

# REFLECTIONS ON DUAL REGULATION OF SECURITIES: A CASE FOR REALLOCATION OF REGULATORY RESPONSIBILITIES

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## I. INTRODUCTION

More than fifteen years ago, I wrote an article analyzing the dual regulatory system for securities.<sup>1</sup> In that article, I undertook to reaffirm the value of complementary state and federal regulation of securities. State securities regulation predated federal regulation by almost a quarter century,<sup>2</sup> and Congress enacted the federal scheme largely to fill regulatory gaps that the states could not fill because of jurisdictional limits on their authority.<sup>3</sup> Moreover, Congress, in the Securities Act of 1933 (1933 Act)<sup>4</sup> and the Securities Exchange Act of 1934 (1934 Act),<sup>5</sup> included savings clauses expressly preserving the jurisdiction of state securities commissions<sup>6</sup> and all rights and remedies, at law or in equity, provided by the states.<sup>7</sup> In my article, I addressed the extensive judicial, congressional, and executive recognition of the dual regulatory systems' advantages.<sup>8</sup> I then sought to refute arguments that duplication and non-uniformity somehow undermined those advantages.<sup>9</sup> I even shamelessly borrowed rhetoric from the Reagan

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1. Manning Gilbert Warren III, *Reflections on Dual Regulation of Securities: A Case Against Preemption*, 25 B.C. L. REV. 495 (1984).

2. See LOUIS LOSS & EDWARD M. COWETT, BLUE SKY LAW 3-10 (1958).

3. See *Federal Securities Act: Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 99 (1933), reprinted in LEGISLATIVE HISTORY OF SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 vol. 2, at 99 (1973) (Dept. of Commerce Study of the Economic and Legal Aspects of the Proposed Federal Securities Act) [hereinafter Securities Act Hearings]. Justice William Douglas, a former chairman of the Securities and Exchange Commission, reiterated this point in his concurring opinion in *Traveler's Health Ass'n v. Virginia*, 339 U.S. 643, 653 (1950). Justice Douglas recognized that the enactment of federal securities laws was not intended to displace existing state laws, but to "fill the gap" resulting from the limited jurisdiction of individual states. *Id.*

4. Securities Act of 1933, 15 U.S.C. §§ 77a et seq. (1994).

5. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a et seq. (1994).

6. See Securities Act of 1933 § 18, Securities Exchange Act of 1934 § 28(a). For a general discussion of the effects of the federal savings clauses, see Russell A. Smith, *State "Blue-Sky" Laws and the Federal Securities Acts*, 34 MICH. L. REV. 1135, 1160-62 (1936).

7. See Securities Act of 1933 § 16; Securities Exchange Act of 1934 § 28(a).

8. See Warren, *supra* note 1, at 501-27.

9. See *id.* at 527-37.

Administration's SEC Transition Team recommending decentralization of securities regulatory power at the federal level through a corresponding expansion of state regulatory power.<sup>10</sup> I concluded that neither federal nor state securities regulation impeded capital formation, but, to the contrary, together built the confidence on which our capital markets have been constructed.<sup>11</sup>

My article did not prove particularly persuasive. Roughly ten years later, Congress, with virtually no debate and no widespread public support, passed a statute euphemistically named the National Securities Markets Improvement Act of 1996 (NSMIA).<sup>12</sup> In that statute, Congress unilaterally withdrew the preexisting power of the states to require pre-sale registration disclosures by issuers, including the power to conduct pre-sale disclosure review,<sup>13</sup> merit review,<sup>14</sup> or any other kind of fairness review in connection with most public and private offerings of securities conducted within the various states' respective jurisdictions. Congress simply rewrote the 1933

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10. *See id.* at 525-26 (citing *Final Report of SEC Transition Team*, [Jan.-June] SEC REG. & L. REP. (BNA) No. 587, at K-1 (Jan. 21, 1981)).

11. *See id.* at 537.

12. Pub. L. No. 104-290, 110 Stat. 3416 (codified in scattered sections of 15 U.S.C. (Supp. II 1996)).

13. The Uniform Securities Act of 1956, adopted in whole or in part by 37 states, requires all offers and sales of securities not otherwise exempt to be registered by filing a disclosure document with the state securities commission or an administrative agency serving similar functions. UNIFORM SECURITIES ACT § 301, 7B U.L.A. 550 (1956). The Act provides three methods of registration: (1) registration by notification for debt securities issued by seasoned issuers, almost never used and now considered a "dead letter"; (2) registration by coordination for securities offerings simultaneously being registered with the SEC, the most commonly used method; and (3) registration by qualification, used in most jurisdictions for a limited number of small local or regional offerings federally exempt under Section 3(b) of the 1933 Act. *See* JOSEPH C. LONG, BLUE SKY LAW § 107[1]. Scholars have criticized the states' imposition of registration by coordination, as the only extensively used registration method, as duplicative of federal registration required by Section 5 of the 1933 Act. *See, e.g.,* Rutherford B. Campbell, Jr., *An Open Attack on the Nonsense of Blue Sky Regulation*, 10 J. CORP. L. 553, 556-57 (1985). One must distinguish, however, between filing and review. At the federal level, the SEC continues to follow policies that exclude a substantial number of registration statements from any administrative review. For a discussion of the SEC's selective review process, see RICHARD W. JENNINGS ET AL., SECURITIES REGULATION: CASES AND MATERIALS 204-05 (8th ed. 1998). Moreover, differing review policies at the state level run the gamut from little, if any, review to intense scrutiny. Thus, the dual system's effectiveness necessarily depends on an ever-changing blend of regulatory intensity.

14. Traditionally, state securities regulators have employed a "fair, just and equitable" test in reviewing registration statements to determine whether the securities had sufficient merit to be offered to local residents. *See generally* AD HOC SUBCOMMITTEE ON MERIT REGULATION OF THE STATE REGULATION OF SECURITIES COMMITTEE, *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785 (1986). For a discussion of the regulatory advantages of merit regulation, see Manning Gilbert Warren III, *Legitimacy in the Securities Industry: The Role of Merit Regulation*, 53 BROOK. L. REV. 129 (1987); Hugh H. Makens, *Who Speaks for the Investor? An Evaluation of the Assault on Merit Regulation*, 13 U. BALT. L. REV. 435 (1984).

Act's savings clause to preempt most state laws requiring registration of, or imposing conditions on, a broadly-defined and open-ended group of securities and securities transactions.<sup>15</sup> In doing so, Congress "stretched its preemptive power under the Commerce Clause beyond all constitutional limits."<sup>16</sup> It inflicted a severe, if not fatal, wound on the dual system of securities regulation that had protected investors and their marketplace since the end of the Great Depression. Some may argue that death comes too slow, that the *coup de grace* should be administered forthwith by an obviously compliant Congress, while the iron is still white-hot.<sup>17</sup> In this essay, however, I suggest a less morbid alternative—one that might contribute to the development of a more rational reallocation of state regulatory power than presently exists in NSMIA's chaotic aftermath.

First, I do not readdress the development of the dual system of regulation, the reasons it flourished for most of this century, or arguments that the pre-NSMIA duality should be reinstated. I do not address my own firmly held views that NSMIA constitutes an unconstitutional exercise of Congress' Commerce Clause power inimical to our federalist system of government. Instead, I address the scope of state regulatory power that remains given NSMIA's dictates and prerogatives. I then suggest for consideration significant alterations to the regulatory role traditionally performed by the states. My suggested alterations include state withdrawal from the registration process, with the consequential demise of merit review, and, in its place, the development of a notification procedure accompanied by state criminalization of violations of both federal registration and state notification requirements. I also suggest the adoption of corollary civil remedies to ensure supportive private enforcement of the new regime. I conclude that this reallocation of regulatory responsibility will realign the dual system of securities regulation to better achieve NSMIA's elusive goal of regulatory uniformity. Moreover, this suggested reallocation should serve the statutory policy of the Uniform Securities Act—that its interpretation be coordinated with the federal securities laws.<sup>18</sup>

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15. See infra notes 19-20 and accompanying text.

16. Manning Gilbert Warren III, *Federalism and Investor Protection: Constitutional Restraints on Preemption of State Remedies for Securities Fraud*, 60 L. & CONTEMP. PROBS. 169, 175 (1997).

17. See, e.g., Rutherford B. Campbell, Jr., *Blue Sky Laws and the Recent Congressional Preemption Failure*, 22 J. CORP. L. 175 (1997).

18. Section 415 of the Uniform Securities Act provides: "This act shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it and to coordinate the interpretation and administration of this act with the related federal regulation." UNIFORM SECURITIES ACT, § 415, 7B U.L.A. 678 (1956). Professors Louis Loss and Edward Cowett, the drafters of the Uniform Securities Act of 1956, firmly believed that "our dual system of federal-state regulation in the securities field is too firmly fixed to make federal preemption even remotely

## II. FEDERAL WITHDRAWAL OF STATE REGISTRATION AUTHORITY

In NSMIA, Congress essentially gutted the states' pre-sale disclosure and merit review authority, as well as the states' regulatory power over the most significant federally-exempt offerings of securities. It did so by amending Section 18 of the 1933 Act, which provided that nothing in the 1933 Act, "shall affect the jurisdiction of the securities commission . . . of any State . . . over any security or any person."<sup>19</sup> The newly revised Section 18 bears little resemblance to the earlier version. In the amendment, Congress ordered the states to make no law dealing with the registration of or otherwise imposing limits or conditions on any "covered security."<sup>20</sup> The term "covered security" includes four legislatively defined categories of securities subject to virtually unlimited regulatory expansion by the Securities and Exchange Commission (SEC).

### *Marketplace Preemption*

The first category of covered securities includes all securities listed on the New York Stock Exchange, the American Stock Exchange, the National Market System of the NASDAQ Stock Market, and any other exchange with substantially similar listing standards, as determined by the SEC.<sup>21</sup> In preempting the states from imposing registration requirements on listed securities, Congress federalized the marketplace exemption adopted by some forty-six states prior to NSMIA's enactment.<sup>22</sup>

In addition, Congress delegated preemptive power to the SEC, which may lead to continued expansion of designated marketplaces vastly beyond that envisaged by the states' marketplace exemption. For example, the SEC has already expanded the marketplace preemption to include all securities listed on the Chicago Board Options Exchange, Tier I of the Philadelphia Stock Exchange, and Tier I of the Pacific Exchange.<sup>23</sup> The Pacific Exchange

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practicable." LOSS & COWETT, *supra* note 2, at 237-38. They added, "[t]he only hope for simplification lies in uniformity and federal-state coordination." *Id.* at 238. Indeed, Congress, in its Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980) (codified in scattered sections of 15 U.S.C.), amended the Securities Act of 1933 to mandate SEC cooperation with the states in the regulation of securities. Securities Act of 1933 § 19(c), 15 U.S.C. § 77s(c) (1994).

19. Securities Act of 1933 § 18, 15 U.S.C. § 77r (1994).

20. *Id.* § 18(a), 15 U.S.C. § 77r(a) (Supp. IV 1998).

21. *See id.* § 18(b)(1).

22. *Exchange Exemptions*, 1 Blue Sky L. Rep. (CCH) § 6401. *See generally* Manning Gilbert Warren III, *The Status of the Marketplace Exemption from State Securities Registration*, 41 BUS. LAW. 1511, 1513 (1986).

23. *See* SEC Rule 146(b), 17 C.F.R. § 230.146(b)(1) (1999).

recently announced plans to join with Archipelago, one of the major “electronic communications networks,”<sup>24</sup> in the creation of the first fully electronic national stock exchange, with Archipelago to function as the Pacific Exchange’s equity market.<sup>25</sup> Moreover, the Chicago Stock Exchange has sought inclusion of its Tier I securities, which will to be added after the resolution of the SEC’s concerns regarding listing and maintenance procedures.<sup>26</sup>

Given the globalization of the securities markets,<sup>27</sup> the rapid development of internet markets,<sup>28</sup> and the growing political and economic pressure to facilitate both, foreign and internet markets will likely be added to the list of designated markets. If those additional markets fail to meet the “substantially similar” criterion, the SEC probably will permit a corresponding dilution of qualitative and quantitative listing criteria of the markets presently designated, as it has done before.<sup>29</sup>

Moreover, NSMIA’s marketplace preemption is the most highly favored category of securities carved out from the states’ regulatory sphere. Unlike its treatment of the other categories of covered securities, Congress has preempted the states from imposing any notice requirements or filing fees on

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24. For a discussion of the development and regulation of electronic communications networks, often referred to as “alternative trading systems,” see Exchange Act Release No. 38,672 [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,942. (May 23, 1997). See also Therese H. Maynard, *What is an Exchange?*—*Proprietary Electronic Trading Systems and the Statutory Definition of an Exchange*, 49 WASH. & LEE L. REV. 833 (1992).

25. See Press Release, Archipelago and the Pacific Exchange Announce Plan to Create a New National Stock Exchange (Mar. 14, 2000). See also Rachel Witmer, *Archipelago, Pacific Exchange Join Forces, Create First Fully Automated U.S. Exchange*, 32 SEC. REG. & L. REP. (BNA) No. 11, at 358 (Mar. 20, 2000).

26. See Securities Act Release No. 7494 [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,001, at 80,102 (Jan. 2, 1998). The SEC stated that it would continue to review the Chicago Stock Exchange listing program and “may determine to include securities listed on [the Chicago Stock Exchange’s] Tier I in the future.” *Id.* at 80,103.

27. See generally Manning Gilbert Warren III, *The Global Harmonization of Securities Laws: The Achievements of the European Communities*, 31 HARV. INTL. L.J. 185 (1990).

28. See generally John C. Coffee, Jr., *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation*, 52 BUS. LAW. 1195 (1997); Jeffrey J. Hass, *Small Issue Public Offerings Conducted Over the Internet: Are They “Suitable” for the Retail Investor?*, 72 S. CAL. L. REV. 67 (1998).

29. The New York Stock Exchange for over sixty years refused to list companies with nonvoting common stock. See NYSE Listed Company Manual § 303.00 (1984). When the New York Stock Exchange began to consider abandoning its “one share, one vote” listing criterion to retain listings it feared would move to other marketplaces, it was preempted by the SEC’s Rule 19c-4, which substantially diluted the criterion. Although Rule 19c-4 subsequently was vacated in *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990), it was incorporated into the New York Stock Exchange’s listing criteria. See generally 4 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION 1826-1854* (1990). For a discussion of the history and rationale of the one share, one vote controversy, see Manning Gilbert Warren III, *One Share, One Vote: A Perception of Legitimacy*, 14 J. CORP. L. 89 (1988).

issuers or other sellers with respect to securities within this category. Thus, Congress has blindfolded the states and deprived them of a significant source of funds previously available for the protection of investors in securities traded in those designated marketplaces.

### *Mutual Fund Preemption*

The second category of covered securities includes all securities issued by investment companies registered under the Investment Company Act of 1940.<sup>30</sup> However, Congress has expressly preserved state authority to require offerors of these mutual fund securities to file with the states any document previously filed with the SEC under the 1933 Act and an annual or periodic report stating the value of securities to be offered or sold to persons located within the state.<sup>31</sup> Congress has also preserved state authority to require a consent to service of process and payment of state-prescribed filing fees.<sup>32</sup> Contrary to its treatment of the states with respect to securities within the marketplace preemption, Congress has agreed to permit the states to require advance notice of mutual fund offerings within their respective jurisdictions.<sup>33</sup>

### *Qualified Purchaser Preemption*

The third category of covered securities includes all securities offered or sold to “qualified purchasers,” the definition of which Congress left to the SEC.<sup>34</sup> This can only be described as *phantom preemption*, because at the time of NSMIA’s enactment, Congress did not know which purchasers of securities might be “qualified,” which securities might consequently be “covered,” and thus to what extent the states would be preempted. Instead, Congress granted the SEC rulemaking authority to “define the term ‘qualified purchaser’ differently with respect to different categories of securities, consistent with the public interest and the protection of investors.”<sup>35</sup> Because the SEC has not defined the term and, in any event, retains broad authority to define and redefine the term, the qualified purchaser notion is a fluid variable.

The SEC could look to its definition of “qualified institutional buyer”

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30. See Securities Act of 1933 § 18(b)(2), 15 U.S.C. § 77r(b)(2) (Supp. IV 1998).

31. See *id.* § 77r(C)(2)(A).

32. See *id.*

33. See *id.*

34. Securities Act of 1933 § 18(b)(3), 15 U.S.C. § 77r(b)(3) (Supp. IV 1998).

35. *Id.*

under Rule 144A<sup>36</sup> or to its often criticized “accredited investor”<sup>37</sup> definition under the Section 4(6)<sup>38</sup> and Regulation D registration exemptions.<sup>39</sup> If the SEC chooses the latter, “covered” securities will include those sold to anyone with \$200,000 in annual income or a \$1,000,000 net worth, regardless of his or her level of investment expertise.<sup>40</sup> At least one commentator has suggested that the SEC define the term “qualified purchaser” so as to encompass virtually all purchasers of securities that, after NSMIA, remain subject to state registration authority.<sup>41</sup> With this open-ended phantom preemption hanging over their heads, the states are poorly positioned to refashion their existing securities registration laws to accommodate their reallocated responsibilities. When the phantom some day becomes embodied, the states know only that Congress has preserved their authority to require notification, the filing of some limited documentation, a consent to service of process, and a filing fee.

### *Exemption Preemption*

The fourth and final category of covered securities includes a hodge-podge of securities and securities transactions already exempt from federal registration,<sup>42</sup> as set forth below: transactions in reporting company securities by persons other than issuers, underwriters or dealers, which includes virtually all secondary trading in securities of reporting companies pursuant to Section 4(1);<sup>43</sup> certain transactions in reporting company securities by dealers, exempt under Section 4(3);<sup>44</sup> certain transactions by brokers, exempt

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36. 17 C.F.R. § 230.144A(a)(1). Rule 144A defines the term “qualified institutional buyer” as one of the entities listed in the rule that “owns and invests on a discretionary basis at least \$100 million in securities of issuers that are not affiliated with the entity.” *Id.*

37. The term “accredited investor” is defined at SEC Rule 215, 17 C.F.R. § 230.215 (1999), to include five categories of entities and three categories of individual investors, including insiders of the issuer, persons with \$1,000,000 net worth, and individuals with \$200,000 income or joint income of \$300,000 in the two years preceding the sale and an expectation of earning that amount in the year of the sale. *Id.*

38. Securities Act of 1933 § 4(6), 15 U.S.C. § 77d(6).

39. Regulation D, 17 C.F.R. §§ 230.501-508 (1999), is a series of eight rules, three of which, Rules 504, 505 and 506, provide substantive exemptions from federal registration. For a discussion of the origin and development of Regulation D, see generally Mark A. Sargent, *The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform*, 68 WASH. U.L.Q. 225 (1990); 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 (1984).

40. See 17 C.F.R. § 230.215(e)-(f) (1999).

41. See Campbell, *supra* note 17, at 207.

42. See Securities Act of 1933 § 18(b)(4), 15 U.S.C. § 77r(b)(4) (Supp. IV 1998).

43. Securities Act of 1933 § 18(b)(4)(A), 15 U.S.C. § 77r(b)(4)(A).

44. See *id.*

under Section 4(4);<sup>45</sup> all securities and securities transactions exempt under Section 3(a),<sup>46</sup> except municipal securities exempt under Section 3(a)(2) that are offered in the state where the issuer is located;<sup>47</sup> securities offered by eleemosynary institutions, exempt under Section 3(a)(4);<sup>48</sup> judicially and administratively approved exchanges of securities, exempt under Section 3(a)(10);<sup>49</sup> and intrastate offerings, exempt under section 3(a)(11).<sup>50</sup> In sum, the Section 3(a) group of covered securities includes, among others, all governmental securities<sup>51</sup> (except locally offered municipal securities), all bank<sup>52</sup> and savings and loan association securities,<sup>53</sup> insurance policies and annuities,<sup>54</sup> and exchanges of securities not involving commissions,<sup>55</sup> and all securities transactions exempt by SEC rule or regulation under Section 4(2)'s private offering exemption,<sup>56</sup> which presently includes only securities transactions exempt under Rule 506 of Regulation D.<sup>57</sup>

Congress, in preempting its own exemptions, apparently forgot that it enacted many of these exemptions from registration at the federal level based on its own recognition that the states already provided sufficient pre-sale regulatory protection.<sup>58</sup> Moreover, given the absence of federal registration, these exempt securities and transactions have warranted "the greatest measure of protection" by the states in the past.<sup>59</sup> Although state notice filing requirements are preserved, Congress has preempted the states from filling the regulatory gaps established by its own exemption scheme. Congress has exempted from state registration its own exemptions from federal registration.

Congress, by enacting this "reform" legislation, has crafted a

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45. See Securities Act of 1933 § 18(b)(4)(B), 15 U.S.C. § 77r(b)(4)(B).

46. See Securities Act of 1933 § 18(b)(4)(C), 15 U.S.C. § 77r(b)(4)(C).

47. See *id.*

48. See *id.*

49. See *id.*

50. See *id.*

51. Securities Act of 1933, § 3(a)(2), 15 U.S.C. § 77c(a)(2) (1994).

52. *Id.*

53. Securities Act of 1933, § 3(a)(5), 15 U.S.C. § 77c(a)(5) (1994).

54. *Id.* § 3(a)(8).

55. *Id.* § 3(a)(9).

56. *Id.* § 18(b)(4)(D).

57. 17 C.F.R. § 230.506 (1999).

58. See Securities Act Hearings, *supra* note 3, at 53 (statement of Hon. Huston Thompson). Although it was acknowledged that Congress could extend its own federal scheme to address the fairness of securities offerings, to do so would have been "getting over into a phase that [was already] covered by the State blue sky laws." *Id.*

59. Edward M. Cowett, *Federal-State Relationships in Securities Regulation*, 28 GEO. WASH. L. REV. 287, 293 n.36 (1959). See also Thomas Z. Wright, *Correlation of State Blue Sky Laws and the Federal Securities Acts*, 26 CORNELL L.Q. 258, 271 (1941).



kaleidoscopic preemption pattern, which has left the states with incoherent registration and exemptive authority. Given its broad preemptive sweep in defining these four categories of covered securities, Congress has significantly reduced the states' power to regulate through registration. Generally speaking, the states, for now, retain registration authority only over securities not covered by the marketplace preemption, non-bank and non-governmental securities, and securities not offered pursuant to Rule 506. In other words, the states can require registration of public offerings by non-bank, non-governmental issuers whose securities are listed solely on the still "uncovered" marketplaces. These uncovered marketplace securities include those securities traded on the NASDAQ SmallCap market or quoted on the NASD OTC Bulletin Board system and otherwise uncovered securities offered in transactions under Section 3(b)'s regulatory exemptions (Rules 504 and 505 of Regulation D<sup>60</sup> and Regulation A<sup>61</sup>) or Section 4(2)'s statutory exemption.<sup>62</sup>

Moreover, the states' remaining registration terrain, as limited to these uncovered categories of securities, is territory beset by erosion. Congress' designation of Rule 506 securities as covered securities has denied the states regulatory discretion with respect to an enormous volume of securities privately offered to investors and available for resale, free of restrictions, if held for only two years.<sup>63</sup> Issuers who may have registered their offerings at the state level or relied on some other federal exemption leaving state authority in place have been provided an escape route from disclosure requirements under the states' registration and exemptive schemes. Moreover, Congress' "coverage" of Rule 506 securities, and not securities privately offered under Rule 505 or publicly-offered under Regulation A, among others, creates a regulatory incoherence that will continuously frustrate state regulatory policy. When one also considers the very real possibility of expanded marketplace preemption<sup>64</sup> and the SEC's yet unused preemptive authority over securities issued to qualified purchasers, one must question whether maintenance of state registration laws remains either a coherent or a practicable regulatory approach.

In rewriting the savings clause of the 1933 Act, Congress saved three specific areas of state authority over covered securities. The first two, as previously discussed, confirmed the states' authority to require notice filings

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60. 17 C.F.R. §§ 230.501-.508 (1999).

61. 17 C.F.R. §§ 230.251-.263 (1999).

62. Securities Act of 1933 § 4(2); 15 U.S.C. § 77d(2) (1994).

63. See SEC Rule 144(k), 17 C.F.R. § 230.144(k).

64. See *supra* notes 21-29 and accompanying text.

and payment of filing fees with respect to all securities other than those subject to marketplace preemption. The third confirmed the states' authority to investigate and prosecute violations of state securities laws. Section 18(c) of the 1933 Act provides that "the securities commission . . . of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions."<sup>65</sup> Moreover, Section 16 still provides that the rights and remedies provided by the 1933 Act "shall be in addition to any and all other rights and remedies that may exist at law or in equity"<sup>66</sup> and that nothing in Section 16 excepting class actions involving covered securities "may be construed to preclude a State . . . from bringing an action involving a covered security on its own behalf."<sup>67</sup> Finally, Section 16(e), consistent with Section 18, provides that "the securities commission . . . of any State shall retain jurisdiction under the laws of such state to investigate and bring enforcement actions."<sup>68</sup> Thus, Congress, in preserving state enforcement authority, has demonstrated a degree of legislative grace.

In summary, Congress' enactment of NSMIA sent four important federal messages to the states. First, Congress' preemption of covered securities dictates shrunken and ever-shrinking state registration authority. Second, Congress expressly has authorized the states to require notification filings to apprise state regulators of securities offerings made to their own local investors. Third, Congress expressly has permitted the states to collect filing fees, thus ensuring a source of funds to finance the states' regulatory systems. Fourth, Congress has reconfirmed the authority of the states to act as "cops on the beat," serving as complementary localized enforcement systems to protect investors and their marketplace.

The states should listen to these messages and develop a consonant regulatory response. The states should consider repeal of their now incongruent registration requirements, the substitution of coordinated notification procedures, and the enhancement of their enforcement authority, including supplementation by more effective investor remedies.

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65. Securities Act of 1933 § 18(c)(1); 15 U.S.C. § 77r(c)(1) (Supp. IV 1998).

66. *Id.* § 16(a).

67. *Id.* § 16(d)(2)(A).

68. *Id.* § 16(e).

### III. A PROPOSAL FOR REALLOCATION OF REGULATORY RESPONSIBILITIES

The SEC, as mandated by NSMIA,<sup>69</sup> in October 1997 submitted a report to Congress assessing the extent to which the states achieved uniformity in their regulatory requirements for non-covered securities during the year following NSMIA's enactment.<sup>70</sup> The SEC reported that while the North American Securities Administrators Association (NASAA)<sup>71</sup> and certain individual state regulators made "progress toward achieving uniformity," widespread disparities remained, requiring "more to be done to accomplish true uniformity among the states."<sup>72</sup> Subsequently, the National Conference of Commissioners on Uniform State Laws established a drafting committee to prepare a post-NSMIA revision of the Uniform Securities Act under the leadership of its Reporter, Dean Joel Seligman.<sup>73</sup> All uniform act projects strive for uniformity of state legislation, not uniformity of state and federal legislation. Yet, after almost forty-five years of experience under the Uniform Securities Act, it is clear that uniformity cannot be achieved even at the state level absent complete federal preemption of securities regulation. The dual system of securities regulation under a constitutional structure embodying federalism assumes a federal statute and fifty sets of disparate state securities statutes. Thus, regulatory harmony, as opposed to regulatory uniformity, would be considerably easier to achieve.

My proposal for a more harmonious reallocation of the states' regulatory responsibilities responds directly to Congress' NSMIA messages: the states must minimize, if not eliminate, their registration hurdles for securities offerings; they are entitled to notice and documentation of securities offerings made within their respective jurisdictions; they are authorized to collect filing fees; and they must be permitted to enforce their own securities laws. My proposal for reallocation is a conceptual outline and, accordingly, does not provide detailed language for actual legislative provisions. I intend only to provide discussion critical to the reallocation debate and the future of

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69. NSMIA, § 102(b); 15 U.S.C. § 78b (Supp. IV 1998).

70. SEC, REPORT ON THE UNIFORMITY OF STATE REGULATORY REQUIREMENTS FOR OFFERINGS OF SECURITIES THAT ARE NOT "COVERED SECURITIES" (Oct. 1997) [hereinafter REPORT ON UNIFORMITY].

71. The North American Securities Administrators Association, Inc. (NASAA), is an organization of securities regulators from 65 jurisdictions located in the United States, Puerto Rico, Canada and Mexico. See NASAA Reports (CCH) ¶ 1, at 11 (1998).

72. REPORT ON UNIFORMITY, *supra* note 70, at ii.

73. The December 2000 draft of the proposed revisions of the Uniform Securities Act, as well as earlier drafts dating back to October 1999, are available on the website of the National Conference of Commissioners on Uniform State Laws (NCCUSL). NCCUSL, Drafts of Uniform and Model Acts, Official site, Uniform Securities Act, <http://www.law.upenn.edu/bl/ulc/securities/sec1200a.html>.

our dual system of securities regulation. My proposal would reallocate regulatory authority in accordance with NSMIA's federal messages, thereby producing a substantially higher degree of regulatory harmony in the dual system of securities regulation.

Moreover, the present definition of preempted "covered securities" is incredibly complex, and the state's interpretive power as to whether particular securities are covered is at least questionable. At best, the definition is a fluid one, subject to continuous regulatory expansion by the SEC regarding the marketplace and qualified purchaser categories of covered securities. In addition, Congress continues to be prodded to accomplish statutory expansion. Even NASAA, finally understanding NSMIA's antistate registration message, has recommended that Congress should expand the multipart definition of covered securities to include numerous types of securities not presently covered under NSMIA's current definition.<sup>74</sup> Because the federal definition of covered securities is in a state of flux, the corollary definition of state registrable securities is as well. In this context, the states are not well-positioned to make prudent regulatory policy determinations, particularly securities registration policies. Congress' NSMIA reallocation has, in effect, rendered the states' registration requirements hopelessly incoherent.

My proposal, as suggested by my previously expressed recognition of NSMIA's congressional messages, recommends consideration of several interrelated concepts. The first and most transformative is that the states consider the elimination of their registration requirements for all offers and sales of securities, whether made in the primary markets as distributions or in the secondary markets as trading transactions. States would thus place registration solely in the federal province, without requiring disclosure or merit review prior to the offer or sale of securities. Consequently, issuers could abandon the complex search for the state registrable security once and for all. Moreover, uniformity of the registration process would be achieved without suffering further excruciating rounds of federal preemption. Congress' hostility to state regulation might be ameliorated and collaboration with the SEC vastly improved. Elimination of state registration requirements would debase arguments that the states' securities laws impose regulatory barriers to capital formation, internationalization, and the facilitation of internet securities markets. Federal and state regulatory philosophies finally would be aligned in the sense that the states' abdication of registration

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74. See NASAA, *NASAA's Comments Regarding the Recommendations Submitted for the Securities Markets Enhancement Act* (last modified May 8, 2000) <<http://www.nasaa.org/whoweare/speeches/smea.htm>>.

authority would leave little to align. Consequently, the states could more efficiently focus their resources on the one area of state securities regulation Congress continues to embrace: enforcement. To the extent that this regulatory transformation creates regulatory gaps, Congress could fill those gaps just as it did with its 1933 legislation.<sup>75</sup>

One could argue that no serious “registration” gaps remain. The abolition of state registration by coordination of offerings of non-covered securities, still the most commonly-used state registration method, arguably would produce no regulatory gap, given continued federal registration of those offerings. The rarely-used state registration by notification method is widely regarded as a dead letter. The states’ third type of registration authority, state registration by qualification, generally has been applied to securities offerings exempt at the federal level under either the intrastate exemption or the three Section 3(b) exemptions, which include Rules 504<sup>76</sup> and 505<sup>77</sup> of Regulation D and Regulation A.<sup>78</sup>

In recent years, state-registered intrastate offerings and exempt Rule 505 offerings have virtually disappeared. Regulation A’s disclosure requirements roughly approximate requirements applicable to fully-registered offerings.<sup>79</sup> Thus, as a practical matter, only Rule 504 offerings could be said to fall into a regulatory gap. It is likely, however, that issuers will no longer rely on Rule 504, because absent state registration, Rule 504 securities would remain restricted in the hands of non-affiliates for two years after purchase.<sup>80</sup> Most, if not all, would-be Rule 504 issuers would be likely to shift their reliance to either Rule 506, thus converting the securities into “covered securities,” or Regulation A and its “mini-registration” disclosure requirements. Consequently, the impact of my proposal, given NSMIA’s current preemption, may not be as far-reaching as it would first appear. The only obvious regulatory gap remaining is the absence of merit review, which, many would argue, leaves no gap at all.

The second concept I propose requires the states to substitute a standardized notification procedure for the registration process they would

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75. See *supra* note 3 and accompanying text.

76. 17 C.F.R. § 230.504 (1999).

77. *Id.* § 230.505.

78. *Id.* § 230.251-.263.

79. See JENNINGS ET AL., *supra* note 13, at 432-34.

80. In Rule 504, 17 C.F.R. § 230.504, the SEC provided that resales of securities offered in transactions exempt under the rule would be restricted unless the securities were acquired in state-registered offerings or state-exempt accredited investor offerings. SEC Rule 504(b)(1), 17 C.F.R. § 230.504(b)(1); SEC Rule 502(d), 17 C.F.R. § 230.502(d). Rule 144 permits such securities to be resold by non-affiliates of the issuer free of all restrictions after a two-year holding period. SEC Rule 144(k), 17 C.F.R. § 230.144(k).

abandon. Effective enforcement depends to a large extent on providing information to state regulators sufficient to apprise them of securities offerings made to investors within the states' respective jurisdictions. Congress, in NSMIA, legislated this policy in its confirmation of state authority to require state filing of all documents filed with the SEC, as well as periodic reports of the value of securities offered to persons located in a given state. Without this information, state regulators would be constrained substantially in their efforts to protect local investors. Moreover, Congress has expressly authorized state regulators to suspend any offer of securities made within their respective states if issuers fail to provide required notice filings.<sup>81</sup> These filings, accompanied by consents to service of process, would significantly enhance the enforcement objectives shared by both Congress and the states. Notice, after all, provides investigatory opportunities. Although Congress preempted state notice filing requirements as to nationally traded securities covered by its marketplace preemption,<sup>82</sup> it may be persuaded to reconsider the issue given the states' complete withdrawal from regulation through registration. Of course, in formulating their notice filing requirements, the states should consider whether they already have access to the information notice filings would provide by virtue of publicly-available SEC databases.<sup>83</sup> Consequently, the states may find it desirable to tailor their notice filing requirements to all offerings exempted from federal registration requirements. They also may want to except from their notice filing requirements offerings made pursuant to Section 4(2)'s statutory exemption.<sup>84</sup> The states' enforcement interests are unlikely to be served by notice filings resulting from business entity formations or private placements to insiders.

The states should consider development of a web-based central notification depository, perhaps coordinated by NASAA, functionally similar to the Central Registration Depository<sup>85</sup> for market professionals established

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81. Securities Act of 1933 § 18(c)(3); 15 U.S.C. § 77r(c)(3) (Supp. IV 1998).

82. *Id.* § 18(c)(2)(D).

83. For example, the SEC mandates the electronic submission of certain required filings under the Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act, the Investment Company Act, and the Public Utility Act. *See* 17 C.F.R. § 232.101 (1999). Since 1996, the SEC has required all domestic public companies to post these filings through the EDGAR system, which then displays them on the SEC's website. *See* U.S. SECURITIES AND EXCHANGE COMMISSION, *EDGAR Database of Corporate Information* (last modified Apr. 17, 2000) <<http://www.sec.gov/edgarhp.htm>>.

84. Securities Act of 1933 § 4(2); 15 U.S.C. § 77d(2) (1994).

85. The Central Registration Depository (CRD), developed jointly by The National Association of Securities Dealers (NASD) and The North American Securities Administration Association (NASAA), facilitates simultaneous state and federal registration of broker-dealers and their agents. NASD Regulation, Inc., now maintains the qualification, employment and disclosure histories of over

by NASAA and the National Association of Securities Dealers. State regulators might make the information they compile and share directly available to local investors through physical or internet access, at least to the extent this would not otherwise result in the loss of federal exemptions. This central notification depository would complement the traditional role of state securities commissions as accessible consumer information bureaus for local investors.<sup>86</sup>

The third part of my proposal suggests that the states, as authorized by NSMIA, impose filing fees in order to finance their enforcement programs. The regulatory process obviously imposes costs upon either the general public through tax revenues or the regulated issuer through filing fees. In my view, the latter would be more equitable. The ability to collect these fees would encourage the states to impose broader notice filing requirements, while at the same time potentially facilitate lower fees. The states should strive to balance their respective levels of fees charged with the budgets of their respective regulatory programs. In making these calculations, the states should also take into account fee revenue obtained from securities professionals, including broker-dealers, investment advisers, and their agents, whose regulation by the states is unaffected by my proposal and vital to my proposal's effectiveness in providing investor protection.

The final concept incorporated into my proposal is that the states grant significantly greater enforcement power to their securities regulators and enhanced civil remedies to their investors. Among other enhancements, the states' securities laws, to promote the desired uniformity with the federal regime, should provide criminal, administrative, and civil remedies for violation of the *federal* registration requirements. These remedies should supplement state remedies provided for violation of state regulatory requirements (which would no longer relate to securities registration violations) and available common law remedies.

This concept resembles that approved by the U.S. House of Representatives in the version of the 1933 Act it initially passed.<sup>87</sup> The House bill contained a provision making it a federal crime to offer in interstate commerce securities that failed to comply with the laws of any state where they were to be sold.<sup>88</sup> Although a Senate amendment ultimately

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500,000 registered agents through its electronic Web CRD system. See <http://www.nasdr.com>.

86. See Warren, *supra* note 1, at 530-31.

87. See Securities Act Hearings, *supra* note 3, at 85.

88. Section 18(a) of the House bill proposed:

It is made unlawful for any person to make use of the mails or any means or instruments of interstate commerce to sell or deliver any security to any person in any State, where such sale or delivery, if it had taken place wholly within such State, would be in violation of the laws thereof

eliminated this provision, it was intended “to insure the states since 1933 it was not an attempt to supplant their laws but an attempt to supplement their laws. . .”<sup>89</sup>

My proposal incorporates the reverse. Because much of their own registration law has been federalized and the rest would be voluntarily abandoned pursuant to my proposal, the states should align their own policies and enforcement resources to supplement the federal securities laws by assisting the SEC in the enforcement of those laws. Accordingly, the states’ securities laws should penalize both *failure to register* violations of *federal* law as well as *failure to notify* violations of *state law*. Existing administrative and criminal sanctions for securities fraud and other misconduct should remain in place. Lastly, the states also should adopt corollary private remedies for rescission based on failure to federally register or to state notify in substitution for the failure to state register remedy currently afforded by the states’ securities laws.<sup>90</sup> Again, these newly-fashioned civil remedies should supplement express causes of action presently provided by the states’ securities laws. This final aspect of my proposal would contribute substantially to a desirable realignment of state and federal enforcement policies in the dual regulatory system.

#### CONCLUSION

In this essay, I have assessed the regulatory dilemma resulting from Congress’ enactment of NSMIA. Although, as a normative matter, I firmly disagree with Congress’ legislation, I have concluded that the states’ securities registration authority has been transformed by NSMIA into an increasingly chaotic regulatory approach. The states should voluntarily discontinue as a matter of policy their ever-shrinking authority to register whatever remains of state registrable securities. My proposal conceptualizes a regulatory approach that both yields to and embraces federal registration authority while enhancing the enforcement role of the states that Congress has continued to reaffirm. By advancing this proposal, I hope to encourage the states to harmonize their own regulatory policies with federal ones in order to preempt further rounds of preemption.

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relating to the sale of securities.

*Id.*

89. Securities Act Hearings, *supra* note 3, at 117.

90. See Uniform Securities Act, § 410(a)(1), 7B U.L.A. 643 (1956).