

# New Michigan Securities Law

Effective October 1, 2009

*Securities  
Registration*

*Exemptions from  
Securities  
Registration*

*Broker-Dealer  
Regulation*

*Investment Adviser  
Regulation*

*Civil Liabilities*

*Administration and  
Enforcement*

*Transition*

## Fast Facts:

Michigan's 45-year-old securities law is changing on October 1, 2009.

The New Act better integrates Michigan's securities law with federal securities laws.

A securities purchaser can be held liable to a seller for antifraud violations.

By Cyril Moscow, Hugh H. Makens, and Shane B. Hansen

## Introduction

On October 1, 2009, Michigan's securities law and regulation will catch up with a multitude of changes in our financial system since our current law was enacted. The current Uniform Securities Act, 1964 PA 265, MCL 451.501 through 451.818 (the "Current Act"), will be replaced by the new Uniform Securities Act (2002), 2008 PA 551, MCL 451.2101 through 451.2703 (the "New Act"). The New Act will enhance the enforcement powers of the Office of Financial and Insurance Regulation (OFIR) in the Department of Energy, Labor and Economic Growth and better conform Michigan's system of securities regulation to the contours of existing federal securities laws. This article summarizes the background and highlights some of the New Act's key provisions, as well as some changes from current law that affect Michigan securities practice.

Federal securities laws were changed significantly in 1996, including federal preemption of state securities laws affecting securities offerings and transactions and the registration and regulation of broker-dealers and investment advisers. Driven in part by those federal law changes, the National Conference of Commissioners on Uniform State Laws developed a new model Uniform Securities Act in 2002 (USA 2002).<sup>1</sup> The new model act replaced the model Uniform Securities Act of 1956, which had been adopted in about 40 states, but with substantial variations. The

model USA 2002 has been adopted in 17 states and proposed in several others. USA 2002's drafters stated three overarching themes, which are reflected in Michigan's new statute:

- (1) The objectives of uniformity; cooperation among relevant states, the federal government, and self-regulatory organizations; investor protection; and, to the extent practicable, capital formation;
- (2) Consistency with the federal National Securities Markets Improvement Act of 1996 (NSMIA); and
- (3) Facilitating electronic records, signatures, and filing.<sup>2</sup>

After six years of efforts by the State Bar of Michigan Business Law Section, OFIR staff, and others, Michigan's legislature adopted USA 2002, with limited modifications to preserve strengths in Michigan's current law. Most of the Current Act's substance is found in the New Act, but its organization and language reflect many technical changes, challenging practitioners, regulators, and courts to work through the effects of these changes section by section. OFIR is preparing proposed rules, taking advantage of the New Act's flexibility through the rulemaking process. No model state rules accompany the model act, but the proposed rules are expected to be similar to those adopted in other states and are likely to incorporate many of the relevant aspects of OFIR's current rules.

## Definitions

To coordinate with federal law, the New Act adds several definitions, including “depository institution” and “institutional investor,” and modifies several others.<sup>3</sup> The crucial definition of “security” remains essentially the same as now, with the addition of explicit references to certain derivative contracts and investments in viatical or life settlement agreements.<sup>4</sup> Fixed and variable insurance products continue to be excluded from the definition and are regulated only as insurance, not as securities. The definition explicitly excludes an interest in a pension or welfare benefit plan that is subject to ERISA, which is helpful for employers offering plan interests under federal Rule 701<sup>5</sup> promulgated by the Securities and Exchange Commission (SEC). The new definition also expressly incorporates concepts that, by caselaw, have historically characterized an investment contract—an investment in a common enterprise with the expectation of profits to be derived primarily from the efforts of others—and states that the term may include an interest in a limited partnership, a limited liability company, or a limited liability partnership.

The New Act defines an “institutional investor,”<sup>6</sup> a term used but not defined in the Current Act. The term includes an entity with total assets in excess of \$10 million and any person, other than an individual, of “institutional character” with total assets in excess of that amount. New defined terms, “record” and “sign,”<sup>7</sup> accommodate electronic recordkeeping and filing processes.

The New Act’s references to various federal laws explicitly incorporate federal agency rules promulgated under them.<sup>8</sup> OFIR is authorized, by rule or order, to incorporate later-adopted amendments, and successor and similar federal statutes, rules, and regulations. Thus, subject to the requirements of Michigan’s Administrative Procedures Act of 1969,<sup>9</sup> this administrative authority should allow OFIR to keep Michigan’s law current with future federal regulatory developments.

## Securities Registration

The New Act makes relatively modest changes in the securities registration provisions, since the Current Act was previously amended to address most of the related changes in federal law. A new notice filing provision was added for “federal covered securities.”<sup>10</sup> The New Act authorizes OFIR to continue its merit regulation by prohibiting securities offerings made on terms that are “unfair, unjust or inequitable,” or with unreasonable underwriting compensation.<sup>11</sup> Largely as a result of NSMIA’s preemption, there have been far fewer registrations by coordination in Michigan in recent years.

## Exemptions from Securities Registration

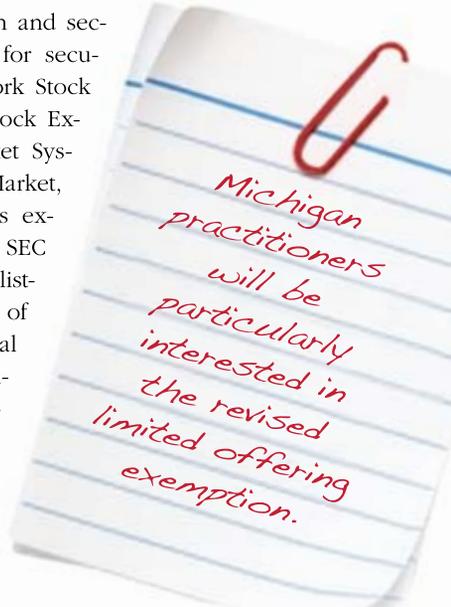
The New Act contains many changes in the technical detail of exempt securities and exempt transactions, though the substance remains similar. Because of NSMIA, federal covered securities are exempted from state registration, though conditions may apply. Michigan practitioners will be particularly interested in the revised limited offering exemption. Although MCL 451.2202(n)

continues the essence of the exemption found in MCL 451.802(b) (9) of the Current Act, it simplifies the elaborate structure of MCL 451.802(b). Sales by an issuer to not more than 25 purchasers in Michigan during any 12 months, in addition to institutional investors or federal covered investment advisers, are exempt if there is no general solicitation or general advertising, a commission is not paid to a person other than a Michigan-registered broker-dealer, and the issuer reasonably believes that all Michigan purchasers, other than institutional investors and federal covered investment advisers, are purchasing for investment. The pre-incorporation agreement exemption is gone, though a version of the existing shareholder exemption remains.

The relationship between the New Act’s exemptions and federal Regulation D remains complex, because NSMIA provides limited federal preemption for sales under a federal rule promulgated under § 4(2) of the Securities Act of 1933 (“1933 Act”),<sup>12</sup> designating them as “covered securities” under § 18(b)(4)(D) of the act.<sup>13</sup> As a result, sales under federal Rule 506 of Regulation D<sup>14</sup> are subject to limited preemption, with states being authorized to require the filing of a form and the payment of a filing fee, and to enforce state antifraud prohibitions against persons relying on federal Rule 506. The state filing requirements for a Rule 506 offering are found in MCL 451.2302(4) of the New Act, which mandates the filing of a Form D and a \$100 filing fee within 15 days of the first sale in Michigan. A sale occurs upon the first of receipt of funds or a signed subscription agreement or the equivalent. Even receipt of funds into an escrow arrangement triggers the filing requirement. The filing is not a condition of the federal exemption and preemption remains in place even if the form is not timely filed,<sup>15</sup> though this conclusion has not yet been accepted by every state regulator and remains unresolved with OFIR.

Unlike Rule 506 offerings, offerings under federal Rules 504 or 505 of Regulation D<sup>16</sup> are based on § 3(b) of the 1933 Act,<sup>17</sup> so there is no preemption for such offerings.<sup>18</sup> Similarly, the federal § 3(a)(11)<sup>19</sup> intrastate offering exemption still requires a concurrent state exemption. MCL 451.2202(1)(s) of the New Act provides an exemption for a rescission offer, provided that the offer complies with the civil liability provisions of MCL 451.2510.

The secondary trading exemption is clarified under MCL 451.2201(f) of the New Act. NSMIA preempted state registration and secondary trading regulation for securities listed on the New York Stock Exchange, the American Stock Exchange, the National Market System of the Nasdaq Stock Market, another national securities exchange determined by the SEC to have substantially similar listing standards, or a security of the same issuer that is equal in seniority or that is a senior security to a listed security, as provided in § 18(b) (1) of the 1933 Act.<sup>20</sup>



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## Broker-Dealer Regulation

Broker-dealer regulation is largely unchanged, except the New Act creates some broker-dealer registration exemptions for firms having no Michigan place of business. Licensed or registered mortgage brokers, mortgage lenders, or mortgage servicers and their employees continue to be exempted from broker-dealer registration with respect to offers or sales of mortgage loans regulated under the Mortgage Brokers, Lenders, and Servicers Licensing Act,<sup>21</sup> but, as under current law, this exemption does not extend to transactions involving securities such as mortgage pools or mortgage-backed securities. Persons holding Michigan real estate licenses do not enjoy any similar exemption with respect to real estate transactions that involve securities.

As under current law, simultaneous agent registration with more than one brokerage firm or issuer is generally prohibited. The New Act creates a number of exemptions from registration for a broker-dealer's agents (often called brokers or registered representatives) and an issuer's agents, subject to various conditions.<sup>22</sup> Like current law, an "agent" is defined with respect to an individual's involvement with purchases or sales of securities.<sup>23</sup> Registration exemptions for a broker-dealer's agents are generally tied to a brokerage firm's registration exemptions or to limited circumstances involving federal preemption of state registration. Registration exemptions for an issuer's agents permit an individual's involvement with the offer or sale of the issuer's or its affiliate's own securities, provided that the individual is not compensated through the payment of commissions or other remuneration based, directly or indirectly, on transactions in the issuer's securities. This exemption is less restrictive than the SEC's interpretation of similar federal law.<sup>24</sup>

Under the New Act, a "finder" must register with Michigan as a broker-dealer, not as a limited classification of investment adviser as under current law. OFIR's rules may address the transition of currently registered finders to state broker-dealer registration. A "finder" means a person who, for consideration, participates in the offer to sell, sale, or purchase of securities by locating, introducing, or referring potential purchasers or sellers. Excluded from coverage is any person whose actions are solely incidental to a distribution of an acquiror's securities in connection with a merger, consolidation, exchange of securities, sale of assets, or other reorganization. Specific statutory duties are imposed on a finder.<sup>25</sup>

To encourage reporting of unlawful or improper conduct, the New Act grants limited immunity from defamation claims against the reporting broker-dealer, agent, investment adviser, federal covered investment adviser, or investment adviser representative, unless the reporting person knew, or should have known at the time that the statement was made, that it was false in a material respect or the reporting person acted in reckless disregard of the statement's truth or falsity.<sup>26</sup> Background and regulatory histories about broker-dealers and their agents are made publicly available by the Financial Industry Regulatory Authority (formerly known as the National Association of Securities Dealers, Inc., or NASD) on its BrokerCheck website.<sup>27</sup>

## Investment Adviser Regulation

Under the New Act, Michigan joins almost all other states in requiring registration of "investment adviser representatives." Individuals employed by or associated with a state-registered or a "federal covered investment adviser" will be required to register with Michigan unless excluded from the definition or exempted from the registration requirement.<sup>28</sup> Excluded from the definition are individuals employed by or associated with a federal covered investment adviser who have no place of business in Michigan or who do not meet the federal definition of an "investment adviser representative." Exempt from registration are those individuals who are employed by or associated with an investment adviser exempt from Michigan registration or a federal covered investment adviser excluded from Michigan's notice filing requirements.<sup>29</sup>

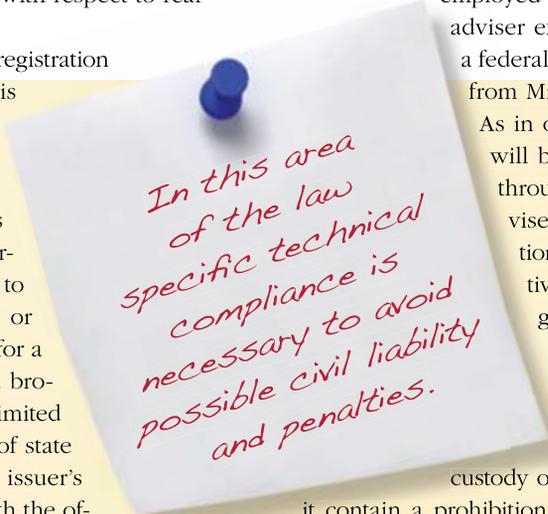
As in other states, this registration probably will be handled by a representative's firm through the Internet-based Investment Adviser Registration Depository.<sup>30</sup> Registration of an investment adviser representative with more than one advisory firm is generally permitted unless prohibited or limited by OFIR rule or order.

Among other changes, the New Act does not contain a prohibition against an investment adviser having custody of clients' funds or securities, nor does it contain a prohibition or limitation on performance-based compensation for investment advisers.<sup>31</sup> There is a new investment adviser registration exemption for firms that do not hold themselves out to the public as an investment adviser and during the preceding 12 months have not had more than five Michigan residents who are qualified as an accredited investor, allowing for an unlimited number of corporate and institutional investors without triggering the firm's registration.<sup>32</sup> Coupled with this registration exemption, these changes should facilitate the formation and operation of private equity funds by investment advisers located in Michigan. OFIR may adopt rules regulating custody-related activities and performance fees charged by state-registered or exempt investment advisers.

## Civil Liabilities

Overall, civil liability for violations of the New Act is similar to current law, but there are several significant changes.<sup>33</sup> Under the New Act, a purchaser can be liable to a seller of a security for antifraud violations.<sup>34</sup> Currently, only sellers can have civil liability. This change may allow a state law securities fraud action in minority shareholder buyouts.

The new statute of limitations bars suits for violation of the registration requirements or for illegally acting as a broker-dealer, agent, investment adviser, or investment adviser representative unless the action is commenced within one year after the violation occurred.<sup>35</sup> It also bars suits for misstatements or omissions by a seller or a purchaser, or fraudulent actions in connection with investment advice, within the earlier of two years after discovery of the facts constituting a violation or five years after the



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violation occurred.<sup>36</sup> These limitations are designed to align with existing federal securities law. Current Michigan limitations are two years after the contract of sale for registration violations and four years for actions based on untruths or omissions.<sup>37</sup>

## Administration and Enforcement

The New Act contains enhanced enforcement powers for OFIR and increased penalties, including the power to order a fine in an amount from \$10,000 for a single violation up to \$500,000 for multiple violations.<sup>38</sup> OFIR may impose additional fines in an amount from \$10,000 for a single violation up to \$500,000 for multiple violations involving individuals who are 60 years of age or older and individuals who OFIR determines are unable to protect their financial interests due to disability, illiteracy, or an inability to understand the language of an agreement presented to them.<sup>39</sup>

The New Act does not contain a statute of limitations for administrative actions by OFIR or criminal actions.<sup>40</sup> Indictments for criminal violations will be governed by the default six-year limitations period in the Code of Criminal Procedure.<sup>41</sup>

## Transition

The New Act contains transitional provisions.<sup>42</sup> The Current Act exclusively governs all actions based on facts or circumstances occurring before the effective date, but actions must be brought not later than three years after the effective date of October 1, 2009. The Current Act exclusively governs any offer or sale made within one year after this effective date pursuant to an

offering made in good faith before this effective date on the basis of an exemption available under current law. All effective registrations, administrative orders, statements of policy, etc., under the Current Act remain in effect until superseded.

## Conclusions

The New Act significantly advances Michigan business law and securities regulation. This article merely summarizes some of the highlights. Any lawyer involved in a securities transaction will need to refer to the text of the New Act, yet to be promulgated rules, and technical commentary. Many of the concepts are derived from federal securities law and the predecessor state statutes. Although most of the New Act's provisions will be familiar to Michigan securities law practitioners, in this area of the law specific technical compliance is necessary to avoid possible civil liability and penalties. ■

## FOOTNOTES

- 7C ULA 22 *et seq.*, available at Uniform Law Commission, Securities Act <<http://www.nccusl.org/Update/ActSearchResults.aspx?ActId=26>>. All websites cited in this article were accessed April 29, 2009.
- Prefatory note, USA 2002, 7C ULA 1, 2-8.
- MCL 451.2102(e) and 451.2102a(a). The statutory definitions are contained in MCL 451.2102 through 451.2104.
- MCL 451.2102c(c).
- 17 CFR 230.701.
- MCL 451.2102a(a).
- MCL 451.2102b(h) and 451.2102c(e).
- MCL 451.2103(2).
- MCL 24.201 through 24.328.
- MCL 451.2302.
- MCL 451.2306(g).
- 15 USC 77d(2).
- 15 USC 77r(b)(4)(D).
- 17 CFR 230.506.
- See SEC Rules 503 and 508, 17 CFR 230.503 and 230.508.
- 17 CFR 230.504 and 230.505.
- 15 USC 77c(b).
- See 15 USC 77r(b)(4)(D).
- 15 USC 77c(a)(11).
- 15 USC 77r(b)(1).
- MCL 445.1651 through 445.1684.
- MCL 451.2402(2).
- MCL 451.2102(b).
- See SEC Rule 3a4-1, 17 CFR 240.3a4-1.
- See MCL 451.2102(i), 451.2413, and 451.2502(b).
- MCL 451.2507.
- FINRA BrokerCheck <<http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/index.htm>>.
- MCL 451.2102(f), 451.2102a(f), and 451.2404.
- MCL 451.2404(2)(a).
- IARD <<http://www.iard.com>>.
- See MCL 451.502(h) and 451.502(b).
- MCL 451.2403(2)(c).
- Compare MCL 451.2509 and 451.810.
- MCL 451.2509(3).
- MCL 451.2509(10)(a).
- MCL 451.2509(10)(b).
- MCL 451.810(e).
- MCL 451.2604(a).
- MCL 451.2604(b).
- See MCL 451.808(e) and 451.809(d).
- MCL 767.24(5).
- See MCL 451.2701 through 451.2703.



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