be made in an "offshore transaction."[8] An offer or sale of securities is made in an "offshore transaction" if the offer is not made to a person in the United States and either:

At the time the buy order is originated, the buyer is outside the United States, or the seller and any person acting on its behalf reasonably believe that the buyer is outside the United states; or The transaction is executed in, on or through a physical trading floor of an established foreign securities exchange that is located outside the United States.[9]

The second condition requires that no issuer, distributor, any affiliates, or any person acting on their behalf make any "directed selling efforts" in the United States.[10] The term "directed selling efforts" is defined to mean any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States for any of the securities being offered in reliance on Regulations S.[11] Notably, this includes placing an advertisement in a publication

with "general circulation in the United States" that refers to the offering of the securities being made in reliance on Regulation S.[12] If these two general conditions are satisfied, Regulation S establishes a safe harbor for issuers, distributors, their respective affiliates, and persons acting on behalf of any of them. This primary offering safe harbor is further separated into three different categories of offerings based on factors such as the nationality of the issuer and its reporting status.[13]

While Regulation S provides a relatively clear, albeit complicated, guide to when an offer or sale of a security in a primary offering is subject to the Securities Act's registration and prospectus delivery requirements, the regulation says nothing about the application of state securities laws. In fact, the fourth preliminary statement to Regulation S states that the regulation does not eliminate the need to comply with any applicable state laws. Accordingly, issuers and others relying on the Regulation S primary offering safe harbor must take into account the potential application of state securities laws and not simply assume that compliance with Regulation S is sufficient.

California's Jurisdiction

The basic operative principle of the CSL is easily stated and conceptually is similar to that of the registration requirements of the Securities Act: The offer or sale of security must be qualified unless it is exempt. Unlike the Securities Act, however, the CSL has three independent qualification requirements depending on the type of transaction. These are issuer transactions,[14] non-issuer transactions,[15] and recapitalizations and reorganizations.[16] It is important to note that in each case the statute declares it unlawful for any person to offer or sell a security. Thus, it is not unlawful under these statutes to offer to buy a security without qualification. However, offers to buy are subject to California's antifraud statute.[17]

As discussed above, the jurisdictional underpinning of Section 5 of the Securities Act is "interstate commerce" as defined in Section 2(7) of that act. As a state, California obviously can not use the same basis for defining the reach of its qualification requirements. Rather, California defines its jurisdiction by specifying that in all three types of transactions the CSL's qualification requirement will apply if the offer or sale of a security occurs "in this state." California Corporations Code § 25008 defines when an offer or sale is made "in this state."

Unfortunately, Section 25008 is mind numbingly complicated and extremely difficult to make sense of. As a starting point, it is important to understand that the CSL defines an offer or sale as occurring in California when any of the following occurs:

- An *offer to sell* is made in California;
- An *offer to buy* is accepted in California; or
- A security is delivered to the purchaser in California if both the seller and purchaser are domiciled in California.[18]

If any of these situations is present, then California jurisdiction attaches to the transaction and the offer and sale must be qualified or an exemption must be identified.

The first situation involves *offers to sell*. When considering offers to sell, it is important to recognize that California's qualification requirements apply to an offer of a security even when that offer is not consummated by a sale or when the sale is consummated outside of California.[19] While it is tempting to believe that an unconsummated offer of a security represents a case of "no harm, no foul" that is not the law under the CSL. For example, a California Court of Appeal in *People v. Kline* upheld a defendant's conviction for an unlawful sale of securities.[20] In doing so, the court noted that "[a]ctual transfer of consideration is not necessary to constitute an unlawful offer to sell securities."[21]

The CSL defines an "offer to sell" to include every attempt or offer to dispose of, or solicitation of an offer to buy, a security, or interest in a security for value.[22] This definition is the same as that used in Section 401(k) of the Uniform Securities Act of 1956, which in turn had borrowed the definition from Section 2(a)(3) of the Securities Act.[23] The generality and breadth of this definition make it difficult to draw a clear line between preliminary talk or general business discussions and an offer to

sell. This difficulty was well illustrated in *B.C. Turf & Country Club v. Daugherty*.[24] In that case, a Canadian lawyer came to California to meet with four investors to see if they were interested in purchasing two race tracks in Vancouver, British Columbia.[25] The Commissioner of Corporations found that this meeting constituted an illegal offer of securities. The Court of Appeal disagreed, noting that when the lawyer visited California, no entity had yet been formed. According to the court, the only thing the lawyer had to sell at that time was his personally owned option to acquire one of the tracks and the general idea of operating race tracks in Vancouver. Thus, the court found that the discussions in California did not amount to a solicitation requiring a permit.[26] In reaching this conclusion, the court noted that "courts must approach this problem with some degree of realism."[27] While the court's decision provides some comfort for issuers, they should be alert to the fact that business discussions in California can ripen into offers that must be qualified unless exempt from qualification.

If it is determined that an offer has been made, it still must be determined whether the offer to sell was made in California. Corporations Code § 25008(b) provides that an offer to sell is made in California in two situations.[28]

First, an offer is made in California when it *originates* from the state. This differs from the approach of Regulation S which focuses on the location of the person to whom the offer is made.[29] Thus, the Commissioner has concluded that even when an offer of a security is initially made in a foreign country, the offer will be subject to the CSL if subsequent discussions are held with the investors while the offeror is in California.[30] The Commissioner reached a similar conclusion involving the offer and sale of limited partnership interests to nonresidents of California pursuant to a private placement memorandum sent to potential investors from Washington, DC.[31] Because the general partner was located in California and was available to answer questions, the Commissioner was unable to conclude that offers would not be made in California.[32]

Second, an offer is made in California when it is directed by the offeror to California and received at the place to which it is directed. In this instance, the location of the offeror is irrelevant and the focus is on the locus of the offeree. Because Regulation S is conditioned on offers not being made to a person in the United States, there is perhaps less opportunity for conflict between California's statute and Regulation S in this respect.

In both of the preceding situations, the offer in question is the offer to sell; not an offer to buy. Thus, the offeror always will be the prospective seller and the offeree always will be the prospective buyer.

The second situation in which California applies jurisdiction involves an *offer to buy* that is accepted in California. An offer to buy is accepted in California when acceptance is communicated to the offeror in California.[33] Note that in this case, the offeror is the prospective buyer; not the prospective seller.[34] The statute further provides that acceptance is communicated to the offeror when the offeree directs the acceptance to the offeror in California reasonably believing the offeror to be in California and it is received at the place to which the acceptance was directed. Thus, this situation focuses not on the offeree's (prospective seller's) location but on the offeror's (prospective buyer's) location. For example, an issuer may make an offer to sell a security in Japan and then fly to California and receive there an offer to buy from the prospective buyer who remains in Japan. If the issuer sends its acceptance of the offer to buy to the prospective buyer in Japan, the CSL will not treat the offer to buy as being accepted in California. On the other hand, further communication by the issuer after returning to California could, as discussed above, constitute an offer to sell that originates from California. In that case, the offer would be subject to the CSL. If the situation is reversed so that it is the prospective buyer who returns to California and sends an offer to buy to the issuer who remains in Japan, the issuer's communication of acceptance to the offeror in California would subject the transaction to qualification (assuming that the offeree reasonably believed the offeror to be in California and the acceptance is received at the place to which it was directed). Note that the offeror (prospective buyer) does not have to be actually present in California for an offer to buy to be accepted in California. Rather, the offeree

(prospective seller) must reasonably believe that the offeror is in California and direct the acceptance to the offeror in California. Further, the acceptance must be received where it was directed.[35]

Given the rather precise statutory requirements for acceptance of an offer to buy in California, parties may believe that they can avoid California's jurisdiction by moving the closing out of state. This will not work, however, if the parties already have had communications in California that constitute an offer. As discussed above, California jurisdiction will attach if an offer is made in California. In *Hall v. Superior Court,*[36] the parties held discussions in Laguna Hills, California about an exchange of securities. The actual exchange agreement was executed at McCarran Airport in Las Vegas, Nevada. The Court of Appeal found that an offer to sell or buy a security had been made in California.[37]

The third situation in which California asserts jurisdiction is when the security is delivered to the purchaser in California if both the seller and the purchaser are "domiciled" in California.[38] A security is considered delivered to the purchaser in California when the certificate or other evidence of the security is directed to the purchaser in California and received at the place to which it is directed.[39] The statute does not define "domicile." Literally, a domicile is a person's home. But where is a corporation or other legal entity's home? One leading treatise has said that the domicile of a corporation "should be considered its state of incorporation by analogy to the holdings in other situations."[40] Note that under Regulation S, execution and delivery of the transaction outside of the United States are not required in order to satisfy the first alternative definition of an "offshore transaction."[41]

California also differs from Regulation S in its treatment of advertising. Under the CSL, an offer to sell or buy is not made "in this state" merely because:

- The publisher circulates or there is circulated on the publisher's behalf any bona fide newspaper or other publication of general, regular and paid circulation that has had more than two-thirds of its circulation outside of this state during the past 12 months; or
- A radio or television program originating outside California is received in California.[42]

As discussed above, the no "directed selling efforts" condition to Regulation S would preclude placing an advertisement in a publication with general circulation in the United States.

Putting these definitions together is an arduous task, but some relatively straightforward conclusions can be reached. First, the CSL will apply if an offer to sell a security originates from California even though the offer is directed to someone outside of California. Second, the Commissioner has taken the view that even when an offer is initially made outside California, subsequent communications from California by the offeror can cause the offer to be made here. Third, offers directed from outside the state to persons in California will be subject to the CSL. Fourth, communication by a prospective seller of a security, whether in or outside California, of an acceptance of an offer to buy that is directed to a prospective buyer in California will be subject to the CSL if the prospective seller reasonably believes the prospective buyer is in California and the acceptance is received at the place it was directed. Fifth, even when an offer to sell does not originate from California, no offer is directed to persons in California, and no acceptance of an offer to buy is directed to California, the delivery of a security to the purchaser in California will be subject to qualification if the seller and buyer are domiciliaries of California.

Resales and Regulation S

Regulation S also establishes a safe harbor for resales of securities that occur outside of this country.[43] However, Regulation S does not provide any safe harbor for resales that occur in the United States. This is made clear in Preliminary Note 6 which states:

> Regulation S is available only for offers and sales of securities outside the United States. Securities acquired overseas, whether or not pursuant to Regulation S, may be resold in the United States only if they are registered or under the [Securities] Act or an exemption from registration is available.

In many instances a person who wishes to resell in the United States securities that were acquired in a Regulation S offering will rely on Rule 144 or Rule 144A under the Securities Act.[44]

Resales under the CSL

The CSL requires that an offer or sale of a security in a nonissuer transaction be qualified or exempt from qualification.[45] A nonissuer transaction is any transaction not directly or indirectly for the benefit of an issuer.[46] Compliance with Regulation S is irrelevant to whether a resale may be effected in California without qualification.

In some cases, a security holder may rely on California's exemption for private resales. Thus, the CSL exempts any offer or sale of a security by the bona fide owner for the owner's own account if the sale is: (1) not accompanied by the publication of any advertisement; and (2) not effected by or through a broker-dealer in a public offering.[47] Although this exemption does not prohibit transactions to be effected through a broker-dealer, they must not be in a public offering. The purpose of the limitation is to allow a broker-dealer to act as a finder or agent in making a private placement of a block of securities on behalf of the security holder. However, the limitation precludes reliance on this exemption for widespread secondary trading in an issuer's securities even by broker-dealers.

In many cases, preemption of the CSL's qualification requirement by virtue of the NSMIA will be available. As discussed above, preemption may occur because the security is listed or approved for listing on the New York Stock Exchange, the NYSE Amex, LLC, the Nasdaq Global Market or an exchange listed in SEC Rule 146.[48] Foreign and, in some cases, domestic issuers may have active trading in their securities on a foreign exchange but not have securities listed on a US exchange. These issuers may wish to have their securities traded by broker-dealers in California. The NSMIA preempts California's qualification requirements with respect to a transaction that is exempt from registration pursuant to Section 4(1) or 4(3) of the Securities Act provided the issuer files reports with the SEC pursuant to either Section 13 or 15(d) of the Securities Exchange Act of 1934 (Exchange Act).[49] In addition, the NSMIA preempts California's qualification requirements with respect to a transaction that is exempt from registration pursuant to Section 4(4) of the Securities Act.[50] Note that preemption under these provisions of the NSMIA is not limited to the security of the issuer that is listed or approved for listing on a specified exchange.

Section 4(1) of the Securities Act exempts transactions by any person other than an issuer, underwriter, or dealer and Section 4(3) exempts transactions by a dealer except during specified periods. Without these exemptions, ordinary secondary trading by ordinary security holders could not occur without registration under the Securities Act. Because transactions effected in reliance on Rule 144 and Rule 144A are based on the availability of the Section 4(1) exemption, state qualification requirements may not be imposed on those transactions, provided the issuer files reports with the SEC pursuant to either Section 13 or 15(d).[51] However, the Commissioner has adopted a regulation exempting from the CSL's nonissuer qualification requirement, transactions effected in reliance on Rule 144A (but not Rule 144).[52]

Section 4(4) is an exemption for broker's transactions that are executed on customer's orders on any exchange or in the over-the-counter market.[53] It does not exempt the solicitation of those orders. This exemption, however, does not cover the broker's selling customer. The selling customer must find his or her own exemption. An ordinary investor most likely could rely on Section 4(1) as discussed above. An issuer, on the other hand, could not because Section 4(1) by its terms is not available to an issuer, underwriter, or dealer.

An issuer that has registered a class of securities under Section 12 of the Exchange Act is required to file reports with the SEC pursuant to Section 13 of the Exchange Act. An issuer that has a registration statement become effective under the Securities Act is required to file reports with the SEC under Section 15(d) of the Exchange Act.

A foreign private issuer whose securities are traded actively on a foreign exchange may be exempt from registration of that class of securities

under Section 12(g) of the Exchange Act for several reasons.[54] For example, the issuer may have $10 million or less in total assets and not be quoted on an automated inter-dealer quotation system.[55] If the foreign private issuer has more than $10 million in total assets, the class of securities will be exempt if it has fewer than 300 holders resident in the United States.[56] Finally, Rule 12g3-2(b) provides an exemption from registration under Section 12(g) of the Exchange Act with respect to a foreign private issuer that submits to the SEC, on a current basis, the material required by that rule.[57] A foreign private issuer will not be subject to Section 15(d) the Exchange Act unless it has had a registration statement become effective under the Securities Act.

Similarly, domestic issuers with securities listed on a foreign securities exchange may not be subject to Section 13 reporting because they do not meet the total asset and number of record holders to trigger the registration requirement of Section 12(g) of the Exchange Act.[58] If these issuers have not had a registration statement become effective under the Securities Act, they will not be subject to Section 15(d) of the Exchange Act. Thus, these domestic issuers, like their foreign private issuer brethren, will not have the benefit of preemption of California's qualification requirements with respect to transactions exempt pursuant to Section 4(1).

To a limited extent, secondary trading of securities of foreign private issuers or domestic issuers not filing reports under Sections 13 or 15(d) of the Exchange Act may be effected in California pursuant to Corporations Code Section 25104(b). That section exempts from the CSL's qualification requirement for nonissuer transactions, any offer or sale effected through a licensed broker-dealer pursuant to an unsolicited order or offer to buy. For purposes of this exemption, an inquiry regarding a written bid for a security or a written solicitation of an offer to sell a security made by another broker-dealer within the previous 60 days is not considered the solicitation of an order or offer to buy. The Commissioner has adopted detailed regulation that defines when an offer to buy a security will be presumed not to be "unsolicited."[59] An issuer who wishes for solicited trading of its securities to occur in California will not be able to rely on Section 25104(b).

The Commissioner has adopted a regulation that will exempt offer and sales of a security from the CSL's nonissuer qualification requirement if the security issued by a corporation organized under the laws of a foreign country or of a certificate of deposit or receipt or other evidence relating to a security if one of three conditions are met.[60] Note that the regulation refers only to a "corporation"—a term not defined in the CSL or the Commissioner's rules. This means that it will not be available for entities that are not corporations such as limited partnerships. Moreover, foreign legal terminology may make it unclear in some cases whether a foreign entity is a corporation for purposes of this exemption. This uncertainty will limit the utility of this exemption for foreign issuers. The three alternative conditions specified in the regulation are as follows:

1. The issuer is currently required to file with the SEC information and reports pursuant to Section 15(d) of the Exchange Act and is not delinquent. For the reasons given above, the preemption afforded by the NSMIA to securities in Sections 4(1), 4(3), and 4(4) exempt transactions makes this alternative irrelevant other than for underwriters.
2. The security appears on the most recent Federal Reserve Board List of "foreign margin stocks or the security is deemed by the SEC to have a "ready market" for purposes of Rule 15c3-1. The list consists of foreign equity securities that have met the eligibility criteria of the Board of Governors of the Federal Reserve System under its Regulation T and are thus eligible for margin treatment at brokers and dealers on the same basis as domestic margin securities.[61] Rule 15c3-1 is the SEC's net capital rule for broker-dealers.[62] Under that rule, a "ready market" exists if there is either: (i) a recognized established securities market in which there exists independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom; or (ii) securities have been accepted as collateral for a loan by a bank and where the broker-dealer demonstrates

to its examining authority that the securities adequately secure the loan.[63]

3. The issuer is not subject to the reporting requirements of either Section 13 or 15(d) of the Exchange Act and *all* of the following conditions are met: (i) the issuer, including any predecessors has been in operation for at least five years and is a going concern actually engaged in business and neither in the organization stage or bankruptcy; (ii) the number of shares outstanding is at least 2.5 million worldwide and the number of shareholders is at least 5,000 worldwide; (iii) the market value of the outstanding shares, other than debt securities and preferred stock, is at least $100 million US dollars worldwide; (iv) the issuer, as of the date of its most recent financial statements (which may not be more than 18 months old and which have been audited in accordance with generally accepted accounting principles of its country of domicile), has net tangible assets of at least $100 million US dollars worldwide; (v) the issuer has net income after all charges, including taxes and extraordinary losses, and including extraordinary gains, of either $50 million US dollars in total for its last three fiscal years or at least $20 million US dollars in each of its last two fiscal years; and (vi) if the security is a debt security or preferred stock, the issuer has not, during the past five years (or during its existence, if shorter), defaulted in the payment of any dividend, principal, interest or sinking fund installment.

A broker-dealer is permitted by this regulation to recommend a security to an investor that is exempted by this regulation only if the broker-dealer can demonstrate that an adequate and reasonable basis exists for that recommendation. In addition, broker dealers initiating a quotation must comply with all or portions of SEC Rule 15c2-11.[64] Given the substantial conditions imposed by this exemption, many foreign issuers may not be able to rely upon it for secondary trading in California.

The CSL and the Commissioner's regulations include numerous other exemptions for securities and transactions. In some cases, these exemptions may be available for nonissuer transactions involving securities of foreign or domestic issuers.[65] However, a discussion of all possible exemptions is beyond the scope of this article.

Recapitalizations and Reorganizations

The CSL, unlike the Securities Act, extends its qualification requirement to specific recapitalization and reorganization transactions.[66] Because the CSL differs from the Securities Act and other state's blue sky laws, practitioners may overlook these special qualification requirements. The CSL lists offers or sales of securities in the following four types of transactions:

1. Issuer transactions in connection with any change in the rights, preferences, privileges, or restrictions of or on outstanding securities;
2. Any exchange of securities by the issuer with its existing security holders exclusively;
3. Any exchange in connection with any merger or consolidation or purchase of assets in consideration wholly or in part of the issuance of securities; and
4. Any entity conversion transaction.

The first category for changes in securities reflects California's long standing concern that the investor protection under the CSL does not end at the moment a security is sold. Thus, an issuer cannot issue shares and then materially and adversely change the rights of shareholders without concern for the CSL.[67] The second category differs from the Securities Act, which specifically exempts exchanges with existing security holders.[68] The third category is conceptually similar to the SEC's approach in Rule 145, which deems an offer or sale of a security to be involved in statutory mergers.[69] The final category covers conversions of a corporation, limited partnership, general partnership, or limited liability company into another form of business entity.

As discussed above, the CSL applies to offers as well as sales of securities and it even applies to unconsummated offers. As with primary offers, it is important to keep this principle in mind in connection with negotiations with respect to prospective recapitalization and reorganization transactions. Fortunately, the CSL exempts negotiations or agreements prior to general solicitation of approval

by the equity security holders, and subject to that approval, of the first, third and fourth categories of transactions listed above. However, it must be noted that this exemption refers only to solicitation of approval by equity security holders and thus is not be available in the case of debt securities. Further, the exemption is not available when the transaction is not subject to the approval of the equity security holders.

Again, federal preemption courtesy of the NSMIA may be available. When the NSMIA does not preempt the transaction, an offer or sale "in this state" must be qualified unless exempt. In the context of recapitalization or reorganization transactions, issuers need to consider whether they have existing security holders in California. Even if the issuer never sets foot in California so that an offer can be said to originate from the state, it is nevertheless possible that an offer or sale will be considered to have been made in California. For example, the issuer may send an acceptance to a security holder in California so that an offer to buy has been accepted in California.

In the case of a change in the rights, preferences, privileges, or restrictions, an offer or sale will be exempt unless the change "materially and adversely" affects any class of outstanding equity security and falls within 13 listed categories.[70] This exemption does not apply to stock splits or reverse stock splits that are the subject of a separate exemption.[71] Neither the authorization of a new class of stock nor the issuance or sale of additional shares of an outstanding class will constitute a change in the enumerated rights.[72] A similar exemption is available for any change in the rights of outstanding debt securities unless the change "substantially and adversely" affects *any* class of securities and is one of eight listed categories.[73] Note that in the case of debt security, change will not be exempted if it substantially and adversely affects any class of securities while in the case of an equity security a change will not be exempted if it materially and adversely affects any class of *equity* securities. The use of "materially" rather than "substantially" was intended to make it clear that in the case of an equity security, it was the quality, not the quantity, of the change that matters.[74]

The CSL also has special jurisdictional exemptions for certain recapitalization and reorganization transactions. Thus any change in the rights, preferences, privileges, or restrictions of or on outstanding securities, or any entity conversion transaction is exempt unless the holders of at least 25 percent of the outstanding shares or units of any class that will be directly or indirectly affected substantially and adversely by that change have addresses in California according to the records of the issuer.[75] A similar exemption is available for exchanges incident to a merger, consolidation, or sale of assets in consideration for the issuance of securities of another issuer.[76] In that case, the 25 pecent residence test is based on the residences of the holders who are to receive the securities (*i.e.*, the issuer to be acquired).[77] The residence is determined by the records of the issuer for which they are holders. For purposes of both of these exemptions, the following securities are not considered to be outstanding: (1) any securities held to the knowledge of the issuer in the names of broker-dealers or nominees of broker-dealers; and (2) any securities controlled by any one person who controls directly or indirectly 50 percent of the outstanding securities of that class.[78] These rules can have the effect of artificially increasing or decreasing the percentage ownership. If a foreign issuer, for example, has 80 percent of its shares held in the name of broker-dealers, those shares will not be treated as outstanding. Thus, the calculation will be based on the 20 percent of the total outstanding shares. This means that the exemption will not be available if the holders of 5 percent of the total outstanding shares have addresses in California because that percentage would constitute 25 percent of the 20 percent of total shares treated as outstanding. If on the other hand, a foreign issuer has a single holder of 50 percent shares with a California address and all of the other shares held by persons with addresses outside of California, the exemption would be available because their would be no holders of outstanding shares for purposes of the statute.[79]

Issuers may, in addition to the exemptions discussed above, avail themselves of other statutory and regulatory exemptions. However, complete discussion of all possible exemptions is beyond the scope of this article.

Stock Dividends

Foreign issuers also may overlook the fact that stock dividends may be subject to qualification under the CSL. Although the CSL, like the Securities Act, defines "sale" in terms of a disposition "for value," the CSL also specifically excludes a dividend from the definition of "sale" if the dividend is payable with respect to the common stock of a corporation solely (except for cash or scrip paid for fractional shares) in shares of that common stock, if the corporation has no other class of voting stock outstanding.[80] Thus, the Commissioner has adopted a regulation providing that stock dividends that are included in the definition of "sale" are transactions requiring qualification.[81] The Commissioner has defined a "stock dividend" as the "issuance of additional shares (including treasury shares) of the issuer to its existing shareholders, or to the shareholder of a class, pro rata, according to the shares previously held (except for any cash or scrip paid for fractional shares), without consideration other than the transfer of surplus to stated capital of an amount equal to or greater than the par, stated or market value of the shares distributed, but without any other consideration being paid by the shareholders, and not by amendment to the articles of incorporation stating the effect on outstanding shares."[82] The term does not include a "stock split," exchange, or reclassification.[83]

Issuers concerned about the possible application of the CSL to stock dividends also may benefit from federal preemption. If federal preemption is unavailable and offers or sales will be made in California, then those offers and sales must be qualified unless exempt.

Conclusion

The enactment of the NSMIA has made the application of state blue sky laws less of a concern for many issuers. However, preemption will not be available always. Foreign issuers that do not have securities listed on a United States exchange and domestic issuers relying on Regulation S are likely to not have the benefit of federal preemption. The CSL has many unusual provisions that differ substantially from the Securities Act and other state blue sky laws. These provisions can apply to primary offerings, resale transactions, reclassifications and reorganizations, and stock dividends. Out-of-state and foreign issuers should be mindful of these provisions when engaged in offerings pursuant to Regulation S, when resales of their securities occur in California, or they have security holders in California.

NOTES

1. Pub L. No. 104-290, 110 Stat. 3416 (1996) (codified in scattered sections of the United States Code). Among other things, the NSMIA preempts state laws requiring registration or qualification of "covered securities." 15 U.S.C. § 77r(a)(1) (Section 18(b)(1) of the Securities Act). The NSMIA defines "covered securities" to include securities listed or approved for listing on the New York Stock Exchange, the American Stock Exchange (now known as the NYSE Amex, LLC), or listed on the National Market System of the Nasdaq Stock Market (now known as the Nasdaq Global Market). 15 U.S.C. § 77r(b)(1)(A). Pursuant to a regulation adopted pursuant to the NSMIA, securities listed or authorized for listing on the following exchanges are also considered "covered securities:" Tier I of the NYSE Arca, Inc.; Tier I of the Philadelphia Stock Exchange, Inc. (now known as Nasdaq OMX PHLX, Inc); The Chicago Board Options Exchange, Incorporated; Options listed on the International Securities Exchange, LLC; and the Nasdaq Capital Market. 15 U.S.C. § 77r(b)(1)(A) and 17 C.F.R. § 230.146. Effective October 24, 2008, the Nasdaq OMX PHLX, Inc. terminated its equity trading platform. The NSMIA also defines "covered securities" to include a security of the same issuer that is equal or in seniority to the listed security described above. 15 U.S.C. § 77r(b)(1)(C). California has codified the NSMIA's preemption with respect to listed securities. Cal. Corp. Code § 25100.1(a).

2. The NSMIA also preempts state registration or qualification requirements by providing that a security is a "covered security" with respect to a transaction that is exempt from registration under the Securities Act pursuant to regulations adopted under Section 4(2) of the Securities Act. 15 U.S.C. § 77r(b)(4) (Section 18(b)(4)(D) of the Securities Act)). As a result, private placements effected in reliance upon Rule 506 of Regulation D (17 C.F.R. § 230.506) are not subject to California's qualification requirement. Cal. Corp. Code § 25102.1(d).

3. 15 U.S.C. § 77e. Section 5 actually makes illegal three distinct activities. Section 5(a) declares the sale or delivery of a security to be unlawful unless a registration statement is in effect. Section 5(b) declares it unlawful to deliver a prospectus unless it meets the requirements of the Securities Act and forbids the delivery of a security for purposes of sale unless preceded or accompanied by a prospectus meeting the requirements of the Securities Act. Section 5(c) declares it unlawful to offer to sell or buy a security unless a registration statement has been filed.

4. 15 U.S.C. § 77b(7).

5. Securities & Exchange Commission Release No. 33-6779 (June 17, 1988) (First Regulation S proposal).

6. 17 C.F.R. §§ 230.901-230.905. Regulation S defines the term "United States" to mean the United States of America, its territories and

possessions, any State of the United States, and the District of Columbia. 17 C.F.R. § 230.902(l).

7. 17 C.F.R. § 230.901.

8. 17 C.F.R. § 230.903(a)(1).

9. 17 C.F.R. § 230.902(h)(1). Offers and sales of securities specifically targeted at identifiable groups of U.S. citizens, such as members of the US armed forces serving overseas, are specifically excluded from the definition of an "offshore transaction." 17 C.F.R. § 230.902(h)(2). On the other hand, an offshore transaction includes offers and sales to certain multinational organizations in the United States but excluded from the definition of a US person and foreign persons with certain accounts in the United States. 17 C.F.R. § 230.902(h)(3).

10. 17 C.F.R. § 230.903(a)(2).

11. 17 C.F.R. § 230.902(c)(1). A number of activities are specifically excluded from the definition of "directed selling efforts." 17 C.F.R. § 230.902(c)(3).

12. 17 C.F.R. § 230.902(c)(1). A publication with a general circulation in the United States is any publication that is printed primarily for distribution in the United States, or has had, during the preceding 12 months, an average circulation in the United States of 15,000 or more copies per issue; and will encompass only the US edition of any publication printing a separate US edition if the publication, without considering its US edition would not constitute a publication in the United States. 17 C.F.R. § 230.902(c)(2).

13. Securities & Exchange Commission Release No. 33-6863 (April 24, 1990) (adopting release).

14. Cal. Corp. Code § 25010.

15. Cal. Corp. Code § 25130.

16. Cal. Corp. Code § 25120.

17. Cal. Corp. Code § 25401.

18. Cal. Corp. Code § 25008(a). In very confusing fashion, the statute also defines when an "offer to buy" or a "purchase of a security" is *made* in California. As noted in the accompanying text, an offer or sale of security is defined as being made in California in reference to an "offer to buy" only in terms of where the "offer to buy" is *accepted* (*i.e.*, not where the offer is *made*). Thus, the location of the making of an "offer to buy" is unnecessary for determining whether an offer or sale has been made in California. The CSL uses the term "offer to buy" in only a handful of other instances. It is only used in conjunction with the phrase "in this state" in Corporations Code Section 25401 which prohibits misstatements and omission of a material fact. The CSL refers to a purchase of a security in its insider trading statute. Cal. Corp. Code § 25402. *See* Bishop, "California's Unique Approach to Insider Trading Regulation," 17 *Insights* 21 (2003). The CSL also refers to purchase or sale of a security in connection with conduct by broker-dealers. Cal. Corp. Code §§ 25210, 25216–25218.

19. All three qualification provisions in the CSL expressly state that it is unlawful for any person to offer *or* sell a security without qualification.

20. *People v. Kline*, 110 Cal. App. 3d 587 (1980).

21. *Id.* at 596.

22. Cal. Corp. Code § 25017(b).

23. 15 U.S.C. § 77b(a)(3).

24. *B.C. Turf & Country Club v. Daugherty*, 94 Cal. App. 2d 320 (1949).

25. It so happens that these individuals were Charles S. Howard, junior and senior, Bing Crosby, and Pat O'Brien. The senior Mr. Howard was the owner of the famous depression-era thoroughbred racehorse, Seabiscuit, immortalized in Laura Hillenbrand's book, *Seabiscuit, An American Legend* (2001).

26. *B.C. Turf* at 332. The case applied a provision of California's Corporate Securities Law of 1917 (former Cal. Corp. Code § 25500) that made it illegal to offer for sale or negotiate for the sale of, or take subscriptions for any security without first having obtained a permit. Although the current law does not use the term "negotiate for the sale of," the Commissioner has taken the position that an "offer" includes preliminary negotiations "looking toward the sale of a security." Commissioner's Opinion No. 76/13C.

27. *B.C. Turf* at 330.

28. In this respect, the definition is similar to Section 414(c) of the Uniform Securities Act of 1956.

29. As noted in the text above, the "offshore transaction" condition to Regulation S requires that offers not be made to persons in the United States.

30. Commissioner's Opinion No. 76/13C.

31. Commissioner's Opinion No. 81/10C.

32. A substantial portion of the opinion was devoted to consideration whether the mere supplying of clarifying information would constitute an offer.

33. Cal. Corp. Code § 25008(b).

34. The statute also refers to "offers to sell" and sets forth the same rules for determining when an offer to sell is accepted in California. However, whether an offer to sell has been accepted in California is not relevant to determining whether an offer or sale of a security has been made in California. As noted above, the statute specifies that an offer or sale of a security is made in California when, among other situations, an offer to buy is accepted "in this state." The statute does not state that an offer or sale of a security is made in California when an offer to buy *or an offer to sell* is accepted "in this state."

35. This leads to the bizarre possibility that an issuer may be saved from a violation by the acceptance being lost in the mail. The rationale for the requirement that the offeree reasonably believe the offeror to be in California is obscure. Read literally, an offeree's unreasonable belief about the offeror's whereabouts would remove the sale from California's jurisdiction.

36. *Hall v. Superior Court*, 150 Cal. App. 3d 411 (1983).

37. *Id.* at 417.

38. Cal. Corp. Code § 25008(a).

39. Cal. Corp. Code § 25008(b).

40. Harold Marsh, Jr. & Robert Volk, Practice Under the California Securities Laws § 3.08[4][b] (Rev. Ed.). The author was a practice consultant for the 2008 and 2009 revisions of this treatise.

41. Securities & Exchange Commission Release No. 33-6863 (April 24, 1990) (adopting release).

42. Cal. Corp. Code § 25008(c). The Commissioner has adopted a regulation for determining whether a newspaper or other publication has more than two-thirds of its circulation outside California. 10 CCR § 260.008.

43. Rule 904 provides that an offer or sale of securities by someone other than an issuer, a distributor, or an affiliate of either of them (excluding

officers and directors who are affiliates only by reason of their positions) will be deemed to occur outside the United States if specified conditions are met.

44. However, a non-affiliate of the issuer who acquires securities in an off-shore public offering is not be able to rely on Rule 144 because it applies to sales by affiliates and sales of restricted securities. In 1998, the SEC amended Regulation S to add Rule 905 to provide that equity securities placed offshore by domestic issuers under Regulation S will be classified as "restricted securities" within the meaning of Rule 144 so that resales without registration or an exemption will be restricted. 17 C.F.R. § 230.905. *See* Securities & Exchange Commission Release No. 33-7505 (February 17, 1998).

45. Cal. Corp. Code § 25130.

46. Cal. Corp. Code § 25011. A transaction is considered to be indirectly for the benefit of an issuer if any portion of the purchase price of any securities involved in the transaction will be received by the issuer. *Id.* For the definition of "issuer," *see* Cal. Corp. Code § 25010.

47. Cal. Corp. Code § 25104(a). The Commissioner has adopted a regulation specifying when an offer or sale does not involve a public offering for purposes of this statute. 10 CCR § 260.102.2.

48. To the extent that the securities are listed or approved for listing on the a national securities exchange certified by the Commissioner pursuant to Corporations Code Section 25100(o), qualification would not be required for issuer, nonissuer, or recapitalization or reorganization transactions. The Commissioner has also adopted a regulation that exempts from the issuer and nonissuer qualification requirements offers and sales of equity securities that are senior to securities listed on an exchange certified under Section 25100(o). 10 CRR § 260.105.33. In addition, any security issued by a person that is the issuer of a security listed on a national securities exchange certified by the Commissioner is exempt from the CSL's nonissuer qualification requirement. Cal Corp. Code § 25101(a). The exchanges certified by the Commissioner are set forth in 10 CRR § 260.101.2 The primary differences between the exemption afforded by Section 25100(o) and that afforded by Section 25101(a) are: (i) Section 25101(a) applies to any security of a listed issuer while Section 25100(o) applies only to the listed security and warrants and other rights to acquire that security; and (ii) Section 25101(a) is an exemption for nonissuer transactions while Section 25100(o) is an exemption from all three of the CSL's qualification requirements. There are also some differences in the exchanges certified by the Commissioner pursuant to each statute. In this regard, the Commissioner has proposed amending various regulations to reflect changes in the names of various exchanges. Finally, the Section 25101(b) excludes certain small offerings. However, because of preemption by the NSMIA, these exemptions are generally not needed.

49. 15 U.S.C. § 77r(b)(4)(A).

50. 15 U.S.C. § 77r(b)(4)(B).

51. *See* Preliminary Note 2 to Rule 144. 17 C.F.R. § 230.144. Rule 144A provides that a person, other than the issuer or a dealer, who offers or sells a security in compliance with the rule's conditions will not be an underwriter within the meaning Section 4(1) of the Securities Act. 17 C.F.R. § 230.144A(b).

52. 10 CRR § 260.105.13.1.

53. Rule 144(g) defines "broker's transactions." 17 C.F.R. § 230.144(g).

54. "Foreign private issuer" is defined in 17 C.F.R. § 240.3b-4.

55. 17 C.F.R. § 240.12g-1.

56. 17 C.F.R. § 240.12g3-2(a).

57. 17 C.F.R. § 240.12g3-2(b).

58. 15 U.S.C. § 78(l)(a) and 17 C.F.R. § 240.12g-1.

59. 10 CCR § 260.104.

60. 10 CCR § 260.105.11.

61. 12 C.F.R. §§ 220.1 -.132. The Federal Reserve Board last published the foreign margin stocks list in 2003. In 2004, the Federal Reserve Board removed all 51 stocks from the then current list of foreign margin stocks because they had not been recertified as required under its procedures. Federal Reserve Board Order dated March 2, 2004 available at: *http://www.federalreserve.gov/boarddocs/press/bcreg/2004/20040303/attachment.pdf*. The Federal Reserve Board will publish a new list if eligible securities are identified pursuant to these listing procedures.

62. 17 C.F.R. § 240.15c3-1.

63. 17 C.F.R. § 240.15c3-1(c)(2)(11).

64. 17 C.F.R. § 240.15c2-ll. In general, that rule prohibits a broker from publishing quotations with respect to certain securities without having specified information in its records.

65. Care must be taken that the exemption is available for nonissuer transactions. For example, Section 25102 establishes 17 exemptions. However, these are exemptions from the CSL's qualification requirement for issuer transactions only.

66. Cal. Corp. Code § 25120. In addition, the CSL defines "sale" to include any exchange of securities and any change in the rights, preferences, privileges, or restrictions of or on outstanding securities. *Id.* § 25017(a).

67. This means that any time a limited partnership or operating agreement is amended, the possible application of the CSL should be considered.

68. 15 U.S.C. § 77c(a)(9). The exemption does require that the no commission or remuneration by paid or given directly or indirectly for soliciting the exchange.

69. 17 C.F.R. § 230.145(a)(2).

70. Cal. Corp. Code § 25103(e). The 13 changes are as follows: (i) to add, change, or delete assessment provisions; (ii) to change the rights to dividends thereon; (iii) to change the redemption provisions; (iv) to make them redeemable; (v) to change the amount payable on liquidation; (vi) to change, add, or delete conversion rights; (vii) to change, add, or delete voting rights; (viii) to change, add, or delete preemptive rights; (ix) to change, add, or delete sinking fund provisions; (x) to rearrange the relative priorities of outstanding equity securities; (xi) to impose, change, or delete restrictions upon the transfer of equity securities in the organizational documents for the entity; (xii) to change the right of holders of equity securities with respect to the calling of special meetings of holders of equity securities; and (xiii) to change, add, or delete any rights, preferences, privileges, or restrictions of, or on, the outstanding shares or memberships of a mutual water company or other corporation or entity organized primarily to provide services or facilities to its shareholders or members.

71. Cal. Corp. Code § 25103(f).

72. 10 CCR § 260.103.1. The regulation refers only to classes of stock and thus leaves open the question of whether the authorization or issuance of additional classes of other forms of equity constitute a change covered by the statute. A careful reading of the list of changes leads to the conclusion that they would not. H. Marsh, Jr. & R. Volk, *supra* n.40 at § 7.03[2].

73. Cal. Corp. Code § 25103(g). The eight listed categories are as follows: (i) to change the rights to interest thereon; (ii) to change their redemption provisions; (iii) to make them redeemable; (iv) to extend the maturity thereof or to change the amount payable thereon at maturity; (v) to change their voting rights; (vi) to change their conversion rights; (vii) to change sinking fund provisions; and (vii) to make them subordinate to other indebtedness.

74. H. Marsh, Jr. & R. Volk ,*supra* n.40 at § 7.03[3].

75. Cal. Corp. Code § 25103(b).

76. Cal. Corp. Code § 15103(c). This exemption is not available for rollup transactions as defined in Corporations Code Section 25014.6. Also, it is not available for voluntary exchanges of securities other than as permitted by 10 CCR § 160.105.15.

77. It should be noted that the statute does not require that all California holders must receive securities. The exemption will be unavailable if any holders of 25 percent of the shares with addresses in California will receive securities in the exchange.

78. Cal. Corp. Code § 25103(d).

79. This can lead to some interesting results. For example, the Commissioner has concluded that a corporation with a single shareholder or two co-equal shareholders has no securities outstanding for purposes of these exemptions. Commissioner's Opinion Nos. 72/9C & 70/125C.

80. Cal. Corp. Code § 25017(f). According to the Commissioner, a stock dividend is not payable "solely in shares of such common stock" when the shareholders are given the option to accept either cash or additional shares. *Compare* SEC Compliance and Disclosure Interpretation Question 103.01:

> *Question*: If a company declares a dividend that is payable in either cash or securities at the election of the recipients, does the declaration of the dividend need to be registered under the Securities Act? *Answer*: No, as there is no sale of the dividend shares under the Securities Act.

available at *http://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm*.

81. 10 CCR § 260.017(d).

82. 10 CCR § 260.107(a).

83. A "stock split" is defined in 10 CCR § 260.103.2.