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# Ay Dios NSMIA!<sup>1</sup>

## PROOF OF A PRIVATE OFFERING EXEMPTION SHOULD NOT BE A PRECONDITION FOR PREEMPTING BLUE SKY LAW UNDER THE NATIONAL SECURITIES MARKETS IMPROVEMENT ACT

### I. INTRODUCTION

In the United States, both federal and state securities law have governed the purchase and sale of securities since 1933.<sup>2</sup> This two-tiered regulatory scheme is often criticized for being unnecessarily complex and redundant, inefficient, and expensive for issuers.<sup>3</sup> “Issuers,” such as large corporations, small business owners, and investment companies, typically sell securities, like stocks and bonds, in order to raise capital for business growth or investment. In order to sell securities to the general public, issuers must typically comply with multifarious registration requirements. Such requirements include submitting securities registration forms, financial disclosures, and fees to state regulatory agencies and the federal Securities Exchange Commission (“S.E.C.” or “Commission”).<sup>4</sup> Even if issuers comply, some states refuse to allow the

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<sup>1</sup> NSMIA refers to the National Securities Markets Improvement Act and is pronounced “NIZ.mee.uh.” Jed Horowitz, *No More Blue Skies? Lawyers Are Scrambling for New Angles*, ONWALLSTREET.COM, Sept. 1, 1998 (on file with author).

<sup>2</sup> The Securities Act of 1933 introduced federal securities regulation to a securities market already regulated by state securities law. *See infra* Part II.

<sup>3</sup> *See, e.g.*, H.R. REP. NO. 104-864, at 39 (1996) (Conf. Rep.), *reprinted in* 1996 U.S.C.C.A.N. 3920 (“[T]he system of dual Federal and state securities regulation has resulted in a degree of duplicative and unnecessary regulation. Securities offerings and the brokers and dealers engaged in securities transactions are all currently subject to a dual system of regulation that, in many instances, is redundant, costly, and ineffective.”); Roberta S. Karmel, *Blue-Sky Merit Regulation: Benefit to Investors or Burden on Commerce*, 53 BROOK. L. REV. 105, 107 (1987) (“The federal-state-[Securities Self-Regulatory Organization] system of securities regulation does not have a well articulated allocation of responsibilities and priorities. It involves conflicting philosophies and considerable overlap and duplication.”).

<sup>4</sup> *See* Rutherford B. Campbell, Jr., *Blue Sky Laws and the Recent Congressional Preemption Failure*, 22 J. CORP. L. 175, 185 (1997) (“Immediately prior to [NSMIA], [state securities] laws generally required that securities offered . . . within a particular state must be registered with the state’s securities division . . . . This broad rule, of course, is duplicative of the fundamental registration rule in the 1933 Act.”). Examples of current securities registration forms include New York’s form M-11 for non-exempt securities or Form 99 for exempt securities under NSMIA. INVESTOR PROTECTION BUREAU, INDEX OF INVESTOR FORMS BY CATEGORY, [http://www.oag.state.ny.us/investors/form\\_categ.html](http://www.oag.state.ny.us/investors/form_categ.html). Each form includes a schedule of fees to be paid. *Id.*

sale of securities that do not meet minimum quality or merit standards.<sup>5</sup> The process of complying with these registration and merit requirements can become prohibitively expensive, especially for smaller issuers.<sup>6</sup>

In October 1996, Congress—drawing upon its constitutional authority to preempt state law<sup>7</sup>—abrogated some of the states' regulatory authority over securities by enacting the National Securities Markets Improvement Act ("NSMIA").<sup>8</sup> Congress intended to streamline the regulation of national securities markets by federalizing the registration and regulation of several types of securities, like those listed on national securities exchanges.<sup>9</sup> NSMIA also preempts state securities laws regulating certain private offerings of securities already exempt from federal registration.<sup>10</sup> However, such an innovative solution for securities markets did not develop without a concomitant set of novel complexities.

Issuers selling securities in "private offerings" (also called "private placements") lack clear instruction as to when, and under what circumstances, they are no longer obligated to comply with state securities regulations. Unless NSMIA specifically exempts a class of securities from state regulation, state regulation of those securities is not preempted and continues to bind issuers.<sup>11</sup> Securities qualifying for the

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<sup>5</sup> For example, state merit standards could disallow the sale of securities if the price were too high, if the underwriter fees or costs of sale were too high, or if purchasers' voting rights would not have parity with voting rights of other classes of shareholders. See MERIT STANDARDS FOR SECURITIES OFFERINGS (Ohio Dep't of Commerce), available at [http://www.securities.state.oh.us/Rules/Existing\\_Guidelines.aspx#DS](http://www.securities.state.oh.us/Rules/Existing_Guidelines.aspx#DS) (last visited Jan. 8, 2007).

<sup>6</sup> See Campbell, *supra* note 4, at 181. In addition to registration fees charged by the state, an issuer's expenses include "legal and accounting costs generated by extensive narrative and financial disclosure requirements in a registered offering." *Id.* at n.32.

<sup>7</sup> The Supremacy Clause of the United States Constitution permits Congress to preempt state law simply by regulating the same subject matter. See U.S. CONST. art. VI, cl. 2; Cheryl Nichols, *The Importance of Selective Federal Preemption in the U.S. Securities Regulatory Framework: A Lesson From Canada, Our Neighbor to the North*, 10 CHAP. L. REV. 391, 396 (2006) (summarizing the role of the Supremacy Clause in preemption of state securities law). State law is automatically "preempted," and is subverted to federal law, wherever a conflict exists between state and federal law. See, e.g., *Gonzalez v. Raich*, 545 U.S. 1, 29 (2005) ("The Supremacy Clause unambiguously provides that if there is any conflict between federal and state law, federal law shall prevail . . . . It is beyond peradventure that federal power over commerce is 'superior to that of the States to provide for the welfare or necessities of their inhabitants,' however legitimate or dire those necessities may be.") (citation omitted).

<sup>8</sup> National Securities Markets Improvement Act of 1996 (hereinafter "NSMIA"), Pub. L. No. 104-290, 110 Stat. 3416, 3416 (1996) (codified as amended at 15 U.S.C. § 77r (2006)).

<sup>9</sup> 15 U.S.C. § 77r(b)(1)(A); see H.R. REP. 104-622, 1996 U.S.C.C.A.N. 3877, at 3878 (1996) (stating that the purpose of NSMIA is to "designat[e] the Federal government as the exclusive regulator of national offerings of securities"). National securities exchanges include larger exchanges like New York Stock Exchange and the NASDAQ. 15 U.S.C. § 77r(b)(1)(A).

<sup>10</sup> 15 U.S.C. § 77r(b)(4)(D); see H.R. REP. 104-622, *supra* note 9, at 3895 ("The Committee intends that the [Securities Act of 1933] section 4(2) exemption from State regulation facilitate private placement of securities consistent with the public interest and the protection of investors.").

<sup>11</sup> See 15 U.S.C. § 77r(c) (limiting the scope of preemption by leaving states the authority to regulate offerings of securities that are completely intra-state); H.R. REP. 104-622, *supra* note 9, at 3878 ("State governments generally retain authority to regulate small, regional, or intrastate securities offerings, and to bring actions pursuant to State laws and regulations prohibiting fraud and deceit, including broker-dealer sales practices abuses."); see also Campbell, *supra* note 4,

federal Rule 506 “private offering” exemption comprise one category of securities that NSMIA exempts from state securities laws.<sup>12</sup> However, the complexity and fragility of a Rule 506 exemption render it unworkable as a basis for preempting state law.

Rule 506 of Regulation D—one of several, objective exemption rules issued in the 1980s under the Securities Act of 1933—provides a regulatory exemption from federal registration for any offer of securities that is “non-public,” or “private.”<sup>13</sup> An “exemption” is valuable to issuers because it excuses the issuer from the expensive and complex registration and disclosure processes involved in public offerings of securities.<sup>14</sup> Private offerings were exempt from federal registration before NSMIA was enacted, but they were not necessarily exempt from state registration and merit regulation.<sup>15</sup> NSMIA now preempts state regulation of Rule 506 private offerings.<sup>16</sup>

Although Rule 506 provides an objective standard for securing a private offering exemption under the Securities Act,<sup>17</sup> it provides an unreasonably complex and untenable standard for preempting state securities regulation. More than a decade following the passage of NSMIA, courts have yet to agree whether an issuer claiming a Rule 506 exemption must prove the exemption in order to demonstrate that NSMIA has preempted state law.<sup>18</sup> Resolving this issue is important to issuers because Rule 506 creates an elusive and mercurial exemption, one that may become invalid months after the securities are offered for sale without regard for state regulation.<sup>19</sup> If state law is automatically revived after a private offering exemption is lost, states would regain

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at 204-05 (Although certain smaller offerings may be exempt from federal registration under Regulation A and Rules 504 and 505 of Regulation D, NSMIA does not preempt state regulation of these offerings.).

<sup>12</sup> 15 U.S.C. § 77d(2) (2006) (providing a registration exemption for offers of securities “not involving any public offering”); 17 C.F.R. § 230.506(a) (2008) (providing to issuers a “safe harbor” for engaging in private offers of securities, criteria that, if met, would guarantee an exemption from registration under § 4(2) of the Securities Act).

<sup>13</sup> 15 U.S.C. § 77d(2); 17 C.F.R. § 230.506. Private offers of securities include offers to banks, investment companies, wealthy individuals, and other financially sophisticated and accredited investors. 17 C.F.R. §§ 230.501, 506 (2008) (defining a class of “accredited investors” to whom issuers could offer securities while maintaining an exemption from federal registration). For a discussion of the Regulation D rules and § 4(2) of the Securities Act of 1933, see *infra* Part III(A).

<sup>14</sup> 15 U.S.C. § 77d(2).

<sup>15</sup> See *Temple v. Gorman*, 201 F. Supp. 2d 1238, 1242 (S.D. Fla. 2002) (“Until 1996, both federal and state regulations governed securities offerings.”).

<sup>16</sup> 15 U.S.C. § 77r(b)(4)(D).

<sup>17</sup> The requirements for a private offering exemption under The Securities Act of 1933 are highly subjective. See *infra* notes 78-82 and accompanying text.

<sup>18</sup> 1 STUART R. COHN, SECURITIES COUNSELING FOR SMALL AND EMERGING COMPANIES § 6:24.50 (2007); see 15 U.S.C. § 77r(b)(4).

<sup>19</sup> In one case, a trial court found that two separate offers two months apart were legally “integrated,” or treated as a single offer. See Reply Brief of Appellants Christopher C. Brown & Funeral.com, Inc., at 24, *Risdall v. Brown-Wilbert, Inc.*, 733 N.W.2d 827, No. A06-1233 (Minn. Ct. App. 2007), 2006 WL 4723912. This means that the issuer lost its valid Rule 506 exemption on the first offer after making the second non-exempt offer. *Id.*

jurisdiction to impose remedies for securities violations *ex post*. The vestige of state regulatory authority over securities obfuscates the private placement issuer's duties and liabilities under state law.

This Note evaluates the two preemption standards adopted under differing judicial interpretations of NSMIA. The "broad" preemption standard does not require an issuer to prove a valid Rule 506 exemption in order to claim an exemption from state law under NSMIA. This standard was first adopted by a federal district court in *Temple v. Gorman* and was most recently reaffirmed by the Minnesota Court of Appeals in *Risdall v. Brown-Wilbert, Inc.*<sup>20</sup> The "narrow" preemption standard requires proof of a valid Rule 506 exemption before a court will preempt state law under NSMIA. The narrow standard was first iterated by the Alabama Supreme Court in *Buist v. Time Domain Corp.* and was recently adopted by the Sixth Circuit Court of Appeals in *Brown v. Earthboard Sports USA, Inc.*<sup>21</sup> The S.E.C. can best resolve this issue by adopting a safe harbor that would guarantee issuers an exemption from state securities regulation upon filing a notice of the exempt offering with the state.

Part II of this Note provides the relevant statutory context for these decisions. It begins by illustrating the development and disintegration of the dual regulatory system. Part III provides two relevant examples of policy changes attempting to rebalance investor protections with regulatory efficiency, objectivity, and simplicity: Regulation D NSMIA. Part IV examines the practical consequences of these judicial interpretations of NSMIA by reviewing case law. Finally, Part V concludes that a broader standard is more consistent with the intent of Congress and can add efficiency, objectivity, and simplicity to securities regulation.

## II. THE DEVELOPMENT OF THE DUAL-REGULATORY SYSTEM

The term "dual-regulatory system" refers, in this context, to the two levels of regulatory agencies governing the purchase and sale of securities in the United States.<sup>22</sup> The two-tiered system is the result of the independent developments of state and federal securities laws in the 19th and early 20th centuries.<sup>23</sup> The following sections discuss the evolution

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<sup>20</sup> 733 N.W.2d 827, 832 (Minn. Ct. App. 2007); *Temple*, 201 F. Supp. 2d at 1243-44; *accord* *Pinnacle Commc'ns Int'l, Inc. v. Am. Family Mortgage Corp.*, 417 F. Supp. 2d 1073, 1087 (D. Minn. 2006); *Lillard v. Stockton*, 267 F. Supp. 2d 1081, 1116 (N.D. Okla. 2003).

<sup>21</sup> 481 F.3d 901, 909-10 (6th Cir. 2007); *Buist v. Time Domain Corp.*, 926 So.2d 290, 298 (Ala. 2005); *accord In re Blue Flame Energy Corp.*, 871 N.E.2d 1227, 1244 (Ohio Ct. App. 2006); *Grubka v. WebAccess Int'l, Inc.*, 445 F. Supp. 2d 1259, 1270 (D. Colo. 2006); *Hamby v. Clearwater Consulting Concepts, LLP*, 428 F. Supp. 2d 915, 921 (E.D. Ark. 2006).

<sup>22</sup> *Karmel*, *supra* note 3, at 107.

<sup>23</sup> *See generally* Ernest W. Walker & Beverly Bailey Hadaway, *Merit Standards Revisited: An Empirical Analysis of the Efficacy of Texas Merit Standards*, 7 J. CORP. L. 651, 651-52 (1982) (summarizing the history of federal and state securities law enactments).

of federal and state regulation of securities in the United States, which provides the historical underpinnings of Regulation D and NSMIA.

#### A. *Blue Sky Law*

Securities regulation and investor protection are old concepts predating the United States. The Bubble Act of 1720 in Britain is one early example of an investor protection law, which purported to protect investors by outlawing certain fraudulent activities of large merchants.<sup>24</sup> By the time Congress passed the first federal securities law in 1933,<sup>25</sup> state legislatures had long assumed a role in securities regulation, some since the mid-19th century.<sup>26</sup> Like the Bubble Act, the first securities and commodities regulations came about at a time when highly speculative and fraudulent investment offers had spread ubiquitously in the United States.<sup>27</sup> This urged state legislatures to pass laws and regulations protecting investors from fraudulent and high-risk securities.<sup>28</sup>

In 1911, Kansas became the first state to enact such securities laws, which became known as “blue sky” laws.<sup>29</sup> Blue sky laws are primarily intended to curb securities fraud.<sup>30</sup> They also promote dissemination of information to investors by providing for mandatory disclosures.<sup>31</sup> The Kansas statute established registration requirements for all offers of securities and licenses for all firms selling securities.<sup>32</sup> Registration of securities involved filing a copy of the security, along

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<sup>24</sup> Jeffrey T. Haughey & Kevin M. Veler, *Blue Sky Laws and State Takeover Statutes: New Importance for an Old Battleground*, 7 J. CORP. L. 689, 693-94 (1982). The Bubble Act responded to wild fluctuations in the market price of British and French merchant companies, a financial crisis attributed to the companies’ sales of subscriptions in fraudulent enterprises. *See id.*

<sup>25</sup> *Id.* at 697.

<sup>26</sup> See Christopher R. Lane, *Halting the March Toward Preemption: Resolving Conflicts Between State and Federal Securities Regulators*, 39 NEW ENG. L. REV. 317, 321 (2005) (citing Massachusetts law regulating the minimum par value of railroad company shares as of 1852).

Commodities exchanges had also been regulated since the 19th century in reaction to speculative trading. Thomas Lee Hazen, *Rational Investments, Speculation, or Gambling? Derivative Securities and Financial Futures and Their Effect on the Underlying Capital Markets*, 86 NW. U. L. REV. 987, 1013-14 (1992).

<sup>27</sup> Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 355 (1991) (“The public’s growing appetite for speculative securities sparked intense public concern about fraudulent promotions.”); Mark A. Sargent, *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785, 792 (1986) (“[The early blue sky laws] reflected, primarily, a strong sense of the ordinary person’s vulnerability to securities fraud.”).

<sup>28</sup> Hazen, *supra* note 26, at 1013-14; Lane, *supra* note 26, at 321.

<sup>29</sup> Sargent, *supra* note 27, at 791, 792 n.34. A “blue sky law” refers to “[a] state statute establishing standards for offering and selling securities, the purpose being to protect citizens from investing in fraudulent schemes or unsuitable companies.” BLACK’S LAW DICTIONARY 183 (8th ed. 2004). The precise origin of the term “blue sky” is debatable, but the term is commonly believed to refer to speculative and fraudulent sales of the “blue sky” to gullible investors. Hazen, *supra* note 26, at 1020 n.180; *but see* Macey & Miller, *supra* note 27, at 359 n.59 (arguing that “blue sky” was used commonly in 1910, but no one using it ever defined it, so Kansans probably used the term to refer to other speculative or fraudulent activity before using it with respect to securities).

<sup>30</sup> Hazen, *supra* note 26, at 1014.

<sup>31</sup> See Macey & Miller, *supra* note 27, at 394-95.

<sup>32</sup> *See id.* at 359-62.

with copies of financial statements and business plans, with the state banking commissioner.<sup>33</sup> Blue sky laws also required periodic financial reports and disclosures for any firm offering or selling securities in Kansas.<sup>34</sup>

Merit review was also a significant feature of Kansas' first blue sky law.<sup>35</sup> Merit review refers to the state's ability to deny intra-state sales of securities for a variety of reasons, like if the offer contains unfair terms, if the security does not promise a fair return, or if the issuer is insolvent or dishonest.<sup>36</sup> Kansas empowered the bank commissioner to perform stringent merit reviews for securities sold within the state in order to stem the proliferation of unscrupulous businesses cozening ignorant investors out of their money.<sup>37</sup>

By 1913, twenty-four states had adopted blue sky laws,<sup>38</sup> and many states copied the Kansas statute in adopting merit review.<sup>39</sup> In 1917, the United States Supreme Court upheld the constitutionality of these laws, finding that they fell within the states' police powers.<sup>40</sup> Today, every state has adopted some form of blue sky law.<sup>41</sup> Most blue sky laws are modeled after the Uniform Securities Act,<sup>42</sup> a model code attempting to harmonize differences in early state securities regulations.<sup>43</sup> Only a minority of states stringently enforces merit reviews.<sup>44</sup>

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<sup>33</sup> See *id.* at 361.

<sup>34</sup> See *id.* at 359-62.

<sup>35</sup> Haughey & Veler, *supra* note 24, at 696.

<sup>36</sup> See, e.g., *id.* at 802-05 (discussing several of the bases on which states deny intra-state offers and sales of securities).

<sup>37</sup> *Id.* at 696 (noting that, under the 1911 Kansas blue sky merit regulations the bank commissioner approved only 100 of the 1400 to 1500 applications received in the first year and a half).

<sup>38</sup> Haughey & Veler, *supra* note 24, at 696.

<sup>39</sup> Macey & Miller, *supra* note 27, at 377-78. The other states adopting strict merit requirements were Arkansas, Idaho, Michigan, Montana, North Dakota, South Dakota, Tennessee, and West Virginia, primarily agrarian states without the investment banking activity found in states that rejected merit requirements. *Id.* at 377-80.

<sup>40</sup> See *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568, 586 (1917) (“[T]he judgment is for the State to make, and in the belief of evils and the necessity for their remedy and the manner of their remedy the State has determined that the business of dealing in securities shall have administrative supervision, and 26 states have expressed like judgments.”); *Caldwell v. Sioux Falls Stock Yards Co.*, 242 U.S. 559, 568 (1917) (deferring to the Court’s decision in *Hall v. Geiger-Jones Co.*); *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 555 (1917) (“Whatever detriment may come from such [speculative] judgments the law may be powerless to prevent; but against counterfeits of value the law can give protection, and such is the purpose of the [“blue sky”] statute under review.”); see also Macey & Miller, *supra* note 27, at 387 (noting that, as a result of the Supreme Court’s holdings in the “Blue Sky Cases” of 1917 states were to free to regulate securities without issue as to the constitutionality of such legislation or regulation).

<sup>41</sup> See Haughey & Veler, *supra* note 24, at 702.

<sup>42</sup> UNIF. SEC. ACT § 101 (2005).

<sup>43</sup> See Haughey & Veler, *supra* note 24, at 702.

<sup>44</sup> Macey & Miller, *supra* note 27, at 389.

### B. Federal Securities Regulation

Congress did not begin regulating securities or securities markets until 1933, during the Great Depression.<sup>45</sup> In a series of congressional hearings held on the 1933 Securities Act, Congress recognized that state regulators had failed to prevent the stock market crash in 1929.<sup>46</sup> The stock market crash was exacerbated by speculative investments and gross over-valuations of worthless securities, which blue sky laws were supposed to prevent.<sup>47</sup> States had limited jurisdiction, however, in that they were unable to effectively regulate interstate securities transactions.<sup>48</sup> Additionally, some states performed their delegated regulatory functions more efficaciously than others.<sup>49</sup>

The 1933 Securities Act and the 1934 Securities Exchange Act serve primarily to police securities fraud and promote the full disclosure and distribution of material information to the market.<sup>50</sup> Congress did not adopt the merit regulations present in many blue sky laws, but instead adopted a policy of full disclosure to protect investors.<sup>51</sup>

The disclosure rules contained in the Securities and Exchange Acts, however, are far more voluminous and demanding than the disclosures required by most blue sky laws modeled after the Uniform Securities Act.<sup>52</sup> The purpose of disclosure is to provide information to investors. A fully informed investor is believed to be able to protect himself or herself from potential risks and fraud better than the government.<sup>53</sup> Justice Louis Brandeis famously summarized this theory of disclosure when he wrote that “[s]unlight is said to be the best of disinfectants; electric light the most efficient policeman.”<sup>54</sup>

Despite the failures of blue sky laws and the addition of federal regulations, the Securities Act, as originally drafted, preserved the states’ concurrent jurisdiction over securities.<sup>55</sup> The Securities Act has been amended several times since 1933, but none of these amendments would

<sup>45</sup> See Haughey & Veler, *supra* note 24, at 697.

<sup>46</sup> Lane, *supra* note 26, at 323-24.

<sup>47</sup> *Id.*

<sup>48</sup> Karmel, *supra* note 3, at 111 (citing *Edgar v. MITE Corp.*, 457 U.S. 624 (1982) (holding that blue sky regulation of *interstate* rather than *intrastate* securities transactions is unconstitutional regulation of interstate commerce)).

<sup>49</sup> Lane, *supra* note 26, at 324.

<sup>50</sup> Haughey and Veler, *supra* note 24, at 698-700.

<sup>51</sup> *Id.* at 698.

<sup>52</sup> Mark A. Sargent, *State Disclosure Regulation and the Allocation of Regulatory Responsibilities*, 46 MD. L. REV. 1027, 1030 (1987).

<sup>53</sup> Haughey & Veler, *supra* note 24, at 698-700 (quoting Robert I. Millonzi, *Concurrent Regulation of Interstate Securities Issues: The Need for Congressional Reappraisal*, 49 VA. L. REV. 1483, 1492 (1963)).

<sup>54</sup> LOUIS D. BRANDEIS, *OTHER PEOPLE’S MONEY AND HOW THE BANKERS USE IT* 92 (1914).

<sup>55</sup> 15 U.S.C. § 77r (1994) (“Nothing in this subchapter shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person.”).



significantly curtail state regulatory authority over securities for over six decades.<sup>56</sup>

### C. *Efficacy of the Dual Regulatory System*

Some commentators have urged that state securities registration requirements and blue sky merit and quality regulations are ineffective in protecting investors and burdensome on efficient capital formation.<sup>57</sup> Each state's securities laws have developed differently, and this has engendered some discord between blue sky laws.<sup>58</sup> Even states adopting the Uniform Securities Act have modified the uniform act's provisions.<sup>59</sup> Additionally, states have developed different interpretations of the blue sky law provisions they adopted,<sup>60</sup> although the provisions may be textually similar. Such variations with regard to merit requirements and quality standards for registration have undermined the intent of the Uniform Securities Act to achieve regulatory uniformity.<sup>61</sup>

Other commentators have argued that the rules for registering most securities in most states are similar, despite the lack of perfect uniformity, and coordinate well with federal registration rules.<sup>62</sup> However, some states have historically enforced their merit and quality provisions much more stringently than others.<sup>63</sup> Moreover, differences in regulation are most evident when issuers claim federal exemptions from registration or are offering securities with substantial risk.<sup>64</sup> These

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<sup>56</sup> See, e.g., Regulation D—Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933, Preliminary Notes, 17 C.F.R. § 230 (2008) (hereinafter Preliminary Notes, Regulation D) (“Nothing in these rules obviates the need to comply with any applicable state law relating to the offer and sale of securities.”); Preliminary Notes, 17 C.F.R. § 230.144A (2008) (A regulatory exemption for securities resold privately to institutions notes that “[n]othing in this section obviates the need for any person to comply with any applicable state law relating to the offer or sale of securities.”).

<sup>57</sup> See, e.g., Karmel, *supra* note 3, at 107, 117-18 (arguing that merit regulation burdens interstate commerce and capital formation by restricting how issuers set prices and compensate underwriters); *but see* Sargent, *supra* note 52, at 1031-34 (arguing that state merit reviews rarely result in the inability to sell the securities, and when they do, issuers typically “withdraw the application for registration and sell around that state.” (internal quotation marks omitted)).

<sup>58</sup> See Haughey & Veler, *supra* note 24, at 701-02.

<sup>59</sup> See *id.*

<sup>60</sup> See *id.*

<sup>61</sup> See *id.*

<sup>62</sup> Sargent, *supra* note 52, at 1030-32 (stating that most state securities acts are based on a uniform act and contain exemptions from registration that are similar to the federal exemptions).

<sup>63</sup> See, e.g., Jay T. Brandi, *Securities Practitioners and Blue Sky Laws: A Survey of Comments and a Ranking of States by Stringency of Regulation*, 10 J. CORP. L. 689, 703-04 (1985) (According to one study in the 1980s, attorneys typically found Texas, California, and Wisconsin to be among the most “stringent” regulators of merit standards for securities.).

<sup>64</sup> Sargent, *supra* note 52, at 1035 (noting that some states will not scrutinize any issue of securities that is registered with the S.E.C. and that some states will carefully scrutinize issues of certain highly speculative securities).

Many states adopted a model state exemption for offers exempt from federal registration under Regulation D, the Uniform Limited Offering Exemption. *Id.* at 1032 n.25. Like the Uniform Securities Act, not all states adopted it, and many states that had adopted the ULOE had modified it. See S.E.C., REPORT ON THE UNIFORMITY OF STATE REGULATORY REQUIREMENTS FOR

variations sustained a specialty market for blue sky lawyers,<sup>65</sup> but they added to the tremendous costs of complying with federal registration and disclosure regulations.<sup>66</sup>

The development of the dual-regulatory system governing securities illustrates that national securities markets must be regulated to protect investors. Indeed, both state and federal securities regulations were developed during financial crises, when investors had been injured by market failures.<sup>67</sup> However, it also illustrates the inefficiencies, inefficacies, and complexities appurtenant to securities regulation in the United States. The development of uniform and model state codes and exemptions were state and private sector responses to the difficulty of selling securities nationally. Changes to the dual-regulatory system should therefore focus on harmonizing the interests of efficiency, objectivity, and simplicity, with the interest of protecting investors.

### III. EFFICIENCY, OBJECTIVITY, AND SIMPLICITY IN THE DUAL-REGULATORY SYSTEM

Federal securities regulatory policy has long reflected that regulation should be limited to the extent needed to protect investors. Two perennial registration exemptions, now found in § 4 of the Securities Act of 1933, suggest that Congress never found it necessary to require registration for “private offers” of securities and most trades between investors.<sup>68</sup> Subsection A will briefly discuss the statutory private offering exemption. This discussion will illustrate how the Supreme Court obfuscated the requirements for obtaining the exemption by establishing a subjective test for all purported private offerings.

Subsection B will discuss the S.E.C.’s adoption of Regulation D under the Securities Act of 1933. Regulation D was one of several S.E.C. attempts to improve the efficiency of securities regulation by providing

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OFFERINGS OF SECURITIES THAT ARE NOT “COVERED SECURITIES” § 1(B)(3)(b) (1997), available at <http://www.sec.gov/news/studies/uniformy.htm>.

<sup>65</sup> See Horowitz, *supra* note 1 (discussing how the market for “blue sky” attorneys diminished after NSMIA).

<sup>66</sup> See Campbell, *supra* note 4, at 181 (noting that an issuer’s high offering costs are caused, in part, by compliance with merit and qualification regulations, discounts on sale price due to resale restrictions, and out-of-pocket costs).

<sup>67</sup> Lane, *supra* note 26, at 321; Macey and Miller, *supra* note 27, at 354 (noting that investors were widely investing in highly speculative schemes prior to the first blue sky laws); Sargent, *supra* note 27, at 792 (noting that state blue sky laws emerged to protect investors from fraudulent investments).

<sup>68</sup> 15 U.S.C. §§ 77d(1)-(2). A private placement is the offer and sale of securities that does not involve a public offering. As the Supreme Court discussed in *S.E.C. v. Ralston Purina Co.*, a private offering does not turn solely on the number of purchasers, but rather the amount and type of information available to the purchasers and the purchasers’ need for protection. 346 U.S. 119, 125-26 (1953).

exemptions to registration for certain offers of securities.<sup>69</sup> Specifically, Rule 506 of Regulation D created a more objective test for obtaining a private offering exemption than the Securities Act alone provided.<sup>70</sup> The Commission also promulgated similar exemptions for other types of securities.<sup>71</sup>

Finally, Subsection C will introduce NSMIA and the preemption standard for state securities law. As the legislative history indicates, NSMIA was intended to obviate state registration, pre-sale qualifications, and proxy regulations for certain securities typically traded in the national securities market.<sup>72</sup> NSMIA exemplifies an effort to rebalance investor protections with the securities market's need for greater efficiency and simplicity.

A. *The Statutory Private Offering Exemption: Section 4(2) of the Securities Act*

The Securities Act of 1933 has always provided a statutory private placement exemption and allowed issuers to avoid registering certain securities.<sup>73</sup> Section 4(2) of the Securities Act provides that “transactions by an issuer not involving any public offering” are exempt from federal securities registration requirements.<sup>74</sup>

However, the provision is ambiguous. NSMIA does not define the words “not involving any public offering.”<sup>75</sup> Prior to the United States Supreme Court's decision in *S.E.C. v. Ralston Purina Co.*, “public offering” seemed to many—indeed, it seemed to the Commission and Ralston Purina Co.—to refer to the number of persons or to the limits of a group offered the securities.<sup>76</sup> The trial and appellate courts in the *Ralston* case also believed that an offer to a defined group, like a company's employees, was not a “public offering.”<sup>77</sup>

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<sup>69</sup> Regulation D—Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933, 17 C.F.R. §§ 230.501-06 (2008) (hereinafter Regulation D).

<sup>70</sup> *Id.* § 230.506.

<sup>71</sup> *See, e.g.*, Regulation A—Conditional Small Issues Exemption, 17 C.F.R. §§ 230.251-63 (2008) (Providing an exemption for small offers of securities totaling not more than \$5,000,000); Rule 147, 17 C.F.R. § 230.147 (2008) (establishing more definite requirements for obtaining an exemption for intrastate offerings of securities under § 3(a)(11) of the Securities Act).

<sup>72</sup> Steve A. Radom, *Balkanization of Securities Regulation: The Case for Federal Preemption*, 39 TEX. J. BUS. L. 295, at 307-08 (2003) (citing Lander v. Hartford Life & Annuity Ins. Co., 251 F.3d 101, 108 (2d. Cir. 2001)).

<sup>73</sup> 15 U.S.C. § 77d(2).

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

<sup>76</sup> *S.E.C. v. Ralston Purina Co.*, 346 U.S. 119, 121-22, 125 (1953) (The Commission took issue with the fact that hundreds of employees were offered unregistered securities, regardless of their positions within the company or their competence with financial matters.).

<sup>77</sup> *S.E.C. v. Ralston Purina Co.*, 102 F. Supp. 964, 968-69 (D.C. Mo. 1952), *aff'd*, 200 F.2d 85, 92 (8th Cir. 1953), *rev'd*, 346 U.S. at 125-26.

The Supreme Court in *Ralston* held that “public offering” refers to an offer to investors who did not know nor have access to information ordinarily disclosed during registration.<sup>78</sup> The S.E.C. further obfuscated this subjective standard by adopting subjective rules consistent with the *Ralston* opinion.<sup>79</sup> Former Rule 146 under the Securities Act required that the issuer in a private offering reasonably believe that each offeree had the knowledge, information, and business experience to evaluate the investment.<sup>80</sup> Under the *Ralston* and Rule 146 standards, the number of offerees is not the *sine qua non* of a private offering.<sup>81</sup> While the new private offering standard served to protect investors, the lack of an objective standard dissuaded issuers from seeking the private offering exemption.<sup>82</sup>

*B. The Regulatory Private Offering Exemption: Rule 506 of Regulation D*

By the 1980s, several commentators and the S.E.C. recognized that complying with federal securities regulations was considerably difficult and expensive.<sup>83</sup> The extensive reporting requirements were especially burdensome for small businesses, which shouldered relatively higher costs than large businesses in acquiring investment capital through securities.<sup>84</sup> Regulation D added efficient exemption rules, couched in objective terms.

1. Regulation D

Regulation D, adopted under the Securities Act in April 1982, originally provided six rules containing three new exemptions from federal registration.<sup>85</sup> Rules 501 through 503 set forth general terms and

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<sup>78</sup> *Ralston Purina*, 346 U.S. at 126-27.

<sup>79</sup> 17 C.F.R. § 230.146 (1975) (rescinded 1982); *see also* Transactions by an Issuer Deemed Not to Involve Any Public Offering (hereinafter Former Rule 146), 39 Fed. Reg. 15,261, 15,266 (May 2, 1974), *repealed by* Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales (hereinafter Exemption Revision), 47 Fed. Reg. 11,251, 11,251 (Mar. 16, 1982); *see also* Note, *Revising the Private Placement Exemption*, 82 YALE L. J. 1512, 1519 (1973).

<sup>80</sup> 17 C.F.R. § 230.146 (1975) (rescinded 1982); *see also* Former Rule 146, *supra* note 79, at 15,262.

<sup>81</sup> *See id.*; *Ralston Purina*, 346 U.S. at 125-26.

<sup>82</sup> *See* Manning Gilbert Warren III, *A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933*, 33 AM. U. L. REV. 355, 357 n.13 (1984) (citing Note, *SEC Rules 144 and 146: Private Placements for the Few*, 59 VA. L. REV. 886, 921-22 (1973)) (noting that the Rule 146 requirements were so stringent that smaller issuers chose not to seek the exemption).

<sup>83</sup> *See id.* at 355 n.1.

<sup>84</sup> *See id.* at 356.

<sup>85</sup> *See* Regulation D, 17 C.F.R. §§ 230.501-06 (2008); Exemption Revisions, *supra* note 79, at 11,251. These rules were amended in 1989, and Rules 507 and 508 were added. *See* Regulation D; Accredited Investor and Filing Requirements (hereinafter 1989 Amendments), 54 Fed. Reg. 11,369, 11,369-74 (Mar. 20, 1989) (codified at 17 C.F.R. §§ 230.507-08 (2008)).

definitions governing the Regulation D exemptions.<sup>86</sup> Rules 504 and 505 provide the first two exemptions from federal registration for limited offers not exceeding a certain value.<sup>87</sup> Rule 506, the third exemption, provides a regulatory private offering exemption in addition to, and in combination with, the statutory private offering exemption under § 4(2).<sup>88</sup>

Rule 501 defines special terms and describes calculation methods used for each exemption.<sup>89</sup> For example, although an issuer loses the Rule 506 private offering exemption if the issuer sells securities to more than thirty-five investors,<sup>90</sup> the thirty-five investors do not include one's spouse or any "accredited investors"<sup>91</sup> like banks, the issuer's officers or directors, or very wealthy individuals.<sup>92</sup>

Rule 502 limns several mandatory general conditions for issuers seeking to qualify for one of the exemptions.<sup>93</sup> First, the issuer cannot publicly advertise the securities or solicit sales from the public.<sup>94</sup> Second, the issuer must disclose substantial financial and non-financial information to any purchaser that was not an "accredited investor" as defined in Rule 501.<sup>95</sup> Third, the issuer must reasonably ensure that no purchaser plans to resell the securities and must disclose this limitation on resale to each purchaser.<sup>96</sup> Finally, Rule 502 warns that all securities offered or sold within six months of the proposed Regulation D offering may be considered part of that Regulation D offering, the "integration" requirement.<sup>97</sup> "Integration" may disqualify the offering for an exemption, unless the issuer can give good reasons the separate offers should not be integrated.<sup>98</sup>

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<sup>86</sup> 17 C.F.R. §§ 230.501-03.

<sup>87</sup> *Id.* §§ 230.504-05.

<sup>88</sup> *Id.* § 230.506.

<sup>89</sup> *Id.* § 230.501.

<sup>90</sup> *Id.* § 230.506(b).

<sup>91</sup> "Accredited investor[s]" are investors presumed to have sufficient financial or business acumen, knowledge, or access to information to weigh the risks of investment. *See id.* § 230.501(a).

<sup>92</sup> *Id.* § 230.501(f).

<sup>93</sup> *Id.* § 230.502.

<sup>94</sup> *Id.* § 230.502(c). Such advertisements include such activities as newspaper publications or television advertisement *Id.* It also includes posting information regarding the offer of securities on the internet. *See Risdall v. Brown-Wilbert, Inc.*, 733 N.W.2d 827, 829 (Minn. Ct. App. 2007).

<sup>95</sup> 17 C.F.R. § 230.502(b). For a definition of "accredited investor," see *supra* note 91.

<sup>96</sup> 17 C.F.R. § 230.502(d).

<sup>97</sup> *Id.* § 230.502(a). This rule prevents issuers from circumventing the dollar limits on exempt offers under Rules 504 and 505 by breaking up the single offer of securities into smaller offers. *See Non-Public Offering Exemption*, 27 Fed. Reg. 11,316, 11,317 (Nov. 16, 1962). The integration requirement contained a "safe harbor" provision that guaranteed that separate offers or sales of securities would not be integrated if they took place more than six months apart. 17 C.F.R. § 230.502(a).

<sup>98</sup> 17 C.F.R. § 230.502(a). Whether two offers should be integrated into a single offer under Regulation D depends upon a variety of factors:

(a) [w]hether the sales are part of a single plan of financing;

The last of the general conditions, Rule 503, requires the issuer to file a notice of sale (“Form D”) with the S.E.C within fifteen days of the first offer.<sup>99</sup> Form D is a check-the-box-style form that allows the issuer to select the exemption or exemptions applicable to the particular securities offering.<sup>100</sup> The form requires the issuer to identify all partners, officers, directors, promoters, non-accredited investors, and shareholders owning 10% or more of any class of the securities offered.<sup>101</sup> The issuer must also state the offering price, the states in which the securities will be offered, and all non-accredited investors, if any.<sup>102</sup>

## 2. The Rule 506 Regulatory Private Offering Exemption

The Rule 506 exemption responded to frustrations and criticisms directed toward the S.E.C. following *Ralston* and Rule 146.<sup>103</sup> It creates a regulatory private offering exemption for any issuer who sells securities to no more than thirty-five investors with sufficient financial acumen<sup>104</sup> and complies with the conditions set forth in Rules 501 and 502 (and originally, Rule 503).<sup>105</sup> Many hedge funds—private investment companies that typically engage in highly leveraged or short-term trading strategies<sup>106</sup>—favor the Rule 506 exemption over other regulatory exemptions because it allows the issuer to sell unregistered securities of unlimited value to an unlimited number of accredited investors.<sup>107</sup>

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(b) [w]hether the sales involve issuance of the same class of securities;

(c) [w]hether the sales have been made at or about the same time;

(d) [w]hether the same type of consideration is being received; and

(e) [w]hether the sales are made for the same general purpose.

*Id.*; Non-Public Offering Exemption, *supra* note 97, at 11,317; *see also* S.E.C. v. Melchior, No. 90-C-1024J, 1993 WL 89141, at \*9 (D. Utah Jan. 14, 1993) (holding that an offer fails the Rule 506 exemption due to its “integration” with previous offers).

<sup>99</sup> 17 C.F.R. § 230.503.

<sup>100</sup> S.E.C., Form D, <http://www.sec.gov/about/forms/formd.pdf> (last visited Jan. 18, 2007).

<sup>101</sup> *Id.* For a definition of “accredited investor,” *see supra* note 91.

<sup>102</sup> *Id.*

<sup>103</sup> *See* Exemption Revision, *supra* note 79, at 11,252; Warren, *supra* note 82, at 355-58. For a discussion of *Ralston Purina* and Rule 146, *see supra* notes 76-82 and accompanying text.

<sup>104</sup> The thirty-five investors do not include accredited investors. *See supra* notes 91-92 and accompanying text. Rule 506 requires the thirty-five investors to have sufficient financial experience to be able to evaluate the investment, or have a financial advisor who does. 17 C.F.R. § 230.506(b)(2)(ii).

<sup>105</sup> 17 C.F.R. § 230.506; *see* 1989 Amendments, *supra* note 85, at 11,369 (filing the Rule 503 notice is no longer required for any Regulation D exemption, but must still be filed under Rule 507). For the requirements of Rules 501 through 503, *see supra* notes 89-102 and accompanying text.

<sup>106</sup> Practising Law Institute, *Hedge Funds*, 1589 PLI/Corp 309, 313 (2007).

<sup>107</sup> *See id.* at 315. Rule 506 does place a limit on the number of investors, but accredited investors are excluded from the calculation of the number of investors under Rule 501. 17 C.F.R. §§ 230.501(e)(1)(iv), 506 (2008).

Rule 506 is considered a “safe harbor” provision for securities issued under § 4(2).<sup>108</sup> A safe harbor is a prophylactic provision that permits one to avoid liability or statutory or regulatory penalties.<sup>109</sup> Rule 506 allows issuers to avoid losing a private offering exemption by providing an objective standard for determining whether an offer of securities qualifies for the exemption.<sup>110</sup>

The adoption of Regulation D and Rule 506 exemplified the S.E.C.’s ideological shift away from qualitative and subjective rules.<sup>111</sup> However, even Rule 506, as originally drafted, did not completely satisfy the market’s need for efficiency and simplicity.<sup>112</sup> Originally, Rule 506 required unmitigated compliance with Rules 501 through 503 and the thirty-five purchaser limitation.<sup>113</sup> These technical requirements were objective, but complex and demanding.<sup>114</sup>

An issuer seeking a regulatory private offering exemption in 1982 faced a host of technical compliance issues under Regulation D. For example, if the purchaser was an individual, not a bank or other institutional investor, the issuer had to inquire as to the individual’s net worth or annual income.<sup>115</sup> If some investors were not accredited, the issuer had to give such investors audited financial statements, plus much of the non-financial information that would have been disclosed through registration.<sup>116</sup> Additionally, the issuer had to gauge the financial acumen of all non-accredited purchasers, or their financial advisors, to ensure that the investor could sufficiently understand the risks of investment.<sup>117</sup>

Failure to satisfy any of the Rule 506 requirements, before the 1989 amendments to Regulation D, was ostensibly fatal to the regulatory exemption.<sup>118</sup> Having satisfied most of the pre-amendment exemption conditions, the issuer could still have lost the exemption fifteen days after the first offer by failing to file the Form D notice of sale.<sup>119</sup> The

<sup>108</sup> 15 U.S.C. § 77d(2); *see also* Warren, *supra* note 82, at 357.

<sup>109</sup> BLACK’S LAW DICTIONARY 1363 (8th ed. 2004).

<sup>110</sup> 17 C.F.R. § 230.506. The standard set forth by the Supreme Court in *Ralston Purina* made it more complex and difficult for issuers to determine whether any particular offer would be considered non-public. *See* Exemption Revisions, *supra* note 79, at 11,252; *S.E.C. v. Ralston Purina*, 346 U.S. 119, 125-26 (1953).

<sup>111</sup> *See* Exemption Revision, *supra* note 79, at 11,251.

<sup>112</sup> *See* Warren, *supra* note 82, at 383.

<sup>113</sup> Regulation D, *supra* note 69, at 11,266 (current version codified at 17 C.F.R. § 230.506).

<sup>114</sup> Mark A. Sargent, *The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform*, 68 WASH. U. L.Q. 225, 240-41 (1990) (noting that initial exuberance regarding Regulation D waned as investors struggled with the disclosure rules, integration, and the notice-filing requirements).

<sup>115</sup> 17 C.F.R. §§ 230.501(6)-(7).

<sup>116</sup> *Id.* § 230.502(b).

<sup>117</sup> *Id.* § 230.506(b)(2)(ii); *see also supra* notes 103-105 and accompanying text.

<sup>118</sup> *Cf.* Warren, *supra* note 82, at 383 (Although the exemption would be lost, the S.E.C. had discretion to make exceptions in any particular case.).

<sup>119</sup> Regulation D, *supra* note 69, at 11,265-66 (current version codified at 17 C.F.R. §§ 230.503, 506(b)) (Rule 506 originally required compliance with Rule 503 as a condition of the private offering exemption.); *see also* Warren, *supra* note 82, at 383.

issuer could also have lost the exemption by selling a non-exempt security at any time during the following six months (due to the “integration” provision of Rule 502).<sup>120</sup> Although the S.E.C. had discretion to exempt issuers that failed to satisfy a technical requirement of Rule 506, investors could seek rescission of their purchase in court, claiming the issuer illegally sold them unregistered, non-exempt securities.<sup>121</sup> An issuer, cast out from under the protective aegis of Rule 506, was forced to prove a § 4(2) statutory exemption under the subjective test in *Ralston*.<sup>122</sup>

In 1989, the S.E.C. addressed these problems of complexity by amending Regulation D.<sup>123</sup> The amendment first omitted the Rule 503 notice filing requirement from every Regulation D exemption, such that no Regulation D exemption will fail due to a failure to file Form D.<sup>124</sup> However, the Commission maintained the notice filing requirement by adding Rule 507, which automatically disqualifies one who violates Rule 503 from claiming any future Regulation D exemption, subject to the discretion of the S.E.C.<sup>125</sup> Thus, the amendment simplifies Regulation D exemption requirements without significantly diminishing investor protections.

The Commission further adopted Rule 508, an additional safe harbor for issuers seeking a Regulation D exemption.<sup>126</sup> Rule 508 allows issuers to commit insignificant violations of Regulation D conditions without abdicating any exemptions, so long as the issuers attempt to comply in good faith and no one was harmed by the violation.<sup>127</sup> Rule 508 maintains, however, that general solicitation<sup>128</sup> or exceeding the permissible number of purchasers under Rule 502 cannot be deemed insignificant.<sup>129</sup> The Sixth Circuit Court of Appeals examined the effect

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<sup>120</sup> 17 C.F.R. § 230.502(a). For a discussion of integration, see *supra* notes 97-98 and accompanying text.

<sup>121</sup> 15 U.S.C. § 77e(a) (2006) (making it unlawful to offer or sell unregistered (and non-exempt) securities); *id.* § 77l(a) (2006) (providing civil liabilities for violating the registration requirements of § 5); Warren, *supra* note 82, at 383.

<sup>122</sup> See Preliminary Notes, Regulation D, *supra* note 56 (“Attempted compliance with any rule in Regulation D does not act as an exclusive election; the issuer can also claim the availability of any other applicable exemption. For instance, an issuer’s failure to satisfy all the terms and conditions of Rule 506 shall not raise any presumption that the exemption provided by section 4(2) of the Act is not available.”); S.E.C. v. *Ralston Purina Co.*, 346 U.S. 119, 125-26 (1953).

<sup>123</sup> 1989 Amendments, *supra* note 85, at 11,369; see Sargent, *supra* note 114, at 241-42.

<sup>124</sup> 1989 Amendments, *supra* note 85, at 11,369; see *supra* note 119 and accompanying text.

<sup>125</sup> 17 C.F.R. § 230.507.

<sup>126</sup> *Id.* § 230.508.

<sup>127</sup> See *id.*

<sup>128</sup> See *supra* note 94 and accompanying text.

<sup>129</sup> 17 C.F.R. § 230.508(a)(2); see *id.* § 230.502(c) (regarding limitations on general solicitation); *Pinnacle*, 417 F. Supp. 2d at 1084 (holding that a failure to provide an audited balance sheet to investors that were not “accredited investors” may defeat a Regulation D exemption); *Risdall*, 733 N.W.2d at 829 (stating that any general solicitation will defeat a Regulation D private placement exemption, without regard to whether the general solicitation was intentional or inadvertent).



of Rule 508 in 1992, finding that a sale to non-accredited investors without providing audited financial statements<sup>130</sup> was harmless error under Rule 508 because the investor represented himself as an accredited investor.<sup>131</sup>

### 3. Lessons from “D-regulation”

Although Regulation D did not remedy all problems with the dual regulatory system, it demonstrates certain goals of regulating securities markets in the United States. These include balancing the investor’s need for protection against fraud and risky investments with the market’s need for efficient, cost minimizing procedures; objective, clearly defined rules; and simple, easy to follow provisions.

The dual regulatory structure of securities markets protected investors at the cost of diminished efficiency in capital formation.<sup>132</sup> Section 4(2) of the Securities Act exempted private offerings of securities from registration to reduce the costs and burdens of registration at a minimal risk to investors.<sup>133</sup> While this exemption promoted efficiency in securities markets, the *Ralston* decision illustrates how liberal use of the exemption could threaten investor protections.<sup>134</sup> The regulatory solution, provided by former Rule 146, rendered the conditions for the private offering exemption so subjective as to diminish the utility of the exemption and the efficiency of securities markets.<sup>135</sup> Rule 506 of Regulation D introduced objective conditions, providing issuers a safe harbor to engage in private offerings without fear of losing their exemption.<sup>136</sup> However, the Rule 506 requirements were so complex and unforgiving that it was easy to lose or fail to qualify for the exemption.<sup>137</sup> Finally, the 1989 amendments introduced an additional safe harbor to Regulation D, simplifying the conditions for each of its exemptions and ensuring that no exemption would fail due to harmless error.<sup>138</sup>

#### C. *The National Securities Markets Improvement Act of 1996*

Efficiency, objectivity, and simplicity in securities regulation only become more important as markets expand both domestically and

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<sup>130</sup> See *supra* notes 95 and 116 and accompanying text.

<sup>131</sup> *Wright v. Nat’l Warranty Co.*, 953 F.2d 256, 260-61 (6th Cir. 1992).

<sup>132</sup> See discussion *supra* Part II.C.

<sup>133</sup> 15 U.S.C. § 77d(2); see discussion *supra* Part III.A.

<sup>134</sup> *S.E.C. v. Ralston Purina*, 346 U.S. 119, 125-26; see discussion *supra* note 76 and accompanying text.

<sup>135</sup> 17 C.F.R. § 230.146 (1975) (rescinded 1982); see also Former Rule 146, *supra* note 79, at 15,262; see discussion *supra* notes 80-82 and accompanying text.

<sup>136</sup> See *supra* notes 103-107 and accompanying text.

<sup>137</sup> See *supra* notes 111-122 and accompanying text.

<sup>138</sup> See *supra* notes 123-131 and accompanying text.

internationally. Between 1979 and 1999 alone, the percentage of U.S. households investing in mutual funds increased from 6% to 49%, which may be attributed to the growth and development of retirement funds.<sup>139</sup> In 2005, individual, non-institutional investors poured an estimated \$400 billion or more into hedge funds.<sup>140</sup> At the end of 2007, registered investment companies in the United States controlled over \$12 trillion of investor capital, excluding hedge funds.<sup>141</sup> International capital markets are also expected to expand dramatically in the near future.<sup>142</sup> One need look no further than the recent merger between the NYSE and Euronext securities exchanges,<sup>143</sup> the merger of In Bev and Anheuser Busch,<sup>144</sup> or Abu Dhabi's purchase of the Chrysler building<sup>145</sup> to witness a more liberal global capital market.

Commentators over the past few decades offered different views regarding the viability of the dual regulatory system, given the growth of securities markets. Some argued that duplicative regulation hampered capital formation by requiring costly compliance with multifarious registration and disclosure requirements.<sup>146</sup> Others argued that merit and quality standards, found in many blue sky laws and the Uniform Securities Act,<sup>147</sup> were costly and unnecessary to protect investors.<sup>148</sup> Still, others defended blue sky laws, arguing that such laws offered investors protection against fraud and excessive risk and illustrating how

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<sup>139</sup> S.E.C. DIVISION OF INVESTMENT MANAGEMENT, REPORT ON MUTUAL FUND FEES AND EXPENSES (2000), available at <http://www.sec.gov/news/studies/feestudy.htm> (last visited Oct. 19, 2008).

<sup>140</sup> Hennessee Group, LLC, *Information on Number of Hedge Funds & Assets (Jan-50 to Jan-07)* (2007), available at <http://www.hennesseegroup.com/information/index.html> (last visited July 25, 2008); Hennessee Group, LLC, *Sources of Hedge Fund Capital* (2007), available at <http://www.hennesseegroup.com/information/index.html> (last visited July 25, 2008). This figure is estimated based on data gathered from hedge fund surveys because hedge funds are not required to register with or submit reports to the S.E.C. See Hennessee Group, LLC, *What is a Hedge Fund?* <http://www.hennesseegroup.com/hedgefund/index.html> (last visited July 25, 2008).

<sup>141</sup> INVESTMENT COMPANY INSTITUTE, 2008 INVESTMENT COMPANY FACT BOOK: A REVIEW OF TRENDS AND ACTIVITY IN THE INVESTMENT COMPANY INDUSTRY 20 (48th ed. 2008), available at [http://www.icifactbook.org/pdf/2008\\_factbook.pdf](http://www.icifactbook.org/pdf/2008_factbook.pdf) (last visited Jan. 21, 2009).

<sup>142</sup> See Brian J. Fahrney, *State Blue Sky Laws: A Stronger Case for Federal Pre-Emption Due to Increasing Internationalization of Securities Markets*, 86 NW. U. L. REV. 753, 775-76 (1992).

<sup>143</sup> See generally NYSE Euronext Corporate Press Kit, available at <http://www.nyse.com/about/newsevents/1173781658059.html> (NYSE commenced trading on April 4, 2007); Jenny Anderson & Heather Timmons, *NYSE Group Reaches Deal to Acquire Euronext*, N.Y. TIMES, June 2, 2006, at C3 (noting that the merger between the large, New York-based exchange and the pan-European exchange would create the first trans-Atlantic marketplace for securities).

<sup>144</sup> See generally Anheuser-Busch InBev, InBev and Anheuser Busch Agree to Combine, Creating the Global Leader in Beer with Budweiser as its Flagship Brand (July 13, 2008), <http://www.anheuserbusch.com/Press/PressImages/FINAL%20PRESS%20RELEASE.pdf>.

<sup>145</sup> See generally Charles V. Bagli, *Abu Dhabi Buys 90% Stake in Chrysler Building*, N.Y. TIMES, July 10, 2008, at B3.

<sup>146</sup> See, e.g., Fahrney, *supra* note 142, at 776; Karmel, *supra* note 3, at 106-08.

<sup>147</sup> See *supra* note 43 and accompanying text.

<sup>148</sup> See, e.g., Rutherford B. Campbell, Jr., *An Open Attack on the Nonsense of Blue Sky Regulation*, 10 J. CORP. L. 553, 566 (1985) (arguing that merit regulation of securities is antithetical to a market economy); Fahrney, *supra* note 142, at 765-66 (noting that merit review adds to the state's administrative fees and the issuer's legal and accounting fees).

such laws allowed inexperienced investors to perform as well as experienced investors.<sup>149</sup> Another commentator urged that blue sky laws provide necessary disclosures to investors that federal disclosures would not reveal.<sup>150</sup> Federal policy would reflect the arguments in favor of a singular regulatory system.

In 1996, Congress passed NSMIA, which limited the applicability of blue sky laws to improve the efficiency of national securities markets.<sup>151</sup> The introduction to NSMIA heralds the intent of the statute, “[t]o amend the Federal securities laws in order to promote efficiency and capital formation in the financial markets, and to . . . promote more efficient management of mutual funds, protect investors, and provide more effective and less burdensome regulation.”<sup>152</sup> The House Commerce Committee report, accompanying House Resolution 2003 (NSMIA), reiterated this contention,<sup>153</sup> and further recognized the need to modify the dual-regulatory system:

Testimony demonstrated a clear need for modernization and indicated that, notwithstanding past reform efforts, there continues to be a substantial degree of duplication between Federal and State securities regulation, and that this duplication tends to raise the cost of capital to American issuers of securities without providing commensurate protection to investors or our markets.<sup>154</sup>

Accordingly, NSMIA federalized registration and disclosure requirements for certain offerings involving “covered securities,” as defined in the act.<sup>155</sup> States are not only prohibited from requiring registration or disclosures for these “covered securities,” but also from prohibiting or regulating the sale of such securities based on their merit or quality.<sup>156</sup>

The term “covered securities,” as defined under NSMIA, encompasses a broad array of securities.<sup>157</sup> “Covered securities” includes securities traded on national exchanges like the NYSE, the AMEX, and

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<sup>149</sup> See, e.g., Lane, *supra* note 26, at 338, 347-48 (arguing that local authorities can best enforce securities regulation and that state authority should be balanced with federal authority, not abrogated); Walker & Hadaway, *supra* note 23, at 681 (finding that inexperienced investors in merit-regulating states have performed as well as experienced investors elsewhere).

<sup>150</sup> See Sargent, *supra* note 52, at 1056-59.

<sup>151</sup> See NSMIA, Pub. L. No. 104-290, 110 Stat. 3416, 3416 (1996).

<sup>152</sup> *Id.*

<sup>153</sup> H.R. REP. NO. 104-622, at 1 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3877.

<sup>154</sup> *Id.* at 2, *reprinted in* 1996 U.S.C.C.A.N. 3877, 3878. “Covered securities” encompass (1) securities traded on national exchanges, (2) securities sold by investment companies registered under the Investment Company Act of 1940, (3) securities sold to “qualified purchasers,” as yet undefined, and (4) certain securities sold in exempt offerings. See Kevin A. Jones, *The National Securities Markets Improvement Act of 1996: A New Model for Efficient Capital Formation*, 53 ARK. L. REV. 153, 156-64 (2000).

<sup>155</sup> See 15 U.S.C. §§ 77r(a)(1)-(2), (b)(4) (2006).

<sup>156</sup> See *id.* §§ 77r(a)(1)-(3).

<sup>157</sup> See H.R. REP. NO. 104-622, at 3877.

the NASDAQ Stock Market.<sup>158</sup> All securities issued by registered investment companies (e.g., most mutual fund shares) are “covered securities” as well.<sup>159</sup> A third category of “covered securities” encompasses securities sold to “qualified purchasers,” a term that the S.E.C. has not yet defined and gives the S.E.C. considerable authority to expand the scope of NSMIA.<sup>160</sup> Finally, “covered securities” includes securities sold in certain offerings exempt from federal registration.<sup>161</sup>

The problems of interpretation raised in this Note concern primarily the fourth and final category of “covered securities,” which includes securities qualifying for the regulatory private offering exemption under Regulation D Rule 506.<sup>162</sup> As indicated earlier, § 4(2) of the Securities Act provides a *statutory* private placement exemption covering any transaction that does not involve a “public offering,” but the statutory exemption employs a highly subjective test.<sup>163</sup> Rule 506 provides a set of objective conditions that would allow an issuer to qualify for a *regulatory* private offering exemption.<sup>164</sup> NSMIA extends the policy of exemption to state regulators because investors in a Rule 506 private offering are, by definition, accredited<sup>165</sup> or otherwise capable of making informed investment decisions without the protection of government.<sup>166</sup> In addition to securities qualifying for the Rule 506 exemption, “covered securities” include securities satisfying certain exemptions: (1) the exemption for transactions by one who is not an issuer, underwriter, or dealer,<sup>167</sup> (2) the exemptions for certain

<sup>158</sup> 15 U.S.C. § 77r(b)(1)(A); *see also* Jones, *supra* note 154, at 156.

<sup>159</sup> 15 U.S.C. § 77r(b)(2); *see also* Jones, *supra* note 154, at 157.

<sup>160</sup> 15 U.S.C. § 77r(b)(3); *see also* Jones, *supra* note 154, at 158-59. Although the Commission has not adopted a formal definition of “qualified purchaser” to date, the Commission has proposed that an appropriate definition would be similar, if not identical, to that of a Rule 501 “accredited investor.” *See* Defining the Term “Qualified Purchaser” Under the Securities Act of 1933, 17 C.F.R. § 230 (proposed Dec. 19, 2001), *available at* <http://www.sec.gov/rules/proposed/33-8041.htm> [hereinafter *Qualified Purchaser*].

<sup>161</sup> 15 U.S.C. § 77r(b)(4); *see also* Jones, *supra* note 154, at 162 (summarizing these securities as “certain government and bank securities, securities issued by certain pension, profit-sharing and similar plans, notes having a maturity of less than nine months, interests in railroad equipment trusts, certain certificates issued in a case under Title 11, and certain insurance, endowment, or annuity contracts”).

<sup>162</sup> 15 U.S.C. § 77r(b)(4)(D) (“covered security” includes any security exempt from federal registration under any S.E.C. rule issued under the Securities Act § 4(2), the private offering exemption).

<sup>163</sup> *See* 15 U.S.C. § 77d(2); *see supra also* notes 73-82 and accompanying text.

<sup>164</sup> *See* 17 C.F.R. § 230.506; *see also supra* notes 103-110 and accompanying text.

<sup>165</sup> *See supra* notes 91-92 and accompanying text.

<sup>166</sup> *See* Jones, *supra* note 154, at 163.

<sup>167</sup> 15 U.S.C. § 77d(1); *id.* § 77r(b)(4)(A). An issuer is one who issues securities. BLACK’S LAW DICTIONARY 850 (8th ed. 2004). An underwriter is usually an investment banker that purchases securities from the issuer and resells the securities to the public. *Id.* at 1562. A dealer is one who buys securities and sells them at retail. *Id.* at 427. For the statutory definitions of the terms “issuer,” “underwriter,” or “dealer,” *see* 15 U.S.C. §§ 77b(4), (11)-(12) (2006). This exemption applies to trades by investors selling securities already issued, trades in the secondary securities market, which are regulated under the Securities Exchange Act of 1934. *See* 79A C.J.S. *Securities Regulation* § 63 (2007); *see also* Jones, *supra* note 154, at 159-60.

transactions by dealers and brokers,<sup>168</sup> and (3) the various exemptions allowed under § 3(a) for securities like federal bonds, insurance policies, and commercial paper.<sup>169</sup>

However, Congress has not abrogated all of the states' regulatory functions. NSMIA does not preclude states from prosecuting securities fraud, thereby preserving the principal function and purpose of blue sky laws.<sup>170</sup> The act also permits states to require notice of offers and sales, payment of fees, and the disclosure of certain other information for the purposes of collecting fees and consenting to service of process.<sup>171</sup> Finally, "covered securities" does not include all securities,<sup>172</sup> and it specifically excludes certain types of securities.<sup>173</sup>

#### IV. THE PRIVATE PLACEMENT PREEMPTION STANDARD UNDER NSMIA

Like Regulation D in 1982, NSMIA was not adopted without its flaws. Indeed, the definition of "covered securities" was amended in 1998 to prevent NSMIA from preventing state courts from ruling on the fairness of mergers and reorganizations, in which shares are commonly exchanged for other shares without registration.<sup>174</sup> Additionally, courts in several state and federal jurisdictions have been unable to agree on a preemption standard under NSMIA for securities qualifying for the Rule 506 private offering exemption.<sup>175</sup> It is not clear whether Congress

<sup>168</sup> See 15 U.S.C. §§ 77d(3)-(4); *id.* §§ 77r(b)(4)(A)-(B). The "dealer" exemption applies to all transactions made by a securities dealer—one who buys and sells securities, usually on the secondary market—except when that dealer is trading as an "underwriter"—one who buys unregistered securities from the issuer with the intent to resell to the public. BLACK'S LAW DICTIONARY 427, 1562 (8th ed. 2004); *see also* Jones, *supra* note 154, at 159-60 & nn.42-43.

The "broker" exemption applies to all transactions by a securities broker—one who buys and sells securities on behalf of someone else—when that broker is merely selling securities based on a customer's order. BLACK'S LAW DICTIONARY 206 (8th ed. 2004); *see also* Jones, *supra* note 154, at 160-61 & n.47.

<sup>169</sup> See 15 U.S.C. § 77c(a) (2006). Not all exemptions found under Securities Act of 1933 § 3(a) are "covered securities" under NSMIA. For example, NSMIA excludes those securities qualifying for the intrastate offering exemption, 15 U.S.C. § 77c(a)(11), and the exemption for charitable and not-for-profit issuers, *id.* § 77c(a)(4). *Id.* § 77r(b)(4)(C); *see also* Jones, *supra* note 154, at 162.

"Covered securities" was later amended to exclude securities exchanged pursuant to a government-approved fairness hearing. *See* Div. Corp. Fin., S.E.C., Revised Staff Legal Bulletin No. 3: Section 3(a)(10) Exemption (Oct. 20, 1999), *available at* <http://www.sec.gov/interps/legal/cfs1b3r.htm>. Such securities are exempt from federal registration under Securities Act § 3(a) if a court has already determined that the transaction is fair to investors. *See* 15 U.S.C. § 77c(a)(10). This corrected the unintended effect of NSMIA preempting a state court from ruling on the fairness of an exchange of securities during a merger or other corporate reorganization. *See* Revised Staff Legal Bulletin No. 3, *supra*.

<sup>170</sup> See 15 U.S.C. § 77r(c)(1); *see also* Jones, *supra* note 154, at 164.

<sup>171</sup> See 15 U.S.C. § 77r(c)(2)(A); *see also* Jones, *supra* note 154, at 164-65.

<sup>172</sup> *See supra* notes 157-162 and accompanying text.

<sup>173</sup> For securities specifically excluded from "covered securities," *see supra* note 169.

<sup>174</sup> *See supra* note 169 and accompanying text.

<sup>175</sup> *Compare* Buist v. Time Domain Corp., 926 So. 2d 290, 298 (Ala. 2005) (holding that proof of a Regulation D exemption is required before the issuer is exempt from state regulation

intended the preemption provision of NSMIA to be applied narrowly—only if the issuer can prove that the security qualifies for the private offering exemption—or broadly—preempting blue sky law for all securities offered pursuant to the private offering exemption. As Chief Judge Babcock of the Colorado District Court phrased the issue, must an issuer “prove preemption by proving exemption?”<sup>176</sup>

Subsection A will discuss the problem of determining Congress’ intent with respect to the breadth of blue sky law preemption under NSMIA. Subsection B will examine the narrow preemption standard for private offerings: NSMIA preempts state regulation private offerings only if the issuer can first prove that the Rule 506 private offering exemption applies.<sup>177</sup> Subsection C will evaluate the broad preemption standard for private offerings under NSMIA: NSMIA broadly preempts blue sky laws for any securities offered pursuant to Rule 506. Proponents of this standard asseverate that Congress intended for national securities offerings to be regulated exclusively by federal law, including securities sold pursuant to a federal exemption, even if the federal exemption is invalid.<sup>178</sup>

#### A. *Preemption of State Law and the Private Offering Exemption*

Although NSMIA preempts blue sky laws regulating several types of securities and transactions, securities sold in private offerings present a special case for the application of NSMIA’s preemption rules. The primary purpose of NSMIA is to improve the efficiency of capital formation in national securities markets, without undermining the protection of investors.<sup>179</sup> The legislative history further suggests that NSMIA would improve efficiency and reduce the cost of capital formation by federalizing securities regulation.<sup>180</sup> Accordingly, NSMIA prohibits states from requiring registration, disclosure, or merit review for certain “covered securities” like those traded in private offerings.<sup>181</sup> This history suggests that Congress intended for the federal government to regulate Rule 506 private offerings exclusively. However, it is not clear whether exclusive regulation of private offerings includes the

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under NSMIA), *with* *Risdall v. Brown-Wilbert, Inc.*, 733 N.W.2d 827, 832 (Minn. Ct. App. 2007) (holding that NSMIA preempts blue sky law regulating any securities offered in reliance upon the regulatory private offering exemption of Rule 506).

<sup>176</sup> See *Grubka v. WebAccess Int’l Inc.*, 445 F. Supp. 2d 1259, 1269 (D. Colo. 2006) (holding that the issuer must prove the exemption in order to prove that state law was preempted under NSMIA).

<sup>177</sup> *E.g.*, *Brown v. Earthbound Sports USA, Inc.*, 481 F.3d 901, 910 (6th Cir. 2007) (“We now agree with those courts that have held that offerings must actually qualify for a valid federal securities registration exemption in order to enjoy NSMIA preemption.”).

<sup>178</sup> *E.g.*, *Risdall*, 733 N.W.2d at 832 (“[W]hen an offering purports to be exempt under federal Regulation D, any allegation of improper registration is covered exclusively by federal law.” (quoting *Pinnacle Commc’ns Int’l Inc. v. Am. Family Mortgage Corp.*, 417 F. Supp. 2d 1073, 1087 (D. Minn. 2006))).

<sup>179</sup> See NSMIA, *supra* note 151, at 3416; see also *supra* notes 151-154 and accompanying text.

<sup>180</sup> See H.R. REP. NO. 104-622, at 16 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3878.

<sup>181</sup> See 15 U.S.C. §§ 77r(a)(1)-(3) (2006).

exclusive imposition of federal remedies when such purportedly private offerings fail to satisfy Rule 506.

The narrow preemption standard stems from a strict, textualist interpretation of the Act. Section 18 of the Securities Act of 1933, as amended by NSMIA, provides unambiguously that only “exempt” securities are “covered securities” under NSMIA:

(a) Scope of exemption. Except as otherwise provided in this section, no law, rule, regulation, or order, or other administrative action of any State or any political subdivision thereof—

(1) requiring, or with respect to, registration or qualification of securities, or registration or qualification of securities transactions, shall directly or indirectly apply to a security that—

(A) is a covered security; or

(B) will be a covered security upon completion of the transaction;

....

(b) Covered securities. For purposes of this section, the following are covered securities:

....

(4) Exemption in connection with certain exempt offerings.—A security is a covered security with respect to a transaction that is exempt from registration under this subchapter pursuant to—

....

(D) Commission rules or regulations issued under section 77d(2) of this title, 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 77d(2) of this title that are in effect on September 1, 1996.<sup>182</sup>

Subsection (b)(4)(D) refers to “rules or regulations issued under section [4](2).”<sup>183</sup> Rule 506 of Regulation D provides, in relevant part:

(a) Exemption. Offers and sales of securities by an issuer that satisfy the conditions in paragraph (b) of this section shall be deemed to be transactions not involving any public offering within the meaning of section 4(2) of the Act.<sup>184</sup>

When NSMIA is read in light of Rule 506, the use of the word “exempt” in subsection (b)(4)(D) suggests that NSMIA will only

<sup>182</sup> *Id.* §§ 77r(a)-(b) (emphasis in subsection 18(b)(4) added).

<sup>183</sup> *Id.* § 77r(b)(4)(D).

<sup>184</sup> 17 C.F.R. § 230.506.

preempt blue sky law from regulating private offerings if such offerings actually satisfy the terms of Rule 506.<sup>185</sup>

NSMIA's preemption standard is more difficult to apply with a Rule 506 private offering than with any other covered security under NSMIA because it is relatively easy to identify other types of covered securities.<sup>186</sup> For example, NSMIA exempts from state regulation all securities sold on national exchanges, federal bonds, and mutual fund shares,<sup>187</sup> but these covered securities are readily identifiable, without complicated inquiry or extensive investigation.

Additionally, the issue of whether one must "prove preemption by proving exemption"<sup>188</sup> does not arise with most transactions exempt from state regulations under NSMIA. The § 4(1) exemption for transactions by those who are not issuers, underwriters, or dealers ordinarily covers average investor transactions in the secondary market without causing undue confusion.<sup>189</sup> The §§ 4(3) and 4(4) exemptions for dealer and broker transactions are simple to apply in most cases because almost all dealer transactions are exempt and broker transactions are exempt if the broker is merely placing a client's order on an exchange or over-the-counter market.<sup>190</sup> One difficulty that may arise in keeping these § 4 exemptions is avoiding status as an "underwriter," one who acquires a security from an issuer with the intent to distribute it to the public.<sup>191</sup> However, even if a case were to arise, challenging NSMIA preemption based on the failure of one of these § 4 exemptions, Rule 144 of the Securities Act provides a safe harbor against underwriter status with an objective set of conditions.<sup>192</sup>

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<sup>185</sup> For a discussion of the terms of Rule 506, see *supra* Part III.B.2.

<sup>186</sup> *But see supra* note 160 and accompanying text (defining the class of "covered securities" as those securities sold to "qualified purchasers"). Depending on how the Commission eventually defines this term, an issue similar to the one analyzed in this Note may arise.

<sup>187</sup> See 15 U.S.C. § 77r(b)(1), (b)(4)(C).

<sup>188</sup> *Grubka v. WebAccess Int'l Inc.*, 445 F. Supp. 2d 1259, 1269 (D. Colo. 2006).

<sup>189</sup> 15 U.S.C. § 77d(1); see Preliminary Note, 17 C.F.R. § 230.144 (2007) ("Section 4(1) was intended to exempt only routine trading transactions between individual investors with respect to securities already issued and not to exempt distributions by issuers or acts of other individuals who engage in steps necessary to such distributions."); see *supra* note 167 and accompanying text.

<sup>190</sup> See 15 U.S.C. §§ 77d(1)-(3); see also *Jones, supra* note 154, at 159-60; see *supra* note 168 and accompanying text.

<sup>191</sup> See 15 U.S.C. § 77b(a)(11); Preliminary Note, 17 C.F.R. § 230.144; see also 15 U.S.C. § 77d(1) (stating that a seller who qualifies as an underwriter is not exempt from the registration requirements of the Securities Act).

<sup>192</sup> See 17 C.F.R. § 230.144(1)-(3); see *Jones, supra* note 154, at 159-60. Under Rule 144, dealers and investors holding unregistered securities can avoid underwriter status by ensuring that there is adequate public information on the security they are selling, holding the security for at least a year before selling, limiting the number of shares sold, and selling the securities in broker transactions, all within the terms of Rule 144. 17 C.F.R. § 230.144(c)-(f). Brokers can avoid being considered underwriters by trading only upon client orders, refusing to solicit sales of the securities, collecting fees at a standard rate for each transaction, and asking clients a few questions about the nature of the securities. See *id.* § 230.144(g).



In contrast, determining whether a security is exempt from registration under Rule 506 requires a much more complicated inquiry.<sup>193</sup> As previously discussed, the issuer must inquire as to each of purchaser's knowledge and finances, to provide such financial and non-financial information to certain purchasers that the issuer would have prepared for certain registration statements, and to avoid making any public statement that may be considered an impermissible general solicitation.<sup>194</sup>

Moreover, a Rule 506 private offering exemption can be transitory, in that certain conditions after the completion of the offering may abrogate the exemption retroactively.<sup>195</sup> Regulation D "integrates" certain offers made within six months of each other and treats them as a single offer,<sup>196</sup> such that a later, non-exempt offer may void an earlier offer's exemption.<sup>197</sup> An issuer who fails to qualify for a Rule 506 exemption might not discover the failure of the exemption until much later because the veracity of private offering exemptions is often tested for the first time in court.<sup>198</sup>

The greater degree of uncertainty appurtenant to every private offering under Rule 506 begs the question whether the conditions for preemption should be as elusive and convoluted as the conditions for exemption. To answer this question affirmatively is to advance the public policy of protecting investors. To resolve this issue by relaxing the conditions for preemption is to effect a more unitary and efficient securities market. Any resolution, however, must be driven by S.E.C. regulation. Courts have not resolved this issue uniformly,<sup>199</sup> which only further undermines the efficiencies NSMIA was intended to introduce.<sup>200</sup>

#### B. *Narrow Construction of NSMIA's Preemption Provision*

Some courts have held that an issuer claiming a regulatory private placement exemption under Rule 506 is not exempt from state law unless the issuer proves the validity of the private offering

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<sup>193</sup> See 17 C.F.R. § 230.506; see also discussion *supra* Part III.B.2.

<sup>194</sup> See *supra* Part III.B.2.

<sup>195</sup> See, e.g., *Buist v. Time Domain Corp.*, 926 So. 2d 290, 297-98 (Ala. 2005) ("Even if the filing of a Form D is sufficient to obtain the exemption necessary for a finding of federal preemption, proof that an exemption was obtained is no evidence that the exemption exists at any later date . . .").

<sup>196</sup> See *supra* notes 97-98 and accompanying text (The integration requirement under Regulation D applies to each of the Regulation D exemptions.).

<sup>197</sup> See *S.E.C. v. Melchior*, No. 90-C-1024J, 1993 WL 89141, at \*9 (D. Utah Jan. 14, 1993).

<sup>198</sup> *Pinnacle Commc'ns Int'l Inc. v. Am. Family Mortgage Corp.*, 417 F. Supp. 2d 1073, 1086-87 (D. Minn. 2006) (Rule 506 exemption threatened more than two years after the initial offering because the issuer named two non-accredited investors on its Form D filing, allegedly due to a clerical error that was later corrected).

<sup>199</sup> Compare *Hamby v. Clearwater Consulting Concepts, LLLP*, 428 F. Supp. 2d 915, 921 (E.D. Ark 2006), with *Temple v. Gorman*, 201 F. Supp. 2d 1238, 1243-44 (S.D. Fla. 2002).

<sup>200</sup> H.R. REP. NO. 104-622, at 16 (1996), reprinted in 1996 U.S.C.C.A.N. 3877, 3878 (1996).

exemption.<sup>201</sup> The U.S. District Court for the Southern District of Florida was the first federal court to decide this issue in 2002, adopting a more liberal interpretation of the NSMIA preemption rules.<sup>202</sup> In *Temple v. Gorman*, the Florida court reasoned that Congress intended to make the federal government the exclusive regulator for national securities offerings.<sup>203</sup>

However, since that time, the weight of authority has been tipped overwhelmingly toward a narrow construction of the NSMIA preemption provision, based on a textualist reading of the statute.<sup>204</sup> The first court to disagree with the *Temple* standard was the Alabama Supreme Court in *Buist v. Time Domain Corp.*<sup>205</sup> In that case, after an allegedly unfair reorganization, a minority shareholder sought rescission based on the corporate issuer's failure to register the securities in Alabama.<sup>206</sup> Although the company had completed the offering and indicated that the offering was subject to the Rule 506 exemption on its Form D,<sup>207</sup> the Court held that the company needed to prove that the securities were exempt under Rule 506 when issued and continued to qualify for the exemption:

[F]ailure to comply with a requirement of Rule 506 "voids" the exemption, thereby eliminating the possibility of preemption . . . . [T]he exempt status of the sale of securities that deviates from any of the material commitments made in its Form D filing is repealed retroactively.<sup>208</sup>

The *Buist* court dismissed the preemption standard adopted by the Florida District Court as unsubstantiated, without any authority.<sup>209</sup>

Other courts were quick to follow at both the state and federal levels. The Colorado Federal District Court later held in *Grubka v. WebAccess* that the statute unambiguously requires proof of the Rule 506 exemption before a finding of state law preemption.<sup>210</sup> The federal court in *Grubka* notably followed the Alabama state court's decision in *Buist*,<sup>211</sup> and not the Florida Federal District Court's in *Temple*.<sup>212</sup> An Ohio appellate court adopted the *Buist* court's preemption standard,<sup>213</sup> as

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<sup>201</sup> See *Brown v. Earthbound Sports USA, Inc.*, 481 F.3d 906, 911-12 (6th Cir. 2007).

<sup>202</sup> *Temple*, 201 F. Supp. 2d at 1243-44.

<sup>203</sup> *Id.* at 1244.

<sup>204</sup> See *Brown*, 481 F.3d at 909-10; *Grubka v. WebAccess Int'l Inc.*, 445 F. Supp. 2d 1259, 1270 (D. Colo. 2006); *Hamby*, 428 F. Supp. 2d at 921; *In re Blue Flame Energy Corp.*, 871 N.E.2d 1227, 1244 (Ohio Ct. App. 2006); *Buist v. Time Domain Corp.*, 926 So. 2d 290, 298 (Ala. 2005).

<sup>205</sup> 926 So. 2d at 297.

<sup>206</sup> See *id.* at 292-93.

<sup>207</sup> *Id.* at 292. For a discussion of Form D, see *supra* notes 119-122 and accompanying text.

<sup>208</sup> *Buist*, 926 So. 2d at 298.

<sup>209</sup> See *id.* at 297.

<sup>210</sup> *Grubka v. WebAccess Int'l, Inc.*, 445 F. Supp. 2d 1259, 1270 (D. Colo. 2006) (finding that NSMIA unambiguously requires an exemption before the statute will preempt state law and that it is unnecessary to turn to legislative history for the intent of Congress).

<sup>211</sup> *Buist*, 926 So. 2d at 298.

<sup>212</sup> *Temple v. Gorman*, 201 F. Supp. 2d 1238, 1244 (S.D. Fla. 2002).

<sup>213</sup> *In re Blue Flame Energy Corp.*, 871 N.E.2d 1227, 1244 (Ohio Ct. App. 2006).

did a California appellate court in a recent case.<sup>214</sup> The U.S. Court of Appeals for the Sixth Circuit, the highest court to review the relevant authority on this issue, also held that preemption was predicated on proof of a valid exemption.<sup>215</sup> In rejecting the holding in *Temple*, the court reasoned that:

[Those suggesting a broad preemption standard] urge us to avert our eyes from the statute's plain language and look instead to legislative intent as supposedly espoused by the gloss on which they . . . rely. But resorting to legislative history is always a risky endeavor, subject to manipulation by individual legislators and by simple mistakes of fact by the courts.<sup>216</sup>

The narrow preemption standard is easily supported by the statute and prevents possible abuse of NSMIA. Requiring some proof that the security is exempt, and therefore a covered security, prevents issuers from circumventing state law investor protections by claiming a Rule 506 exemption in offering documents, or even claiming the exemption *ex post*.<sup>217</sup> "Such an intent seems unlikely, in any event; that a defendant could avoid liability under state law simply by declaiming its alleged compliance with Regulation D is an unsavory proposition and would eviscerate the statute."<sup>218</sup>

However, there are practical problems with the narrow preemption standard. NSMIA preempts state registration and merit regulation of exempt private offerings,<sup>219</sup> and the Rule 506 private offering exemption may be lost retroactively.<sup>220</sup> Under the narrow preemption standard, issuers would only have to prove a private offering exemption to the states after the offering, when an investor raises the issue of NSMIA preemption.<sup>221</sup> This means that states do not actually regulate securities offered pursuant to Rule 506. Instead, the validity of the Rule 506 exemption only determines whether each individual state is allowed to impose remedies for failing to register the non-exempt security. This provides little, if any, additional protection to investors.

Second, the uncertainty of preemption eviscerates the economies that normally inhere in preemption because it gives issuers an incentive to register private offerings with the states, instead of relying on

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<sup>214</sup> *Apollo Capital Fund, LLC v. Roth Capital Partners, LLC*, 70 Cal. Rptr. 3d 199, 220 (Cal. Ct. App. 2007) (accepting the 6th Circuit's decision in *Brown* as the strongest authority on this issue, given the line of cases criticizing the holding in *Temple*).

<sup>215</sup> *See Brown v. Earthbound Sports USA, Inc.*, 481 F.3d 901, 912 (6th Cir. 2007).

<sup>216</sup> *Id.*

<sup>217</sup> *See COHN*, *supra* note 18, § 6:24.50.

<sup>218</sup> *Grubka v. WebAccess Int'l, Inc.*, 445 F. Supp. 2d 1259, 1270 (D. Colo. 2006).

<sup>219</sup> *See supra* Part III.C.

<sup>220</sup> Warren, *supra* note 82, at 383; *see supra* notes 195-198 and accompanying text.

<sup>221</sup> An issuer is required to file a Form D notice of sale with the S.E.C. and the state when conducting a private offering. 17 C.F.R. §§ 230.503, .507 (2008). Form D does not require proof that the Rule 506 exemption is valid. *See* S.E.C., Form D, <http://www.sec.gov/about/forms/formd.pdf> (last visited Oct. 20, 2008).

preemption. This result undermines the purpose of NSMIA, to make national securities markets simpler and more efficient by federalizing regulation.<sup>222</sup>

Finally, although blue sky laws largely provide the same rescission remedy as federal law—forcing the issuer to return all amounts purchasers paid for the securities, plus interest—the state laws provide other remedies, which may amount to greater expenses to issuers than under federal law.<sup>223</sup> For example, the Uniform Securities Act provides for payment of costs and attorneys fees for failure to register securities under state law, but the remedies under the Securities Act do not.<sup>224</sup> Several states have adopted the Uniform Securities Act’s model remedies.<sup>225</sup> The imposition of different remedies by different states for a failure to satisfy the Rule 506 conditions increases the costs of ensuring legal compliance of private offerings, encourages unnecessary and purely prophylactic registration, and undermines much of the efficiency and simplicity NSMIA purported to introduce to securities markets.

### C. *Broad Construction of NSMIA’s Preemption Provision*

The broad construction of NSMIA’s preemption provision for private offerings is more consistent with the purpose of NSMIA and other securities regulations in achieving efficiency, objectivity, and, simplicity.<sup>226</sup> Under the broad preemption standard, an issuer commencing a private offering pursuant to Rule 506 obtains the benefit of preemption simply by claiming the exemption in their offering documents.<sup>227</sup> Some courts have held that blue sky laws are preempted once the issuer files Form D, the notice of sale pursuant to Regulation D.<sup>228</sup>

Florida’s Southern District Court turned to the legislative intent to glean the appropriate preemption standard.<sup>229</sup> The issuer in *Temple v. Gorman* sold shares of an online retailer to 112 investors in a Rule 506 private offering.<sup>230</sup> After the collapse of technology stocks between 1999 and 2001, purchasers sought rescission of their purchases and sued the

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<sup>222</sup> See *supra* Part III.C.

<sup>223</sup> Compare 15 U.S.C. § 771(a)(2) (2006), with UNIF. SEC. ACT § 509 (2002), available at <http://www.uniformsecuritiesact.org/usa/DesktopDefault.aspx?tabindex=2&tabid=48>.

<sup>224</sup> UNIF. SEC. ACT § 509(1).

<sup>225</sup> See, e.g., ARK. CODE ANN. § 23-42-106(a)(1) (West 2000); MICHIGAN COMP. LAWS. ANN. § 451.810 (West 2002).

<sup>226</sup> See *supra* Part III.

<sup>227</sup> See *Risdall v. Brown-Wilbert, Inc.*, 733 N.W.2d 827, 832 (Minn. Ct. App. 2007) Neither the parties in their brief nor the court in its opinion acknowledged whether the issuer properly filed Form D; the issue of preemption turned only on whether the issuer claimed the exemption in its private placement memorandum. *Id.*

<sup>228</sup> See *Pinnacle Commc’ns Int’l, Inc. v. Am. Family Mortgage Corp.*, 417 F. Supp. 2d 1073, 1087 (D. Minn. 2006); *Temple v. Gorman*, 201 F. Supp. 2d 1238, 1243-44 (S.D. Fla. 2002). For a discussion of Form D, see *supra* notes 119-122 and accompanying text.

<sup>229</sup> *Temple*, 201 F. Supp. 2d at 1243; see also H.R. REP. NO. 104-622, at 16 (1996), reprinted in 1996 U.S.C.A.N. 3877, 3878 (stating that NSMIA’s purpose is to federalize securities markets).

<sup>230</sup> *Temple*, 201 F. Supp. 2d at 1239-40.

issuer for failing to register under Florida's blue sky laws.<sup>231</sup> The court cited Congressional Reports, in which the House Commerce Committee stated it "intends that the section 4(2) exemption from State regulation facilitate private placement of securities consistent with the public interest and the protection of investors."<sup>232</sup> Because the issuer had filed Form D and had issued the securities pursuant to Rule 506, the court held that the state could not demand a separate registration statement.<sup>233</sup>

When the Florida District Court decided *Temple*, few doubted that Congress intended to provide expansive preemption in order to assume exclusive regulatory authority over national securities markets. The Second Circuit, in *Lander v. Hartford Life & Annuity Ins. Co.*, noted that NSMIA and the Securities Litigation Uniform Standards Act of 1998 ("SLUSA")—which requires certain class action securities fraud cases to be litigated in federal courts<sup>234</sup>—are part of a common scheme to federalize regulation of certain nationally traded securities.<sup>235</sup> One article from 1998 lamented the extinction of the blue sky lawyer, stating "[t]he chief cause of the decreased workload [for lawyers specializing in blue sky law] was the Congressional passage in 1996 of the National Securities Markets Improvement Act (NSMIA). The legislation transferred the lion's share of responsibility for securities regulation from individual states to the federal government."<sup>236</sup>

Many courts have also adopted a broad preemption standard. The North Dakota Federal District Court in *Lillard v. Stockton* agreed with the preemption standard established in *Temple* but had little other authority available.<sup>237</sup> The District Court of Minnesota also adopted the broad preemption standard in *Pinnacle Communications International, Inc. v. American Family Mortgage Corp.*, citing, as the court in *Temple*, the intent of the legislature.<sup>238</sup> Most recently, a Minnesota appellate court adopted the broad preemption standard in *Risdall v. Brown-Wilbert, Inc.*<sup>239</sup> However, the *Risdall* court cited policy reasons for adopting broad preemption: federal courts interpreting federal law are better at deciding the issue of whether a Regulation D exemption is valid.<sup>240</sup> In other words,

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<sup>231</sup> See *id.* at 1240.

<sup>232</sup> *Id.* at 1243 (quoting H.R. REP. NO. 104-622, at 3894-95).

<sup>233</sup> *Id.* at 1244.

<sup>234</sup> Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227, 3228 (1998) (codified as amended at 15 U.S.C. 77p(b) (2006)).

<sup>235</sup> See *Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 108 (2d Cir.2001) (holding that a class action against a seller of variable annuity contracts must be brought in federal court under SLUSA).

<sup>236</sup> Horowitz, *supra* note 1. The article further suggests that, in order for blue sky lawyers to maintain their practices, they must change their focus or try to manufacture new issues. See *id.*

<sup>237</sup> 267 F. Supp. 2d 1081, 1116 (N.D. Okla. 2003) (disposing of the issue without deeper analysis because plaintiffs failed to respond to the argument that NSMIA preempted their state law claims).

<sup>238</sup> 417 F. Supp. 2d 1073, 1087 (D. Minn. 2006).

<sup>239</sup> See 733 N.W.2d 827, 832 (Minn. Ct. App. 2007).

<sup>240</sup> See *id.*

the broad preemption standard not only improves market efficiency, but also promotes judicial economy by barring multifarious pronouncements on Rule 506 and NSMIA from state-court judges.<sup>241</sup>

While the broad preemption standard admittedly contradicts the plain language of the statute, it does not follow that Congress or the S.E.C. intended for NSMIA's preemption provision for private offerings to be applied so narrowly. Congress left much to the discretion of the S.E.C. and purposefully included several lacunae for the S.E.C. to fill in order to best protect the interests of investors.<sup>242</sup> Moreover, the legislative history is replete with references to acts by the commission to clarify the meaning of the act.<sup>243</sup>

Accordingly, the Sixth Circuit's argument in *Brown* that the S.E.C. imposed the Rule 506 conditions as a requirement of preemption is weak at best.<sup>244</sup> While it is true that the S.E.C. has broad authority to define the breadth of the term "covered security,"<sup>245</sup> the S.E.C. did not adopt Regulation D for the purpose of defining a class of "covered securities" to be exempt from blue sky laws. Congress defined "covered security" to include private offerings subject to preexisting and future regulatory exemptions.<sup>246</sup> However, the S.E.C. tailored Rule 506 to facilitate compliance with the § 4(2) statutory private offering exemption,<sup>247</sup> not to be a workable litmus test for preempting state securities law. The S.E.C. has yet even to define sales to "qualified purchasers," an entire class of "covered securities," which Congress provided specifically for the S.E.C. to define.<sup>248</sup>

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<sup>241</sup> See *id.*

<sup>242</sup> See 15 U.S.C. § 77r(b)(3) (Supp. 2008) (providing statutory permission for the Commission to define the term "qualified purchaser" at its own discretion, to mold at it sees fit); 15 U.S.C. § 77r(b)(4)(D) (allowing an exemption for any Commission rule promulgated under § 4(2)).

<sup>243</sup> See S. Rep. 104-293, at 15 (1996) ("The Committee recognizes that the rapidly changing marketplace dictates that effective regulation requires a certain amount of flexibility. Accordingly, the bill grants the SEC general exemptive authority under both the Securities Act and the Securities Exchange Act. This exemptive authority will allow the Commission the flexibility to explore and adopt new approaches to registration and disclosure. It will also enable the Commission to address issues related to the securities markets more generally.")

<sup>244</sup> The Sixth Circuit asseverates that the language of NSMIA's preemption provision best reflects legislative intent:

[F]ar from defining "covered securities" in a manner that generally incorporates all securities, the SEC has promulgated specific requirements that must be met in order for a security to be "covered." Therefore, we hold that NSMIA preempts state securities registration laws with respect only to those offerings that actually qualify as "covered securities" according to the regulations that the SEC has promulgated.

*Brown v. Earthbound Sports USA, Inc.*, 481 F.3d 901, 912 (6th Cir. 2007).

<sup>245</sup> See *Qualified Purchaser*, *supra* note 160.

<sup>246</sup> 15 U.S.C. § 77r(b)(4).

<sup>247</sup> See *supra* Part III.B.2.

<sup>248</sup> See *Qualified Purchaser*, *supra* note 160 (seeking comment regarding the definition of "qualified purchaser," as used to define a "covered security" under NSMIA).

V. THE SAFE HARBOR SOLUTION—IMPROVEMENTS IN EFFICIENCY, OBJECTIVITY, AND SIMPLICITY

The narrow preemption standard is antithetical to the principles of efficiency and simplicity espoused by the legislature upon enacting NSMIA. As discussed above in Part III, federal securities regulatory policy has always excluded private offerings from the burdensome registration and mandatory disclosure provisions of the Securities Act.<sup>249</sup> Part III.C provided evidence that Congress intended NSMIA to inject efficiency into securities regulation by assuming exclusive regulatory authority over private securities offerings.<sup>250</sup> Part IV illustrated how the narrow preemption standard undermines the efficiency of securities markets and the judiciary by empowering states and state judges to establish local rules and remedies for unregistered private offerings that fail the Rule 506 conditions.<sup>251</sup> The narrow preemption standard for private offerings is unreasonable and unsustainable because it reduces efficiency, adds new complexity to securities law, and provides no substantial protections for investors.

In order to ensure a national standard that is efficient, objective, and simple, the S.E.C. should adopt a safe harbor provision for private offerings of securities. Because courts of several local jurisdictions may not be bound by each other's interpretation of NSMIA,<sup>252</sup> it is unlikely that we will see a judicial solution to this problem. The S.E.C., on the other hand, is given plenipotentiary authority under NSMIA to craft rules clarifying or defining the preemption standard.<sup>253</sup> Section 19 of the Securities Act of 1933 provides the following:

The Commission shall have authority from time to time to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this subchapter, including rules and regulations governing registration statements and prospectuses for various classes of securities . . . .<sup>254</sup>

Moreover, NSMIA itself added a provision specifically permitting the S.E.C. to define an entire class of securities for which state blue sky laws would be preempted:

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

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<sup>249</sup> See *supra* Parts III.A and III.B; Conference Report on the National Securities Markets Improvement Act of 1996, 142 Cong. Rec. S12093-02, at S12093 (Oct. 1, 1996) (statement of Sen. D'Amato).

<sup>250</sup> See *supra* Part III.C.

<sup>251</sup> See *supra* Part IV.

<sup>252</sup> See, e.g., *Risdall v. Brown-Wilbert, Inc.*, 733 N.W.2d 827, 832 (Minn. Ct. App. 2007) (making an independent determination as to whether an issuer needs to prove exemption before proving preemption while acknowledging the countervailing authorities).

<sup>253</sup> See 15 U.S.C. § 77s(a) (2006); see also *S.E.C. v. Life Partners, Inc.*, 912 F. Supp. 4, 10 (D.D.C. 1996) (noting that Rule 506 was the product of the S.E.C.'s exercise of authority to elucidate the requirements in generating a § 4(2) private placement offering).

<sup>254</sup> 15 U.S.C. § 77s(a).

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.<sup>255</sup>

Accordingly, the S.E.C. need only draft a rule that is efficient, objective, and simple, while balancing investor protections.

A broad preemption standard may be tailored as not to diminish investor protections or promote any fraudulent avoidance of blue sky laws. While this may seem to be a simple task, the S.E.C. should recognize that the narrow preemption standard does provide protections to investors. As discussed in Part IV.B, a broad preemption standard could permit any issuer to claim the Rule 506 private offering exemption in bad faith, or even *ex post* when confronted with a lawsuit.<sup>256</sup> As discussed in Part III.C, Congress had good policy reasons for leaving regulation of certain securities to the states.<sup>257</sup> One option would be to tailor the definition of “qualified purchaser” to include investors who purchase securities in a private offering *pursuant* to rules and regulations under § 4(2) of the Securities Act.<sup>258</sup> Another would be to amend NSMIA to broaden the definition of “covered securities” to include those offered *pursuant* to rules and regulations under § 4(2) of the Securities Act.<sup>259</sup> However, these methods fail to avoid the potential abuse for those issuing securities not intended to be exempt from state regulation under NSMIA.

An efficient safe harbor provision should aim at preempting state blue sky law for all private offerings of securities, with little left to judicial scrutiny. Accordingly, an efficient safe harbor provision should establish a set of conditions for the issuer to meet prior to issuing the securities in order to establish and provide notice of a bona fide private offering.

Second, the conditions should be couched in objective, unambiguous terms. Former Rule 146 of the Securities Act was intended to facilitate compliance with the § 4(2) private offering standard established in the *Ralston* decision, but the rule failed because it required an issuer to determine the extent of each offeree’s knowledge, information, and business experience.<sup>260</sup> An objective safe harbor provision, on the contrary, should inform the issuer immediately whether the blue sky law will be preempted with respect to the issuer’s offering, before a single security is sold.

Finally, the provisions of the proposed safe harbor must be drafted simply, without complex requirements that would undermine the

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<sup>255</sup> *Id.* § 77r(b)(3) (2006).

<sup>256</sup> *See supra* Part IV.B.

<sup>257</sup> *See supra* Part III.C.

<sup>258</sup> *See* 15 U.S.C. § 77r(b)(3) (providing statutory permission for the Commission to define the term “qualified purchaser” at its own discretion); *id.* § 77r(b)(4)(D) (currently defining “covered security” to include those securities exempt pursuant to regulations adopted under § 4(2) of the Securities Act).

<sup>259</sup> *See id.* § 77r(b)(4)(D).

<sup>260</sup> *See id.* § 77d(2); 17 C.F.R. § 230.146 (1975), *repealed* by Exemption Revision, *supra* note 79, at 11,251; *see supra* Part III.A.



purpose of simplifying the dual regulatory system. The safe harbor provision should not require complex filings or disclosures as a means of ensuring compliance with the Rule 506 private offering exemption.

Instead, the proposed safe harbor provision should guarantee preemption once the issuer has (1) filed a Form D notice of sale with the S.E.C. and the state, (2) indicated on Form D that the securities are offered pursuant to Rule 506, and (3) issued written notice to the investor of the anticipated Rule 506 exemption, via private placement memorandum or otherwise. Such requirements would be efficient because they would effectively preempt blue sky laws for all bona fide private offerings. These requirements are objective because they allow issuers to conclude with certainty that they need not comply with blue sky regulations and do not involve any subjective inquiry as to the intent or knowledge of the issuer or investor. Additionally, these requirements are simple because issuers are already required to file Form D with the S.E.C., although not as a condition of exemption,<sup>261</sup> and some states already require Form D for certain limited offerings.<sup>262</sup>

Moreover, the safe harbor would not undermine investor protection. The Form D filing requirement avoids fraudulent attempts to escape blue sky laws when issuing non-exempt securities. In fact, the court in *Temple* looked to whether the issuer filed Form D as evidence of a bona fide private offering.<sup>263</sup> The written notice requirement avoids ex post claims of a Rule 506 exemption. The court in *Risdall* looked to whether the issuer had indicated in their private placement memorandum to investors that the securities were offered pursuant to the Rule 506 private offering exemption.<sup>264</sup> Finally, those who abuse the safe harbor or fail the private offering exemption would still be subject to well-established federal remedies.<sup>265</sup>

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<sup>261</sup> 17 C.F.R. § 230.503 (2008) (requiring filing of Form D); *id.* § 230.507 (2008) (providing punitive measures for issuers who fail to file Form D).

<sup>262</sup> See S.E.C., Form D, <http://www.sec.gov/about/forms/formd.pdf> (last visited Oct. 20, 2008). The Uniform Limited Offering Exemption permits the filing of Form D for Rule 505 and 506 offerings. Rutheford B. Campbell, Jr., *Regulation A: Small Business' Search for a "Moderate Capital"*, 31 Del. J. Corp. L. 77, 93 (2006).

<sup>263</sup> *Temple v. Gorman*, 201 F. Supp. 2d 1238, 1244 (S.D. Fla. 2002) (finding that the information provided on Form D was evidence that an offer was issued pursuant to the Rule 506 private offering exemption).

<sup>264</sup> *Risdall v. Brown-Wilbert, Inc.*, 733 N.W.2d 827, 832 (Minn. Ct. App. 2007).

<sup>265</sup> 15 U.S.C. § 77f(a) (providing civil liabilities for violating the registration requirements of the Securities Act).

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