Winter 1997

Blue Sky Laws and the Recent Congressional Preemption Failure

Rutheford B. Campbell Jr.
University of Kentucky College of Law, rcampbel@uky.edu

Click here to let us know how access to this document benefits you.

Follow this and additional works at: https://uknowledge.uky.edu/law_facpub
Part of the Securities Law Commons

Recommended Citation

This Article is brought to you for free and open access by the Law Faculty Publications at UKnowledge. It has been accepted for inclusion in Law Faculty Scholarship Articles by an authorized administrator of UKnowledge. For more information, please contact UKnowledge@lsv.uky.edu.
Blue Sky Laws and the Recent Congressional Preemption Failure

Rutheford B Campbell, Jr.*

I. INTRODUCTION .................................................. 176

II. STATE AND FEDERAL SECURITIES LAWS AND POLICIES AT THE TIME OF THE PASSAGE OF THE ACT ........................................ 180
   A. The Recent Federal Balance Between Capital Formation and Investor Protection .................................................. 180
      1. General Observations About Capital Formation .................. 180
      2. Offerings up to $1 Million .................................. 181
      3. Offerings Between $1 Million and $5 Million .............. 183
      4. Offerings over $5 Million .................................. 184
      5. Concluding Observations .................................. 184
   B. A Survey of State Laws Concerning the Registration and Qualification of Securities ........................................ 185
      1. A Rule 504 Offering ......................................... 191
      2. A Rule 147 Offering ......................................... 192
      3. A Regulation A Offering .................................. 193
      4. Offerings Under Rules 505 and 506 ....................... 194
      5. A Registered Offering .................................. 195
   C. Coordination Prior to the Act: A Demonstration of State Hegemony ... 190
      1. A Rule 504 Offering ......................................... 191
      2. A Rule 147 Offering ......................................... 192
      3. A Regulation A Offering .................................. 193
      4. Offerings Under Rules 505 and 506 ....................... 194
      5. A Registered Offering .................................. 195
   D. Critical Comment on the State of Affairs at the Passage of the Act .... 196

III. THE NATIONAL SECURITIES MARKETS IMPROVEMENT ACT OF 1996 ........ 196
   A. Introduction .................................................. 196
   B. Preemption (and Non-Preemption) Provisions .................. 196
      1. "Covered Securities" .................................. 196
      2. The Scope of Preemption .................................. 199
      a. Registration and Merit Qualification .............. 199

* Willbert D. Ham Professor of Law, University of Kentucky College of Law. The author benefitted from the thoughtful comments of John M. Rogers. The author expresses his gratitude for the research assistance of Dustin C. Haley and C. Bradford Harris, outstanding members of the Class of 1997 of the College of Law.
Society's securities laws impose mandated regimes designed to deal with these bargaining failures in trades for capital. The laws are intended not only to reduce culpable conduct, such as fraud, but also to improve more generally the bargaining for capital.

Society, however, has offered up quite different prescriptions to deal with these matters. The federal government, which entered the securities regulation business well after the states, impounded a disclosure philosophy in the Securities Act of 1933 (the

---


2. Kansas is usually credited with the first modern blue sky law enacted in 1911. Within two years thereafter, 23 additional states had enacted some form of blue sky laws. LOUIS LOSS & EDWARD M. COWETT, BLUE SKY LAW 10 (1985). The Securities Act of 1933 is the first piece of major federal securities legislation.
1933 Act). Under that regime, an issuer is legally entitled to sell any security, no matter how horrible or overpriced the security, so long as the issuer complies with the 1933 Act's disclosure requirements. In some instances, those disclosure requirements obligate the issuer to provide the Securities and Exchange Commission (the Commission or the SEC) and investors with prescribed information in connection with the public offer and sale of securities.3 In other instances, the information is disclosed only to investors4 and not the Commission, and sometimes in those cases the requirement for disclosure is stated only as the general obligation to disclose all "material" information, instead of a more particularized obligation to disclose enumerated information.5

Contrasted to the federal disclosure regime of the 1933 Act, the states adopted securities statutes6 (blue sky laws) that require offerings to comply with certain substantive standards, and if the offerings fail to meet those standards, the securities cannot be sold in the particular state, even if all material facts are disclosed. These state qualification regimes or merit requirements work much like consumer legislation by prohibiting sales of securities that are considered by regulators to be defective.7 To implement the enforcement of their substantive standards, states’ merit qualification statutes require informational filings by issuers with state agencies as a way to enable regulators to determine if the issue is in compliance with the particular state’s merit standards.8

Both a disclosure regime and a qualification regime generate costs. In the more traditional sense, costs for society result when governments expend resources implementing and enforcing the requirements of their laws. Salaries of regulators, for example, must be paid. Societal costs also are generated when a company pays its employ-

3. This occurs, for example, in the case of offerings registered under the 1933 Act.
4. This is the case, for example, in an offering under Rule 505 or Rule 506, 17 C.F.R. §§ 230.505-.506 (1996), where disclosure of prescribed information to investors, but not to the Commission, is normally a prerequisite to the exemption provided by the Rules.
5. This is the case, for example, in an offering exempt as an intrastate offering under Rule 147, 17 C.F.R. § 230.147 (1996). Under that Rule, no disclosure is required as a prerequisite for the availability of the offering. Id. Nonetheless, the issuer must disclose all material facts in order to avoid liability under the antifraud provisions of the securities laws, such as Rule 10b-5 under the Securities Exchange Act of 1934. Id. § 240.10b-5.
6. Some of the best history of blue sky laws is the result of work by Professor Loss and various co-authors. See, e.g., 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 29-152 (3d ed. 1989); LOSS & COWETT, supra note 2, at 3-10. In an interesting scholarship by Jonathan Macey and Geoffrey Miller, the authors present a somewhat different view about the precipitating forces driving the adoption of state blue sky laws. See Jonathan R. Macey & Geoffrey P. Miller, ORIGIN OF THE BLUE SKY LAWS, 70 TEX. L. REV. 347 (1991).
8. The Uniform Securities Act and its commentary indicate that qualification is the heart of blue sky regulation. UNIF. SECURITIES ACT § 304(a), 7 B.U.A. 562 (1985). States, however, supplement their blue sky laws with a disclosure philosophy as well. Accordingly, states generally require prospectus delivery to investors in connection with the offer and sale of securities registered within the state. See, e.g., ALA. CODE § 8-6-7(c) (1996); ARK. CODE ANN. § 23-42-403(d) (Michie 1995); Sec. Comm'r Rul. § 10.2; CONN. GEN. STAT. § 36b-18(d) (Supp. 1996); CONN. AGENCIES REGS. § 36-500-18(d) (1979); DEL. CODE ANN. tit. 6, § 7306(d) (1996); IDAHO CODE § 30-1426 (1996); KY. REV. STAT. ANN. § 292.380(1) (Michie 1996).
ees, lawyers, and accountants to prepare necessary documents and guide it through the maze of regulations and requirements of the various regimes.

In addition, and perhaps even more importantly to the economist, both disclosure and qualification regimes impose mandatory terms on the bargain struck between the parties and thus generate misallocation costs. For example, in a disclosure regime, issuers are required to "sell" and investors are required to "buy" investment information at a prescribed minimum level. If the parties, absent governmental mandates, would bargain for less information, then misallocation costs are imposed on the transaction by governmental regulations.

Similarly, if in a qualification regime an issuer is denied the right to sell its securities because, for example, the offering violates the state's merit standard prohibiting excessive underwriters' commissions, willing traders (i.e., the issuer that needs capital and the investors that want to invest in the deal) are unable to trade and thus engage in what they consider to be value-maximizing transactions. As a result, investors must put their capital somewhere else, which also generates a misallocation cost, since capital is not permitted to flow freely to its most efficient use.

The justification for the imposition of a mandatory regulatory scheme on the distribution and sale of securities depends on the idea that the regulations generate net benefits for society. To state this notion more completely, the justification is that the benefits of the regime outweigh the costs of the regime, whether such costs are described as misallocation costs or the more traditional out of pocket costs of running administrative agencies and enforcing and complying with laws. Most of us, it seems fair to say, would favor governmental intrusion into free bargaining only if the benefits to society of such governmental action outweigh its costs.

Twelve years ago in this journal, this author examined state blue sky laws under a cost-benefit analysis not unlike that articulated immediately above. The Article concluded that state blue sky laws are unjustifiable under any such analysis. Blue sky laws impose significant costs on society and generate no meaningful benefit. The reme-

9. The costs described in this paragraph as "misallocation" costs are not necessarily costs that are distinct from those described in the preceding paragraph. For example, the lawyer's fees described in the preceding paragraph are misallocated costs to the extent that the amount of legal services allocated to the deal is more than would be demanded in free bargaining between the investor and the company.

10. Typically, state securities administrators may deny registration to an offering if "the offering has been . . . made with unreasonable amounts of underwriters' . . . compensation . . . ." UNIF. SECURITIES ACT § 306(a)(2)(F), 7B U.L.A. 575 (1985).

11. Economists see value in economic efficiency. Definitions of economic efficiency may vary, however. See, e.g., Jules L. Coleman, Efficiency, Utility, and Wealth Maximization, 9 HOPSTRA L. REV. 509, 512 (1980) (stating that "[e]conomists as well as proponents of the economic analysis of law employ at least four efficiency-related notions, including: (1) Productive efficiency, (2) Pareto optimality, (3) Pareto superiority, and (4) Kaldor-Hicks efficiency"). Judge Posner defines economic efficiency as a state in which goods are allocated to those who are willing to pay the most for them. POSNER, ECONOMIC ANALYSIS, supra note 1, at 11-15. By mandating levels of disclosure or by denying investors the right to invest in certain deals that do not pass merit scrutiny, state governments limit the trading for investment information or capital and thus, throttle the economically efficient allocation of those goods.


13. Id. at 577-79.
The Article assumed that society wanted some regulation of securities in order to deal with perceived costs of bargaining failures and so argued for the seemingly simple notion that a single set of reasonable and efficient laws at the federal level was preferable to fifty-plus sets of essentially repetitive laws at the federal and state levels.

Late in 1996, Congress enacted and the President signed into law the National Securities Markets Improvement Act of 1996 (the NSMIA or the Act). The NSMIA may seem to go a long way toward the remedy suggested eleven years ago, if one were to judge by the congressional rhetoric accompanying the consideration and passage of the act. In reality, however, the NSMIA as passed is a paltry response to the problems generated by state registration and merit qualification requirements.

The purpose of this Article is to provide an analysis of the Act and to offer harsh criticism upon the unfortunate circumstance that the Act, standing alone and without further action by the Commission, eliminates relatively few of the unjustified costs and little of the drag on capital formation generated by blue sky laws. The lament of this Article is especially strong and the criticism especially harsh as concerns the plight of small entrepreneurs, which is the segment of the economy that most needs relief from the oppressive pall of state regulation and, ironically, is the very segment of the economy that received the least help from the Act. Finally, this Article observes that the Act delegates to the Commission authority to interject vitality into the Act, especially as concerns the legitimate capital formation needs of small issuers. Ultimately, however, the author is doubtful of the Commission's will to take effective action in that regard.

14. Id. at 579.

This article deals principally with Title I of the Act, which is also known as the Capital Markets Efficiency Act of 1996 and which contains §§ 101-109 of the Act. Title I of the Act deals with preemption of state securities laws and thus, has the most direct impact on capital formation for most companies.

16. The joint congressional committee charged with the responsibility to resolve differences in the House and Senate versions of the Act issued its Joint Explanatory Statement of the Committee of Conference and characterized the situation prior to the Act as involving a "dual system of regulation that, in many instances, is redundant, costly, and ineffective." H.R. CONF. REP. NO. 104-864, at 39 (1996). The Committee stated its intent for the Act 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 . . . ." Id. at 39-40.

17. The earlier House version of the Act, which was called the Capital Markets Deregulation and Liberalization Act of 1995, had meaningful preemption provisions. Specifically, that bill preempted all state control over registration and merit qualification except with regard to intrastate issues, blank check companies, and other situations specifically designated by the Commission. H.R. 2131, 104th Cong. § 3(a) (1995).

18. See infra text at part II.B.
19. See infra text at parts IV.A-B.
20. See infra text at part IV.C.
21. See infra text at part V.
II. STATE AND FEDERAL SECURITIES LAWS AND POLICIES AT THE TIME OF THE PASSAGE OF THE ACT

To demonstrate what the Act does or does not do, this Article offers a brief and necessarily general look at the state and federal securities laws that were in place at the time of the passage of the Act. The descriptions of state and federal laws are not intended in any sense to be exhaustive. Instead, the descriptions are offered only to demonstrate the admirable progress that the Commission had made regarding the important balance between investor protection and capital formation and to demonstrate how the states had, to a significant degree, undone this federal progress.

A. The Recent Federal Balance Between Capital Formation and Investor Protection

For this author to praise the Commission for its balance is perhaps somewhat ironic, because he has in the past been a harsh critic of the impact of Commission rules and actions on capital formation, especially in connection with the impact on smaller issuers. Nonetheless, while the Commission has taken actions in the past that were so bad as to practically foreclose certain issuers from any meaningful capital formation, in recent years the Commission has moved to a situation in which its rules, considered as a whole and in light of the common law interpretations of the underlying exemptions, reflect an admirable attempt to balance investor protection with capital formation. A brief survey of the generally available laws and regulations regarding the offering of securities demonstrates this point.

1. General Observations About Capital Formation

Issuers interested in capital formation through the sale of securities have a number of generally available avenues for meeting the registration requirements of the 1933 Act. The most likely options include registration, Rule 147, Rule 504, Rule 505, Rule 506, and Regulation A. Other methods of complying with Section 5 of the


23. Perhaps the two best examples of this are, first, old Rule 146, 17 C.F.R. § 230.146 (1981), which is discussed and criticized extensively in Campbell, The Plight of Small Issuers, supra note 22, at 1142-57, and second, the bald attempt by the Commission in connection with the adoption of Rule 144 to drive all resales of restricted securities into Rule 144. The conditions of Rule 144, however, could not at the time of its adoption be met by small issuers. Id. at 1150-53. Interestingly for the point of this section—which is that the Commission now does a much better job of balancing the competing needs of capital formation and investor protection—both those examples occurred years ago and have to a large degree been corrected by subsequent Commission action.

25. Id. § 230.504.
26. Id. § 230.505.
27. Id. § 230.506.
28. Id. §§ 230.251-.263.
1933 Act exist but are not often used because they either involve special situations or special issuers, or are comparatively unattractive. The selection by an issuer of one of the foregoing options (assuming, of course, that the issuer can meet the prerequisites of the particular option) is driven to a large degree by costs to the issuer of the particular option. Naturally, if all other factors are equal, the issuer will opt for the least expensive alternative to meet its obligations under the 1933 Act.

Two important points must be made regarding these costs. First, relative costs, not absolute costs, often are most critical to the issuer. To make this point with a simple, extreme example, $50,000 in offering costs will be less significant to an issuer offering $5 million in securities than to an issuer offering $100,000 in securities. Issuers can stand offering costs of one percent ($50,000/$5 million), while offering costs of fifty percent ($50,000/$100,000) will necessarily kill the transaction. To rephrase, as offerings get larger, the offerings can stand larger absolute offering costs without collapsing from their own weight.3

Second, offering costs generated by securities laws include, but are not limited to, the issuer’s obvious, out-of-pocket expenses.2 For example, complicated and uncertain offeree or purchaser qualification requirements may generate costs for an issuer as a result of the risk that the 1933 Act may be inadvertently violated. In finance terms, this risk has an immediate, negative present value for the issuer. Another, similar cost for an issuer results when onerous resale restrictions are imposed on purchasers of the issuer’s securities (persons acquiring shares in offerings are herein referred to as Holders). An investor is willing to pay less for securities (or, stated differently, must be paid a higher return on an investment) that involve a significant restriction on the investor’s ability to disinvest. Accordingly, the factors described in each of these examples, although perhaps not properly designated as out-of-pocket expenses, clearly generate costs for the issuer and thus will be carefully evaluated as an issuer considers whether a particular offering is economically advantageous.

In light of the foregoing, consider the options available for an issuer to meet its obligations under the 1933 Act as offerings increase in size.

2. Offerings up to $1 Million

For public or private offerings up to $1 million, Rules 504 and 147 both provide attractive alternatives for an issuer. Rule 504 now permits a non-reporting company to make a public offering of up to $1 million of its securities. The offering may be made without mandated disclosure, except as required by antifraud provisions, and without

29. For example, § 3(a)(9) of the 1933 Act, 15 U.S.C. § 77c(a)(9) (1996), provides an exemption for an offering in which an issuer exchanges its securities with its existing security holders.

30. For example, securities issued by domestic governments or banks are exempt from registration. 15 U.S.C. § 77c(a)(2) (1996).

31. This point clearly does not lead to the conclusion that society should only be concerned about situations in which offering costs are so large that the offering is impossible to complete. Even below such extreme costs, society should be unwilling to underwrite costs that do not generate benefits at least equal to costs.

32. Examples of an issuer’s obvious out-of-pocket expenses include the legal and accounting costs generated by extensive narrative and financial disclosure requirements in a registered offering.
offeree or purchaser qualification requirements or limitations on resales. Rule 147 permits any company that meets the intrastate criteria of the Rule to sell an unlimited amount of securities without registration and without mandated disclosures, except as required by antifraud provisions. The only offeree qualification requirement is that the offerees and purchasers must be residents of the same state as that in which the issuer is incorporated and doing business. The only resale restriction on stock taken in a Rule 147 transaction is that for a period of nine months, Holders must limit resales to only residents of the same state as the original offering.

While one may quibble with certain aspects of these exemptions, fundamentally both are consistent with the need of small issuers to access the public capital market within a reasonable cost structure that does not effectively foreclose the issuer from public financing. At the same time, investors in such transactions are accorded two meaningful protections that are entirely appropriate in the circumstances. First, investors are able to protect themselves by bargaining for investment information. Any investor presented with an opportunity to invest in a Rule 504 or Rule 147 offering can condition his or her investment on receiving information about the issuer and the transaction. Because transactions under these rules are typically small, localized, and sold directly by the issuer, structural impediments to bargaining for investment information should, as a general matter, be minimized.

Second, the investor is protected by the antifraud provisions of the 1933 and 1934 Acts. Accordingly, to say that issuers in such transactions have no mandated disclosure requirements is entirely incorrect, since issuers must disclose all material information. As a part of any such offering, therefore, the issuer is required to disclose all information that a reasonable investor would likely consider significant to his or her investment decision. The point here is that disclosure is, indeed, required in Rule 504 and Rule 147 transactions, although the disclosure requirement is stated in general, rather than specific, terms. The author’s experience as a transactions lawyer confirms that the generality of the norm does not diminish the seriousness with which the obligation is treated. Additionally, it confirms that the obligation under antifraud provisions to disclose all material facts results in significant, affirmative disclosures to investors.

Small issuers operating in this range, if subject only to these federal limitations, may have a realistic chance to raise capital. They can, for example, identify investors through general advertising, such as newspaper advertisements. This would be enormously helpful for small issuers, who must overcome large obstacles in raising the capital they need to run their businesses. Investors, on the other hand and in light of the need of small issuers to raise capital, are appropriately protected by market forces and

---

34. Id. § 230.147.
35. For a technical discussion of the restrictions on resales that apply to securities taken under the exemption provided by Rule 147, see Rutheford B Campbell, Jr., Resales of Securities Under the Securities Act of 1933, 52 Wash. & Lee L. Rev. 1333, 1351-56 (1995) [hereinafter Campbell, Resales].
37. This, of course, is the standard articulated by the Supreme Court in TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976).
by the important antifraud remedies, which require issuers to disclose all material facts to all investors prior to the sale of securities. In short, the Commission struck an appropriate balance for offerings of this size.

3. Offerings Between $1 Million and $5 Million

Issues between $1 million and $5 million also can satisfy the registration requirements of the 1933 Act in various ways that generally are consistent with a balance between capital formation and investor protection. In the case of public offerings within this range, the exemption provided by Regulation A is probably the most attractive for companies that are not reporting under the 1934 Act. For reporting companies, registration on one of the SB Forms is probably the most attractive, assuming that the issuer is able to meet the "small business issuer" criteria, which is a prerequisite for the use of the form. While both Regulation A and registration on the SB Forms require prescribed, detailed narrative and financial disclosures, the requirements of both are essentially reasonable. The mandated financial disclosures, for example, generally are reasonable with regard to the types of disclosures (e.g., with regard to audit requirements and compliance with Regulation SX) and extent of disclosures (e.g., number of years of income and balance sheet information). The two options are also reasonably certain in their requirements and impose no restrictions on the resale of securities in the hands of Holders.

In private offerings, Rule 505 probably is the most attractive option for issuers operating in the $1 million to $5 million range and, again, is consistent with the balance notion and the idea that larger deals can support more investor protection without destroying capital formation. Thus, for example, Rule 505, unlike Rule 504, requires in most instances that purchasers be supplied with prescribed, detailed disclosures, includ-

38. 17 C.F.R. §§ 230.251-263 (1996). Although Regulation A provides an exemption from the registration requirements of § 5 of the 1933 Act, the exemption is predicated upon filing and information delivery requirements that look very much like the rules applicable to a registered offering. Nonetheless, as described in the text, the Regulation is attractive for smaller offerings because the amount of information that must be filed with the Commission and delivered to investors is less than the information required in a full blown registration statement.

39. In fact, Rule 147 would be the most attractive way to meet the registration requirements in a public offering of this size. The discussion assumes, however, that it is unlikely that an offering of this size could be completed within limitations placed on the residence of offerees and the doing business requirement of the issuer.

40. Regulation A is limited to companies not subject to the reporting requirements of the 1934 Act. 17 C.F.R. § 230.251(a)(2) (1996).

41. Registration Statement under the Securities Act of 1933, Form SB-1, 17 C.F.R. § 239.9 (1996); Registration Statement under the Securities Act of 1933, Form SB-2, 17 C.F.R. § 239.10 (1996).

42. 17 C.F.R. § 230.405 (1996). The most important criteria are revenues of less than $15 million, a U.S. or Canadian issuer, and a public float of less than $25 million.

43. Regulation A Offering Statement under the Securities Act of 1933, Form 1-A, 17 C.F.R. § 239.90 (1996), prescribes the informational filing and disclosure requirements for Regulation A offerings.

44. The Commission provides two SB Forms, Registration Statement under the Securities Act of 1933, Form SB-1, and Registration Statement under the Securities Act of 1933, Form SB-2.

45. See infra note 49.
ing financial statements.46 This more extensive (as compared to Rule 504) disclosure requirement, which generates added offering expenses, is appropriate because of the increased size of the transaction.

In summary, as the sizes of offerings increase and thus move into the range of larger transactions, the Commission's regime typically requires more investor protection. As described above, the protection is usually in the form of specific, mandated disclosure. Generally, however, these increased obligations and the costs generated by them are relatively small and will not throttle capital formation.

4. Offerings over $5 Million

Issuers making public offerings in excess of $5 million most likely comply with the requirements of the 1933 Act by registering the securities on one of the Commission's S Forms.47 Not surprisingly, disclosure demands for such offerings are normally increased over the disclosure requirements placed on smaller public offerings effected under Regulation A or on the SB forms.48 Thus, for example, Form S-1, the Commission's S Form utilized when none other is available, requires more extensive disclosures than either Regulation A or the Commission's BD forms.49

Private offerings in excess of $5 million most likely will be undertaken pursuant to Rule 506. Often, such offerings require more disclosures than the smaller offerings under Rule 505.50 Additionally, Rule 506, unlike Rule 505, imposes purchaser qualification requirements, which specify that each purchaser must either be an "accredited investor" or sophisticated.51

5. Concluding Observations

The foregoing description suggests that over time the Commission developed a generally sensible array of methods through which issuers can comply with their registration obligations under the 1933 Act. Under this regime, the demands on the issuers to

---

47. For example, the Registration Statement under the Securities Act of 1933, Form S-1, is the registration form to be utilized by an issuer when "no other form is authorized or prescribed . . . ." Id. § 239.11.
48. However, a notable and significant exception to this general, expected circumstance exists. As the shares of the issuer become more widely traded (assuming the issuer has certain indicia of stability and soundness), the Commission is more willing to rely on the efficient market, as opposed to transaction oriented disclosures, to ensure the dissemination of information about the issuer and to impound such information in the price of securities. Thus, while the generally available Form S-1 requires more extensive disclosures than either Regulation A or the BD forms, Form S-3, which is the form available for widely traded, blue chip securities, requires fewer disclosures. This is based on the idea that the information disclosures by such widely traded, blue chip companies have been made previously in other filings with the Commission and thus are generally available to investors and impounded in the price of the securities.
49. For example, with regard to financial disclosures, registrations on Form S-1 require three years of income information and two years of balance sheet information, which must be audited and computed in conformity with the Commission's Regulation S-X. Form 1-A, on the other hand, requires audited financials only if the issuer prepares them for other purposes, does not require compliance with Regulation S-X and requires only one year of balance sheet information and two years of income information. Form 1-A, Part F/S.
51. Id. § 230.506(b)(2)(ii).
provide additional investor protection increase as the size of the offerings increase. Thus, while one may disagree with some of the criteria, especially as applied at the margin, the Commission’s overall approach demonstrates an appreciation of the trade-off between investor protection and capital formation. The balances struck by the Commission reflect an understanding of the significance of the relative, as opposed to the absolute, costs of offerings. The Commission’s approach further reflects an appreciation of what has been apparent to many for years, which is that the antifraud rules, especially when combined with the competition in the financial markets, provide a powerful disclosure incentive for issuers raising capital through the sale of securities.

B. A Survey of State Laws Concerning the Registration and Qualification of Securities

Immediately prior to the Act, blue sky laws generally required that securities offered or sold by an issuer within a particular state must be registered with the state’s securities division or the issuer must seek an exemption from the registration requirements. This broad rule, of course, is duplicative of the fundamental registration rule in the 1933 Act. Typically, states provided for registration by qualification, notification, or coordination. In the years before the passage of the Act, a number of states enacted the Small Corporate Offering Registration (SCOR) provisions, which

52. In an attempt to provide more concrete information regarding blue sky laws, the author selected five states (sample states) and researched in more detail the way the blue sky laws of those particular states deal with many of the issues raised in this section of the paper. The author selected his home state of Kentucky as one of the states, simply because he had easy access to information. He then selected the two states that fall alphabetically on each side of Kentucky. The five sample states, therefore, are Iowa, Kansas, Kentucky, Louisiana and Maine. Thus, while the sample is not random in a true sense, the sample was selected without any objective in mind or any intent to include or exclude states with particular characteristics. This sample represents approximately 10% of the blue sky jurisdictions.


55. This method of registration was permitted under the Uniform Securities Act, UNIF. SECURITIES ACT § 304, 7B U.L.A. 562-65 (1985), and under the laws of all five of the sample states. IOWA CODE § 502.207 (1991); KAN. STAT. ANN. § 17-1258 (1995); KY. REV. STAT. ANN. § 292.370 (Banks-Baldwin Supp. 1996); LA. REV. STAT. ANN. § 51:705(B) (West 1987); ME. REV. STAT. ANN. tit. 32, § 10404 (West Supp. 1995).

56. This method of registration was permitted under the Uniform Securities Act, UNIF. SECURITIES ACT § 302, 7B U.L.A. 555-56 (1985), and under the laws of all of the sample states except Iowa. KAN. STAT. ANN. § 17-1256 (1995); KY. REV. STAT. ANN. § 292.350 (Banks-Baldwin 1996); LA. REV. STAT. ANN. § 51:705(D) (West 1987); ME. REV. STAT. ANN. tit. 32, § 10402 (West Supp. 1995).

57. This method of registration was permitted under the Uniform Securities Act, UNIF. SECURITIES ACT § 303, 7B U.L.A. 559-60 (1985), and under the laws of all of the sample states except Louisiana. IOWA CODE § 502.206 (Supp. 1996); KAN. STAT. ANN. § 17-1257 (1995); KY. REV. STAT. ANN. § 292.360 (Banks-Baldwin 1996); ME. REV. STAT. ANN. tit. 32, § 10403 (West Supp. 1995).

58. Four of the five sample states by administrative action permitted the use of Form U-7, and the fifth state, Louisiana, is reported to have recognized the form and permitted its use unofficially. IOWA ADMIN. CODE r. 191-50.22 (1989); KAN. ADMIN. REGS. 81-4-2 (1991); 808 KY. ADMIN. REGS. 10:280 (1993); 1A Blue Sky L. Rep. (CCH) at 23,053 (Louisiana unofficially recognized SCOR and allowed registration on Form U-7); CODE M.E. R. ch. 525, § 4 (1991).
provided a special form for qualification registration of offerings made pursuant to the exemption from federal registration provided by Rule 504 in Regulation D.59

Of the three methods of registration at the state level, registration by coordination was the most desirable from the issuer's perspective. However, because that method of registration could be used only when the offering was covered by a federal "registration statement," coordination was necessarily limited in its availability. Thus, for example, registration by coordination normally was unavailable for offerings sold under Regulation A because those offerings technically were offered pursuant to an exemption and not pursuant to a registration statement.60

At the time the Act became law, state statutes often contained merit qualification standards, under which regulators were empowered to deny registration if an offering failed to meet certain substantive standards.61 Under the merit standards in the Uniform Securities Act, for example, administrators were empowered to deny registration for reasons that included "fraud" upon purchasers62 (a term that, according to the Comments to the Uniform Securities Act, "is not limited to common-law deceit"63), "unreasonable amounts of . . . underwriters' . . . commissions" or "promoters' profits," or "unreasonable amounts or kinds of options."64 Not surprisingly, merit criteria varied from state to state, although the Uniform Securities Act provided the model for many of the states' standards.65 Some state statutes, for example, went well beyond the Uniform

---


60. This appears to have been the case in Kansas, Kentucky and Maine. KAN. STAT. ANN. § 17-1257 (1995); KY. REV. STAT. ANN. § 292.360 (Banks-Baldwin 1996); ME. REV. STAT. ANN. tit. 32, § 10403 (West 1996). The fourth state in the sample, Louisiana, did not permit registration by coordination. The fifth state, Iowa, does permit registration by coordination with a Regulation A filing. IOWA CODE § 502.206(1) (1995) (permitting registration by coordination where a registration statement had been filed under the Securities Act of 1933 or "for any proposed sale pursuant to the exemption contained in subsection b of section 3 of such Act").

61. For example, all of the five sample states had statutory bases for merit regulation. IOWA CODE § 502.209 (1995); KAN. STAT. ANN. § 17-1260 (1995); KY. REV. STAT. ANN. § 292.390 (Banks-Baldwin 1996); LA. REV. STAT. ANN. § 51:707 (West 1987); ME. REV. STAT. ANN. tit. 32, § 10406 (West 1996). An exhaustive 1986 report by the ABA found that merit regulation was applicable, in various forms, in 39 states. ABA Ad Hoc Subcomm. on Merit Regulation of the State Regulation of Securities Comm., Report on State Merit Regulation of Securities Offerings, 41 BUS. LAW. 785, 788-89 (1986). Professor Mark Sargent was Reporter for the ABA Report.

63. Id. § 306 cmt. (E).
64. Id. § 306(a)(2)(F).
65. For example, all of the five sample states had merit standards that to a significant degree were similar to the Uniform Securities Act. Thus, four of the five states had a merit standard similar to § 306(a)(2)(A) of the Uniform Securities Act, which permitted the administrator to deny registration if the registration statement contained material misstatements or omissions of facts. IOWA CODE § 502.209(1)(a) (1991); KY. REV. STAT. ANN. § 292.390(1)(a) (Banks-Baldwin 1997); LA. REV. STAT. ANN. § 51:707(A)(1) (West 1987); ME.
Securities Act standards by providing a “fair, just and equitable” standard as a condition of registration.66

State blue sky laws in force at the time of the passage of the Act also provided numerous exemptions from the registration requirements.67 Because the application of merit criteria depended on registration, meeting the criteria for a particular state exemption from registration also eliminated the application of state merit standards to the particular offering.

Of the blue sky exemptions, upon which most issuers could rely to meet their normal capital needs, the small offering exemption was perhaps the most important. Under the Uniform Securities Act version of the small offering exemption, offers to less than ten persons within a twelve-month period were exempt from registration, if the issuer reasonably believed that purchasers took for investment, and no brokerage commissions were paid in connection with the offering.68 The exemption in the Uniform Securities Act, however, permitted the administrator to “withdraw,” “further condition,” or “waive” the terms of the exemption.69 While some form of the small offering exemp-


Interestingly, Professor Sargent reported in 1993 of the “diminishing . . . impact of merit regulation.” Mark A. Sargent, A Future for Blue Sky Law, 62 U. Cin. L. Rev. 471, 480 (1993) [hereinafter Sargent, A Future]. Professor Sargent pointed out that Illinois and Louisiana eliminated merit regulation by statute, that Wisconsin by statute effectively diminished the effect of merit regulation in that state, that administrators in other jurisdictions provide for presumptive merit approval for certain firmly underwritten registered offerings and that the SCOR form limits the impact of merit regulation in some states. Id. at 480-82. He opined that those developments “contributed to merit regulation’s decline in importance.” Id. at 482. While one should not doubt the well researched and well reasoned conclusions of Professor Sargent regarding the wane and relative strength of merit regulation, merit regulation was not a dead letter at the time of the adoption of the Act. See supra notes 56 and 61.

67. See Unif. Securities Act § 402, 7B U.L.A. 599-620 (1958). Like the 1933 Act, the Uniform Securities Act provided for numerous exempt securities and exempt transactions. Most, however, were special cases that were unavailable for the general financing needs of a typical issuer.


69. Id.
tion was widely available among the states, the terms of the small offering exemption, not surprisingly, often varied from state to state.

The much heralded Uniform Limited Offering Exemption (ULOE) provided an exemption from state registration for offerings made under Regulation D. The ULOE, however, was significantly less than a complete coordination with Regulation D. Most importantly in that regard, the ULOE provided no coordination with Rule 504. Additionally, even concerning Rule 505 and Rule 506 offerings, the ULOE imposed additional requirements beyond those of Rules 505 and 506. Finally, approximately one-

70. For example, a small offering exemption was found in all five of the sample states. IOWA CODE § 502.203(9) (1995); KAN. STAT. ANN. § 17-1262(1) (1995); KY. REV. STAT. ANN. § 292.410(1)(i) (Banks-Baldwin 1996); LA. ADMIN. CODE tit. 64, § 705 (1992); ME. REV. STAT. ANN. tit. 32, § 10502(2)(P), (Q) (West 1988 and Supp. 1996); CODE ME. R. ch. 536 §§ 1-5 (1995).


Variations in the maximum number of offerees (or purchasers or stockholders) were found among the states as well. IOWA CODE § 502.203(9)(a) (1995) (less than 36 purchasers); KAN. STAT. ANN. § 17-1262(1)(1)(1995) (not to exceed 20 sales); KY. REV. STAT. ANN. § 292.410(1)(i) (Banks-Baldwin 1996) (25 offerees, although the Director under administrative custom willingly increases the number of offerees, but typically predicates such expansion upon disclosure of information to all offerees); LA. ADMIN. CODE tit. 64, § 705(B)(4) (1992) (no more than 35 purchasers); ME. REV. STAT. ANN. tit. 32, § 10502(2)(P) (West 1988); CODE ME. R. ch. 536 § 3(a) (1995) (number of security holders may not exceed 10 as a consequence of the sale); ME. REV. STAT. ANN. tit. 32, § 10502(2)(Q) (West Supp. 1995); CODE ME. R. Ch. 536 § 3(b) (1995) (number of security holders may exceed 10 but not exceed 25 as a consequence of the sale, provided the issuer files a notification for exemption with the administrator).

Finally, as one last example of a variation in the small offering exemption, in Kentucky, issuers utilizing a small offering exemption were required to file a "claim of exemption," which had to be accompanied by a small filing fee and mandated, scheduled disclosures. KY. REV. STAT. ANN. § 292.415 (Banks-Baldwin 1996); 808 KY. ADMIN. REGS. 10:190, § 1 (1995).


73. See supra text accompanying note 25.

74. Included among the additional requirements that the ULOE imposes are requirements that all non-accredited investors must be sophisticated and that the investment be suitable for the purchaser. Section 1D,1 & 2, Uniform Limited Offering Exemption, NASAA Rep. (CCH) ¶ 6201, at 6103 (May 1989).
fifth of the state jurisdictions never adopted the ULOE75 and those that did sometimes imposed additional and often varying criteria to their state's version of the ULOE.76

In addition to the small offering exemption and the ULOE, most states had an exemption from registration for securities traded on certain national securities exchanges.77 The Uniform Securities Act, for example, provided exempt security status for any security listed or approved for listing upon notice of issuance on the New York, American or Midwest Stock Exchange.78 By the time the Act was passed, most states had extended this exemption to include securities listed or approved for listing upon notice of issuance on the National Association of Securities Dealers Automated Quotation/National Market System (NASDAQ/NMS).79


76. Commentators often are harsh respecting any claim that the ULOE actually results in uniform criteria. See Maynard, supra note 72, at 504 (stating that the ULOE has not provided a uniform exemption in all 50 states coordinating with Regulation D). Turning once more to the insightful observations of Professor Sargent, he reported that "some state administrators bitterly opposed" the ULOE and "imposed many obstacles" to this modest attempt at coordination and uniformity. Sargent, A Future, supra note 66, at 477.

Among the four sample states that adopted the ULOE, no two states' versions of the ULOE were the same. For example, variations among the states in their ULOE suitability requirements were sometimes present. Compare IOWA ADMIN. CODE tit. 191-50.16(2)(d)(1) (1994), with KAN. ADMIN. REGS. 81-5-6(a)(10), and LA. ADMIN. CODE tit. 64, § 703(B)(4)(a) (1990); compare IOWA ADMIN. CODE tit. 191-50.16(2)(d)(2) (1994), with LA. ADMIN. CODE tit. 64, § 703(B)(4)(b) (1990).


78. UNIF. SECURITIES ACT § 402(a)(8), 7B U.L.A. 600 (1958). The provision also provided for exempt security status for "any other security of the same issuer which is of senior or substantially equal rank" to the listed security. Id.

States, at the time of the passage of the Act, also typically had numerous other exemptions available for sales of securities. The Uniform Securities Act, for example, contained a series of exempt securities\(^8\) and exempt transactions,\(^8\) each of which provided an exemption both from registration and merit requirements. None of the exemptions in the Uniform Securities Act, however, were broadly appropriate for normal capital formation activities by a typical corporation. Instead, the exemptions covered such securities as those issued by charities,\(^8\) banks,\(^3\) and regulated public utilities.\(^4\) The exemptions similarly covered such transactions as sales by certain non-issuers,\(^8\) sales by secured parties,\(^6\) and sales by the issuer to underwriters.\(^7\) Individual states generally followed this pattern from the Uniform Securities Act.\(^8\)

In summary, at the time the Act became law, the typical corporation involved in normal capital formation met its registration requirements under state law either through registration and compliance with merit standards or through the small offering exemption, the marketplace exemption, or the ULOE.

**C. Coordination Prior to the Act: A Demonstration of State Hegemony**

It is instructive to consider a series of specific, typical examples of the ways issuers with particular capital needs may have coordinated state and federal registration requirements prior to the Act. The examples demonstrate that state laws undo the critical and thoughtful federal balance between capital formation and investor protection. The examples demonstrate, in other words, state hegemony over capital formation.

---

\(^8\) The exempt securities in the Uniform Securities Act included certain securities issued by governmental entities, regulated financial institutions, certain other, non-financial regulated institutions (such as public utilities) and charities, short-term commercial paper and securities issued in connection with employee benefit plans. Additionally, as described above, the Uniform Securities Act granted exempted security status to securities traded on certain, designated national stock exchanges. **Unif. Securities Act** § 402(a), 7B U.L.A. 599-600 (1958).

\(^8\) The exempt transactions in the Uniform Securities Act include certain offers and sales by non-issuers, offers and sales to underwriters or designated financial institutions, transactions involving debt securities secured by real estate, transactions by executors or administrators, or by pledgees, transactions involving preincorporation certificates and certain offers and sales to existing securityholders. **Unif. Securities Act** § 402(b), 7B U.L.A. 600-02 (1958). Also, as described above, the Uniform Securities Act provided for a small offering transactional exemption.

1. A Rule 504 Offering

Assume that prior to the Act a small company ($250,000 in total assets) wished to raise a relatively small amount of equity ($100,000). As described above, Rule 504 permitted this issuer to make a public offering of the securities and imposed neither resale restrictions on any Holder nor disclosure obligations on the issuer. The antifraud provisions of the securities laws required the issuer to disclose all material facts to all purchasers.

On the capital formation side of the equation, therefore, such a Rule 504 offering permitted the small issuer to identify potential purchasers of its securities through, for example, a newspaper advertisement or other broadly circulated offering mechanisms. Further, the issuer was accorded flexibility regarding how it disclosed all material facts. Finally, the issuer was unhampered by the onerous resale restrictions that may have made an offering unattractive to potential purchasers and thus more expensive to the issuer.

Concerning investor protection, the investors were, first of all, protected by their own abilities to bargain for investment information. Since one might reasonably assume that our small offering was sold in face-to-face transactions, our investors should have encountered few structural bargaining impediments. Additionally, investors in our example were protected by the obligation on the issuer to disclose all material facts to investors, an obligation imposed by the antifraud provisions of the federal securities laws.

This balance struck at the federal level, however, was entirely undone by state blue sky laws as they existed prior to the Act. Generally, the only way our issuer could have met the state registration obligations was through the small offering exemption. That exemption, however, destroyed the capital formation benefits of Rule 504 by prohibiting public offerings, severely limiting the number of offerees or purchasers and imposing restrictions on the resales of the securities taken by Holders. Matters were substantially worse if one assumes that the issuer was located in one state but on the border of two other states and the issuer wanted to make its offering in all three states. As the prior discussion indicates, the small offering exemption differed from state to state, which meant that the issuer was required to deal with three states, each of which may have had varying laws regarding its small offering exemption.

In addition, the issuer in this example was required to deal with the matter of whether the issuer’s CEO, who, it shall be assumed, effected the sales of the securities on behalf of the issuer, was required to register as a broker under the laws of each of the states in which the offering was made. The problem was that states had requirements respecting persons who engage in broker-like functions, and if our CEO fell

89. The issuer could, however, register on a SCOR form, if one were available in the state or states of the offering. See supra notes 58-59 and the accompanying text. In offerings in the area of $100,000, however, such an alternative would most likely be too expensive for the issuer. Also certain special issuers, such as companies in regulated industries or charities, might be accorded exempt status for their securities. See supra text accompanying notes 77-88. Most typical issuers, obviously, are unable to meet the special exemptive provisions.

90. See supra text accompanying notes 67-76.

91. Usually state blue sky laws prohibited anyone from acting as a “broker-dealer,” “agent,” or “investment advisor” unless the person was registered as such. UNIF. SECURITIES ACT § 201(a), (c), 7B U.L.A. 528.
within the definition of "broker" (or a related definition) under the laws of any of the states, the CEO may have become subject to an obligation to register as a broker with the particular state. Whether or not the CEO ultimately met the state's broker criteria and thus was subject to registration, the matter had to be resolved by legal counsel under the laws of all three states,\(^{92}\) which again added to the costs of the transaction. The simple point here is that the sensible balance between investor protection and capital formation struck at the federal level in Rule 504 was undone by multiple levels of state regulations.

2. A Rule 147 Offering

Assume that prior to the Act a small, local issuer proposed to raise $250,000 in an intrastate offering. Rule 147\(^{93}\) provided such an issuer with an attractive route for capital formation, since the issuer could have offered the securities publicly (although only within the particular state), and disclosure was not a prerequisite for the availability of the exemption. Additionally, neither the limitations on resales nor offeree qualification criteria were unreasonably burdensome, complex or uncertain. Thus, as with Rule 504, an issuer with small capital needs, such as our hypothetical one, could have utilized Rule 147 as a cost-efficient way to access public capital.

Rule 147 also provided appropriate protection for investors. As was the case in a Rule 504 offering, the protection was based on competition in the capital market and the disclosure obligations of the antifraud laws.

The benefits and balance of the federal regime, however, were once again undone by state law. Essentially, the only option available in most states for our hypothetical issuer was the small offering exemption, since neither the ULOE nor the marketplace exemption fit a small issuer involved in a public, Rule 147 offering.\(^{94}\) Registration, of course, was theoretically available for such offerings, but the costs of state registration for such small offerings normally put that option out of reach of issuers engaged in offerings of the size of our hypothetical issuer.\(^{95}\)

Under the criteria for the state small offering exemption, the offering could not have been made publicly but, instead, must have been limited to as few as ten offerees. Further, it was subject to significant, additional limitations on resales, and no commissions could have been paid in connection with the placement of the securities.\(^{96}\) In addition, at least in some instances, small offerings of this type were subject to mandatory disclosure obligations and filing obligations at the state level.\(^{97}\) Finally, the issuer was

\(^{(1958)}. \) Each of the sample states had similar provisions. IOWA CODE § 502.301 (1991); KAN. STAT. ANN. § 17-1254 (1995); KY. REV. STAT. ANN. § 292.330 (Banks-Baldwin 1996); LA. REV. STAT. ANN. § 51:703 (West 1987); ME. REV. STAT. ANN. tit. 32, § 10301 (West 1988)

92. For a discussion of the pernicious effect on capital formation caused by state regulation of the broker-dealer function, see Campbell, An Open Attack, supra note 12, at 572-75.
93. 17 C.F.R. § 230.147 (1996); see supra notes 34-35 and the accompanying text.
94. The ULOE was limited to offerings under Rule 505 and 506. See supra text accompanying notes 72-76. The marketplace exemption was limited to issuers with securities traded on national exchanges or on the NASDAQ/NMS. See supra text accompanying notes 77-79.
95. Issuers would most likely be required to register by qualification.
96. See supra notes 68-71 (discussing the small offering exemption).
97. These requirements were not part of the small offering exemption. But, for example, in Kentucky the
required to deal with the state’s broker registration provisions. Considered together, the additional criteria imposed by state securities laws significantly undercut the capital formation benefits for small issuers using Rule 147.

3. A Regulation A Offering

To consider the way Regulation A offerings were impacted by blue sky laws prior to the Act, assume that a non-reporting company proposed to raise $2 million by selling equity publicly in five states. Regulation A worked well for such an offering. The company could use the “test the waters” provisions and make the offering publicly with a reasonable amount of mandated disclosures, and the resales of the securities were essentially unrestricted.

At the state level, however, the issuer faced a bleaker landscape. None of the generally available state exemptions, as described above, worked for the offering. Regarding registration options, the issuer was unable to register by coordination, since that method was usually reserved only for an offering “for which a registration statement has been filed,” and the filing of the Offering Statement in a Regulation A offering was not a “registration statement.”

Issuer utilizing the small offering exemption was required to file a “claim of exemption” with the Division of Securities. The claim of exemption required, inter alia, a prospectus. KY. REV. STAT. ANN. § 292.415 (Banks-Baldwin 1996); 808 KY. ADMIN. REGS. 10:190(1)(d) (1996). Also in Kentucky, as a matter of administrative custom the Division would waive the statutory limit under the small offering exemption of 25 offerees and permit additional offers to be made by an issuer, but only if the issuer submitted and utilized an offering circular.

98. See supra text accompanying notes 91-92.
100. Id. § 230.254.
101. Id. §§ 230.251-.253; Registration Statement under the Securities Act of 1933, Form 1-A.
103. The assumption is that the issuer was not a reporting company, which means that the marketplace exemption would be unavailable. The fact that the offering was public would cause the small offering exemption to be unavailable. Since the offering was not under Rules 505 or 506, the ULOE was not available. See supra text accompanying notes 67-76.
105. In four of the five sample states, the issuer would have been required to register the offering. See supra note 57 and accompanying text.


States, under the spell of their securities administrators, appear unlikely to do much to reduce the state imposed regulatory burden on the use of Regulation A. Two noted commentators, Professor Sargent and Professor Steinberg, provide an interesting insight into this. Both report that state administrators do not oppose the increase in the limit of Regulation A to $5 million but do strongly oppose the test the water provisions of revised Regulation A. See Sargent, A Future, supra note 66, at 477-79; Marc J. Steinberg, The Emergence of
The registration obligation of the issuer under state law, therefore, could be satisfied only by registration through qualification with the five states. This registration was a daunting and, more importantly, an expensive task. If the number of states was increased to ten, twenty, or fifty states, the state burdens became utterly overwhelming. The unwillingness of the states, therefore, to grant registration by coordination with Regulation A offerings substantially undercut the usefulness of that exemption and thus undid the federal balance between capital formation and investor protection struck in Regulation A.

4. Offerings Under Rules 505 and 506

Prior to the Act, Rule 505\textsuperscript{106} may have been attractive for an issuer that wanted to sell $2 million in securities in five states in a fundamentally private transaction. Consistent with the balance between capital formation and investor protection, such an offering under Rule 505 required more in the way of investor protection than was required of the smaller, local offerings described above. Most significantly, prescribed, mandatory disclosures were imposed in connection with most Rule 505 offerings,\textsuperscript{107} and all securities acquired in a Rule 505 offering were subject to significant resale restrictions.\textsuperscript{108} The disclosure for the $2 million offering under Rule 505, however, was at a reasonable level, again reflecting the Commission's thoughtful and sensible concept that requirements for exemptions should not be so onerous and expensive as to destroy the utility of the particular exemption as a capital formation vehicle.\textsuperscript{109}

If, instead of $2 million, the issuer wanted to sell $6 million in such a transaction, Rule 506\textsuperscript{110} was available. The requirements of Rule 506 were in large part similar to Rule 505, in that Rule 506 was also predicated upon prescribed disclosures and upon limited resales. Again consistent with the idea that the costs of additional investor protection are less likely to undermine capital formation as deals get larger, Rule 506 required more investor protections than Rule 505. Specifically, Rule 506 required that

\begin{itemize}
  \item State Securities Laws: Partly Sunny Skies for Investors, 62 U. CIN. L. REV. 395, 408-11 (1993). Professor Sargent opines that "some state administrators are likely to resist" any pressure to "exclude [Regulation A] ... offerings from the coverage of rigorous state registration standards." Sargent, supra, at 478. Professor Steinberg is bolder in his characterization of the resistance one should expect from the states. He characterizes the test the water provisions by using phrases such as "evidences a lack of concern for the investing public," "outlandish" and "lax," and, one might assume that these phrases accurately reflect the opinions of some state administrators. Steinberg, supra at 409-10.

  \item If, as appears certain, states are not inclined to facilitate the use of Regulation A, because they feel it is an unwise exemption, states can effectively destroy Regulation A merely by doing nothing at all. Strategically, the status quo, which is that Regulation A most likely requires qualification registrations in each state, essentially eliminates Regulation A as an effective exemption.

  \item 106. 17 C.F.R. § 230.505 (1996).
  \item 107. Id. §§ 230.502(b)(2)(i), .505(b).
  \item 108. Id. §§ 230.502(d), .505(b).
  \item 109. Rule 502(b)(i) provides a somewhat complex range of disclosures. The particular disclosures required in an offering are generally determined by the size of the offering. Generally, as the size of offerings increase, disclosure demands under the Rule increase. The disclosure rules apply both to Rule 505 and Rule 506 offerings. Id. § 230.502(b)(2)(i).
  \item 110. Id. § 230.506.
purchasers must be either accredited or sophisticated\textsuperscript{111} and generally imposed greater disclosure requirements than Rule 505.\textsuperscript{112}

Because of the availability of the ULOE, one might assume that state laws imposed little drag on such offerings. Matters, however, were not without difficulties. First, the ULOE itself imposed requirements on the offering beyond the conditions mandated by Rules 505 and 506. Second, not all states had adopted the ULOE, and those that had often imposed additional conditions on their particular version of the ULOE.\textsuperscript{113} Finally, the issuer was required to deal with problems generated by the broker laws of all five states,\textsuperscript{114} which meant that the law in each of the five states had to be researched to determine if the person executing the sales of the securities on behalf of the issuer became subject to the states' broker laws. While the ULOE relieved the more extreme problems described in the preceding subsections of this Article, it turns out that even the ULOE failed to prevent a significant realignment by the states of the federally struck balance between capital formation and investor protection.

5. A Registered Offering

Assume that prior to the Act a company that reported under the 1933 Act and was traded on the NASDAQ/NMS wanted to raise $10 million in a public offering. In such an instance, federal registration was required,\textsuperscript{115} and the company faced the full impact of the 1933 Act. Although, as a result, the company encountered substantial offering expenses in connection with the filing of its registration statement and delivering of prospectuses to investors, these offering expenses were unlikely to throttle capital formation, since as a relative matter the expenses were probably modest.\textsuperscript{116}

The issuer had two relatively attractive ways to deal with state registration requirements in such an offering. First, in most states the issuer had a marketplace exemption.\textsuperscript{117} Second, the issuer in most states had the option of registration by coordination.\textsuperscript{118} Also, because such an offering usually was distributed in an underwritten transaction, the issuer's problems regarding state broker laws\textsuperscript{119} disappeared, since the underwriters and members of any selling group would have been properly licensed with the states. Thus, the state law drag on capital formation in such an offering was less than in any of the foregoing examples.

Nonetheless, the state laws generated waste in such cases. More specifically, the issuer was required to research and then take steps necessary to comply with the regis-

\begin{itemize}
\item \textsuperscript{111} 17 C.F.R. § 230.506(b)(2)(ii) (1996).
\item \textsuperscript{112} See supra note 109.
\item \textsuperscript{113} See supra notes 51-55 and accompanying text (discussing ULOE matters mentioned in this paragraph).
\item \textsuperscript{114} See supra text accompanying notes 91-92.
\item \textsuperscript{115} The reason state registration was required was because none of the exemptions from registration were available.
\item \textsuperscript{116} For example, even if expenses of complying with securities laws amounted to $100,000 in such a transaction, that is only one percent of the total offering price.
\item \textsuperscript{117} See supra text accompanying notes 77-79.
\item \textsuperscript{118} See supra text accompanying notes 55-60.
\item \textsuperscript{119} See supra text accompanying notes 91-92.
\end{itemize}
tration requirements of perhaps fifty separate sets of securities laws. Since society (or investors) received no measurable benefit from the issuer’s doing the same thing fifty times, the costs associated with the issuer’s compliance represented waste.\textsuperscript{120}

\textbf{D. Critical Comment on the State of Affairs at the Passage of the Act}

One may express criticism of the blue sky laws in place at the passage of the Act, in terms of state hegemony over a federal policy balancing the need for investor protection with the need to promote capital formation. The spectrum of tradeoffs at the federal level that one may rightly assume was carefully crafted by Congress and the SEC was significantly undone by state regulations. Alternatively, one may express criticism of such blue sky laws in terms of the wild inefficiencies involved in a bizarre system that required an issuer selling stock to comply with more than fifty sets of different rules, each with its own complicated prescription for the possible bargaining failures that may have been present in the capital allocation transactions. Such a system was too strange to require any further discussion, except to observe that it could only be understood in terms of its historical development and the vigor of the bureaucratic resistance to change. What was needed was one set of sensible, balanced rules governing capital formation, and that result was possible only through federal preemption.

\textbf{III. THE NATIONAL SECURITIES MARKETS IMPROVEMENT ACT OF 1996}

\textbf{A. Introduction}

The foregoing illuminates many of the problems generated by blue sky laws and the reasons why Congress chose to examine the matter. Unfortunately, the Act resulting from Congress’s examination of these problems changes only slightly state hegemony and eliminates little of the pernicious impact of state securities laws on capital formation, especially as concerns small issuers.

\textbf{B. Preemption (and Non-Preemption) Provisions}

The essence of the Act with regard to preemption is that states no longer have the authority to enact rules requiring the registration or merit qualification of certain securities or with respect to certain transactions. The Act, however, preserves states’ rights to pass and enforce their own, individual antifraud rules. States also, within certain limits, may require issuers to file copies of all of their SEC documents with the states and may continue to collect filing fees.

\textit{1. “Covered Securities”}

At the heart of the Act’s preemption provisions is the concept of “covered securities.”\textsuperscript{21} The Act defines four categories of covered securities. The first category involves basically the same securities that were the subject of the state marketplace ex-

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{120} See Campbell, \textit{An Open Attack}, \textit{supra} note 12, at 556-67.
\item \textsuperscript{121} NSMIA, \textit{supra} note 15, § 102(a), 15 U.S.C. § 77r(b) (1996).
\end{itemize}
\end{footnotesize}
which specifically are securities listed on the New York and American Stock Exchanges and on the NASDAQ/NMS. Also included in this category of covered securities are those traded on exchanges that have listing standards determined by the Commission to be substantially similar to the foregoing trading venues.

The second category of covered securities involves those issued by a registered investment company. The third class of covered securities includes any security issued to a "qualified purchaser." The term "qualified purchaser" is not defined in the Act. Instead, the authority to define the term is delegated to the Commission. The only statutory limit on the Commission's authority to define "qualified purchaser" is that the term must be defined in a way that is "consistent with the public interest and the protection of investors." The Act, in turn, requires the Commission, when it determines the "public interest," to "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." Contrasted to this broad statutory charge regarding the definition of "qualified purchas-

122. See supra notes 77-79 and accompanying text.

A security is a covered security if such security is—

(A) listed, or authorized for listing, on the New York Stock Exchange or the American Stock Exchange, or listed on the National Market System of the Nasdaq Stock Market (or any successor to such entities);

(B) listed, or authorized for listing, on a national securities exchange (or tier or segment thereof) that has listing standards that the Commission determines by rule (on its own initiative or on the basis of a petition) are substantially similar to the listing standards applicable to securities described in subparagraph (A); or

(C) is a security of the same issuer that is equal in seniority or that is a senior security to a security described in subparagraph (A) or (B).

Id.

124. Id. § 102(a), 15 U.S.C. § 77r(b)(2) (1996). The section provides: “A security is a covered security if such security is a security issued by an investment company that is registered, or that has filed a registration statement, under the Investment Company Act of 1940.” Id.

125. NSMIA, supra note 15, § 102(a), Securities Act § 18(b)(3) (1996). 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.

126. The statute is merely permissive regarding any obligation on the part of the Commission to define “qualified purchaser.” The House Committee that considered the House version of the Act, however, clearly anticipated that the Commission would act promptly to define “qualified investor” (“The Committee intends that the Commission move promptly to adopt such a rule or regulation to give effect to the provision”). H. R. Rep. No. 104-622, § 102 (1996).


128. The NSMIA amends Section 2 of the 1933 Act by adding a new subsection (b), which provides:

Whenever pursuant to this title 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.

er,” however, is the Committee Report accompanying the House version of the bill, which indicates a narrower appropriate range for the Commission’s definition of “qualified investor.”

The fourth category of “covered securities” is the most complicated. Part of the difficulty is the result of an awkward description of the category and the apparent confusion of exempt securities under the 1933 Act with exempt transactions under the 1933 Act. The statute describes the category as including any “security . . . with respect to a transaction that is exempt from registration . . . pursuant to” certain, enumerated exemptions under the 1933 Act, including the following:

(i) the exemption provided by Section 4(1) (the exemption for all transactions other than those by issuers, underwriters or dealers);
(ii) the exemption provided by Section 4(3) (the exemption for most dealer transactions);
(iii) the exemption provided by Section 4(4) (the exemption for some brokers’ transactions);
(iv) most of the exemptions provided by Section 3(a) (except the exemptions for securities issued by charities, issued by issuers of municipal securities located in the particular states, or issued pursuant to the intrastate exemption); and
(v) exemptions provided by any Commission regulation passed pursuant to its authority under Section 4(2).

Glaringly absent from this fourth category of covered securities are securities issued in transactions exempt under Section 3(a)(11), which includes Rule 147, under Section

129. See infra notes 169-70 and accompanying text.
130. The NSMIA describes the fourth category of covered securities in § 106(a), which provides:

A security is a covered security with respect to a transaction that is exempt from registration under this title pursuant to—

(A) paragraph (1) or (3) of section 4, and the issuer of such security files reports with the Commission pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934;
(B) section 4 (4);
(C) section 3(a), other than the offer or sale of a security that is exempt from such registration pursuant to paragraph (4) or (11) of such section, except that a municipal security that is exempt from such registration pursuant to paragraph (2) of such section is a covered security with respect to the offer or sale of such security in the State in which the issuer of such security is located; or
(D) Commission rules or regulations issued under section 4(2), except that this subparagraph does not prohibit a State from imposing notice filing requirements that are substantially similar to those required by rule or regulation under section 4(2) that are in effect on September 1, 1996.

131. The exemptions of 1933 Act can be divided between exempt securities and exempt transactions, although, ironically, the 1933 Act also at points mixes up its transactional exemptions with its exempt securities. Specifically, § 3 of the 1933 act is entitled “Exempt Securities,” but subsections 3(a)(9) through 3(a)(11) involve only transactional exemptions. See, e.g., III LOSS & SELIGMAN, supra note 6, at 1142-44.
3(b), which includes Rule 504, Rule 505 and Regulation A, and under the common law of Section 4(2).

2. The Scope of Preemption

a. Registration and Merit Qualification

Within the limits imposed by the definitions of covered securities, the preemption provisions of the Act regarding states’ rules governing the registration and merit qualification are extremely broad, essentially eliminating all state control over these matters. This means that existing state laws and regulations requiring the registration and merit qualification of securities simply do not apply to the offer and sale of covered securities. On the other hand, present state laws and regulations governing registration and merit qualification continue in full force with regard to the offer and sale of securities not covered by the Act.

The Act also has certain provisions designed to prevent any end run by the states regarding the complete preemption of registration and qualification of covered securities. Thus, the Act prohibits states from enacting any law or regulation concerning any offering document used in connection with the offer and sale of covered securities.

Under this prohibition states could not require specific legends on any offering documents or, perhaps even more extreme, demand that certain financial disclosures be included in the offering documents relating to covered securities even with respect to the offers and sales of covered securities within their own borders. As concerns registration and merit qualification of covered securities, the Act clearly is designed to effect a complete preemption of states’ rights to legislate and enforce their own rules.

b. Proxy Statements and Reports to Shareholders

The Act also limits the power of states to impose conditions on the use of proxy statements, reports to shareholders, or other disclosure documents that are required to be filed with the Commission. Although this particular section of the Act is replete with ambiguities, these uncertainties are to a large extent cured by the exception to

134. As amended by the NSMIA, Section 18(a)(2) of the 1933 Act provides that no state “shall . . . limit or impose any conditions upon the use of (A) with respect to a covered security described in subsection (b), any offering document that is prepared by or on behalf of the issuer . . . .” NSMIA, supra note 15, § 106(a), 15 U.S.C. § 77r(a)(2)(A) (1996).
135. As amended by the NSMIA, § 18(a)(2)(B) of the 1933 Act provides that no state shall . . . limit or impose any conditions upon the use of . . . (B) Any proxy statement, report to shareholders, or other disclosure document relating to a covered security or the issuer thereof that is required to be and is filed with the Commission or any national securities organization registered under section 15A of the Securities Exchange Act of 1934, except that this subparagraph does not apply to the laws, rules, regulations, or orders, or other administrative actions of the State of incorporation of the issuer . . .
136. The ambiguities in the subparagraph are created by poor legislative drafting, which makes it difficult or impossible to determine what is modified by the phrase “relating to a covered security or the issuer thereof” and the phrase “that is required to be and is filed with the Commission or any national securities organi-
this preemption provision, which leaves states free to enact such laws and rules governing corporations incorporated within their own state. Thus, to use an example constructed from our sample states, Kentucky in all events retains power to require and govern proxy statements for corporations chartered in Kentucky.

On the other hand, Kentucky's power is less than clear concerning its right to exercise authority over the proxy solicitations by an Iowa corporation of Kentucky residents who own stock in the Iowa corporation. As a matter of policy, clearly the better interpretation is that Kentucky's power to govern that proxy solicitation is entirely preempted by the statute, since otherwise the Iowa corporation could face regulation from fifty jurisdictions regarding the content of its proxy statement. Today's reality is, however, that none of the five sample states had securities laws purporting to exercise any significant control over the proxy solicitation process by corporations outside its own borders. Thus, unless states decided to draft and put into place such extra-territorial proxy rules, these particular drafting ambiguities probably are unimportant as a practical matter.

c. Antifraud Provisions

The Act specifically reserves for state regulators jurisdiction under their own state's laws to pursue and prosecute fraud or deceit generally, and in particular, unlawful conduct by brokers and dealers. While, again, awkward sentence construction and poorly chosen words in the Act create some minor ambiguities, these problems seem relatively insignificant. The clear intent here is to leave these matters just as they were prior to the passage of the Act.

zation registered under section 15A of the Securities Exchange Act of 1934. Either of the phrases may be read to modify only "other disclosure documents" or may be read to modify "and any proxy statement, report to shareholders, or other disclosure document."

137. See supra note 52.

138. Depending on the way one reads the two ambiguous phrases, see supra note 136, Kentucky with respect to such solicitation may have authority after the Act to: (i) exercise no authority over such proxy solicitation; (ii) exercise authority over such proxy solicitation, unless it relates to a covered security; (iii) exercise authority over such proxy solicitation, unless the solicitation requires filing with the SEC; or (iv) exercise authority over such proxy solicitation unless the proxy statement relates to a covered security and requires filing with the SEC.

139. See supra note 52.

140. As amended by the NSMIA, § 18(c)(1) of the 1933 Act provides:

Consistent with this section, the securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with the securities or securities transactions.


This section generates another slight ambiguity, although perhaps not too great this time. While the sentence construction of the section is certainly problematic, it seems clear that the intent of the section is that the words "by a broker or dealer" modifies only "unlawful conduct" and does not modify "fraud or deceit." If the latter two terms were modified by the words "by a broker or dealer," the section would reserve for states only jurisdiction over antifraud rules as they relate to conduct of brokers or dealers. Clearly, that is not the intent of the Act.
Importantly, this approach leaves states free to enforce antifraud standards that differ from the antifraud standards enforced at the federal level. For example, state civil liability statutes that predicate antifraud recovery on simple negligence, instead of higher levels of culpability, such as recklessness or intent, are not preempted by the Act. Therefore, state regulators may continue to enforce and state courts may continue to grant civil liabilities under such negligence based statutes. Nothing in the Act affirmatively touches these statutes, and one should not, as a negative implication from the use of the words “fraud” or “deceit,” infer any intent to preempt state statutes that permit recovery for negligent misstatements or omissions.

States’ continuing authority to define their own antifraud standards, particularly the standard of “materiality,” could be used to counter some of the preemptive effects of the Act. Consider the possibility, for example, that state courts, legislatures or, more likely, state administrators might begin to define the individual state standards of “materiality” more expansively than the federal standard of “materiality” and might even articulate regulations particularizing the types of information that normally are considered “material.” Such tactics, if widely adopted, would be a severe blow to the uniformity that is the policy basis for preemption.

d. Filings and Fees

To make the Act more palatable to the states, the Act preserves the rights of states to continue to collect filing or registration fees. The Act does this by specifically permitting states to continue to collect such fees “in amounts determined pursuant to State law as in effect on the day before” the effective date of the Act. Also, it permits states to change their fee structures after the effective date of the Act.


142. Federal cases have made much of the use of the words “deceptive” and “manipulative” in § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1994), and the U.S. Supreme Court has held that such words require a level of culpability beyond simple negligence. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976).

143. States could, for example, define “materiality” as any fact that “might” affect the judgment of a reasonable person. This expansive standard, apparently because of its expansiveness, was rejected as an appropriate federal standard in TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976) (stating “the might” formulation is “too suggestive of mere possibility, however unlikely”). Or, even more insidiously, state regulators might administratively define as “material” income statements for the three years, and balance sheets for the two years, immediately preceding any sale of securities by a corporate issuer. Then, an issuer involved in a national level distribution would have to research and comply with the common law, statutory law, and administrative regulations of each jurisdiction.

The Act itself may provide a basis to deal with such an eventuality, however, since the section of the Act that permits continued state activity in this area indicates that such state activity is to be “consistent with this section.” NSMIA, supra note 15, § 102(a), 15 U.S.C. § 77r(c)(1)(1996).

The possibility, even though it may be quite remote, that states may undertake such action as described herein led the author previously to recommend federal preemption of state antifraud provisions. Campbell, An Open Attack, supra note 12, at 575-77.


145. Id. As amended by the NSMIA, § 18(c)(2)(B) of the 1933 Act provides:
Complementary to these provisions preserving fees for the states is a section in the Act that permits any state securities commission to require the filing with the particular state of any documents filed with the Commission under the 1933 Act, although the section provides that such filings are "solely for notice purposes and the assessment of any fee." The Act also permits state commissions to require the filing of a consent to service of process and, of course, the payment of the required state fees. The Act, however, prohibits any state filing or fee requirements with regard to the sale of securities listed on the New York or American Stock Exchanges or on NASDAQ/NMS. Since a significant percentage of federal registration statements will involve these listed securities, this provision represents an important exception to the broad permissibility in the Act of state imposed filing and fee requirements.

Although these provisions may not enable states fully to compensate themselves for filing fees necessarily lost as a result of the preemption provisions of the Act in the short run, the breadth of the provisions will, over time, provide states wide flexibili-

Until otherwise provided by law, rule, regulation, or order, or other administrative action of any State, or any political subdivision thereof, adopted after the date of enactment of the Capital Markets Efficiency Act of 1996, filing or registration fees with respect to securities or securities transactions shall continue to be collected in amounts determined pursuant to State law as in effect on the day before such date.


147. As amended by the NSMIA, § 18(c)(2)(A) of the 1933 Act provides:

Nothing in this section prohibits the securities commission (or any agency or office performing like functions) of any State from requiring the filing of any document filed with the Commission pursuant to this subchapter, together with annual or periodic reports of the value of securities sold or offered to be sold to persons located in the State (if such sales data is not included in documents filed with the Commission), solely for notice purposes and the assessment of any fee, together with a consent to service of process and any required fee.

Notwithstanding subparagraphs (A), (B), and (C), no filing or fee may be required with respect to any security that is a covered security pursuant to subsection (b)(1), or will be such a covered security upon completion of the transaction, or is a security of the same issuer that is equal in seniority or that is a senior security to a security that is a covered security pursuant to subsection (b)(1) of this section.


148. The reference to a "covered security pursuant to subsection (b)(1)," which is referenced in the foregoing language as exempt from any filing or fee requirement by states, includes not only securities on the New York and American Stock Exchanges and the NASDAQ/NMS but also securities listed on any national exchange whose listing standards are determined by the Commission to be "substantially similar" to the foregoing. NSMIA, supra note 15, § 102(a), 15 U.S.C. § 77r(b)(1) (1996). For the text of the language of that section, see supra note 123.

149. Because of the structure of state fee provisions, states may in the short run lose revenues following the NSMIA and may be required to obtain legislation in order to exploit fully the fee generating provisions of the NSMIA. In Kentucky, for example, the provisions governing fees in most cases are in statutes. See KY. REV. STAT. ANN. § 292.380(5) (Banks-Baldwin 1996) (governing filing fees for state registrations); Id. § 292.415(2) (Banks-Baldwin 1996) (governing fees for filing of claims of exemptions). The language of such provisions seems to leave the Division of Securities no room, for example, to demand a fee from issuers of covered securities who are no longer required to file a registration statement in Kentucky. See, e.g., KY. REV. STAT. ANN. § 292.380(5) (Banks-Baldwin 1996) (establishing and apparently limiting the collection of certain fees "for the registration of securities by notification or coordination, or qualification . . . "). To exploit the
ty to develop laws and regulations that protect the revenues generated from securities offerings within their borders. Indeed, the Act seems nearly to provide a road map for states desiring to protect or even increase their revenues from securities sold in their state. The not-too-subtle suggestion of the Act is that states could require all issuers filing federal registration statements to file copies of the federal registration statement with the states, and the states could then charge each such issuer a filing fee. Similarly, states could establish filing requirements and hefty filing fees with respect to Form Ds required by state law to be filed with the states in any Regulation D offering.

This type of conduct, at least in an extreme form, would have an unpleasant odor to it, smelling like pure taxation on the sale of securities within the particular state. Nonetheless, states need money to run their securities divisions and thus may be anxious to implement Congress’s suggestion and exploit filing fees as a source of needed revenue.¹⁵⁰

IV. LIFE AFTER THE ACT

A. Generally

Judged by the rhetoric of its legislative history, the Act was intended to be revolutionary regarding the dual control by the federal government and states over the sale of securities and the capital formation process. The Act was to modernize and rationalize “our scheme of securities regulation to promote investment, decrease the cost of capital, and encourage competition.”¹⁵¹ The legislation was responsive to the recognition that “the system of dual federal and state securities regulation has resulted in a degree of duplicative and unnecessary regulation,”¹⁵² and that such a dual system, “in many instances, is redundant, costly, and ineffective.”¹⁵³

The changes wrought by the Act in this dual system of securities regulation, however, are generally insignificant. The Act does little to promote investment or decrease the cost of capital. This is especially true in the case of small issuers, who are most battered by state blue sky laws and who, ironically, receive the least from the Act. The Commission can, however, through the exercise of authority delegated to it in the Act, ameliorate the pernicious effect of the dual system of control over securities registration that will continue after the Act. One should not, however, be overly optimistic that the Commission will use its regulatory power to put real teeth in the Act.

¹⁵⁰ NSMIA’s fee generating provisions fully, state securities commissioners may be required to seek legislative help on the matter, which will generate some time lag.
¹⁵¹ In Kentucky, for example, all fees generated by the Department of Financial Institutions from securities fees go back to the department for its operations. Ky. Rev. Stat. Ann. § 287.485 (Banks-Baldwin 1996).
¹⁵³ Id.
B. Life Immediately After the Act

To understand how little the Act changes the regulation of securities, consider again the five transactions outlined in Section II.C of the Article. One finds that the Act results in no changes in the rules applicable in most of the examples and relatively slight changes in the remaining examples.

1. A Rule 504 Offering

The assumption is that a small company ($250,000 in total assets) desires to sell $100,000 in stock under the federal exemption from registration provided by Rule 504. To enhance the facts, the discussion assumes that the issuer wants to make its offering in its home state and two adjoining states. The result prior to the Act was that the issuer most likely would have met its state securities obligations through the small offering exemption, which eliminated the benefits of Rule 504 and altered dramatically the balance between capital formation and investor protection struck at the federal level through Rule 504. Also the issuer was required to evaluate the broker law of each of the three states to determine whether the person executing sales on behalf of the issuer, the CEO, for example, was subject to the states laws governing brokers.

The Act changes none of this. Since the securities involved in the offering are issued under Rule 504, which is based on Section 3(b) of the 1933 Act, the securities in this example are not "covered securities" and thus not subject to preemption. Similarly, the broker considerations are unchanged by the Act.

2. An Intrastate Offering

The assumption is that prior to the Act a small, local issuer proposes to raise $250,000 in an intrastate offering under Rule 147. The analysis indicated that prior to the Act the issuer was most likely to rely on the small offering exemption to meet its state registration requirements, and those requirements again eliminated much of the benefits of the federal exemption and reset the balance between capital formation and investor protection struck at the federal level through Rule 147.

As in the case of offerings under Rule 504, the Act changes none of the foregoing. The term "covered securities" under the Act does not include securities issued under the exemption provided by Section 3(a)(11) and thus Rule 147. The issuer in our example, therefore, is in exactly the same place after the Act as it was before the Act.

---

154. See supra notes 89-120 and accompanying text.
155. See supra notes 89-98 and accompanying text.
156. The Act contains provisions designed to ameliorate the burden of the dual system of regulation of brokers, NSMIA, supra note 15, § 103, 15 U.S.C. § 78o(h) (1996), and mandates that federal authorities attempt to eliminate duplication and enhance coordination and cooperation with the states as concerns the regulation of brokers. NSMIA, id., § 108, 15 U.S.C. § 78q(i) (1996). The Act does not, however, deal with the problem raised at this point, which is that activities of persons, such as officers or employees of an issuer, executing sales on behalf of an issuer in the Rule 504 offering may be subject to state blue sky laws regarding brokers. See generally Campbell, An Open Attack, supra note 12, at 567-75.
157. See supra notes 34-35 and accompanying text.
3. A Regulation A Offering

The assumption is that a non-reporting company made a $2 million public offering in five states pursuant to the exemption provided by Regulation A. The problem for the issuer at the state level prior to the Act was that the issuer was unable to qualify for an exemption from the states’ registration requirements, and generally registration by coordination was not available for such an offering. The issuer, therefore, faced the likelihood of filing up to five state qualification registration statements, a result that effectively eliminated Regulation A as a workable exemption for the issuer.\(^{158}\)

The Act, again, changes nothing. Securities issued under Regulation A are not “covered securities.”

4. Offerings Under Rules 505 and 506

The first assumptions are that the issuer wants to sell $2 million in stock in five states under the exemption from registration provided by Rule 505. Then the assumptions are changed, but only to increase the size of the offering to $6 million, which makes Rule 506 the appropriate exemption from registration at the federal level. The analysis of the situation prior to the Act suggests that the ULOE was the most likely way for the issuer to meet most of the states’ registration obligations.\(^{159}\) The ULOE, however, included requirements that went beyond those of Rules 505 and 506 and had not been adopted by all states. In addition, those states that had adopted the ULOE often added their own variations to the basic ULOE provisions. The analysis also emphasizes the obligations to comply with each of the five states’ broker laws and the costs generated thereby.

Concerning the $2 million offer under Rule 505, the Act again changes nothing. Rule 505 is enacted in accordance with the Commission’s power granted by Section 3(b). Thus, securities issued under that exemption are not “covered securities” and are not covered by the preemption provisions of the Act.

The issuer’s situation in the $6 million offering under Rule 506 does change under the Act. The offering under the Act involves “covered securities” that are subject to the Act’s preemption provisions.\(^{160}\) Thus, that issuer is freed of the expense of researching and taking necessary steps to comply with the ULOE’s requirements (or, if the ULOE is unavailable, other exemptions’ requirements) in the five states where the offering is made. However, the issuer must still ensure that it does not run afoul of the broker law in each of the five states.

\(^{158}\) See supra notes 38-43 and accompanying text.

\(^{159}\) See supra notes 72-76 and accompanying text.

5. A Registered Offering

The final example involves assumptions that the issuer is reporting under the 1934 Act, trades on the NASDAQ/NMS, and wants to raise $10 million in a public offering registered with the Commission. Prior to the Act, the issuer most likely met its state registration requirements through a combination of the marketplace exemption and registration by coordination. Further, the issuer surely had no broker problems, since one could assume that the members of an underwriting syndicate or a selling group were properly registered as brokers under applicable state laws.161

In this example, the Act results in some changes. Since the assumption is that the securities are traded on the NASDAQ/NMS, the offering would involve “covered securities,” and, therefore, the Act preempts all registration and merit qualification regarding the offering.

The net benefits from this preemption, however, are in relative sense quite modest, since at the time of the Act approximately forty-six states had adopted a marketplace exemption from registration and merit qualification requirements.162 As a result, the issuer’s situation in the vast majority of states is fundamentally unchanged by the Act. The total savings in the remaining few jurisdictions generated by the preemption of the requirement to file a coordinated registration statement with the particular states certainly must be considered relatively insignificant when compared to the $10 million generated for the issuer by the offering.163 In short, the issuer gets little that it did not have prior to the Act.

6. Summary and Critical Observations

The foregoing demonstrates the modest gains wrought by the Act and describes the types of offerings in which the gains will appear. It also identifies the companies most likely to reap these gains. Perhaps the most disappointing aspect of the Act is that those who need relief most from state blue sky laws are those who in particular get no relief under the Act. Small issuers who depend on Rule 147, Rule 504, and Regulation A are still unable to use those exemptions efficiently after the passage of the Act because of state laws requiring registration of securities. In addition, these issuers continue to be buffeted by state laws governing the registration of brokers.

Instead, the companies most likely to benefit from the Act are either those companies with relatively larger private capital needs (e.g., the company that wishes to raise $6 million privately under Rule 506) or companies which are broadly traded (e.g., the NASDAQ/NMS company that wishes to raise $10 million publicly). Yet, even in those situations, the particular gains from the Act may in a relative sense be slight. Thus, in the example of the $6 million private offering under Rule 506, the savings that result from not having to comply with the ULOE provisions of the five states may be relatively insignificant compared to the total offering price of $6 million. Similarly, in the example of the $10 million registered offering by the NASDAQ/NMS company, the

---

161. See supra notes 91-92 and accompanying text.
163. Again, it is the relative not absolute costs of offering expenses that are critical. See supra note 31 and accompanying text.
savings generated by the issuer’s not having to comply with the state marketplace exemptions and not having to register by coordination compared to the total offering price of $10 million may also be relatively insignificant.

This is not to argue against the appropriateness of exempting offerings by NASDAQ/NMS companies and offerings under Rule 506 from state blue sky laws. The resulting savings, even if relatively slight, and the elimination of state hegemony are welcome. One should strongly applaud these gains. The disappointment, of course, is because so much more was possible.

C. The Hope of a Better Life Through Commission Action

1. Generally

The role of the Commission after the Act will be important, since Congress, although unwilling itself to legislate meaningful preemption, delegated to the Commission the authority to expand significantly and beneficially on the legislative preemption. The will of the Commission to respond to this delegation is uncertain, however.

2. The Commission’s Delegated Rulemaking Authority Under the Act

The Act on its face grants the Commission authority to expand the scope of preemption through its delegated power to define “covered securities.” More specifically, the Act authorizes the Commission to define “qualified purchasers.” Under the Act, securities sold to such “qualified purchasers” are “covered securities” and thus the subject of the Act’s preemption.

Regarding the limit of the Commission’s definitional power over the critical term, “qualified purchasers,” the Act states only that the term shall be defined “consistent with the public interest and the protection of investors.” Section 106 of the Act states that when the Commission in its rulemaking is required to consider whether an action is “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.”

Under such criteria, the appropriate response of the Commission is to determine that all purchasers of securities in transactions exempt under Rules 504, 505, 147, and Regulation A are “qualified purchasers.” Such an expansive definition is consistent with the legislative mandate from the Act, since each of those rules or regulation encapsulates a balance between the protection of investors and capital formation that the Act requires the Commission to consider in arriving at its definitions. As described earlier, Rules 504, 505, 147, and Regulation A, individually and especially as a whole and in light of their histories, reflect the considered view of the Commission, developed over an extended time period and with the benefit of significant administrative experience, as

166. Id.
167. Id.
to the appropriate balance between investor protection and capital formation in each of
the situations covered by the particular rule or regulation.

If the Commission by regulation were to define "qualified purchasers" in such an
expansive manner as to include all purchasers under Rules 504, Rule 505, Rule 147,
and Regulation A, the resulting benefits would be important and appropriately focused.
Generally, the definition would accord society significant relief from the economic
waste and unwarranted drag on capital formation generated by the registration and qual-
ification provisions of state blue sky laws. More specifically, however, small issuers
would be the most visible beneficiaries of such a definition and would finally be in a
position to take full advantage of the Commission's apparent reckoning, which is encaps-
sulated in its rules, regarding the proper balance between investor protection and capital
formation. An interesting question here is just why the Commission might be unwilling
to opt for such an expansive definition of "qualified purchasers." One possible explana-
tion is based on the legislative history of the Act. For example, some Committee lan-
guage may be read as endorsing a strict limit on the Commission's authority to define
"qualified purchasers." In fact, an extreme view of the language is that only sophis-
ticated investors should be included in the definition of "qualified purchasers." The
Commission, however, should reject any such limited view of its appropriate
definitional range. In the first place, such a reading is contrary to the statutory language
of delegation, which, as described above, in no way limits the definitional scope of
"qualified purchasers" to persons who are sophisticated but, instead, clearly delegates a
more expansive authority to the Commission. Second, the particular Committee lan-
guage underlying such a limited interpretation of the Commission's authority is so dis-
jointed and confusing as to be essentially worthless.

Perhaps a more important piece of legislative history is apparent if one traces the
path of the Act through its various versions in Congress. In that case, one finds that an
earlier version of the Act on the House side contained a blanket preemption provision,

170. At one point the report states that "[i]n all cases . . . the Committee intends that the Commission's
definition be rooted in the belief that 'qualified' purchasers are sophisticated investors, capable of protecting
themselves in a manner that renders regulation by State authorities unnecessary." Id.
171. For example, at one point the Report states regarding the Commission's definition of "qualified pur-
chasers" that the securities involved should "be fundamentally national in character and generally (though not
always) subject to regulation at the Federal level." Id. The meaning of "national in character" is impossible to
determine. Further, the test that securities should be "subject to regulation at the Federal level" is similarly
meaningless, since the sales of all securities (assuming that the transactions meet the jurisdictional means) are
subject to § 5 of the 1933 Act and thus subject to federal regulation.

Also, in the same paragraph in which the Committee states that "in all cases" the definition of "quali-
fied purchasers" should be rooted in the sophisticated investor concept, the Committee states that the Com-
mission may define the term [qualified purchasers] "differently with respect to different categories of securi-
ties, consistent with the public interest (including consideration of efficiency, competition and capital forma-
tion) and the protection of investors." Obviously, the right to define "qualified purchasers" "differently with
respect to different categories of securities" (which, interestingly, is language that also appears in the Act
means that no definition, including sophistication, is exclusive. Read as a whole, this entire passage is inco-
sistent with the notion of any predetermined limit on the Commission's definitional power, but is instead
consistent with the flexibility that is also apparent on the face of the statute.
except, principally, for securities issued under the intrastate exemption provided by
Section 3(a)(11) of the 1933 Act. The Act as passed, however, eliminated from the
preemption provisions not only securities issued under Section 3(a)(11) but also securi-
ties issued under Section 3(b) of the 1933 Act, which is, of course, the basis for Regu-
lation A, Rule 504 and Rule 505. The Commission may, therefore, conclude that all of
this is part of the political compromise in the legislative process that is accordingly im-
pounded in the Act. The Commission may consider it inappropriate in such circum-
stances to utilize its rulemaking power in a way that is inconsistent with the compro-
mise embodied in the Act itself.

Again, such an interpretation of the legislative history is unwarranted. Instead, the
constriction of the breadth of the legislative preemption over the course of the legisla-
tive process is entirely consistent with a broad delegation of authority to the Commiss-
ion to expand preemption through the administrative process. For example, Congress,
over the course of the legislative process, may have become reluctant through legisla-
tion to extend preemption. This evolution of this legislative reticence may have been
based on politics. In short, Congress may have chosen to avoid the political heat for its
action by delegating decisionmaking on the matter to an agency. Another explanation
why Congress may have been unwilling through legislation to preempt broadly is based
on the manifest expertise of the Commission respecting such matters. Congress may
have concluded that any further expansion of preemption needed the blessing of the
Commission, again with its experience and wisdom on such matters.

In short, legislative history does not compel or even lend much support to an un-
willingness on the part of the Commission to define “qualified purchaser” expansively.

Other explanations for a narrow administrative action in this matter are also unsat-
sfactory. For example, a less pleasant explanation for an unwillingness on the part of
the Commission to expand the definition of “qualified purchaser” is administrative hyp-
cracy. This explanation supposes that, in fact, deep in its administrative heart, the
Commission may not like the type of balance encapsulated in its own rules but, instead,
may prefer the state balance, which is substantially more restrictive on capital forma-
tion. As a political matter, however, the Commission wants to be able to visit with
small business people and tout the progressiveness of the Commission’s rules and how
much the Commission has done for small businesses, while knowing full well that
the state blue sky laws effectively nullify its own federal rules. State hegemony, there-
fore, may in fact serve the interests of the Commission and thus make the Commission
unwilling to disrupt existing state regimes over small issuers.

One final explanation for any unwillingness on the part of the Commission to ex-
 pand preemption is based on the Commission’s failure to recognize the hegemonic re-
alignment effected by the Act. Prior to the Act, the states had the raw power, which
they regularly exercised, to nullify any Commission action that expanded capital forma-

173. See, e.g., Levitt Reviews Recent Small Business Initiatives at California Forum, THE SEC TODAY,
May 6, 1996, at 1 (reporting SEC Chairman Arthur Levitt’s remarks to the California Forum on Small Busi-
ness Capital Formation, in which he highlighted the SEC’s revisions of Rule 504 and Regulation A and the
 availability of those exemptions to small businesses). In fact, as described earlier, blue sky regulations signifi-
cantly destroy the benefits of such federal exemptions for small entrepreneurs.
tion opportunities. That circumstance is reversed by the Act, at least to the extent the Commission acts to further its own policies through preemption. The Commission should recognize, therefore, that by expanding the definition of “qualified purchasers” it finally can ensure the hegemony of its own well considered and sound policies embedded in Rules 504, 505, and 147 and Regulation A.

State regulators certainly will scream loudly if the Commission exercises its definitional power in a manner that significantly expands the statutory preemption. The Commission, however, should not flinch in the face of such political heat. Indeed, as described above, one explanation for the breadth of the Congressional delegation is the desire by Congress to focus such political heat on the Commission and away from itself. In short, it is time for the Commission to stand its ground against state regulators.

V. CONCLUSION

When the Act was first introduced in the House as the Capital Markets Bill, there was cause for optimism regarding the probability of meaningful relief from the insidious impact of state blue sky laws. Essentially, the Capital Markets Bill, with one important exception, preempted state control over the registration and merit qualification of securities. The Act as signed by the President, however, reflects the vicissitudes of the political process. Thus, although the Act was born of high sounding principles, ultimately the Act makes only slight adjustments in the requirements faced by issuers under state registration and merit qualification provisions prior to the Act. The interesting wild card, however, is the power delegated to the Commission in the Act. The plain words of the Act give the Commission ample authority to enhance significantly the preemption under the Act. Congress has laid in the Commission’s lap, finally, the means to eliminate state hegemony over capital formation and much of the nonsense of state blue sky laws and to provide badly needed and long overdue relief to small entrepreneurs.

174. Thus, for example, the 1992 Amendments to Rule 504, which allowed small public offerings without registration, were meaningless in light of the registration requirements at the state level. See supra part II.C.1. But see Steinberg, supra note 105, at 408 (characterizing the Commission’s adoption of the 1992 amendments to Regulation A as “hardball,” but concluding that “[i]f present conditions prevail, the outcome will be that the SEC . . . struck out”).
