

Structured Thoughts

*News for the financial
services community.*



Blue Sky Laws and Bank Notes

Every state has its own “blue sky” or securities law that is designed to protect investors against fraudulent sales practices and activities independently of the federal securities laws. Blue sky laws may even require registration of, or at least notice filings with respect to, securities exempt from registration under federal law. For example, blue sky laws may still require a notice filing for offerings of securities issued or guaranteed by banks, often referred to as “bank notes,” even though these offerings are exempt from registration under Section 3(a)(2) of the Securities Act of 1933, as amended (the “Securities Act”). This article provides a brief overview of the blue sky laws and the application of such laws to offerings of bank notes. These laws are particularly relevant to the structured products market, as a number of significant issuers, to both institutional and retail investors, are U.S. and non-U.S. banks.

Blue Sky Laws

Blue sky laws are designed to protect investors against fraudulent sales practices and activities. While these laws can vary from state to state, most state laws typically require issuers to register their offerings before they can be sold in a particular state, unless the offerings are exempt from registration. These laws also license brokerage firms, their brokers and certain investment advisers and their representatives.

Covered Securities

In October 1996, Congress enacted the National Securities Markets Improvement Act (“NSMIA”), which preempted the application of blue sky laws regarding a substantial number of securities offerings and/or transactions, and which

substantially changed the scope of blue sky regulation. NSMIA amended Section 18 of the Securities Act to exempt “covered securities” from the registration requirements of the blue sky laws. Any offering document with respect to a covered security is similarly exempted from state regulation if the document is prepared by or on behalf of the issuer.

Covered securities include the following:

- securities listed or authorized for listing on the New York Stock Exchange (“NYSE”) or Nasdaq, and securities of the same issuer that are equal or senior in rank to such securities (collectively, “listed covered securities”);
- securities registered under the Investment Company Act of 1940, as amended;
- securities offered under to Rule 506 of Regulation D under the Securities Act; and
- securities exempt under Section 3(a) of the Securities Act (with certain exceptions).

No state filings or fees may be required in offerings of covered securities, but states may require certain notice filings and charge filing fees for offerings of other covered securities.¹ NSMIA also permits states to continue to enforce their own antifraud laws.²

Bank Notes

Section 3(a)(2) of the Securities Act exempts from registration under such act any security issued or guaranteed by a bank. This exemption is based on the notion that, whether state or federal, banks are highly and relatively uniformly regulated, and as a result will provide adequate disclosure to investors about their finances in the absence of federal securities registration requirements. In addition, banks are also subject to various capital requirements that may increase the likelihood that holders of their debt securities will receive timely payments of principal and interest.

Under Section 3(a)(2), a “bank” is defined broadly to mean any national bank, or any banking institution organized under the law of any state, territory, or the District of Columbia, the business of which is substantially confined to banking and is supervised by the state or territorial banking commission or similar official. To qualify as a bank under Section 3(a)(2), the institution must meet both of the following requirements: (i) it must be a national bank or any institution supervised by a state banking commission or similar authority; and (ii) its business must be substantially confined to banking. Therefore, securities issued by bank holding companies, finance companies, investment banks, and loan companies are not exempt from registration under Section 3(a)(2), even though many investors may think of these institutions as “banks,” given that their businesses are not substantially confined to banking. As a result, an offering of securities by any of these institutions must be registered under the Securities Act unless another exemption from registration applies.³

Securities Guaranteed by a Bank

As noted above, the Section 3(a)(2) exemption is also available for securities “guaranteed” by a bank. Whether an offering is guaranteed by a bank is interpreted broadly by the Securities and Exchange Commission (the “SEC”). The staff of the SEC has taken the position in no-action letters that the term “guarantee” is not limited to a guaranty in a legal sense, but also includes arrangements in which the bank agrees to ensure the payment of a security.

¹ Section 18(c)(2)(A) and (B) of the Securities Act.

² Section 18(c)(1) of the Securities Act.

³ Of course, many of these types of entities have a subsidiary or affiliated company that is able to offer securities without registration in reliance upon Section 3(a)(2).

However, in a typical guaranteed offering, a bank's affiliate will serve as issuer of the relevant securities, and the entity that is the bank will execute a written guarantee of the payment obligations on those securities.

Non-U.S. Banks

U.S. branches of foreign banks are entitled to rely on the Section 3(a)(2) exemption. In 1986, the SEC announced its decision to cease granting no-action letters regarding securities issued or guaranteed by U.S. branches or agencies of foreign banks, and formalized its position that such a branch or agency will be deemed to be a "national bank" or a "banking institution organized under the laws of any state" if "the nature and extent of federal and/or state regulation and supervision of that particular branch or agency is substantially equivalent to that applicable to federal or state chartered domestic banks doing business in the same jurisdiction."⁴ As a result, several domestic branches of non-U.S. banks are currently frequent issuers or guarantors of structured products and other debt securities in the United States.

Application of Blue Sky Laws to Bank Notes

As noted above, covered securities are exempt from the registration requirements of the blue sky laws pursuant to NSMIA. Bank notes qualify as covered securities because they are exempt from registration under the Securities Act under to Section 3(a)(2). However, bank notes typically are not listed or authorized for listing on the NYSE or Nasdaq, which means that states may still require certain notice filings and charge filing fees for bank note offerings.

Most states in fact provide exemptions from registration for bank notes. For example, the State of Texas provides an exemption from registration for securities issued by domestic banks and certain thrifts:

"The sale by the issuer itself, or by a registered dealer, of any security issued or guaranteed by any bank organized and subject to regulation under the laws of the United States or under the laws of any State or territory of the United States, or any insular possession thereof, or by any savings and loan association organized and subject to regulation under the laws of this State, or the sale by the issuer itself of any security issued by any federal savings and loan association."⁵

In addition, most states do not require registration for bank notes offered by a foreign bank through its U.S. branch or agency under the principles of comity, on the theory that the domestic branch or agency is subject to oversight and regulation by U.S. banking authorities. However, it is understood that there are a few states, including Texas, that do not extend the exemption to U.S. branches or agencies.

Nevertheless, in 1998 the Texas State Securities Board (the "Board") issued no-action letter relief and did not require registration for bonds issued by the State of Bank of India in minimum denominations of \$1,000 and marketed to U.S. residents of Indian origin ("NRIs") through U.S. branches.⁶ The Board emphasized that the bonds would be treated as bank deposits subject to the banking regulations administered by the Reserve Bank of India and the Indian Government, that reserve requirements had been extended to NRI deposits, and that the bonds were subject to the same reserve requirements applicable to similar deposits. The Board also pointed out that the bonds would be marketed in the United States through the issuer's New York and Chicago branches, which were regulated by New York and Illinois, respectively, and by the Federal Deposit Insurance Corporation, and that the issuer represented that the nature and extent of state and federal regulation of the branches was substantially equivalent to that applicable to Texas state-chartered banks. This would suggest that bank notes offered by U.S. branches or

⁴ SEC Release No. 33-6661 (Sept. 23, 1986).

⁵ Tex. Rev. Civ. Stat. Ann. art. 581-5, § L.

⁶ See 3A Blue Sky L. Rep. (CCH) ¶ 55,828Q.

agencies of foreign banks should also be accorded similar relief in Texas, as such branches or agencies would be subject to the same regulation and oversight as U.S. banks.⁷

As a reminder, where certain covered securities, including bank notes, are offered, a state may still reserve the right to require a notice filing and the payment of a filing fee if the security is not otherwise exempt from registration under that state's laws.⁸ In addition, some states may require filing fees for each series of bank notes offered (rather than a single one-time fee) and may not place a cap on aggregate fees paid.

Conclusion

Section 3(a)(2) of the Securities Act provides bank issuers with the ability to issue securities, including structured notes, without registering the offering with the SEC. However, even in the case of securities that are covered securities, bank issuers must still determine if any applicable blue sky laws provide an exemption from state registration. If there are no such exemptions, notice filings and payment of filing fees may be required. These notice filings and filing fees should also be taken into consideration during any discussion of offering expenses.

Contacts

F. Lee Liebolt, Jr.
Law Office
(212) 286-1384
llieboltlaw@gmail.com

Ze'ev Eiger
(212) 468-8222
zeiger@mofo.com

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology, and life science companies. We've been included on *The American Lawyer's* A-List for seven straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com. © 2011 Morrison & Foerster LLP. All rights reserved.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

⁷ Another helpful fact would be a minimum denomination significantly higher than \$1,000 per note, in order to help insure that the offering is more of an institutional offering than a retail offering.

⁸ See, e.g., 7 Tex. Admin. Code §§ 114.1-.4, 3A Blue Sky L. Rep. (CCH) ¶¶ 55,590P – 55,590S.