CHAPTER 6:

The Case for Federal Pre-Emption of State Blue Sky Laws

Rutheford B. Campbell Jr.

THE NEED FOR LAWS TO GOVERN CAPITAL FORMATION

American society long ago abandoned an unregulated securities market and imposed legal requirements on businesses (issuers) when they offer or sell their securities to investors.[1]

In a market economy such as ours, imposing rules on capital formation makes economic sense.[2] Without some regulation of the conduct of businesses offering and selling their securities to investors, those businesses may have an incentive to misstate or fail to disclose material investment information. This may amount to unfairness to, and an undesirable fraud on, investors in connection with the purchase and sale of securities.

Misstated or undisclosed material investment information may also facilitate an inefficient allocation of precious market capital. There is no way to be sure, for example, that an investor's decision to turn over his or her capital to a business amounts to an efficient allocation of that capital, if that decision is made as a result of the business's misstatements of or failure to disclose material investment information.

Society's rules regulating capital formation are usually of two separate but related types. First is society's antifraud rules, which prohibit businesses offering or selling their securities to investors from engaging in manipulative or deceptive acts. These antifraud rules require that a business in connection with its offer or sale of securities disclose all material information to investors and refrain from making material misstatements.[3]

Society's second, related rule governing capital formation requires that a business offering its securities to investors "register" the securities or meet the conditions for an exemption from this registration requirement. Registration typically requires that the business offering securities to investors provide closely prescribed investment information to a designated governmental agency (typically through the filing of a registration statement with, for example, the Securities and Exchange Commission (SEC) and also provide that prescribed investment information to investors (typically by providing investors with a prospectus)).[4]

These two broad types of capital formation rules imposed by society[5]—antifraud rules and rules requiring registration—incentivize the efficient disclosure of accurate, material investment information in connection with the offer and sale of securities. Disclosure of such investment information by the business offering its securities to investors reduces fraud and unfairness to investors and increases the likelihood that market capital provided by investors will be allocated to its highest and best use.

These societal rules may, however, generate additional offering costs for the business that is seeking external capital. The additional costs may retard, or in some cases completely choke off, the flow of capital from investors to businesses. If, for instance, the costs (such as accounting fees, legal fees, and filing fees) of complying with society's rules regarding capital formation force the company's overall cost of issuing capital to rise above its expected return, the business is unlikely to undertake the project.

The problem with the rules governing capital formation enacted by states, territories, and the District of Columbia (state blue sky laws) is that the registration requirements of those blue sky laws raise the offering costs of capital formation to an inefficient and in some cases an intolerable level.

There are obvious and significant increased costs generated as a result of imposing multiple registration regimes on businesses soliciting capital. If, for example, a company solicits broadly for its capital, it may be required to comply with the separate and independent registration requirements of all of the 50-plus blue sky jurisdictions. There are, however, no material efficiencies or investor protections generated by requiring an issuer to do the same thing 50-plus times under 50-plus separate and different registration regimes.

Unfortunately, the burden imposed by the registration requirements of 50-plus blue sky regimes falls disproportionately on the 5 million or so small businesses in the United States, making it difficult for such small businesses to raise the capital they need to survive and compete.

These small businesses are vital to the national economy.[6] They provide a wide array of services and products and may account for as much as 30 percent of the employment in the United States. Even that large number, however, may understate the significance of the economic energy and opportunity generated by small businesses.

Although Congress has to an extent pre-empted the registration requirements of state blue sky laws, the federal pre-emption is largely incomplete. Most important in that regard is the fact that the pre-emption so far offers scant relief to small businesses when they search for external capital.

The federal government should completely pre-empt state authority over the registration of securities. Society needs a single set of efficient rules governing the registration of securities. Imposing 50-plus independent registration regimes on capital formation by businesses generates economic waste, high costs, and inefficient conditions on businesses—especially small businesses—when they attempt to access the external capital that is vital for their survival and ability to compete.

TODAY'S LAWS GOVERNING CAPITAL FORMATION

State Blue Sky Laws. All states, the District of Columbia, and the territories have laws that govern the offer and sale of securities.[7] These blue sky laws came into existence in a flourish shortly after the beginning of the 20th century.[8] By the time Congress got around to enacting the Securities Act of 1933, 47 of the then-48 states had enacted blue sky laws.[9]

Not surprisingly, historians may conclude that blue sky laws were a response to perceived fraud and manipulation surrounding the offering and sale of securities.[10]

Blue sky laws generally require that businesses offering or selling their securities within the particular state must register those securities with that state, providing the state regulators and investors with prescribed investment information.[11] Most blue sky laws also have "merit" or "qualification" requirements, which are substantive standards that must be met in order for a business to sell registered securities within the state.[12]

Blue sky statutes normally contain a number of exemptions from the state registration requirements.[13] One of the most common, for example, is a small-offering exemption, which may exempt offerings limited to a small number of offerees or purchasers from the state registration requirements.[14]

Most states also have a limited exemption for offerings made under Regulation D of the Securities Act of 1933.[15] The prototype for this state exemption, the Uniform Limited Offering Exemption (ULOE),[16] was promulgated by the North American Securities Administrators Association (NASAA). Some form of ULOE has been widely adopted by states. NASAA's version of ULOE provides an exemption from the state's registration obligations for offerings that meet the requirements for exemption from federal registration provided by Rule 505 or Rule 506 of Regulation D and also meet additional requirements imposed by ULOE.[17]

Within our system of federalism, each state exercises a significant measure of sovereignty over its rules governing the offer and sale of securities within its state. In the case of the registration requirements imposed by blue sky laws, this means that—barring federal pre-emption of state authority over registration—a business offering its securities widely must meet the particular registration requirements of each state where it offers its securities to investors.[18] Meeting the particular registration requirements of Kansas, for example, does not necessarily mean that the requirements of Nebraska—or any other state—have been met. If, therefore, a business offers its securities in four states, it may be required to meet the separate and distinct registration requirements in each of the four states. If the offer is nationwide, it may be required to meet the registration requirements of all 50-plus blue sky jurisdictions.

Blue sky laws also prohibit fraud or manipulation in connection with the offer and sale of securities within the applicable state.[19] Most important, with regard to business capital formation activities, these laws require that a business selling its securities refrain from making material misstatements of facts and disclose all material investment information.[20] States usually impose criminal, civil, and administrative penalties on a business that violates these rules.[21]

Federal Securities Laws. The bedrock of the federal laws governing capital formation came about with the passage of the Securities Act of 1933 (Securities Act).

The Securities Act requires that businesses offering and selling their securities must either file a registration statement with the SEC and provide investors with investment information or, alternatively, qualify for an exemption from the registration requirement.[22] The Securities Act also prohibits fraud and manipulation in connection with the capital raising activities of businesses.[23]

Both the registration provisions and the antifraud provisions of the Securities Act are broadly applicable, establishing jurisdiction by even the slightest brush with interstate facilities or transportation.[24] This means that any wide offering of securities by a business is subject not only to the 50-plus state blue sky laws but also to the Securities Act as well.

Although there are significant overlaps and duplications, there are differences between blue sky laws and the Securities Act.

One important difference is that the registration requirements of the Securities Act are based on a disclosure philosophy, while the registration requirements of blue sky laws are, as described above, generally based on a qualification or merit philosophy.[25] Registration at the federal level, therefore, does not require the registrant to meet any substantive requirements regarding the quality or price of the investment. The issuer's only obligation under the Securities Act is to disclose prescribed investment information to the SEC and to investors.[26] The registrant does not have to convince the SEC that the offering is a fair deal for investors.

It is worth noting here that Congress in 1933 got this right. In a market economy, allocation of capital and the pricing of investments must be left to the capital market. Assigning that responsibility to bureaucrats would amount to an economic disaster. Capital formation would be outrageously expensive and destructively slow. Allowing bureaucrats to limit the flow of capital only to deals that they determine to be well priced and fair would ensure an inefficient allocation of market capital. With the Securities Act, Congress correctly tried to enhance an efficient allocation of capital by improving information flows among the parties. It did this by incentivizing the most efficient provider of investment information, which is the issuer, to make that information available to the parties involved in the reallocation of market capital.

The exemptions from registration in the 1933 act and in state blue sky laws are also different.

While the statutory and regulatory exemptions from federal registration under the Securities Act have not been entirely economically sound in all cases, Congress and the SEC in recent decades have made progress in moving the federal regime in the right direction, They have done this by expanding exemptions in situations in which the costs of registration will practically foreclose small businesses from the capital markets and in situations where the parties to the transaction have cheap access to investment information.

This sensible evolution under the Securities Act is captured by a provision in the National Securities Market Improvement Act (NSMIA) of 1996, which amended Section 2(b) of the Securities Act. As thus amended, Section 2(b) mandates a rational and balanced approach toward the federal regime governing capital formation. Section 2(b) of the 1933 act states that when the SEC is enacting regulations "in the public interest, [it] shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[27]

As originally adopted, there was, however, a fundamental flaw in the 1933 act: It did not pre-empt state authority over registration. States retained authority over the registration of securities offered in the particular state, including the authority to enforce merit requirements.

Continuing state authority over registration meant, for example, that if an issuer wanted to offer its securities broadly through a public medium—in 1933, perhaps, in a newspaper advertisement, or today by posting a notice on the issuer's website—the issuer was more than likely required to meet the federal registration requirements, all state registration requirements, and all applicable state merit requirements. The issuer was, in short, subject to 50-plus separate regimes, each with its own individual registration rules and in most cases merit rules.

This overall regime continued unabated for more than half a century and to a significant extent continues today.

THE PRE-EMPTION OF STATE AUTHORITY OVER REGISTRATION

The federal government has pre-empted some state authority over registration. This is a result of provisions in NSMIA and the Jumpstart Our Business Startups (JOBS) Act.

NSMIA pre-empted state registration authority over offerings by issuers traded on national securities exchanges[28] and offerings by registered investment companies (mutual funds).[29]

NSMIA also pre-empted state registration authority over offerings conducted under Rule 506 of Regulation D.[30] Meeting the requirements of Rule 506 for an exemption from the federal registration obligation requires that the investors must either be sophisticated or accredited (such as wealthy investors or insiders), and unaccredited investors must be provided with extensive, prescribed investment information.[31]

In NSMIA, Congress also delegated authority to the SEC to expand pre-emption by regulation to offers limited to "qualified purchasers as defined by the Commission."[32] The only restriction on the breadth of this delegation to the SEC to define "qualified purchasers" is that the definition of "qualified purchasers" must be “consistent with the public interest and the protection of investors.”[33] The SEC has never used this provision to expand pre-emption of state authority over registration.

The JOBS Act pre-empted state registration authority over offerings under the new crowdfunding exemption.[34] That exemption from federal registration is available for offerings made exclusively on the Internet, is limited both with regard to the total amount of the offering and the amount any investor may purchase, and requires the disclosure of investment information.[35]

The JOBS Act[36] also delegated authority to the SEC to pre-empt state registration authority over offerings under the new Regulation A rules (generally referred to as Regulation A+ rules), provided the offering is limited to “a qualified purchaser, as defined by the Commission.”[37] The exemption provided by Regulation A+ is predicated on the disclosure of prescribed investment information to the SEC and investors, and the amount of information required to be disclosed depends on the size of the offerings. Offerings of up to $20 million (Tier 1 offerings) require substantially less disclosure than offerings of up to $50 million (Tier 2 offerings). The final Regulation A+ rules pre-empt state registration authority over Tier 2 offerings but do not pre-empt state registration authority over Tier 1 offerings.

State authority over registration continues for all other offerings of securities by issuers. These include: (1) registered offerings by issuers of its securities that are not traded on a national exchange; (2) private placements under the common law of Section 4(a)(2); (3) offerings under Rule 504;[38] (4) offerings under Rule 505;[39] (5) Tier 1 offerings under Regulation A+; and (6) intrastate offerings under Rule 147.

Offerings under the exemptions from federal registration listed in the preceding paragraph—exemptions that are important to small businesses seeking external capital and, indeed, are largely designed to facilitate efficient small-business capital formation—continue to be subject to the registration requirements of all blue sky jurisdictions.

IMPACT OF BLUE SKY LAWS ON CAPITAL FORMATION

No argument is made here that states should have no role in the regulation of capital formation. Indeed, state blue sky laws, properly limited and directed, can play a beneficial role in promoting an efficient allocation of capital and protecting investors.

The appropriate state role in the regulation of capital formation involves the robust enforcement of state antifraud rules.

State antifraud laws provide significant economic penalties—for example, private recoveries and civil and criminal penalties—for the failure to disclose all material information in connection with an issuer’s sale of securities. The economic costs to the issuer of such penalties incentivize disclosure of investment information, which in turn promotes fully informed decision making and protects investors. States should continue to enforce their antifraud rules vigorously and, indeed, should increase state resources dedicated to the enforcement of their antifraud rules.

The problem created by blue sky laws is state authority over registration. These laws and regulations significantly impede efficient capital formation that is vital to this country’s market economy. At the same time, these state registration rules offer no economic or societal benefits, such as protection of investors from fraud.

The pernicious effect of state registration rules is easily and vividly demonstrated by considering the impact of those laws on a business that proposes to solicit broadly for investors. If, for example, a business intends to announce its offering by posting information about the offering on its website or by advertising for investors in a widely distributed publication, the business seeking capital would likely be subject to the separate and individual registration requirements of each of the 50-plus jurisdictions that have blue sky laws. In each state, therefore, the issuer would be required either to register its securities under the registration provisions of that particular state or meet the particular state's requirements for an exemption from registration.

Even if the offering were limited to four states, the business soliciting for investors would have four separate state registration regimes to satisfy, which, again, could be satisfied only by filing registration statements in each of the jurisdictions or by qualifying for an exemption from the registration requirement in each of the four states.

From a policy point of view, this of course makes no sense. It increases the costs of a critical element of an efficient market economy, which is an efficient access to external capital. It is nothing short of bizarre for society to impose an obligation to meet 50-plus—or four, or two—separate registration regimes on businesses seeking external capital.

While the pernicious effects generated by the costs of meeting multiple registration regimes is apparent, it is impossible to find any material benefit in such an overall system. If state registration authority were eliminated, investors would still be protected by federal registration provisions and by both state and federal antifraud requirements. Imposing 50-plus blue sky registration regimes in addition to these investor protections adds nothing of significance, except an increase in offering expenses that makes access to capital more difficult.

In all cases, the registration requirements of state blue sky laws amount to economic waste, generating costs without any economic benefit. These state registration requirements, however, have been especially debilitating on small businesses in need of external capital.

The reason that the harmful effects of state registration provisions fall disproportionately on small businesses is due principally to the structural and economic circumstances that small businesses face when they attempt to access external capital.

Small businesses usually seek relatively small amounts of external capital. This means that financial intermediation is likely unavailable. Financial intermediation is a fancy term for professional assistance (such as from brokers or underwriters) in finding investors. The yield from small offerings simply will not support the fees required by competent and honest financial intermediation. For example, in my research, I found that only 5.8 percent of Regulation D offerings of $1 million or less reported having any financial intermediation.[40]

Related to this is the problem of relative offering costs. These are offering costs as a percentage of the size of the deal. Offering costs of $100,000 are 100 percent of a $100,000 offering but only 1 percent of a $10 million offering. It is relative, not absolute, offering costs that foreclose businesses from the capital markets. Using these extreme examples, offering expenses of $100,00 in an offering of $100,000 (relative offering expenses of 100 percent) will prevent the offering, while similar offering expenses in a $10 million offering (1 percent relative offering expenses) should not foreclose the business from the capital market.

These related matters—the absence of financial intermediation and disproportionate relative offering costs—are huge problems for small businesses. Because small businesses typically seek small amounts of external capital, relative offering costs go through the roof when small businesses are saddled with multiple sets of registration rules imposed by state blue sky laws.

A harmful consequence of state blue sky registration requirements—a consequence readily demonstrable by empirical data—is the extent to which those state laws have wrecked well-conceived, efficient federal exemptions from registration designed for small businesses.

Regulation A, for example, is an exemption from federal registration requirements provided by the SEC under authority delegated to it by Congress. The Regulation A exemption requires a disclosure of closely tailored investment information, disclosures designed to ameliorate the stifling requirements of the extensive disclosures required in a registration statement.[41]

Although for decades Regulation A was the only exemption available to small issuers for a broad, interstate solicitation for investors, and although there are more than five million small businesses in the U.S. economy that inevitably will need external capital at some point, offerings under Regulation A have nearly disappeared. Data show, for example that between 1995 and 2004, there were on average only 7.8 Regulation A offerings per year. Between 2005 and 2011, there were on average 23.1 Regulation A offerings per year.[42]

The apparent principal reason for the non-use of this very attractive exemption was state blue sky registration requirements. If a small business in need of external capital for its operation or expansion used Regulation A as a basis for a broad solicitation for investors, that small offering was subject to the registration requirements of all 50-plus blue sky jurisdictions, which amounted to an intolerable burden for small businesses.

Data regarding the use of the exemptions from federal registration provided by Regulation D[43] offer what perhaps is even more vivid evidence of how state blue sky registration requirements have robbed small businesses of the ability to use efficient, balanced federal registration exemptions as a basis for access to external capital.

Regulation D offers businesses three exemptions from federal registration requirements: (1) Rule 504 provides an exemption for offerings of $1 million or less;[44] (2) Rule 505 provides an exemption for offerings of $5 million or less;[45] and (3) Rule 506 provides an exemption for offerings that are unlimited as to size.[46]

Rule 504 is specially structured for small businesses. There are no disclosures or offeree qualification requirements (such as sophistication or wealth) that are predicates to the availability of the exemption provided by Rule 504. On the other hand, in the largest of the Regulation D offerings—Rule 506 offerings—the exemption is predicated on all accredited investors (generally wealthy investors or insiders) or, alternatively, requires disclosure of substantial amounts of investment information and sophisticated investors.

This so-called scaled approach of Regulation D—requiring more extensive investor protection as the size of the offering increases—is an appropriate response to the problem of relative offering costs. Small Rule 504 offerings, for example, are simply too small to support the costs associated with extensive and thus expensive disclosure requirements. Capital formation for small businesses in such circumstances would be stymied. In striking a balance, the SEC was content in the case of these small offerings to rely on the ability of the parties to bargain for investment information and the more general requirements of federal antifraud provisions, which require a company selling its securities to provide investors with all material investment information.

Notwithstanding the apparent attractiveness of a Rule 504 for small offerings, small businesses have to a large extent abandoned the use of Rule 504 and made these small Regulation D offerings under Rule 506. In a sample consisting of 7,880 Regulation D offerings of $1 million or less, 78.6 percent of those offerings were made under Rule 506.[47] Data also show that more than 80 percent of these small Regulation D offerings that are made under Rule 506 are also limited to accredited investors.[48]

The reason that small businesses abandon Rule 504 and move to Rule 506 and limit their offerings to accredited investors (persons who may amount to less than 5 percent of the total population)[49] is to avoid state blue sky registration provisions. Offerings under Rule 506 pre-empt state registration authority.

In short, as was the case with Regulation A offerings, state blue sky registration provision wrecked the well-considered, efficient federal registration exemptions provided to small businesses by Regulation D. Again, therefore, small businesses were the losers.

Small businesses are critical to the national economy.[50] In regard to access to external capital formation, however, they face significant structural and economic disadvantages, which to a large degree are a result of high relative offering costs and the absence of financial intermediation. Imposing 50-plus separate blue sky registration regimes on small businesses seems to complete the circumstances for the perfect pernicious storm for small businesses seeking external capital necessary for them to survive and compete.

WHAT WON'T—AND WHAT WILL—SOLVE THE PROBLEM

An efficient regulation of capital formation—regulation that ameliorates fraud and misinformed investment decisions and promotes the allocation of capital to its most efficient use—requires a single set of efficient rules regarding the registration of securities. Within our system of federalism, however, achieving this goal has proven difficult.

States Will Never Eliminate State Registration Authority. The problem of the pernicious effects of state registration rules will never be solved by states. The allure of sovereignty and the base instinct of turf protection have proven too much for states to resist.

One should recognize, however, that over the years, states acting through NASAA have offered initiatives and protocols seemingly designed to enhance cooperation and simplification in regard to issuers' meeting state registration requirements.

Data show that although these initiatives have been broadly adopted by states, in the end they have overwhelmingly failed to ameliorate the pernicious impact of state registration requirements on small business capital formation. In that regard, consider the following:

Small Company Offering Registration (SCOR). Today's version of SCOR is designed to provide a simplified state registration and a coordinated review of that registration by states. It is particularly designed for offerings made in reliance on an exemption from federal registration provided by Rule 504 or Regulation A.[51] While the SCOR protocol was adopted by nearly all states[52] it is today virtually unused. For example, the total coordinated SCOR reviews in recent years were: four in 2012, four in 2013, and one in 2014.[53]

Coordinated Review of Equity (CR Equity). NASAA's website describes this protocol as a "uniform procedure designed to coordinate the blue sky registration process among states."[54] While CR Equity has been adopted by the vast majority of states,[55] it is, once again, rarely used. Between 2012 and 2014, only one CR Equity was filed.[56]

NASAA Coordinated Review of Regulation A Offerings Review Protocol (Regulation A+ Coordinated Review). After passage of the JOBS Act, NASAA adopted a new coordinated review regime for offerings under new Regulation A+.[57] The protocol was adopted by 49 of NASAA's 53 members.[58] As of March 7, 2016, only 10 Regulation A+ offerings had been filed with the states for a Regulation A+ Coordinated Review.[59]

Not only have the NASAA initiatives failed to reduce the burden of state authority over registration, NASAA and state regulators have also, over the past 30 years, waged a coordinated, imaginative, and quite effective campaign to preserve state registration authority over small businesses' offerings. For example, in addition to the usual tactics of offering testimony in the legislative and administrative process and lobbying legislators, the anti-pre-emption forces were able to insert a provision to rescind the NSMIA pre-emption of state authority over Rule 506 offerings in an early iteration of the legislation that became the Dodd–Frank Act.[60] The provision was not part of the ultimately authorized Dodd–Frank Act.

Most recently, state regulators sued the SEC, claiming that the commission's regulatory pre-emption of state registration authority over Tier 2 Regulation A+ offering exceeded its delegated authority under Title IV of the JOBS Act.[61] The Court of Appeals for the District of Columbia has now ruled in favor of the SEC, holding that the pre-emption did not exceed the Commission's delegated authority under the JOBS Act.[62]

History demonstrates, therefore, that there is no chance that states will voluntarily surrender, or even reduce, their registration authority.

The SEC Will Never Eliminate State Registration Authority. The SEC has never been willing to facilitate to any material extent the expansion of pre-emption of state registration authority, notwithstanding the demonstrable inefficiency and harm to small-business capital formation wrought by state registration regimes.

When, for example, the legislation that in 1996 became NSMIA was under consideration by Congress, the SEC refused to offer testimony supporting a broad pre-emption of state regulatory authority.[63] Nonetheless, in NSMIA, Congress delegated broad authority to the SEC to expand by regulation pre-emption of any offering made to "qualified purchasers, as defined by the Commission."[64]

Since enactment of NSMIA in 1996, however, the SEC has never once used this delegated authority under NSMIA to expand pre-emption by regulation, even, for example, in the face of overwhelming evidence that state registration authority was wrecking the SEC's well-conceived exemptions in Regulation A and Regulation D.[65]

In short, while the SEC has, for the past 20 years, enjoyed broad authority to improve the efficient allocation of capital and provide a meaningful remedy to the plight of small businesses searching for external capital, it has chosen not to act. Thus history suggests rather strongly that the Commission will never ameliorate, to any material degree, the problem foisted on to small businesses by state registration rules.

Only Congress Can Solve this Problem. The politics of pre-emption is such that only Congress can solve the problem. Indeed, looking back over the past 20 years, the only meaningful steps to reduce the inefficiency foisted on, and unfairness toward, small businesses caused by state registration authority have been through congressional actions pre-empting blue sky authority over registration. NSMIA pre-empted state regulation authority over Rule 506 offerings, and the JOBS Act pre-empted state registration authority over offerings under the new crowdfunding exemption.

CONCLUSION

Congress should pre-empt state authority over the registration of securities completely. Efficient regulation of capital formation can occur only if businesses, especially small businesses, searching for external capital are subject to one set of registration rules. Subjecting businesses to more than 50 sets of independent rules requiring the registration of securities makes no sense and can be understood only in light of the history of misguided actions by state and federal regulators.

States do, however, have an important role in the efficient regulation of capital formation, and that role is in the enforcement of their own state antifraud provisions. State laws that prohibit fraud and material misstatements in connection with a company's offer and sale of its securities make economic sense, especially when backed up by criminal penalties, administrative sanctions, and private rights of recovery. Pre-empting state registration authority would leave states free to join the SEC in its fight against fraud in connection with the offer or sale of securities.

—**Rutheford B. Campbell Jr.** is Spears–Gilbert Professor at the University of Kentucky College of Law. The author's views and arguments in this chapter are expressed only to support his position on state blue sky laws, and should not be read as endorsing the views of other authors in other chapters.

ENDNOTES

1. States, as opposed to the federal government, were first to offer a comprehensive regime regulating the offer and sale of securities. There are numerous excellent accounts of the history of the enactment of state blue sky laws, for instance, Louis Loss and Edward M. Cowett, *Blue Sky Law* (Boston: Little, Brown and Company, 1958).
2. There has been a long academic debate about the need for the regulation of capital formation. See, for example, George J. Stigler, "Public Regulation of the Securities Market," *The Business Lawyer*, Vol. 19, No. 3 (April 1964), pp. 721–753. For an exhaustive discussion of the debate, see Louis Loss, Joel Seligman, and Troy Paredes, Securities Regulation (Aspen Law and Business, 2013), pp. 285–326. Society, however, has never seriously considered reverting to an unregulated capital market.
3. Certainly the most prominent antifraud provision is Rule 10b-5, 17 C.F.R. § 240.l0b-5 (2016), which was enacted by the Securities and Exchange Commission under delegated authority from Congress. 15 U.S. Code § 78j(b) (2016).
4. See, for instance, 15 U.S. Code § 77e (2016).
5. Loss, Seligman, and Paredes, *Securities Regulation*, p. 15: The authors refer to the "prescription of fraud" and the "policing of affirmative disclosure of corporate information" as the "basic foundation of any system of investor protection."
6. The best empirical data on small businesses are each year collected and rendered by the Small Business Administration. See, for instance U.S. Small Business Administration, *The Small Business Economy: A Report to the President* (Washington, DC: U.S. Government Printing Office, 2010), https://www.sba.gov/sites/default/files/sb_econ2010.pdf (accessed October 5, 2016).
7. Loss, Seligman, and Paredes, *Securities Regulation*, p. 66. ("Today all 50 states, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands have blue sky laws in force.")
8. Loss and Cowett, *Blue Sky Law*, p. 10 (reporting that within two years of the first adoption of blue sky laws by Kansas in 1911, 23 states had adopted blue sky laws, and that "[a]ll but six…[of those acts] were either identical with the Kansas statute or modeled upon it").
9. Hawaii, then a territory, also had adopted blue sky laws. See Loss, Seligman, and Paredes, *Securities Regulation*, p. 65.
10. Commentators concede, however, that hard evidence of fraud prior to comprehensive securities laws is difficult to find. See, for instance, James S. Mofsky, *Blue Sky Restrictions on New Business Promotions* (New York: Matthew Bender and Company, 1971). ("Although the amount of fraud has never been measured, it would not be surprising to find an amount of dishonesty among promoters and securities salesmen consistent with the wild times.")
11. See, for instance, Uniform Securities Act (1956) § 301 and § 304(d). See also the discussion in Rutheford B. Campbell Jr., "An Open Attack on the Nonsense of Blue Sky Regulations," *The Journal of Corporation Law*, Vol. 10, No. 3 (Spring 1985), pp. 556–557.
12. See, for example, Uniform Securities Act (1956) § 306(a)(2)(F) (for example, no excessive underwriting commissions). For a discussion of merit regulation, including the various merit criteria, see ibid., pp. 563–567. A 1986 American Bar Association report found that some form of a merit regime was applicable in 39 states: American Bar Association, "Report on State Merit Regulation of Securities Offerings," *The Business Lawyer*, Vol. 41, No. 3 (May 1986), pp. 788–789. Today, more than a majority of blue sky jurisdictions are merit regimes. See, for instance, North American Securities Administrators Association, "Application for Coordinated Review of Regulation A Offering," http://www.nasaa.org/wp-content/uploads/2014/05/Coordinated-Review-Application-Sec-3b.pdf (accessed October 5, 2016).
13. See, for instance, Uniform Securities Act (1956) § 402 (a) (exempting certain securities from the registration requirement) and § 402(b) (exempting certain transactions from the registration requirements).
14. See, for instance, Uniform Securities Act (1956) § 402(b)(9) (exempting from registration an offer by the issuer to not more than 10 offerees within the state, provided the investors are purchasing for investment and no commission is paid for soliciting investors). One finds significant variations among states as to the conditions for this exemption. See Rutheford B. Campbell Jr., "State Blue Sky Laws and the Recent Congressional Preemption Failure," *The Journal of Corporation Law*, Vol. 22, No. 2 (Winter 1997), p. 175.
15. Regulation D provides an exemption from *federal* registration for offerings. The predicates for the exemption may require disclosure of investment information to investors and sophistication or wealth on the part of investors. The exemption provided by Rule 504 of Regulation D (offerings up to $1 million), 17 C.F.R. § 230.504 (2016), requires neither disclosure nor sophistication or wealth; Rule 505 of Regulation D (offerings up to $5 million), 17 C.F.R. § 230.505 (2016), may require disclosure; and Rule 506 (no limitation on the size of the offering), 17 C.F.R. § 230.506 (2016), may require both disclosure and sophistication or wealth. A recent amendment of Regulation D will raise the maximum Rule 504 offering to $5 million and repeal Rule 505. See Securities Act Release No. 33-10238, October 26, 2016.
16. See, generally, Reg D/ULOE: Uniform m Limited Offering Exemption, NASAA Rep. (CCH) ¶ 6201, at 6101, April 29, 1989.

17. For a discussion of ULOE, including its requirements, extent of adoption by states, and the lack of uniformity among the adopting states, see Rutheford B. Campbell Jr., "The Insidious Remnants of State Rules Respecting Capital Formation," *Washington University Law Quarterly*, Vol. 78, No. 2 (2000), pp. 419–423.
18. State registration requirements are triggered by an *offer* of securities into the particular state. A violation of a state's registration requirement, therefore, does not also require that an investor *purchase* the issuer's securities. Uniform Securities Act (1956) § 301 ("unlawful…to offer or sell any security unless…registered…or…exempted").
19. See, for instance, Uniform Securities Act (1956) § 101 (making it unlawful "in connection with the offer, sale, or purchase of any security…to make any untrue state of material fact…or…engage in any…fraud or deceit").
20. Uniform Securities Act (1956) § 101 uses language nearly identical to federal Rule 10b-5, 17 C.F.R. § 240.10b-5 (2016), which is interpreted to require disclosure of all material facts.
21. See, for instance, Uniform Securities Act (1956) § 408 (administrative sanctions), § 409 (criminal sanctions), and § 410 (private, civil right of recovery).
22. 15 U.S. Code § 77e (2016) (requiring registration for a public offering), and 15 U.S. Code § 77d(a)(2) (2016) (providing an exemption from registration for an issuer offering that is not a "public offering").
23. See, for instance, 15 U.S. Code §§ 77k and 77l (2016).
24. See, for instance, 15 U.S. Code § 77e (2016) (predicating jurisdiction on the "use of any means or instruments of transportation or communication of interstate commerce or of the mails").
25. Campbell, *An Open Attack*, pp. 563–567. See also footnote 12 and accompanying textual discussion.
26. 15 U.S. Code §§ 77e, 77f, and 77g (2016).
27. 15 U.S. Code § 77b(b) (2016).
28. 15 U.S. Code § 77r(b)(1) (2016).
29. 15 U.S. Code § 77r(b)(2) (2016).
30. 15 U.S. Code § 77r(b)(4)(E) (2016).
31. 17 C.F.R. § 230.506 (2016).
32. 15 U.S. Code § 77r(b)(3) (2016).
33. Ibid. The breadth of this delegation to expand pre-emption is illuminated by another part of the NSMIA, which states that the SEC, when acting "in the public interest…shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." 15 U.S. Code § 77b(b) (2016).
34. 15 U.S. Code § 77r(b)(4)(C) (2016).
35. 15 U.S. Code § 77d(a)(6) and § 77d-1(2016).
36. The statutory authority for the new Regulation A+ rules is found at 15 U.S. Code § 77c(b)(2) (2016).
37. The statutory basis for this pre-emption is found at 15 U.S. Code § 77r(b)(4)(D) (2016); the SEC's regulatory implementation of this is found at 17 C.F.R. §§ 230.256 (2016).
38. A recent amendment to Regulation D will raise the limit of a Rule 504 offering to $5 million. See Securities Act Release No. 33-10238, October 26, 2016.
39. A recent amendment of Regulation D will repeal Rule 505. See Securities Act Release No. 33-10238.
40. Rutheford B. Campbell Jr., "The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions," *The Business Lawyer*, Vol. 66, No. 4 (August 2011), pp. 919 and 931.
41. 17 C.F.R. § 230.251-.263 (2011). As a result of the JOBS Act, Regulation A changed significantly. Since those amendments, it is generally referred to as Regulation A+.
42. Rutheford B. Campbell Jr., "The New Regulation of Small Business Capital Formation: The Impact—If Any—of the JOBS Act," *Kentucky Law Journal*, Vol. 102, No. 4 (2013–2014), pp. 815–848.
43. 17 C.F.R. § 230.501-.508 (2016).
44. A recent amendment of Regulation D will raise the maximum Rule 504 offering to $5 million. See Securities Act Release No. 33-10238.
45. A recent amendment of Regulation D will repeal Rule 505. See Securities Act Release No. 33-10238.
46. See footnote 15 and accompanying textual discussion.
47. Campbell, "The Wreck of Regulation D," p. 928, Table III (finding in a sample of 7,880 Regulation D offerings that 78.6 percent of those Regulation D offerings of $1 million or less were made under Rule 506).

48. Ibid., p. 930, Table VII (finding that 88.3 percent of the sample offerings (203 of 230) of $1 million or less made under Rule 506 were limited to accredited investors; 91.8 percent of the sample offerings (191 of 208) between $1 million and $5 million made under Rule 506 were limited to accredited investors). Subsequent data developed by others are generally consistent with data from my article, although those more recent data are to some extent used to support other points or conclusions. See, for instance, Manning Gilbert Warren III, "The False Promise of Publicly Offered Private Placements," *SMU Law Review*, Vol. 68, No. 3 (2015), p. 899, and Vladimir Ivanov, "Capital Raising Through Regulation D," U.S. Securities and Exchange Commission, November 20, 2014, p. 4, http://www.sec.gov/info/smallbus/sbforum112014-ivanov.pdf (accessed October 5, 2016).

49. Justin Bryan, "High-Income Tax Returns for 2012," Statistics of Income, *IRS Statistics of Income Bulletin* (Summer 2015), p. 2, https://www.irs.gov/pub/irs-soi/soi-a-inhint-id1510.pdf (accessed October 5, 2016) (approximately 3.62 percent of all 2012 tax returns reported incomes of $200,000 or more).

50. Rutheford B. Campbell Jr., "Regulation A: Small Businesses' Search for 'A Moderate Capital,'" *Delaware Journal of Corporate Law*, Vol. 31, No. 1 (2005), pp. 77–123 (relying on data provided annually by the Small Business Administration).

51. North American Securities Administrators Association, "Coordinated Review," http://www.nasaa.org/industry-resources/corporation-finance/coordinated-review/ (accessed October 5, 2016).

52. NASAA reported that as of 1996, 43 jurisdictions had adopted the CR–SCOR. NASAA, "State Adoptions of Small Corporation Registration Program and Form U-7," May 1996.

53. E-mail from Joy Sakamoto-Wengel, Assistant Attorney General, Maryland Division of Securities, Atlantic CR–SCOR Region, to author, November 20, 2015, 15:10 EST, on file with author; telephone interview with Lynn Hammes, director, Finance & Administration, Kansas Securities Commissioner's Office, Midwest CR–SCOR Region, November 19, 2015; telephone interview with Patricia Loutherback, director, Registration Division, Texas State Securities Board, Southwest CR–SCOR Region, November 19, 2015; telephone interview with Sarah Reynolds, Division of Securities, Washington State Department of Financial Institutions, West CR–SCOR Region, November 19, 2015.

54. North American Securities Administrators Association, "Coordinated Review." See also, Coordinated Review, a website that appears to be sponsored by NASAA, http://www.coordinatedreview.org/cr-equity/overview/ (accessed October 6, 2016): CR–Equity provides a uniform procedure designed to coordinate the blue sky registration process among states in which the issuer seeks to sell its equity securities; offers issuers registration efficiencies by creating a uniform scheme of review; simplifies the process for resolution of issues raised during review of the registration application; and offers issuers expedited review. CR–Equity generally is intended only for initial public offerings of common stock, preferred stock, warrants, rights and units comprised of equity securities.

55. The Coordinated Review website reports that the CR–Equity protocol has been adopted by all but two jurisdictions.

56. Telephone interview with Brett Warren, counsel, Division of Corporation Finance, Pennsylvania Securities Commission, December 28, 2015.

57. NASAA, "NASAA Coordinated Review of Regulation A Offerings Review Protocol," March 2014, http://www.nasaa.org/wp-content/uploads/2014/05/NASAA-Regulation-A-Review-Protocol-final-Adopted-March-7.pdf (accessed October 5, 2016).

58. Amendments to Regulation A, Securities Act Release No. 33-9741, March 25, 2015; 17 C.F.R. §§ 230.251-.263 (2016).

59. E-mail from Faith L. Anderson, Esq., Chief of Registration and Regulatory Affairs, Washington Department of Financial Institutions Securities Division, to author, March 7, 2016, 5:28 PM EST, on file with author.

60. Restoring American Financial Stability Act of 2009, § 928.

61. Petition for Review, *Galvin v. SEC*, No. 15-1150 (D.C. Cir. May 22, 2015).

62. *Lindeen v. SEC*, No. 15-1149, 2016 WL 3254610 (D.C. Cir. June 14, 2016).

63. Arthur Levitt, SEC Chairman, hearings of the Capital Markets Deregulation and Liberalization Act of 1995, testimony before the Subcommittee on Telecommunications and Finance, Committee on Commerce, U.S. House of Representatives, 1995, p. 102.

64. 15 U.S. Code § 77r(b)(3) (2016).

65. In 2015, the SEC, operating at that point under broad delegated authority from Congress in the JOBS Act, pre-empted state registration authority over Tier 2 Regulation A+ offerings (limited to $50 million). 17 C.F.R. § 230.256 (2016). The SEC failed, however, to pre-empt state registration authority over Tier 1 offerings, an exemption designed specifically for small offerings by small businesses under Regulation A+. It seems clear that there will be very few Tier 1 Regulation A offerings, due in large part to the SEC's failure to pre-empt state registration authority over Tier 1 offerings. As support for my prediction of low use by the approximately 5 million small businesses in this country, consider preliminary data. The SEC's final Regulation A+ rules became effective on June 19, 2015. Between that date and May 15, 2016, only 37 Tier 1 offerings were filed with the SEC. Regulation A+ data were obtained from the online subscription-only Lexis Securities Mosaic, Form 1-A Data, http://www.lexissecuritiesmosaic.com (accessed May 24, 2016). (Click "SEC Filings" tab, follow "SEC Filings" hyperlink, and search for "Form 1-A.")