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By Rutheford B Campbell, Jr. *

THE SIGNIFICANCE AND PLIGHT OF SMALL BUSINESSES

THE ECONOMIC AND SOCIETAL IMPORTANCE OF SMALL BUSINESSES

Most of us probably consider small businesses to be economically significant to our national economy. One might speculate, in that regard, that small businesses generate an important portion of the total productivity and jobs available in this country. Looking around in our daily lives, we deal with many providers of goods and services that appear to be small businesses. These include doctors, lawyers, restaurants, automobile dealers, automobile repairs, laundries, and bookstores (the list goes on and on). Not only are these ventures important to consumers, but they also appear to be relatively labor-intensive enterprises that provide employment for a significant percentage of our work force.[1]

Available information indicates that such appearances and impressions regarding the important role of small businesses in our economy are essentially accurate. Small businesses are a vital, statistically significant part of the economy of the United States, even, perhaps, to an unexpected degree. Start, for example, with the very smallest businesses in our economy, those with fewer than 20 employees. One finds that about 90% of all business firms in the United States (approximately 4.5 million firms)

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1. Industries dominated by small business include: eating and drinking places; offices and clinics of doctors of medicine; retail stores; automotive repair shops; motor vehicle dealers; residential care; services to dwellings and other buildings; management and public relations services; home furniture and furnishing stores; and lumber and other building materials dealers. Industries dominated by large businesses include: institutions of higher learning; security brokers and dealers; motor vehicles and equipment; hospitals; family clothing stores; commercial banks; title insurance; air transportation; household appliances; and refrigeration and service industry machinery. *See* U.S. SMALL BUSINESS ADMINISTRATION, THE STATE OF SMALL BUSINESS: A REPORT OF THE PRESIDENT 1994, at 54, Table 1.13 (1995) [hereinafter THE STATE OF SMALL BUSINESS 1994].

come within this category.[2] Such firms employ about 20% of all workers (approximately 19 million persons).[3] Moving up in size, but certainly still within what most would consider to be the category of small businesses, firms with less than 100 employees represent 98% of all business firms in this country (a total of approximately 5 million firms). These firms provide jobs for about 39% of our total work force (approximately 36 million jobs).[4]

These obviously are huge numbers, and they give some general idea of the significance of small businesses, with regard both to the delivery of goods and services and to the generation of jobs. One also may sense that small entrepreneurs have relatively high levels of energy, vitality, and innovativeness and thus that raw, broad economic data of the kind described above may even understate the significance of small business. Again, one is able to find support for these premises by examining statistics regarding job creation and innovations. For example, in 1993, the top 15 industries dominated by small businesses created approximately 730,000 jobs, while in that same year, the top 15 industries dominated by large firms created only approximately 196,000 new jobs.[5] Regarding innovation, studies commissioned by the SBA estimate that small businesses are responsible for 55% of all manufacturing product innovations and that small

2. According to data compiled by the U.S. Small Business Administration (SBA), Office of Advocacy, there were a total of 5,051,025 business firms in the United States in 1991, of which 4,528,899 (89.7% of all firms) had less than 20 employees. See State of Small Business 1994, supra note 1, at Table A.4, p. 164.

3. The total employment in the United States that year was 92,307,559, and firms with less than 20 employees employed 18,712,812 workers, or 20.3% of the total work force. *Id.* This percentage appears to have been fairly constant in recent years. For example, in each year during the period from 1988 to 1991, firms with less than 20 employees accounted for between 20% and 21% of all jobs in the United States. *Id.* at 244, Table A.11. The total payroll for 1991 for all firms with less than 20 employees was approximately $381.5 billion, which was 17.8% of the total national payroll for that year. *Id.* at 164, Table A.4.

4. According to data compiled by the SBA Office of Advocacy for the year 1991, the total number of business firms in the country was 5,051,025 and 4,968,710 of the firms had less than 100 employees. That year, the total number of workers employed by all firms was 92,307,559, of which 35,859,223 were employed by firms with less than 100 workers. The percentage of the total work force employed by firms with less than 100 employees, which for 1991 was 38.8%, has been reasonably constant in recent years. For example, for the years 1988 to 1991, the percentage of the total work force employed by firms with less than 100 employees consistently fell between approximately 39% and 40%. For example, for the year 1991, the total annual payroll for firms with less than 100 employees was 34.2% of the total annual payroll of all firms. *Id.* at 164, Table A.4, & 244, Table A.11.

5. *Id.* at 54, Table 1.13. For 1993, it was reported that "[s]mall-business-dominated industries added [more than] over a million jobs during the year while large-business-dominated industries reduced employment by over 200,000." *Id.* at 27. For similar information for the period 1982-1993, *see id.* at 300, Table A.26. For purposes of these tables and statistics, "[s]mall-business-dominated industries are industries in which a minimum of 60[%] of the industry employment is in firms with fewer than 500 employees." *Id.*

firms account for twice as many innovations per employee as do larger firms.[6]

Although the foregoing statistical information indicates the importance of small businesses to our national economy, the actual value of small businesses may transcend such statistics and cold economic evaluations. Small businesses have a nearly mystical place in our society. They are a part of our national persona. Entrepreneurial opportunities through the operation of a small business may be the modern equivalent of the western frontier in the nineteenth century, representing an escape valve for those ambitious risk-takers who want to make a better life for themselves and their families. The venting of the entrepreneurial instinct through small business opportunities, therefore, may well be an important component of a stable democracy.

CAPITAL FORMATION: THE PLIGHT OF SMALL BUSINESSES

Small businesses need access to external capital, since small businesses, like large businesses, often do not generate enough internal cash to meet their needs. Thus, in 1987, for example, approximately 81% of businesses with 5 to 9 employees obtained external funds through borrowing; the same year, approximately 90% of firms with 20 to 49 employees borrowed money from external sources.[7]

The characteristics of small business, however, which include relatively small amounts of revenues and assets, relatively small capital needs, few stockholders, and the absence of significant trading activity in the firm's stock, make it difficult for small businesses to access external capital. Such characteristics, in comparative terms, necessarily exclude small firms from the wide array of financing opportunities available to larger concerns.

Not surprisingly, therefore, commercial banks appear to be a significant source of external financing for small businesses. For example, on June 30, 1994, commercial banks had on their books nearly 5 million business loans of less than $250,000; the total amount of all such loans was approximately $156 billion.[8] The total number of business loans of less than

6. *Id.* at 15 (noting that "[s]mall firms have been estimated by the Futures Group to be responsible for 55[%] of manufacturing product innovations and they produce more than twice as many innovations per employee as large firms[,]" and that "[t]hey . . . produce twice as many significant innovations per employee.").

7. *Id.* at 348, Table B.18. In 1987, the average total debt for firms with five to nine employees was $126,220; for firms with 20 to 49 employees, the average debt for 1987 was $474,890. *Id.* at 349, Table B.19.

8. U.S. SMALL BUSINESS ADMINISTRATION, THE STATE OF SMALL BUSINESS: A REPORT OF THE PRESIDENT 1995, at 307, Table B.9 (1996) [hereinafter THE STATE OF SMALL BUSINESS 1995].

$1 million was about 5.4 million loans, with a total value of about $294 billion.[9]

Equally predictable, underwritten offerings generally are unavailable for small issuers. In 1988, for example, among entities with assets of $10 million or less, only 83 firms undertook initial public offerings of securities (the average offering was $7.9 million).[10] Although by 1994 such small issuers made 189 initial public offerings, averaging $10.3 million per offering,[11] in both years, the number of initial public offerings[12] were minuscule when compared to the literally millions of small businesses with capital needs.

One also gets a sense of the relatively disadvantaged position of small issuers by comparing their access to the capital market. In any year, initial public offerings by small issuers amount to only about 7% or 8% of the total dollar volume of initial public offerings.[13] Small companies, however, account for around 40% of the business activities[14] and control 40% of the assets in our economy.[15]

CONCLUSIONS

The foregoing discussion leads to a few simple conclusions about small businesses: (i) there are many of them; (ii) they are important to the economy; (iii) they need access to external capital; and (iv) external capital sources for small businesses are limited.

9. *Id.*

10. *Id.* at 309, Table B.11.

11. *See* THE STATE OF SMALL BUSINESS 1995, *supra* note 8, at 309, Table B.11.

12. *See* THE STATE OF SMALL BUSINESS 1994, *supra* note 1, at 164, Table A.4.

13. The SBA estimates that initial public offerings by small issuers (businesses with assets under $10 million before the offering) generated only 7.9% of the total dollar volume of initial public offerings by all companies for the period 1988-1994. THE STATE OF SMALL BUSINESS 1995, *supra* note 8, at 299, Table B.1. For 1994 alone, such small issuers accounted for 6.9% of the total dollar volume of initial public offerings. *Id.* at 309, Table B.11. One should recognize that these figures are for "initial" public offerings. Initial public offerings are likely to be only a fraction of the total public offerings made by larger corporations, as larger corporations are quite likely to have made previous public offerings of their securities and thus, many public offerings of their stock would not be "initial." On the other hand, initial public offerings are likely to represent nearly all of the public offerings by small issuers, as it is unlikely that an issuer would be a "small" issuer (i.e., have assets of less than $10 million), if it had made a public offering previously.

14. *See supra* note 4 and accompanying text.

15. SBA estimates for 1993 indicate that unincorporated businesses and small corporations with assets of less than $25 million accounted for approximately 40% of the total business assets in our economy. THE STATE OF SMALL BUSINESS 1995, *supra* note 8, at 299, Table B.1.

THE IMPACT OF FEDERAL AND STATE SECURITIES LAWS ON SMALL BUSINESSES

Over the years, federal and state securities regulation has added significantly to the plight of small businesses by making it unnecessarily difficult for them to raise capital.[16] In fairness to the U.S. Securities and Exchange Commission (Commission or SEC), however, one must recognize that in recent years the federal rules governing the distribution of securities have become much more reasonable with regard to small issuers.[17] Examples of sensible changes at the federal level include the adoption and subsequent amendments to Rule 144[18] and Regulation D,[19] the adoption and sensible interpretations of Rule 147,[20] the modifications and expansion of the availability of Regulation A,[21] and the development of the special registration forms for small issuers.[22] Considered as a whole, these developments reflect an awakening of the Commission to the significance of small businesses in this country and to the fact that small businesses cannot reach their full potential if they are saddled with unreasonable regulations

16. *See* Rutheford B Campbell, Jr., *An Open Attack on the Nonsense of Blue Sky Regulation*, 10 J. CORP. L. 553 (1985); Rutheford B Campbell, Jr., *The Plight of Small Issuers (and Others) Under Regulation D: Those Nagging Problems that Need Attention*, 74 KY. L.J. 127 (1985-86); Rutheford B Campbell, Jr., *The Plight of Small Issuers Under the Securities Act of 1933: Practical Foreclosure from the Capital Market*, 1977 DUKE L.J. 1139 [hereinafter Campbell, *Practical Foreclosure*].

17. *See* Rutheford B Campbell, Jr., *Blue Sky Laws and the Recent Congressional Preemption Failure*, 22 J. CORP. L. 175, 180-85 (1997).

18. 17 C.F.R. § 230.144 (1997). As originally enacted, Rule 144 was practically unavailable for small issuers, principally because holders of securities of small issuers could not meet the brokers' transaction requirements. *See* Campbell, *Practical Foreclosure*, *supra* note 16, at 1150-53. Subsequently, the SEC added section (k) to Rule 144, which permitted resales by nonaffiliates after a three-year holding period without meeting the brokers' transaction requirement (and other requirements) of the rule. Recently, the Commission amended Rule 144(k) to lower the holding period to two years. 17 C.F.R. § 230.144(k).

19. 17 C.F.R. § 230.501-.508. The most significant amendments to Regulation D for small issuers were the amendments increasing the size limit of Rule 504 to $1 million and permitting the Rule 504 offering to be made publicly.

20. *Id.* § 230.147. The SEC has taken a generous attitude regarding the availability of Rule 147, which clarifies conditions for the intrastate offering exemption, from the date of its enactment. Rule 147 details those conditions that will allow an issuer doing business within a state or territory to offer and sell securities to persons resident within that state or territory without triggering the registration requirements under § 5 of the Securities Act of 1933 (1933 Act). Rule 147 interprets liberally the "doing business within" provision, permitting its use in transactions with various interstate contacts. *See* Notice of Adoption of Rule 147 Under the Securities Act of 1933, Securities Act Release No. 5450, 1 Fed. Sec. L. Rep. (CCH) ¶ 2340, at 2611 (Jan. 7, 1974) (adopting Rule 147 and providing liberal interpretive examples of the availability of the rule to apply to transactions with interstate contacts).

21. 17 C.F.R. § 230.251-263.

22. The SEC provides two forms for the registration of public offerings by small issuers. They are Registration Statement Under the Securities Act of 1933, Form SB-1, and Registration Statement Under the Securities Act of 1933, Form SB-2, both as amended in Phase Two Recommendations of Task Force on Disclosure Simplification, 62 Fed. Reg. 39,755, 39,763-64 (1997).

regarding capital formation.[23] Unfortunately, these advances at the federal level were not matched at the state level. As a result, the drag on capital formation imposed by state blue sky regulations, especially as concerns small issuers, became even more prominent.[24]

The most visible problem in state regulation was the multi-state regulation of the capital formation process. Take, for example, the simple situation in which a small issuer desired to raise capital by selling securities in four states. The issuer was required to comply with four sets of state securities laws (in addition, of course, to federal laws), all of which were essentially designed to achieve the same ends but which may have had quite different rules of compliance. The economic extravagance of such a system is apparent and seemingly irrefutable; the societal benefits of requiring an issuer to do the same thing four times (five times, if one adds the federal requirements) are at best difficult to comprehend. The problem, of course, is exacerbated as more states are included in the offering.

Another related problem with state regulation was that the states had the power to neutralize any of the federal rules that improved access to capital by small (or large) issuers. By enacting or by letting stand more restrictive state rules, state regulators were able to exercise hegemony over the SEC, thus effectively neutralizing the new balance struck at the federal level between capital formation and investor protection.

Take, for example, the recent changes in Rule 504[25] of Regulation D, which permit public offerings of up to $1 million by small issuers without offeree qualifications, mandated disclosures, or resale restrictions. States essentially neutralized the effects of those changes by refusing to include Rule 504 under their Uniform Limited Offering Exemption (ULOE) or otherwise providing a similar exemption that was consistent with the federal policy of Rule 504.[26] Accordingly, an issuer in the author's home state

23. These developments, however, may be explained by an alternative, ugly interpretation based on a theory of administrative hypocrisy. Under this interpretation, the SEC realigned its rules in a way that is more congenial to capital formation by small investors, knowing full well that substantially all of its progress in that regard would be eliminated by state blue sky laws, which effectively trump federal laws and rules. The SEC, so the interpretation goes, actually favors the states' more conservative positions, but it (hypocritically) wants to be able to tout its own behavior as beneficial to small business. The reality for small issuers, of course, is that the more restrictive state laws continue to dictate the rules of capital formation. *See* Campbell, *supra* note 17, at 209, where the author describes, but does not necessarily endorse, such an interpretation.

24. *See* Campbell, *supra* note 17, at 203-06.

25. 17 C.F.R. § 230.504.

26. Uniform Limited Offering Exemption, NASAA Rep. (CCH) ¶ 6201, at 6101 (Apr. 29, 1989). Although the ULOE provides generally that offerings under Rule 505 or Rule 506 of Regulation D are exempt from state registration, it attaches additional conditions and limitations to this exemption, including requirements in sales to nonaccredited purchasers that the investment be suitable and the purchaser have the knowledge and experience to be able to evaluate the merits and risks of a given investment. For discussions of the ULOE, see Ronald L. Fein et al., *ULOE: Comprehending the Confusion*, 43 BUS. LAW. 737 (1988); Therese

of Kentucky, for example, could not make an unregistered public offering under Rule 504 because Kentucky had no comparable exemption. An issuer using Rule 504 in Kentucky could either register the securities, which requires[27] a registration statement and mandated, scheduled disclosures to investors, or utilize Kentucky's small offering exemption, which on its face prohibits public offerings by: (i) limiting the issuer to twenty-five offerees; and (ii) prohibiting the payment of a commission or other remuneration for soliciting offerees.[28] The policy of Rule 504, therefore, was trumped by state blue sky law.

THE IMPACT OF THE NATIONAL SECURITIES MARKET IMPROVEMENT ACT OF 1996 ON SMALL ISSUERS

The National Securities Market Improvement Act of 1996 (NSMIA or the Act)[29] seems designed to deal with these problems. Indeed, in its Joint Explanatory Statement, the Committee of Conference described the then existing "dual system of regulation" of securities as one "that, in many instances, is redundant, costly, and ineffective."[30] The purpose of NSMIA, as defined by the committee, is to "eliminate duplicative and unnecessary regulatory burdens while preserving important investor protections by reallocating responsibility over the regulation of the nation's securities markets in a more logical fashion. . . ."[31] Notwithstanding such rhetoric and the Act's apparently broad preemption of state laws, NSMIA itself has no significant effect on the capital formation rules that govern small issuers. Rather, small businesses are subject essentially to the same state rules after NSMIA as they were before the Act.[32]

To understand why NSMIA itself provides no relief for small issuers, one need only compare the manner in which small issuers raise capital

H. Maynard, *The Uniform Limited Offering Exemption: How "Uniform" is "Uniform?"--An Evaluation and Critique of the ULOE,* 36 EMORY L.J. 357 (1987); Mark A. Sargent & Hugh H. Makens, *ULOE: New Hope, New Challenge,* 45 BUS. LAW. 1319 (1990).

27. Many states, including Kentucky, developed a special form for registering Rule 504 offerings. The form, known as SCOR (Small Corporate Offering Registration), was officially designated Form U-7 and developed by the State Regulation of Securities Committee of the American Bar Association's Section of Business Law, in conjunction with the North American Securities Administrators' Association (NASAA). Small Corporate Offerings Registration Form (Form U-7), NASAA Rep. (CCH) ¶ 5057, at 5197 (Apr. 26, 1996). By September 1997, SCOR was adopted in 43 states (including five unofficial recognitions of the form). Small Corporate Offering Registration Program and Form U-7, 1 Blue Sky L. Rep. (CCH) ¶ 6461 at 2557 (Apr. 26, 1997).

28. KY. REV. STAT. ANN. § 292.410(1)(i) (Banks-Baldwin 1997).

29. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in scattered sections of 15 U.S.C.) [hereinafter NSMIA].

30. H.R. CONF. REP. NO. 104-864, at 39 (1996).

31. *Id.* at 39-40.

32. Congress, however, delegated to the SEC broad authority to expand preemption through regulation. *See infra* notes 52-56 and accompanying text.

with the limits of NSMIA's statutory preemption provisions. Regarding the manner of capital formation by small business, in 1994, out of the four million or so small businesses in the United States, fewer than 200 sold stock through initial public offerings.[33] All the rest of those small businesses that sought outside capital during 1994 did so in reliance on an exemption from the registration requirements of the Securities Act of (1933).[34]

Under the 1933 Act, the registration exemptions upon which small businesses generally can rely for such offerings are quite limited and thus easy to identify. Specifically, exemptions available to small businesses engaged in raising capital are typically confined to the intrastate offering exemption provided by Rule 147,[35] the small offering exemptions provided by Rule 504[36] and Rule 505,[37] and the exemption provided by Regulation A.[38] Although other exemptions are actually or theoretically available to small issuers, they are either specialized in their scope[39] or comparatively unattractive.[40]

NSMIA itself, however, provides no preemption for offerings under any of these broadly utilized exemptions from registration. Instead, the statute itself preempts state authority only with regard to securities listed for trading on certain exchanges or the NASDAQ/National Market System

33. In 1994, only 189 small issuers (defined here as issuers with less than $10 million in assets before the offering) made initial public offerings. *See supra* notes 11-12 and accompanying text. It is safe to estimate that more than four million small businesses were in existence that year. *See supra* notes 2-3 and accompanying text.

34. This is something of an overstatement, as a portion of these unregistered financings may have involved transactions that did not generate a "security" under the federal securities laws or were illegal under federal securities laws.

35. 17 C.F.R. § 230.147 (1997).

36. *Id.* § 230.504.

37. *Id.* § 230.505.

38. *Id.* §§ 230.251-.263.

39. *See, e.g.*, 15 U.S.C. § 77c(a)(2) (1994) (providing an exemption from registration for securities issued by banks); *id.* § 77c(a)(9) (providing an exemption from registration for transactions involving single company recapitalizations).

40. The intrastate exemption provided by § 3(a)(11) of the 1933 Act, *id.* § 77c(a)(11), as defined by the common law, is an example of an exemption that has fallen into disuse because of its comparative disadvantage. Rule 147, 17 C.F.R. § 230.147, is comparatively clearer and thus less risky than § 3(a)(11). Another example is § 4(6), 15 U.S.C. § 77d(6), which is unused because of the comparative advantage of Regulation D. 15 C.F.R. §§ 230.501-.508. To a lesser degree, perhaps, offerings under the common law of § 4(2), 15 U.S.C. § 77d(2), are also less attractive than offerings under Regulation D.

Special mention should be made of the exemption provided by Rule 506. Securities issued in Rule 506 transactions are "covered securities" and thus subject to the statutory preemption of NSMIA. 15 U.S.C.A. § 77r(b)(4)(D) (West Supp. 1997). Rule 506 is attractive for private offerings in excess of $5 million. Because that amount of capital normally exceeds the needs of small issuers or the maximum amount of securities small issuers are able to market, the author gives Rule 506 minimal consideration in this Article. If, however, a small issuer is able to use Rule 506 effectively, NSMIA does provide benefits because it preempts state regulation over such offerings. *See* Campbell, *supra* note 17, at 205.

(NMS), securities issued by registered investment companies and securities issued pursuant to certain enumerated exemptions under the 1933 Act.[41] This latter category, however, excludes from preemption securities issued pursuant to the federal exemptions provided by Rule 147, Rule 504, Rule 505, and Regulation A.

In summary, NSMIA itself essentially changed nothing for small issuers.[42] Accordingly, when small issuers attempt to raise capital, the various states continue to impose additional layers of rules respecting capital formation. If a small issuer attempts to raise its capital in four states, it has five jurisdictions with which to contend. If it raises capital in a single state, it has two jurisdictions with which to contend.

Similarly, on the matter of state hegemony, nothing has changed. States continue to set rules of capital formation and thus neutralize the positive effects of changes in federal capital formation rules. Rule 504 again serves as a good example.[43] After NSMIA's passage, issuers practically cannot make small public offerings under Rule 504, because such offerings are inconsistent with state blue sky laws, and the Act has no preemptive statutory effect over such state laws.

Speculation about the political basis for this legislative outcome is interesting. Why, for example, did Congress agree on a version of NSMIA that was so unhelpful to small businesses? Intriguing, in that regard, is the fact that an earlier House version of the Act, then known as the Capital Markets Deregulation and Liberalization Act of 1995 (Capital Markets Bill),[44] offered significant relief for small issuers.[45] This relief, however, evaporated during the subsequent legislative process.

One explanation for the outcome is provided by public choice theory[46] or interest group theory.[47] Public choice theory proposes that small groups in which each member has much to gain or lose as a result of legislation will have more influence over the outcome of the legislation than will

41. NSMIA, Pub. L. No. 104-290, § 102, 110 Stat. 3416, at 3417-19 (1996) (to be codified at 15 U.S.C. § 77r). More specifically, NSMIA omits from its list of "covered securities," and thus from statutory preemption, securities issued in transactions exempt under § 3(a)(11), § 3(b), and the common law of § 4(2).

42. Although NSMIA does provide benefits for issuers using Rule 506, the author assumes that Rule 506 is not attractive to small issuers. *See* Campbell, *supra* note 17, at 205.

43. *See supra* notes 25-28 and accompanying text.

44. H.R. 2131, 104th Cong. (1995).

45. Section 3(a) of that bill preempted state authority over all offerings, except those made in reliance on the intrastate exemption. *Id.* § 3(a).

46. The literature on public-choice theory is vast. A compact and clear description of the application of public-choice theory to legislative behavior and the impact of interest groups on legislative outcomes is offered by Daniel A. Farber & Philip Frickey, *The Jurisprudence of Public Choice*, 65 TEX. L. REV. 873, 873-901 (1987), and by Jonathan R. Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 227-33 (1986).

47. Macey, *supra* note 46, at 224 n.5.

larger groups in which each member has relatively little to gain or lose. This is true, the theory goes, even though the total gain or loss of the larger group may be greater than the total gain or loss of the smaller group.[48] Public choice theory offers an economic explanation for all of this.[49]

One is able to fit public choice theory to the outcome in this situation by examining how NSMIA affected three interest groups: the mutual fund industry, state securities regulators, and small issuers. The mutual fund industry appears to be a relatively small group without insurmountable "free-rider" problems, and that group got essentially what they wanted out of the legislation in the form of an express preemption of all state laws respecting the public offerings of their securities.[50] Similarly, the state administrators, acting in concert through NASAA, apparently exerted considerable influence over NSMIA's ultimate terms. The earlier version of the bill that became NSMIA preempted state authority, and thus the authority of state administrators, over all registration and merit qualification, except as concerned securities issued under the intrastate exemption.[51] As enacted, however, this single exception to total federal preemption was

48. "The 'free[-]rider' problem suggests that it should be nearly impossible to organize large groups of individuals to seek broadly dispersed public goods. Instead, political activity should be dominated by small groups of individuals seeking to benefit themselves, usually at the public expense." Farber & Frickey, *supra* note 46, at 892. A "free rider" is one who attains or attempts to attain benefits from an action without participating in bringing about or paying for the action.

49. See, e.g., William W. Landes & Richard A. Posner, *The Independent Judiciary in an Interest Group Perspective*, 18 J.L. & ECON. 875 (1975), wherein the authors describe the economic perspective as follows:

> In the economists' version of the interest-group theory of government, legislation is supplied to groups or coalitions that outbid rival seekers of favorable legislation. The price that the winning group bids is determined both by the value of legislative protection to the group's members and the group's ability to overcome the free-rider problems that plague coalitions. Payment takes the form of campaign contributions, votes, implicit promises of future favors, and sometimes outright bribes. In short, legislation is "sold" by the legislature and "bought" by the beneficiaries of the legislation.

Id. at 877 (citation omitted). Because of the free-rider problems and high transaction costs in forming large groups, economists predict that large groups generally will not be as effective in influencing legislation as will small groups, which have lower transaction costs and fewer free-rider problems. *See* MICHAEL T. HAYES, LOBBYISTS AND LEGISLATORS: A THEORY OF POLITICAL MARKETS 69-70 (1981) (observing that "[m]embers of the mass public will generally find it irrational to obtain the information necessary to identify their interests on any given issue and moreover will be ill-equipped to interpret any information they do obtain"); *see also* Farber & Frickey, *supra* note 46, at 892; Macey, *supra* note 46, at 229-32.

50. NSMIA defines a "covered security" to include "a security issued by an investment company." 15 U.S.C.A. § 77r(b)(2) (West Supp. 1997). NSMIA preempts state rules over registration and merit qualification with respect to "covered securities." *Id.* § 77r(a)(1). Incidentally, this is a good outcome for society. The distribution of mutual fund securities is a national matter that should not be regulated by the individual states.

51. *See supra* note 47.

expanded dramatically to include not only securities issued in transactions exempt under the intrastate exemption but also securities issued under Rule 504, Rule 505, Regulation A, and the common law of section 4(2) under the 1933 Act. Again, NASAA provided the cohesion for a relatively small interest group, which accordingly minimized the free-rider problems.[52] Public choice theory, therefore, would have predicted that the state administrators could be effective in bending the Act more to their liking.[53]

On the other hand, the millions of small issuers, who in total seemingly had more to gain or lose than either the mutual fund industry or the individual state administrators, received essentially nothing from the legislation. Small issuers constituted a large, diffuse group; free-rider problems are enormous for such a group and thus make it difficult for the group to exercise effective influence over legislation. The transaction costs for that diffuse group were simply too high for them to be effective in getting their way in the matter.

Another view of NSMIA, however, is less cynical about the legislative process than the view proffered by public choice theory[54] and ultimately is more hopeful regarding the final outcome of the scope of preemption. This interpretative version of NSMIA relies on the relationship between Congress and its administrative agencies and more specifically on Congress' use of an administrative agency, in this case the SEC, as a vehicle to achieve a sensible outcome without congressional members' expending undue amounts of their political capital. This version suggests that the Commission pursuant to its delegated authority should act boldly to complete the preemption begun by the statute itself. All of this requires explanation, however.

As described above, an earlier version of the legislation that became NSMIA, the Capital Markets Bill, preempted all state control over registration and merit qualification, except for transactions exempt from federal registration under the intrastate exemption. As it became law, however, preemption under the statutory language of NSMIA was significantly reduced from the broad preemption proposed in the Capital Markets Bill,

52. *See* Campbell, *supra* note 17, at 198-99.

53. For a brief description and history of NASAA, *see* Maynard, *supra* note 26, at 360, n.7. (noting that NASAA "is comprised of representatives from all [50] states, the District of Columbia, Puerto Rico, and several of the Canadian provinces. NASAA has been responsible for promulgating a number of statements of policy with respect to registration of particular types of securities, as well as developing several uniform registration forms.").

54. *See, e.g.*, Landes & Posner, *supra* note 49, at 877 (describing the economic view as one in which legislation is " 'sold' by the legislature" in return for "[p]ayments [that] take the form of campaign contributions, votes, implicit promises of future favors, and sometimes outright bribes"). The assumption regarding the conduct of legislators, specifically that they act without regard for the best interests of society, not surprisingly, is hotly contested by some. *See, e.g.*, Abner J. Mikva, *Symposium on the Theory of Public Choice: Foreword*, 74 VA. L. REV. 167 (1988) ("The politicians and other people I have known in public life just do not fit the 'rent-seeking' egoist model that the public choice theorists offer.").

leaving states, as a matter of statutory language, essentially unfettered in their control over the capital formation activities of small issuers. At the same time, however, NSMIA authorized the Commission through its rulemaking to expand the scope of the statutory preemption to include transactions in which securities are offered or sold to any "qualified purchasers, as defined by the Commission by rule."[55]

The SEC's definitional authority respecting "qualified purchasers" is set by statute and is exceedingly broad. Specifically, NSMIA states that the definition of "qualified purchaser" shall be "consistent with the public interest and the protection of investors."[56] NSMIA further requires that, when "the Commission is . . . required to consider . . . whether an action is . . . in the public interest," the Commission shall consider, "in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[57] In short, the Act indicates that the Commission under the "qualified purchaser" rubric is able to expand significantly the scope of preemption, limited only by the principles of the protection of investors and the promotion of competition and capital formation.[58]

All the foregoing is consistent with an interpretation of NSMIA in which Congress retreated from the politically expensive statutory preemption regime originally contained in the Capital Markets Bill in favor of a more modest statutory preemption regime found in NSMIA. To accomplish its original political end, however, which was a broad preemption of state authority over capital formation, this shift to a more moderate statutory

55. 15 U.S.C.A. § 77r(b)(3). The section provides:

> A security is a covered security with respect to the offer or sale of the security to qualified purchasers, as defined by the Commission by rule. In prescribing such rule, the Commission may define the term "qualified purchaser" differently with respect to different categories of securities, consistent with the public interest and the protection of investors.

Id.

56. *Id.*

57. *Id.* § 77b(b). This section in full provides as follows:

> Whenever pursuant to this subchapter the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

Id.

58. Admittedly, certain committee language is inconsistent with such a broad interpretation of the SEC's authority to expand preemption. Such committee language, however, is confusing and inconclusive. Additionally, to interpret such committee language as significantly limiting the authority of the SEC to expand the definition of "covered securities," and thus preemption, is inconsistent with the clear language of the statute itself described in the text. In all events, of course, clear language of a statute should trump committee language. *See* Campbell, *supra* note 17, at 207-10.

preemption was accompanied by an expansive delegation to an administrative agency, which delegation not only permits bold action by the Commission but, indeed, through statutory language suggests with some strength that such aggressive regulatory preemption is appropriate.

Under this view of NSMIA, the SEC should complete the statutory preemption by defining "qualified purchasers" to include all purchasers of securities acquired in transactions exempt under Regulation A, Rule 147, Rule 504, and Rule 505. This outcome is supported not only by the foregoing analysis of the relationship between Congress and the SEC, but also by the language of NSMIA and public policy considerations.

Leaving aside for the moment Rule 147 transactions, expanding preemption to include securities issued in transactions exempt under Regulation A, Rule 504, and Rule 505 is consistent with NSMIA's mandate that the preemption expansion under the "qualified purchasers" rubric be based on an appropriate balance between investor protection and capital formation, because each of those exemptions is based to a significant degree on a determination by the Commission that the terms of the exemptions are consistent with an appropriate balance between investor protection and capital formation. In other words, the Commission already is on record with its conclusion that Regulation A, Rule 504, and Rule 505 are consistent with the preemption expansion criteria of NSMIA.

Regulation A, for example, was enacted under section 3(b) of the 1933 Act, which limits regulations thereunder to those "in the public interest and for the protection of investors."[59] The SEC's 1992 amendments to Regulation A, in which the SEC expanded the limits of Regulation A offerings and approved the "test the water" provisions, and the release accompanying the adoption of those amendments confirm the thoughtful balance the SEC struck in Regulation A between investor protection and capital formation.[60]

Similarly, today's versions of Rules 504 and 505, which are part of Regulation D, are the results of protracted, well-considered administrative actions in which the SEC sought a proper balance between capital formation and investor protection.[61] Accordingly, for example, when the SEC fine-tuned this balance in 1992 by expanding the availability of Rule 504,

59. 15 U.S.C. § 77c(b) (1994).

60. In the release adopting the 1992 amendments to Regulation A, the SEC described its consideration and analysis of the changes on competition and investor protection in Regulation A. Small Business Initiatives, Securities Act Release No. 6949, 7 Fed. Sec. L. Rep. (CCH) ¶ 72,439, at 62,167-70 (July 30, 1992).

61. The release accompanying the initial adoption of Regulation D described the regulation as intended to "facilitate capital formation consistent with the protection of investors." Regulation D--Revision of Certain Exemptions from Registration, Securities Act Release No. 6389, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,106, at 84,907 (Mar. 8, 1982). For a discussion of the balance between investor protection and capital formation in Rule 504 and Rule 505, *see* Campbell, *supra* note 17, at 190-92, 194-95.

the release accompanying the adoption of the amendments again emphasized that those amendments were adopted only after consideration of investor protection and the need for capital formation.[62]

Such an argument, that the Commission's rules are based on a preexisting, thoughtful balance of investor protection and promotion of capital formation, admittedly is more difficult to make in the context of Rule 147. The problem here goes back to uncertainty regarding the policy basis for section 3(a)(11).[63] Commentators have always had trouble finding clear evidence of the policy basis for section 3(a)(11),[64] although two separate bases seem the most attractive candidates. One such basis is that the geographic proximity between the bulk of the issuer's business activities and the offerees of the securities diminishes the need for the mandated disclosure requirements of section 5 of the 1933 Act.[65] This, of course, is a straightforward economic argument that bargaining for investment information in such instances is efficient and thus that no governmentally mandated disclosures of investment information are necessary. This theory seems based, in turn, on the idea that this unfettered bargaining for investment information represents the appropriate balance between investor protection and capital formation.

The second such possible policy basis for section 3(a)(11) is the existence of state blue sky laws.[66] The rationale here is that if the offering is truly local, the federal government can appropriately rely on the states to enact laws and rules dealing with the offer and sale of such securities.[67]

It is impossible to determine whether the Commission based the present version of Rule 147 solely on the existence of a state regulatory scheme. Although the release adopting the rule indicates that the existence of the state regulatory schemes was a significant factor, the release provides some

62. *See* Securities Act Release No. 6949, 7 Fed. Sec. L. Rep. (CCH) at 62,165-78.

63. 15 U.S.C. § 77c(a)(11).

64. *See, e.g.*, LOUIS LOSS & JOEL SELIGMAN, 3 SECURITIES REGULATION 1276 (3d ed., 1989) (observing that "[t]he legislative history of § 3(a)(11) is sparse"). In his early, fine piece on Rule 147, Professor Hicks lists six possible bases for exempting intrastate offerings from the registration requirements of the 1933 Act, including the protection accorded by the geographic proximity of the issuer and the offerees, and the existence of state regulatory schemes. J. William Hicks, *Intrastate Offerings Under Rule 147*, 72 MICH. L. REV. 463, 499 (1974).

65. *See* Hicks, *supra* note 64, at 502.

66. *Id.*

67. None of this is conclusive. The release accompanying the adoption of Rule 147 indicates a strong desire to promote both investor protection and capital formation, the latter to be served by the certainty of the criteria of the exemption provided by Rule 147. Conditions for Intrastate Offering Exemption, Securities Act Release No. 5450, 1 Fed. Sec. L. Rep. (CCH) ¶ 2340, at 2611 to 2611-2 (Jan. 7, 1974). This release recognizes the two possible bases for the exemption provided by § 3(a)(11), noting that, "[i]n theory, the investors would be protected both by their proximity to the issuer and by state regulation," and adds that "Rule 147 reflects this [c]ongressional intent and is limited in its application to transactions where state regulation will be most effective." *Id.* at 2611-2.

basis for the conclusion that meeting the requirements of Rule 147 also provide appropriate protection for investors even without state blue sky laws.

In any event, even if Rule 147 originally were based solely on the existence of a state regulatory scheme, the Commission still could (and this author believes that it should) conclude that today the appropriate balance between investor protection and capital formation is struck by preemption with respect to Rule 147 transactions. The Commission could easily conclude that investors, following such preemption, would be appropriately protected by two factors. First is their ability to bargain for investment information, which is facilitated by geographic proximity between the issuer and the investors. Additionally, investors would be protected by the federal antifraud rules under the 1933 Act and the Securities Exchange Act of 1934,[68] which rules mandate disclosure by the issuer of all material facts, a sensible level of required disclosure in such instances. In light of this and in light of the benefit to capital formation, especially to small investors, of removing the second layer of regulation at the hands of the state, the Commission could and should determine that preemption of state regulation respecting Rule 147 transactions is consistent with the preemption criteria of NSMIA.

CONCLUSIONS

Small businesses may account for 40% of the business activities in this country, but capital formation rules always have discriminated against small businesses and imposed rules that make it unreasonably difficult for small companies to exploit external sources of capital. NSMIA, through its broad statutory delegation to the SEC of the right to expand the preemption of state blue sky laws, provides a unique opportunity for the Commission to deliver much-needed and much-deserved help to small issuers engaged in capital formation and to finally break the hegemonic hold states have over the rules governing capital formation by small businesses. Society will benefit if the SEC moves boldly to implement this delegated authority to expand the statutory preemption of NSMIA.

68. The most obvious examples are § 12(a)(2) in the 1933 Act, 15 U.S.C. § 77*l*(a)(2) (1994), and Rule 10b-5 in the 1934 Act, 17 C.F.R. § 240.10b-5 (1997).