

# THE INSIDIOUS REMNANTS OF STATE RULES RESPECTING CAPITAL FORMATION

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As we move into the Twenty-First Century, state blue sky laws and regulations continue to govern a significant portion of the capital formation activities of our domestic businesses. As a result, state administrators, influenced by their historically informed preferences and local traditions, continue to play important roles when businesses attempt to access external capital sources.

Today, however, the effects of state blue sky laws, regulations, and administrators on capital formation are felt almost exclusively by small businesses.<sup>1</sup> The capital formation activities of larger businesses generally have been freed from state control, most recently by the preemption contained in the National Securities Markets Improvement Act of 1996 (NSMIA).<sup>2</sup>

Although allowing states to retain control over smaller, local concerns while giving the federal government jurisdiction over larger, national enterprises may have a sensible ring to it, such a split system in fact is unsound. First, the system is inherently discriminatory against small businesses. When small businesses attempt to raise capital, they may be subject to more than fifty sets of laws and regulations, while larger corporations are subject to only one. Such discrimination is not only unfair to

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1. Although a precise definition of "small" or "large" business is difficult, small businesses generally have two characteristics that distinguish them from large businesses. First, small businesses are small as an economic matter, and one, roughly, can measure this by the number of assets or the revenue stream of the business. Second, small businesses have limited trading in their securities. These characteristics generate many of the problems unique to small businesses in their efforts to generate external capital.

2. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.). Even before NSMIA, state control over the capital formation activities of larger corporations had waned somewhat. An example of this is the provision in the Uniform Securities Act providing an exemption from state registration requirements for securities that are registered for trading on certain national exchanges. UNIF. SECURITIES ACT § 402(a)(8), 7B U.L.A. 600 (1985). Additionally, the exemption extends to "any other security of the same issuer which is of senior or substantially equal rank." *Id.* Most states expanded this exemption by regulation to include securities traded on the NASDAQ Nation Market System. *See Exchange Exemptions*, 1 Blue Sky L. Rep. (CCH) ¶ 6401 (Oct. 1996) (stating that 46 states have adopted such a marketplace exemption). One participant in this symposium has written on the marketplace exemption. *See Manning Gilbert Warren III, The Statutes of the Marketplace Exemption from State Securities Registration*, 41 BUS. LAW. 1511 (1986). *See also* Mark A. Sargent, *A Future for Blue Sky Law*, 62 U. CIN. L. REV. 471, 474-75 (1993).

small entrepreneurs but also leads to inefficiencies and misallocations of societal resources. The increased transaction costs generated by complying with multiple securities regimes make small companies less competitive in relation to larger companies, even if the small companies have an equal or even superior product.

In addition to the pernicious effects of discrimination, blue sky laws are substantively unsound. They are early Twentieth Century solutions to Nineteenth Century problems. They subject those under their jurisdiction to rules and regulatory attitudes that are descended from the traditions of an outmoded philosophy of merit regulation.<sup>3</sup> Such paternalistic and archaic rules and attitudes respecting capital formation simply have no place in the Twenty-First Century, with its inexpensive and instantly available investment information and financial reporting systems. Blue sky laws, in short, amount to the regulatory equivalent of a buggy whip factory.

Three years of experience since the enactment of NSMIA demonstrates what most of us already understood: the states and the Securities and Exchange Commission are either unable or unwilling to move society to a single, unified, and balanced set of rules respecting capital formation. Only further Congressional intervention, therefore, can eradicate the insidious remnants of state control over capital formation.

The purpose of this Article is to argue that Congress, notwithstanding the significant problems illuminated by public choice theory and interest group analysis,<sup>4</sup> should complete the work it started with NSMIA by entirely

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3. Determining exactly how many states engage in merit regulation is difficult because, for example, “[t]here is . . . no universally agreed upon definition of merit regulation.” Ad Hoc Subcomm. on Merit Regulation of the State Regulation of Sec. Comm., *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785, 787 (1986) [hereinafter *Report on State Merit Regulation*]. Nonetheless, the *Report on State Merit Regulation* reported in 1986 that “a majority of the states have merit language in their statutes.” *Id.* at 790. In 1997 this author reported that in a sample of five states (representing approximately 10% of the blue sky jurisdictions), all had statutes containing merit standards. See Rutheford B Campbell, Jr., *Blue Sky Laws and the Recent Congressional Preemption Failure*, 22 J. CORP. L. 175, 186 n.65 (1997). In 1997 the Commission reported that “approximately 40 states undertake a merit review.” Securities and Exchange Comm’n, *Report on the Uniformity of State Regulatory Requirements for Offerings of Securities That Are Not “Covered Securities,”* (Oct. 11, 1997) <<http://www.sec.gov/news/studies/uniformy.htm>> [hereinafter *SEC Report on Uniformity*].

4. Landes and Posner provide the following description of the application of public choice theory, or as it is often called, interest group analysis, to the legislative process:

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

William M. Landes & Richard A. Posner, *The Independent Judiciary in an Interest-Group*

preempting state control over capital formation. Only in this manner is it possible to reach the goal of a modern, fair, and efficient regulatory scheme for capital formation.

### I. A BRIEF LOOK AT THE “PROGRESS” OF STATE BLUE SKY LAWS AND WHERE WE ARE TODAY

To understand current blue sky regulations, brief comments on the history of blue sky laws and their relationship to the enactment of federal securities regulation are helpful. Because able scholars previously have provided a good look at and interesting explanations for the enactment of blue sky laws,<sup>5</sup> however, only the briefest historical discussion is needed here.

The first point is simply to note that blue sky laws predate the Securities Act of 1933 (1933 Act). The first modern state blue sky law was enacted by Kansas in 1911,<sup>6</sup> and other states quickly followed Kansas’ lead by enacting similar provisions governing capital formation.<sup>7</sup> The first piece of modern

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*Perspective*, 18 J.L. & ECON. 875, 877 (1975). Two outstanding discussions of public choice theory applied to the legislative process can be found in Daniel A. Farber & Philip P. Frickey, *The Jurisprudence of Public Choice*, 65 TEX. L. REV. 873, 873-901 (1987) and Jonathan R. Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 227-233 (1986).

5. See, e.g., LOUIS LOSS & EDWARD M. COWETT, BLUE SKY LAW 3-10 (1958) (providing the historical background for enactment of blue sky laws); 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 29-50 (3d ed. 1989) (explaining the historical developments that led to state blue sky laws); Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEXAS L. REV. 347, 348-89 (same).

Authors often appear to assume that extensive fraud in the securities market was a significant factor leading to blue sky laws. See, e.g., JAMES S. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS 9 (1971) (“[A]lthough the amount of fraud has never been measured, it would not be surprising to find an amount of dishonesty among promoters and securities salesmen consistent with the wild times.”); Ernest W. Walker & Beverly Bailey Hadaway, *Merit Standards Revisited: An Empirical Analysis of the Efficacy of Texas Merit Standards*, 7 J. CORP. L. 651 (1982) (concluding that “many naive and some sophisticated investors were duped”).

Professors Macey and Miller, however, find a history much more complicated than the standard accounts would admit. Their assessment of the facts surrounding the adoption of state blue sky laws is that “although fraudulent securities undoubtedly occurred during the early decades of the century, the standard account that securities fraud was rampant before the advent of blue sky regulation is not proven.” Macey & Miller, *supra*, at 350. The Professors then explain the advent of blue sky laws in terms of “a process of interest group rivalry not significantly different from the process observed in many other legislative contexts.” *Id.* at 352.

6. See LOSS & COWETT, *supra* note 5, at 7. Professors Macey and Miller provide a wonderful account of the situation that led to, and the interesting characters involved in, Kansas’s enactment of its original blue sky law. See Macey & Miller, *supra* note 5, at 359-64. For a brief discussion of earlier state laws that were certainly more limited than, but generally in the nature of, later securities laws, see Conrad G. Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements?*, 1976 WIS. L. REV. 79, 80-81.

7. For example, Professors Loss and Cowett report that twenty-three states enacted blue sky laws within two years of the Kansas legislation. See LOSS & COWETT, *supra* note 5, at 10. See also

federal securities legislation<sup>8</sup> was not enacted until twenty-two years after the initial Kansas blue sky statute, and by that time, blue sky laws were pervasive and well-entrenched.

A second point to acknowledge is the historical difference in the initial philosophical footings of blue sky laws on the one hand and the 1933 Act on the other. State blue sky laws were qualification statutes<sup>9</sup> and were essentially consumer legislation administered by agents of the state.<sup>10</sup> Blue sky laws provided substantive standards to be met by issuers of securities and established a regulatory vetting process in which state regulators had to approve offerings as consistent with the substantive statutory standards before the issuer was allowed to sell its securities to the citizens of the particular state.

The 1933 Act, on the other hand, adopted a disclosure philosophy<sup>11</sup> and thus subjected issuers to no review of the merits, quality, or price of their shares offered for sale. Once the issuer provided the disclosures mandated by the 1933 Act, it was free to sell its securities, no matter how poor the quality or how high the price of those securities.

The final observation about early history is that Congress, even in the face of such extreme philosophical differences between its new legislation and existing state blue sky laws, chose in 1933 not to preempt state blue sky laws.<sup>12</sup> At one level, perhaps this is not surprising. The country was in the depths of the Great Depression, and one can understand the reluctance to eliminate any laws designed to protect unwary investors from sharp or fraudulent practices connected with the sale of securities.

Whatever the rationale, when Congress in 1933 began to enact federal securities legislation with its different philosophy and made the decision not to preempt the area of business capital formation, it sowed the seeds for a confrontation between state and federal regulators operating within

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Goodkind, *supra* note 6, at 82-83 n.22.

8. Professors Macey and Miller report that, prior to the Securities Act of 1933, “[t]here was some federal regulation of securities sales . . . under the postal fraud laws, but the level of enforcement was minimal.” Macey & Miller, *supra* note 5, at 348 n.1.

9. Thus, for example, the Official Comment to the Uniform Securities Act emphasizes that the Uniform “Act, unlike the federal statute, is not primarily a disclosure Act.” Unif. Securities Act § 304\*cmt., 7B U.L.A. 566 (1985). *See also* Unif. Securities Act § 303\*cmt., 7B U.L.A. 560 (1985).

10. *See, e.g.*, Joseph C. Long, *State Securities Regulation—An Overview*, 32 OKLA.L. REV. 541, 543 (1979) (referring to blue sky laws as “the first consumer protection statutes”).

11. Professor Loss and Dean Seligman provide an extensive narrative and analysis of the “battle of the philosophies” that erupted in connection with the original adoption of the 1933 Act. *See* LOSS & SELIGMAN, *supra* note 5, at 171-93. The outcome of the “battle” is described simply by the authors: “President Roosevelt chose the disclosure philosophy.” *Id.* at 178.

12. Securities Act of 1933 Pub. L. No. 73-22 (May 27, 1933) § 18, 48 Stat. 74. NSMIA changed this section. *See* 15 U.S.C. § 77r (1999).

diametrically opposed philosophical constructs and the shadows of different histories. Interestingly, this apparently fragile relationship between competing agencies and competing philosophies turned out to be quite sturdy and thus lasted for decades without serious incident.<sup>13</sup>

Over the years, however, some commentators were critical of capital formation rules that involved differing philosophies and subjected national offerings to more than fifty sets of regulations and regulators. Until the 1980s, these commentators mainly focused on the matter of merit regulation.<sup>14</sup> Subsequently, criticism of blue sky regulation became broader, in the sense that aspects other than merit regulation began to attract attention. At the same time, however, the criticism became more focused on the particular impact of state securities laws on the capital formation process.<sup>15</sup>

In 1995, what previously was an academic fight in legal journals spilled onto the floor of Congress with the introduction of the Capital Markets Deregulation and Liberalization Act of 1995 (Capital Markets Bill).<sup>16</sup> As initially introduced, this legislation would have preempted all state control over the capital formation process, except for offerings made pursuant to the Intrastate Exemption.<sup>17</sup>

As the Capital Markets Bill, or NSMIA as it was finally be called, wound its way through the legislative process, various committee reports reflect

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13. Occasionally, of course, disagreements arose. Dean Sargent, for example, points out that “some state administrators bitterly opposed [the] expansion of state [ULOE] and federal [Regulation D] exemptions and have imposed many obstacles that make the coordination of federal and state exemptions difficult and costly.” Sargent, *supra* note 2, at 477. It also was no secret that many state administrators were unhappy with the amendments to Regulation A, in which the SEC adopted its “test the waters” mechanism for Regulation A offerings. See, e.g., Marc J. Steinberg, *The Emergence of State Securities Laws: Partly Sunny Skies for Investors*, 62 U. CIN. L. REV. 395, 408-11 (1993).

14. Even in 1987, Dean Mark Sargent was able to say that “the current debate over state securities regulation has focused almost entirely on the state securities administrators’ authority to review the substantive merits of registered offerings.” Mark A. Sargent, *State Disclosure Regulation and the Allocation of Regulatory Responsibilities*, 46 MD. L. REV. 1027, 1027 (1987). The literature on the subject around the time of and predating Dean Sargent’s observation includes Ad Hoc Subcomm. on Merit Regulation of the State Regulation of Securities Comm., *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785 (1986); Goodkind, *supra* note 6; John F. Hueni, *Application of Merit Requirements in State Securities Regulation*, 15 WAYNE L. REV. 1417 (1969); James S. Mofsky & Robert D. Tollison, *Demerit in Merit Regulation*, 60 MARQ. L. REV. 367 (1977).

15. For example, in 1985 this author wrote an article arguing for elimination of all state laws dealing with securities regulation, except for state laws prohibiting fraud in connection with the sale of securities. See Rutheford B. Campbell, Jr., *An Open Attack on the Nonsense of Blue Sky Regulation*, 10 J. CORP. L. 553 (1985).

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

17. See 15 U.S.C. §77c(a)(11) (1994 & Supp. IV 1998) (providing an exemption from registration for an offering by an issuer that is incorporated and doing business in the same state in which all of the offerees and purchasers have their residence). Section 3(a) of the Capital Markets Bill, H.R. 2131, 104th Cong. (1995), would have preserved state authority over intrastate offerings of securities and also would have preserved states’ authority to deal with antifraud matters.

Congress' intent to eradicate the cumulative effect of a regime that, when considered as a whole, subjected the capital formation process to fifty-plus sets of laws, regulations, and regulators and to eliminate the inefficient drag on capital formation caused by state blue sky regulation. One committee report, for example, described the pre-NSMIA situation as involving a system of rules "that, in many instances, is redundant, costly, and ineffective"<sup>18</sup> and stated that NSMIA was intended to "eliminate duplicative and unnecessary regulatory burdens while preserving important investor protections by reallocating responsibility over the regulation of the nation's securities markets in a more logical fashion."<sup>19</sup>

Notwithstanding the breadth of the Capital Markets Bill as initially introduced and the high-sounding rhetoric one finds in committee reports, NSMIA's positive impact on capital formation was dismal. Essentially, the Act only preempted state jurisdiction over offers and sales of mutual fund securities, securities in companies traded on national securities exchanges or the NASDAQ National Market System, and offers and sales of securities pursuant to certain carefully selected exemptions from registration provided by Section 3 and Section 4 of the 1933 Act.<sup>20</sup>

The special treatment for mutual funds was, obviously, significant for mutual funds and their investors. The preemption also resulted in savings for society and thus amounted to sound congressional action. Freeing mutual funds from the grasp of state securities regulators, however, had only an indirect benefit on capital formation.

Only slightly more helpful to capital formation was the preemption of offers and sales by companies with shares traded on national exchanges or the NASDAQ National Market System. Although that provision amounted to a wide preemption of state authority over the capital-raising efforts of larger corporations, even before NSMIA such capital-raising generally had devolved to federal control. This occurred because most state blue sky laws or regulations contained a "marketplace exemption" pursuant to which shares traded on national exchanges or the NASDAQ National Market system were

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

19. *Id.* at 39-40.

20. Section 102(a) of NSMIA preempts state control over "covered securities." 15 U.S.C. § 77r(a) (1994 & Supp. IV 1998). The Act then defines four classes of "covered securities." These include: securities listed for trading on certain national exchanges and the NASDAQ National Market System, see 15 U.S.C. § 77r(b)(1) (1994 & Supp. IV 1998); securities issued by registered investment companies, see 15 U.S.C. § 77r(b)(2) (1999); securities issued to a "qualified purchaser" (although the Act does not define that term but instead delegates definitional obligations to the Commission), 15 U.S.C. § 77r(b)(3) (1994 & Supp. IV 1998); and securities "with respect to a transaction that is exempt from registration . . . pursuant to" particular, described 1933 Act exemptions from registration, 15 U.S.C. § 77r(b)(4) (1994 & Supp. IV 1998).

exempt from state registration requirements.<sup>21</sup>

The value of the third broad preemptive provision of NSMIA, which preempted state control over securities offered or sold under most of the exemptions provided by Section 3 and Section 4 of the 1933 Act, was severely limited by its exclusions. Specifically, omitted from preemption were offers and sales of securities under the exemptions provided by Rule 504, Rule 505, Section 3(a)(11), Rule 147, Regulation A, and the common law of Section 4(2). Those provisions, of course, are the lifeblood of small issuers, and thus the result of the preemptive regime of NSMIA is that capital formation by small issuers continues to be subjected to control under all state blue sky regimes, as well as the federal regime.

Notwithstanding the fact that Congress, perhaps in response to political pressures,<sup>22</sup> limited the statutory preemption effected by NSMIA, there is some indication that the breadth of the preemption in NSMIA and, indeed, the political compromise underlying the statute, may be subject to future bargaining, through either Commission action or further Congressional activity. With respect to the power of the Commission to affect the scope of preemption established by the statutory language of NSMIA itself, Congress left the Commission with authority to expand the scope of NSMIA's preemption. This was effected when Congress delegated to the Commission, at least in the view of this author, significant authority to expand the definition of "covered security."<sup>23</sup> In addition, Congress seemingly indicated that it may itself be willing to reconsider the breadth of NSMIA's preemption, unless states get their houses in order. This signal came when Congress in NSMIA required the Commission to conduct a study and then report back to Congress in twelve months on the state of uniformity among the state securities regulatory schemes.<sup>24</sup> The Commission submitted this

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21. *Exchange Exemptions*, *supra* note 2, at ¶ 6401 (reporting 46 states with a marketplace exemption).

22. Various explanations may be offered for the significant constriction in the breadth of federal preemption between the Capital Markets Bill as initially proposed, and NSMIA as finally enacted. Any such explanation, however, should include a recognition of the political compromise inherent in NSMIA's final terms. *See* Rutheford B Campbell, Jr., *The Impact of NSMIA on Small Issuers*, 53 *BUS. LAW.* 575, 583-87 (1998).

23. NSMIA preempts state authority over "covered securities," and included in this category are securities offered or sold to "qualified purchasers, as defined by the Commission by rule." *See* 15 U.S.C. § 77r(b)(3) (1994 & Supp. 1998). In a previous article, this author argued that the Commission should infer a broad delegation of power to define "qualified purchasers," focusing on its statutory obligation to define the term "consistent with the public interest and the protection of investors." Campbell, *supra* note 3, at 207-210.

24. Section 102(b) of NSMIA requires the Commission to "conduct a study, after consultation with States, issuers, brokers, and dealers, on the extent to which uniformity of State regulatory requirements for securities or securities transactions has been achieved for securities that are not

report to Congress on October 11, 1997.<sup>25</sup>

At the time of the writing of this paper, no further material activity has occurred at either the Commission or Congressional levels, although in the summer of 1999, one report surfaced indicating that Congress may be about to reconsider the scope of NSMIA's preemption with a specific eye toward expanding preemption in a way that would substantially benefit small issuers.<sup>26</sup> No such bill has yet been introduced, however.

## II. THE CASE FOR CONGRESSIONAL ACTION

The reasons why Congress should preempt state control over capital formation,<sup>27</sup> and thus finish the work it commenced in NSMIA, can be articulated simply.

### A. *The Nonsense of Subjecting Small Issuers to Fifty-Plus (or Even Two) Registration Regimes*

Even considered in the abstract, any legal regime that requires the same act to be subjected to fifty-plus different sets of laws and regulations appears irrational on its face. When one considers that, in this case, an essential element of the free enterprise system, capital formation, is the subject of fifty-plus sets of laws and regulations governing the same act, the regime becomes even more troublesome.

NSMIA amounts to Congressional recognition of this obvious point. One need only to look to various committee reports<sup>28</sup> to find that the complexity and costs of complying with multiple schemes were the major driving forces behind NSMIA. What is impossible to rationalize, at least on any sound policy basis, is Congress' failure to extend federal preemption to offerings by small businesses. Arguments that one may offer in support of excluding small businesses from the preemptive scope of NSMIA are unpersuasive.

Presumably, no one would argue that small companies have no

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covered securities." Pub. L. No. 104-290, § 102(b), 110 Stat. 3416 (1996).

25. See SEC Report on Uniformity, *supra* note 3.

26. *This Weeks' Highlights* [1998-1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶5 (Aug. 4, 1999) Commerce Clearing House reported that the Senate Banking Committee was beginning to "work on the Securities Markets Enhancement Act." Regarding the impact of the proposed legislation on the capital formation activities of small issuers, it was reported that it was recommended that small offerings under Regulation D and Regulation A be added to the uniform exemption from state "registration." *Id.* One assumes that this reference to "exemption" should have been to "preemption."

27. To clarify, the argument here is limited to the preemption of all state control over the registration of securities. *But see* Campbell, *supra* note 15 (arguing for a more expansive preemption, including the preemption of broker-dealer registration requirements).

28. See *supra* notes 18-19 and accompanying text.



substantial need for external capital. While one probably is willing to take notice of this fact, hard evidence of small issuers' need for access to external capital is available. For example, data collected by the Small Business Administration (SBA) indicates that a substantial majority of businesses with fewer than fifty employees utilize borrowed funds to help finance their operations.<sup>29</sup> SBA data also indicate that banks make a tremendous number and dollar amount of small loans to business, a significant number of which are presumably made to small businesses. Thus, for example, during 1994, commercial banks, which not surprisingly are a principal source for these loans, had nearly five million business loans of less than \$250,000 each, totaling approximately \$156 billion.<sup>30</sup>

Perhaps a more persuasive argument against federal preemption over capital formation by small businesses can be based on the factual assumption that small issuers typically sell their securities in fewer than all states, and so subjecting small issuers to blue sky regulation will be less harmful, as small issuers will have fewer states (and accordingly lesser costs) to deal with in their typical offerings. Thus, for example, if one imagines that small issuers usually sell their securities in ten or fewer states, and sometimes in only one state, the capital formation activities of such issuers are subjected only to between two and eleven sets of laws and regulations,<sup>31</sup> as compared to the fifty-plus regimes to which issuers in larger offerings may be subject.

While at first blush the smaller transaction costs faced by such small issuers appear to ameliorate the burden on small business capital formation, in fact, that appearance is deceiving. The concern here is transaction costs that are so high as to foreclose a small business from public capital or, at least, so high as to raise its costs of capital to a level that makes the small company non-competitive, and it is relative, rather than absolute, costs that are important in this matter. Thus, for example, General Motors is better able to pay for blue skying a \$100 million offering in fifty states than a small corporation is able to pay for blue skying a \$100,000 offering in three states. Because of the relative sizes of the two offerings, the expenses associated with blue skying the GM offering are a small fraction of one percent of the total yield from the offering, while the costs of blue skying the offering by

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29. *See, e.g.*, U.S. SMALL BUS. ADMIN., THE STATE OF SMALL BUSINESS: A REPORT OF THE PRESIDENT 1994, at 348 tbl. B.18 (1995) [hereinafter THE STATE OF SMALL BUSINESS 1994]. For additional and somewhat later information about borrowing by small businesses, see U.S. SMALL BUS. ADMIN., THE STATE OF SMALL BUSINESS: A REPORT OF THE PRESIDENT 1996, at 273-80 (1997) [hereinafter THE STATE OF SMALL BUSINESS 1996].

30. *See* U.S. SMALL BUS. ADMIN., THE STATE OF SMALL BUSINESS: A REPORT OF THE PRESIDENT 1995, at 306 tbl. B.8 (1996) [hereinafter THE STATE OF SMALL BUSINESS 1995].

31. The numbers of regimes include the state jurisdictions plus the federal jurisdiction.

the small corporation, depending on the circumstances, could amount to thousands of dollars, or a significant percentage of the total yield from that offering.

Ironically, under NSMIA, General Motors, in connection with its \$100 million offering, is required to comply with only one regime, the federal securities laws, because NSMIA preempted state control over securities traded on certain national exchanges;<sup>32</sup> a small issuer attempting to raise \$100,000 by offering in three contiguous states, on the other hand, must comply with four regimes. After NSMIA, therefore, small corporations are disadvantaged in relation to large corporations not only in terms of the absolute dollars each must pay in blue sky costs but also, and perhaps more importantly, in terms of their transaction costs as a percentage of the yield from the offering.<sup>33</sup>

One is able to offer, at least, another possible but even more troubling explanation for the failure to preempt state control over the capital-raising activities of small corporations. This explanation, simply stated, is that rule makers, in today's world of multi-national corporations and multi-billion dollar acquisitions, do not consider small businesses to be very important. So, while regulators and other makers of economic rules may, for political reasons, mouth a concern for small businesses, their perception of the relative insignificance of small businesses generates an attitude of benign neglect and a focus of regulatory and other rule-making energies on the seemingly more important, and certainly more exciting and higher profile, activities of larger corporations.

To the extent this unarticulated line of thinking undergirds the failure to preempt state control over the capital formation activities of small businesses, it is shameful and without factual support. Indeed, empirical studies indicate that the contributions of small businesses to the national economy are significant, and anecdotal evidence suggests that the importance of small businesses may even exceed their importance as reflected by such empirical studies.

According to data assembled by the Small Business Administration, the

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32. See 15 U.S.C. § 77r(b)(1) (1994 & Supp. IV 1998).

33. The picture is actually even worse for the small issuer, as it has another blue sky expense that it must pay. Specifically, small issuers must be concerned that the persons they use to effect the sale of their securities do not run afoul of the state (and federal) obligations to register as brokers, dealers, agents, etc. This can be a significant problem for small issuers, because they usually do not utilize professional underwriters in their offerings, who can be assumed to be registered properly both at the national level and the state level as brokers, dealers, agents, etc. General Motors, on the other hand, will rely on professional underwriters and thus will not have to worry about this matter. See Campbell, *supra* note 15, at 567-75 (advocating federal preemption of broker-dealer registration requirements).

smallest firms, those with fewer than twenty employees, employ around 18 million workers in the United States, and this amounts to about twenty percent of the total number of jobs available in this country. There are approximately 4.5 million of these very small firms.<sup>34</sup> Firms with fewer than 100 employees (which includes, of course, all firms with fewer than twenty employees) employ a total of about 36 million workers, which amounts to nearly thirty-nine percent of the total number of jobs in the United States.<sup>35</sup> Obviously, such huge numbers eviscerate any claim of insignificance of small businesses.

Other data and estimates help paint the picture of the impact of small businesses, suggesting, for example, that small firms create a disproportionately large number of new jobs as compared to larger firms.<sup>36</sup> Other, somewhat more anecdotal studies estimate that small businesses, as compared to larger businesses, generate a disproportionately large percentage of manufacturing product innovations.<sup>37</sup>

The picture that emerges, therefore, is that of a material portion of the economy which is subjected to disproportionately burdensome and expensive rules respecting capital formation. The result is not only unfair to small entrepreneurs but also broadly inefficient in society. Resources are misallocated, services are provided by relatively less efficient firms, and the full benefits of the American entrepreneurial spirit are less likely to be achieved.

### *B. Neither the States nor the Commission Will Provide Remedies*

Society could remedy the problems discussed above in one of two ways. The first is for all fifty states to achieve uniformity among their individual

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34. See STATE OF SMALL BUSINESS 1994, *supra* note 29, at 164 tbl. A.4. Interestingly, only about 500,000 firms in the United States employ more than twenty employees. These larger firms, however, employ 80% of all workers. See *id.* For information on prior years, see *id.* at 244 tbl. A.11 (indicating that these numbers and percentages have been fairly constant in recent years). In terms of total payroll, in 1991, firms with fewer than 20 employees paid approximately \$381.5 billion (17.8% of the total payroll for all firms). See *id.* at 164 tbl. A.4.

35. See *id.* at 164 tbl. A.4, 244 tbl. A.11. See also *id.* at 244 tbl. A.11 (reporting similar figures in other recent years).

36. For example, in 1993, the number of jobs created in the top 15 industries dominated by small businesses (730,000) amounted to over three times the number of jobs created in the top 15 industries dominated by large businesses (196,000). See *id.* at 54 tbl. 1.13. See also *id.* at 300 tbl. A.26 (similar information on prior periods). In this case, an industry is considered to be dominated by small businesses if at least 60% of all firms have fewer than 500 employees. See *id.* at 300.

37. See *id.* at 15 (“Small firms have been estimated by the Futures Group to be responsible for 55 percent of manufacturing product innovations and they produce more than twice as many innovations per employee as large firms. They also produce twice as many significant innovations per employee.”).

blue sky laws and regulations through cooperative action. This, of course, is an incomplete remedy, assuming it could be achieved. Even with total uniformity among the states, the capital formation process would still be subject to two distinct sets of rules: the single, uniform set of state rules and the federal rules. Still, society would benefit if the capital formation process were subject only to two regimes instead of fifty-plus regimes.

The other and more complete remedy is federal preemption.<sup>38</sup> In that case, of course, issuers and society would be subject to only one mandatory set of capital formation rules.<sup>39</sup>

### 1. *Uniformity Among States Is Impossible*

One defense that is raised, both explicitly and implicitly, by state administrators in response to efforts to eliminate state supervision of the capital formation process is the claim that the states have made significant progress toward a goal of uniformity.<sup>40</sup> Thus, the states may argue that their regulatory regimes are not overly expensive to society.<sup>41</sup>

38. A third possibility could be based on proposals by Professor Roberta Romano to allow issuers to select a single registration regime from any of the state and federal jurisdictions. See Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 *YALE L.J.* 2359 (1998) (advocating allowing a firm to select the particular securities regime to which the firm is subject from domestic state and federal regimes and regimes of foreign nations). Professor Romano probably would allow a corporation to choose to be subject to the laws of all 50 states if the corporation so desired. One can only imagine that no corporation (or investor, if investors were permitted to vote on the matter) in its right mind would opt into such an expensive and inefficient regulatory scheme.

39. During the 1960s, some scholars began to criticize mandatory disclosure. See, e.g., HENRY MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966); George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, *AM. ECON. REV.* Mar. 1973, at 132; George J. Stigler, *Public Regulation of the Securities Markets*, 37 *J. BUS.* 117 (1964) (criticizing the 1963 *Report of the Special Study of the Securities Market*). Concluding that there was “little basis” for the Securities Exchange Act of 1934 [the 1934 Act] and “no evidence that it was needed or desirable,” Benston concludes his piece by stating that “[c]ertainly there is doubt that more required disclosure is warranted.” *Id.* at 153. Professor Loss and Dean Seligman offer a defense of mandatory disclosure in their treatise. See LOSS & SELIGMAN, *supra* note 5, 183-93.

40. See, e.g., SEC Report on Uniformity, *supra* note 3, Part III.B.1.a.(I)(C) (“Many of the state responses [to an SEC questionnaire soliciting views respecting the uniformity of state regulation] describe state actions to increase uniformity, including the Coordinated Equity Review (CER) program and NASAA Statements of Policy.”).

41. State regulators always supplement their argument about the low costs of state regulation with the argument that state regulation is essential for the protection of investors. As the SEC report stated:

Several states emphasized that state blue sky laws have played a strong role in protecting investors in their states and promoting the stability and integrity of the states’ securities markets. Certain states asserted that the states, as opposed to the Commission, are in the best position to regulate small offerings, which are usually local or regional in nature.

*Id.* at 9 (describing responses from state administrators to a questionnaire on uniformity initiated by

Viewed broadly, the claim of increasing uniformity among state securities laws and regulations seems plausible. Approximately forty-one jurisdictions have adopted or substantially adopted the Uniform Securities Act,<sup>42</sup> which means that most states have some version of a small offering exemption<sup>43</sup> and also provide for registration by qualification, notification, or coordination.<sup>44</sup> A significant majority of states have adopted some form of the Uniform Limited Offering Exemption (ULOE),<sup>45</sup> most states also have adopted the Small Company Offering Registration (SCOR) form,<sup>46</sup> and NASAA has promoted a regional review program for SCOR filings.<sup>47</sup>

State regulators also point to other bases for their claim of increasing uniformity. For example, NASAA has promulgated Statements of Policy dealing with various securities matters, and a number of states have adopted some or all of these uniform policies.<sup>48</sup> Finally, the vast majority of states are part of a coordinated equity review program.<sup>49</sup>

Notwithstanding such apparent gains, meaningful uniformity in fact

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the SEC).

42. Forty-one out of 53 jurisdictions (the 50 states plus the District of Columbia, Guam, and Puerto Rico) have “adopted or substantially adopted with modifications” the Uniform Securities Act. *See Jurisdictions Adopting the Uniform Securities Act*, 1 Blue Sky L. Rep. (CCH) ¶ 5500 (1998).

43. *See* UNIF. SECURITIES ACT § 402(b)(9), 7B U.L.A. 600-01 (1985).

44. *See* UNIF. SECURITIES ACT §§ 301-04, 7B U.L.A. 550, 555-56, 559-60, 562-65 (1985).

45. The SEC reported in its 1997 report to Congress that “[a]pproximately 30 states have adopted ULOE to some extent.” SEC Report on Uniformity, *supra* note 3, at 9. Nine of the ten states sampled by the author of this Article have some form of ULOE. *See infra* notes 52 and 67 and accompanying text.

46. North American Securities Administrators Association (NASAA) Reports lists 43 “states that have, either officially or unofficially, adopted the SCOR registration program or that recognize the filing of Form U-7.” *State Adoptions of Small Corporate Offering Registration Program and Form U-7*, NASAA Rep. (CCH) ¶ 267 (May, 1996). The Commission reported to Congress in 1997 that “[t]hirty-six states reported that they have adopted the SCOR form. Another four states accept filings on the SCOR form although the form has not been formally adopted.” SEC Report on Uniformity, *supra* note 3, at 16. For a complete description of the form and the requirements respecting the use of the SCOR form, *see* NASAA Rep. (CCH) ¶ 411 (Nov. 1999), and *NASAA Small Company Offering Registration (SCOR) Manual*, NASAA Rep. (CCH) ¶ 416 (Dec. 1999).

47. Under this program, “a group of states in close geographical proximity to one another agree to permit one securities regulator in the region to lead the review of the form and communicate comments to the issuer.” SEC Report on Uniformity, *supra* note 3, at 16.

48. As a result of a survey of state administrators, the SEC reported: “Of the 46 states responding to the survey, 28 states indicated that they have adopted or apply some or all of the NASAA Statements of Policy.” SEC Report on Uniformity, *supra* note 3, at 14.

49. “Of the states that register offerings eligible to use CER, all but four are currently participating in CER.” *NASAA Coordinated Equity Review Program*, NASAA Rep. (CCH) ¶ 10,001 (Dec. 1998). Under this program, certain equity offerings are eligible for a coordinated state review pursuant to which all individual state comments are transmitted through two “lead states”—one a merit state and one a non-merit state. These lead states then deal with the issuer to work out the comments of the individual states and ultimately clear the offering on behalf of all participants. For a description of the coordinated equity review program, *see* SEC Report on Uniformity, *supra* note 3, Part III.B.1.a.ii(A).

continues to elude the states. Consider, for example, from the foregoing list of cooperative actions among the states, the question of whether the small offering exemption, which is part of the Uniform Securities Act, is in fact uniform among the states. The small offering exemption under the Uniform Securities Act provides a transactional exemption from registration for offerings by an issuer to no more than ten offerees in a twelve month period, provided that the purchasers take for investment and that no commission is paid in connection with the sale.<sup>50</sup>

In the first place, of course, not all states have adopted the Uniform Securities Act,<sup>51</sup> and even those that have adopted the Uniform Act often incorporate their own idiosyncratic twists into the uniform small offering exemption. Thus, among a ten-state statistical sample,<sup>52</sup> one state has no small offering exemption,<sup>53</sup> and in the other nine states, the terms of the small offering exemption are less than uniform. One variation concerns who must be counted to establish the upper limits of the exemption. For example, among the nine states from the sample with a small offering exemption, one state determines the availability of the small offering exemption by reference to offerees,<sup>54</sup> seven states determine the availability of the exemption by reference to purchasers,<sup>55</sup> while one state's criterion is the number of stockholders following the offering.<sup>56</sup>

States also differ in their limit on the maximum number of offerees or purchasers (or stockholders) permitted under the small offering exemption. Maryland, for example, permits ten purchasers,<sup>57</sup> while Illinois permits

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50. See Unif. Securities Act § 402(b)(9), 7B U.L.A. 601-02 (1985).

51. See *supra* note 42, and accompanying text.

52. The author of this Article examined the laws and regulations of the following ten states: Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts and Michigan. This statistical sample includes the author's home state of Kentucky and the nine states that fall nearest to Kentucky in the alphabet.

53. Louisiana has no small offering exemption. Louisiana does, however, have a private offering exemption available for offerings that are exempt from federal registration under § 4(2) of the 1933 Act. See LA. ADMIN. CODE tit. 64, § 705 (Supp. 1987). One of the further conditions for the exemption, however, is that there be no more than 35 purchasers during any 12-month period. See *id.*

54. Massachusetts calculates its small offering exemption by offerees. See MASS. GEN. LAWS ch. 110A § 402(b)(9) (1998).

55. See 815 ILL. COMP. STAT. 5/4 (West 1999); IND. CODE § 23-2-1-2(b)(10) (1989); IOWA CODE § 502.203 (1999); KAN. STAT. ANN. § 17-1262 (1995); KY. REV. STAT. ANN. § 292.410 (Michie 1995); MD. REGS. CODE tit. 2, § 4.10 (1999); MICH. COMP. LAWS ANN. § 451.802(b)(9)(D)(2),(3) (West 1989).

56. The limit on the number of security holders permitted under Maine's small offering exemption is either 10 or 25, depending on certain factors, including the level of disclosure made by the issuer. See ME. REV. ST. ANN. tit. 32, § 10502(2)(P), Q) (West 1999).

57. See MD. REGS. CODE tit. 2, § 4.11(c).

thirty-five purchasers.<sup>58</sup> States also have different counting regimes for the small offering exemption. Of the nine states from the sample with a small offering exemption, two states count universally (i.e., count both intrastate and interstate offerees and/or purchasers),<sup>59</sup> four states count only intrastate transactions,<sup>60</sup> and three states allow issuers to choose whether to count based on intrastate transactions or universally.<sup>61</sup>

The sample reveals other variations in the small offering exemption. Six states provide an individualized informal procedure through which issuers can petition for relief from some or all of the conditions in the small offering exemption.<sup>62</sup> Finally, seven states require some filing in connection with the utilization of the small offering exemption.<sup>63</sup>

Now consider the ULOE. The ULOE provides an exemption from state registration requirements for offers and sales made under Securities Act Rules 505 or 506, provided that the issuer meets all the requirements of one of those rules and certain additional requirements, such as a suitability or sophistication requirement for all nonaccredited investors.<sup>64</sup>

Preliminarily, in considering the matter of uniformity among the states respecting the ULOE, one must recognize the exhaustive work on the ULOE of Professor Therese Maynard, who mounted a withering attack on any claim that the ULOE in fact was uniform among the states.<sup>65</sup> Professor Maynard's

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58. See 815 ILL. COMP. STAT. 5/4. See *supra* note 56, for an example of a state that has more than one limitation calculation.

59. Kansas and Maine calculate their purchasers universally. See KAN. STAT. ANN. § 17-1262; ME. REV. ST. ANN. tit. 32, § 10502(2)(P).

60. Illinois, Iowa, Massachusetts and Michigan calculate their purchasers by intrastate offerees. See 815 ILL. COMP. STAT. 5/4; IOWA CODE § 502.203; MASS. GEN. LAWS ch. 110A § 402(b)(9); MICH. COMP. LAWS ANN. § 451.802(b)(9)(D)(2),(3).

61. Indiana, Kentucky and Maryland allow issuers to choose between calculation formule based on either intrastate transactions or universal transactions. See IND. CODE § 23-2-1-2(b)(10); KY. REV. STAT. ANN. § 292.410; MD. REGS. CODE tit. 2, § 4.10.

62. These states are Indiana, Iowa, Kentucky, Maryland, Massachusetts and Michigan. See IND. CODE § 23-2-1-2(b)(10)(I); IOWA CODE § 502.203(9)(d); KY. REV. STAT. ANN. § 292.410(i)(6); MD. REGS. CODE tit. 2, § 4.10(A)(3); MASS. GEN. LAWS ch. 110A, § 402(b)(9); MICH. COMP. LAWS ANN. § 451.802(b)(9)(G).

63. These states are Illinois, Indiana, Kentucky, Maine, Maryland, Massachusetts, and Michigan. See 815 ILL. COMP. STAT. 5/4(G)(4); Bradley W. Skolnik, Indiana Securities Commissioner, *Statement of Policy Regarding Exemptions Claimed Pursuant to IC 23-2-1-2 and 710IAC 1-13-6* (visited Apr. 6, 2000) <<http://www.state.in.us/sos/security/orpol.html>>; KY. REV. STAT. ANN. § 292.415; ME. REV. ST. ANN. tit. 32, § 10502(2)(Q); MD. REGS. CODE tit. 2, § 4.12(D); MASS. GEN. LAWS ch. 110A § 402(b)(9); MICH. COMP. LAWS ANN. § 451.802(b)(9)(D)(3).

64. See *Uniform Limited Offering Exemption*, NASAA Rep. (CCH) ¶ 6201 (Oct. 1990). Other additional conditions imposed by ULOE include the prohibition of paying any brokerage commission to anyone not registered with the state, "bad boy" provisions, and the obligation to file the federal Form D with the state. See *id.*

65. See Therese H. Maynard, *The Uniform Limited Offering Exemption: How "Uniform" is "Uniform?"—An Evaluation and Critique of the ULOE*, 36 EMORY L.J. 357 (1987). Professor

work, which is confirmed by others,<sup>66</sup> is consistent with this author's ten-state sample, which similarly suggests a substantial lack of uniformity among the states' ULOE provisions.

Thus, for example, while nine of the ten states in the sample have adopted some form of a ULOE,<sup>67</sup> seven states limit their coordination through ULOE to offers under Rule 505 and Rule 506,<sup>68</sup> while two states also permit ULOE coordination with Rule 504 offerings.<sup>69</sup> As further examples of lack of uniformity, Maryland's "bad boy" provisions differ from (and apparently are stricter than) those found in the NASAA version,<sup>70</sup> and Maryland's regulation also does not contain a suitability requirement for non-accredited investors.<sup>71</sup> Massachusetts and Kansas calculate non-accredited investors' net

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Maynard concludes:

The ULOE was intended to ease [the] burden by providing a uniform exemption in all fifty states which would also coordinate with Regulation D. In actual practice, however, the ULOE has not achieved its goal. The modifications made by the NASAA member states have resulted in the same confusing array of exemptive requirements that existed prior to the ULOE.

*Id.* at 504.

66. See Sargent, *supra* note 2, at 477 ("The additional state requirements vary substantially from jurisdiction to jurisdiction, thus undermining ULOE's claim to being uniform.")

67. Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maryland, Massachusetts and Michigan have some form of the ULOE. See ILL. ADMIN. CODE tit. 14, § 130.420 (1996); IND. ADMIN. CODE tit. 710, r. 1-13-6 (1999); IOWA ADMIN. CODE r. 191-50.16 (1997); KAN. ADMIN. REGS. 81-5-6 (1997); 808 KY. ADMIN. REGS. 10:210 (1999); LA. ADMIN. CODE tit 64, § 705 (1987); MD. REGS. CODE tit. 2, § 4.15; MASS. REGS. CODE tit. 950, § 14.402(B)(13)(i) (1997); MICH. ADMIN. CODE r. 451.803.7 (1999).

68. Illinois, Iowa, Kansas, Louisiana, Maryland, Massachusetts, and Michigan limit their coordination through ULOE to offers under Rule 505 and Rule 506. See ILL. ADMIN. CODE tit. 14, § 130.420; IOWA ADMIN. CODE r. 191-50.16; KAN. ADMIN. REGS. 81-5-6(a); LA. ADMIN. CODE tit 64, § 705; MD. REGS. CODE tit. 2, § 4.15; MASS. REGS. CODE tit. 950, § 14.402(B)(13)(i); MICH. ADMIN. CODE r. 451.803.7. Under NSMIA, securities sold in rule 506 transactions are "covered securities" and thus no longer subject to state regulation. NSMIA, *supra* note 2, § 102(a), 15 U.S.C. § 77r(b)(4) (1999).

69. Indiana and Kentucky permit ULOE to be coordinated with Rule 504 offerings, as well as with Rule 505 and Rule 506 offerings. See IND. ADMIN. CODE tit. 710, r. 1-13-6(d)(1); 808 KY. ADMIN. REGS. 10:210.

70. NASAA's ULOE becomes unavailable for persons convicted of certain crimes, while Maryland's ULOE becomes unavailable for convictions for or pleas of *nolo contendere* to certain crimes. MD. REGS. CODE tit. 2, § 4.15(C)(1)(b). Furthermore, while NASAA's ULOE may still be available if an issuer did not have reason to know of a "bad boy" violation, see *Uniform Limited Offering Exemption* 1.B, NASAA Rep. (CCH) ¶ 6201 (May 1989), the Maryland exemption provides for no such defense to a "bad boy" violation, see MD. REGS. CODE tit. 2, § 4.15. The Maryland regulation additionally disqualifies a target person subject to a U.S. Postal Service false representation or cease and desist order, see MD. REGS. CODE tit. 2, § 4.15(C)(1)(d), a disqualification not specifically enumerated by NASAA. See *Uniform Limited Offering Exemption*, NASAA Rep. (CCH) § 6201 (May 1989). Finally, the criteria for waiver of the "bad boy" exclusions appear somewhat different in the Maryland and NASAA versions of ULOE. Compare MD. REGS. CODE tit. 2, § 4.15(C)(3), with *Uniform Limited Offering Exemption* 1.B.7, NASAA Rep. (CCH) ¶ 6201 (May 1999).

71. See MD. REGS. CODE tit. 2, § 4.15.



worth differently from NASAA's ULOE and differently from each other.<sup>72</sup> Thus, this author's statistical sample supports prior scholarly conclusions that ULOE provisions often vary from state to state.

Other claims of uniformity are also problematic. For example, the SCOR program, which seems to be a major point of pride for those claiming uniformity, is less than completely uniform across the states. Once again, one finds less than complete adoption of the SCOR program by the states. NASAA Reports, for example, indicates that thirty-six jurisdictions "officially" recognize the SCOR form for registration purposes, while another seven jurisdictions recognize the form "unofficially."<sup>73</sup> But even among the states recognizing the SCOR regime, variations exist.<sup>74</sup> Indeed, the Policy itself emphasizes in its first paragraph that state securities administrators "may waive any standard set forth in this Policy Statement for good cause and may also impose substantive standards not contained in this Policy Statement,"<sup>75</sup> and, therefore, one predictably finds differences in the rules of the SCOR regime among the ten states in the sample.<sup>76</sup>

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72. Massachusetts, like NASAA, has a suitability requirement that presumes an investor is suitable if the investment does not exceed 10% of the investor's net worth. Unlike the NASAA version, however, Massachusetts excludes principal residence and furnishings from the calculation and adds spouse's net worth to the equation. *See* MASS. REGS. CODE tit. 950, § 14.402(b)(13)(i)(4)(a). Massachusetts has an additional provision that, in sales to non-accredited investors or accredited investors who are natural persons, the investment may not exceed 25% of an investor's net worth. *See* MASS. REGS. CODE tit. 950, § 14.402(b)(13)(i)(5). Kansas presumes that a sale to a non-accredited investor is a suitable investment if the investment does not exceed 20% of the investor's net worth, excluding a principal residence, its furnishings, and personal automobiles. KAN. ADMIN. REGS. 81-5-6(a)(10).

73. *State Adoption of Small Corporate Offering Registration Program and Form U-7*, NASAA Rep. (CCH) ¶ 267 (May 1996). In its report to Congress in October, 1997, the SEC stated that "[t]hirty-six states reported that they have adopted the SCOR form. Another four states accept filings on the SCOR form although the form has not been formally adopted." SEC Report on Uniformity, *supra* note 3, at 17.

74. The description found in *State Adoption of Small Corporate Offering Registration Program and Form U-7*, NASAA Reports (CCH) ¶ 267 is confusing but indicates less than complete uniformity in terms and provisions among the states adopting the basics of the SCOR form. After indicating that a significant number of states have declared that "issuers filing Form U-7 must comply with the NASAA Instructions to the form," the report states: "Other states have adopted the NASAA Instructions with modifications. Still other states have not officially adopted laws, regulations or policies that recognize the NASAA Instructions or permit the filing of Form U-7 subject to a state's own procedures." *Id.*

75. *Statement of Policy Regarding Small Company Offering Registrations*, NASAA Reports (CCH) ¶ 411 (Apr. 28, 1996) [hereinafter NASAA Statement of Policy].

76. States often differ among themselves and/or from NASAA's policy regarding the use of SCOR in areas such as: (a) eligible offerings (*e.g.*, Illinois permits SCOR offerings for Rule 504 offerings, see ILL. ADMIN. CODE tit. 14, § 130.525(a)(8) (1997); Michigan allows SCOR filings for Rule 504 and Section 3(a)(11) offerings, see MICH. ADMIN. CODE r. 451.803.11(1) (1999); NASAA's policy permits use of SCOR for offerings under Rule 504, Regulation A, and Section 3(a)(11), see NASAA Statement of Policy, *supra* note 75, ¶ 411); (b) eligible issuers (*e.g.*, NASAA policy permits use of SCOR by limited liability companies, see NASAA Statement of Policy, *supra* note 75, ¶ 413,

Finally, the costs of a SCOR registration<sup>77</sup> are often relatively high, and the seam in which SCOR use is both legally permissible<sup>78</sup> and economically sensible for the issuer is quite narrow.<sup>79</sup> As a result, one should not be surprised to learn that the use of SCOR appears to be modest. For example, again according to information gathered from ten sample states, Iowa reports that only four SCOR registration statements became effective in that state during each of the calendar years 1997, 1998, and 1999.<sup>80</sup> Indiana reports that only two SCOR registration statements became effective between January, 1997 and August, 1999.<sup>81</sup> Information gathered from other sample states reflects similarly modest utilization of SCOR.<sup>82</sup>

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while regulations of some states, such as Iowa, omit permission for use of SCOR by limited liability companies) see IOWA ADMIN. CODE r. 191-50.22(1)(a) (1997); Michigan also further limits the use of SCOR by excluding its use by "commodity pools," "equipment leasing programs," "real estate programs" and "issuers with complex capital structures," MICH. ADMIN. CODE R. 451.803.11(3)(a) (1999); (c) calculation of aggregate offering price limit (e.g., Kansas aggregates sales within the last 12 months under Rule 504, Section 3(b) or in violation of Section 5, see KAN. ADMIN. REGS. 81-4-2(a)(3) (1997), while Michigan also includes in its aggregation formula sales under Section 3(a)(11), see MICH. ADMIN. CODE R. 451.803.11(3)(b)(v) (1999), and Maryland aggregates sales under Section 3(b) and in violation of Section 5, MD. REGS. CODE tit. 2, § 312(D)(1); and (d) per share offering price (NASAA policy requires an offering price of at least \$1 per share, NASAA Statement of Policy, *supra* note 75, ¶ 413, while some states, such as Maryland, have raised the minimum offering price to \$5 per share), see MD. REGS. CODE tit. 2, § 312(D)(4)-(6)).

77. Form U-7 has 118 items that must be answered and includes a requirement for GAAP financials (often audited), exhibits, etc. 1 Blue Sky Rep. (CCH) ¶ 5124. The SCOR Issuer's Manual runs for over 90 pages in the NASAA Reports. See *NASAA Small Company Offering Registration (SCOR) Manual*, NASAA Rep. (CCH) ¶ 416 (Dec. 1999). When one considers the external legal and accounting costs and internal costs (*i.e.*, the costs of employees and officers who must participate in gathering and rendering information) generated by such requirements, this author, who has experience writing registration statements, would be surprised if total offering expenses were less than \$30,000 and not surprised if the expenses exceeded \$50,000. In addition, to the extent the transaction is underwritten, those costs, which will be significant, must also be paid.

As described earlier, it is relative, not absolute, offering expenses that are significant to an issuer. See *supra* discussion accompanying note 31. Thus, if one imagines that total offering expenses for an SCOR filing, before any underwriter's commissions, amount to \$50,000, expenses on a \$500,000 SCOR offering, before any underwriting commissions, would amount to 10% of the yield from the offering. Relative offering costs in that range obviously and significantly detract from the attractiveness of SCOR.

78. SCOR registration under the NASAA formula is available only for offerings under Rule 504, Regulation A and Section 3(a)(11). The use of the Form U-7 is limited in other ways as well. For example, petroleum and mining companies cannot use the form. See NASAA Statement of Policy, *supra* note 75, ¶ 413.

79. Economically, it is sensible for an issuer to utilize SCOR, or any other option, only if the relative costs are reasonable. See *supra* note 77.

80. See Letter (e-mail) from Thomas E. Alberts, Securities Exemption Attorney, Iowa Office of the Securities Commissioner, to Rutheford B Campbell, Jr., Professor of Law, University of Kentucky (Feb. 29, 2000) (on file with the author).

81. Telephone Interview by Herbert Stapleton with Linda Hayden, Registration Clerk, Indiana Securities Division (Feb. 29, 2000).

82. For the three calendar years 1997, 1998 and 1999, Kansas reports, that, respectively, 15, 6 and 3 SCOR filings became effective. See Letter (FAX) from Steve Wassom, Chief Auditor and

Another uniformity problem arises from the way states have dealt with NASAA's Statements of Policy. Presently, NASAA lists thirty-four Statements of Policy available for adoption by states, covering a myriad of matters from cattle-feeding programs<sup>83</sup> to commodity pool programs<sup>84</sup> to offerings of debt instruments by not-for-profit health care entities.<sup>85</sup> These Policies, however, have not been uniformly adopted by the states. For example, while the adoption rate for the various Policies differs, just under twenty-one blue-sky jurisdictions, on average, adopt any NASAA Policy.<sup>86</sup> In other words, only about forty percent of blue-sky jurisdictions adopt NASAA's Policies,<sup>87</sup> leaving a substantial lack of uniformity concerning the subject matter of the Policies.<sup>88</sup>

NASAA's Coordinated Equity Review Program, which provides for coordinated review of offerings filed with multiple states, is another example of a well-meaning attempt to reduce non-uniformity that, unfortunately, at best generates an incremental gain on that score. Although NASAA reports wide participation in the program,<sup>89</sup> one must, when considering the impact of the policy on uniformity among the states, be clear what the program does and does not do. Coordinated review does not change the idiosyncratic nature of any of the participating states' laws or regulations. Indeed, the Policy itself emphasizes that "comments may . . . be generated independently by the

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Director of Finance, Kansas Office of the Securities Commissioner, to Ruthford B Campbell, Jr., Professor of Law, University of Kentucky (Feb. 29, 2000) (on file with author). Michigan reports that a total of 12 SCOR filings (an average of three per year) became effective during the period of 1997 through 1999. *See* Telephone Interview by Herbert Stapleton with Karen Wildmo, Attorney, Michigan Securities Division (Mar. 1, 2000).

One state, Maryland, refused to provide information voluntarily, stating that the Division would respond only pursuant to a request under the state's freedom of information act. *See* Telephone Interview by Herbert Stapleton with Leah R. Schuman, Senior Examiner Maryland Office of the Attorney General, Division of Securities (Mar. 1, 2000).

83. *See Registration of Publicly Offered Cattle-Feeding Programs*, NASAA Rep. (CCH) ¶¶ 601-606 (Sept. 17, 1980). Twenty-eight jurisdictions have adopted this Policy. *See NASAA Statement of Policy Adoptions*, NASAA Rep. (CCH) 263.

84. *See Registration of Commodity Pool Programs*, NASAA Rep. (CCH) ¶¶ 1201-1207 (Sept. 21, 1983). Thirty-four jurisdictions have adopted this Policy. *See NASAA Statement of Policy Adoptions*, NASAA Rep. (CCH) ¶ 263 (Feb. 2000).

85. *See Health Care Facility Offerings*, NASAA Rep. (CCH) ¶¶ 2001-2005 (Apr. 5, 1985). Nineteen jurisdictions have adopted this Policy. *See NASAA Statement of Policy Adoptions*, NASAA Rep. (CCH) ¶ 263, at 294.

86. *See NASAA Statement of Policy Adoptions*, NASAA Rep. (CCH) ¶ 263 (Feb. 2000).

87. The average number of jurisdictions adopting NASAA's Policies is 20.7. *See NASAA Statement of Policy Adoptions*, NASAA Rep. (CCH) § 263 (Feb. 2000). Therefore, with 53 blue sky jurisdictions, see *supra* note 42, the average rate of adoption for the policies is approximately 39.1%.

88. In its 1997 report to Congress, the SEC reported: "Of the 46 states responding to the survey, 28 states indicated that they have adopted or apply some or all of the NASAA Statements of Policy." SEC Report on Uniformity, *supra* note 3, III.B.1.a.ii(B).

89. *See supra* note 49.

various [state] examiners,” as they enforce their particular, state disclosure regime, and accordingly “the issuer may ultimately have to resolve the comment directly with that particular state.”<sup>90</sup> Thus, while the program does facilitate efficient review, it does not eliminate the costs associated with an issuer’s obligation to research and meet the requirements of each state’s particular laws and regulations.

The next observation about the coordinated review program is that it is attractive only for a narrow range of offerings. Indeed, the policy itself excludes coordinated review for certain types of offerings.<sup>91</sup> Even more important to the program’s use (or non-use) is the narrow range of offerings in which issuers will elect to use the procedure. Only issuers that are not traded on national exchanges or the NASDAQ National Market System will ever seek a coordinated review,<sup>92</sup> and those companies, because of their small size, typically will either be unable to find the professional underwriting support to undertake a public offering or be put off by the huge expense of a public offering, because they often have relatively modest capital requirements. Thus, one is not surprised to find that by late 1999, only seventeen coordinated equity review offerings had become effective.<sup>93</sup>

The point of this section is not to argue that states have made no progress toward uniformity nor, certainly, that states are acting in bad faith. Instead, the discussion is intended only to demonstrate that gains in uniformity at the state level have been only incremental and further, that one should expect nothing more from states’ efforts at coordination. The seductive force of sovereignty on well-meaning state rule-makers and regulators who believe fervently that they are the first line of defense against the perpetration of evil acts on innocent and helpless citizens of their state is simply too great.<sup>94</sup>

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90. *NASAA Coordinated Equity Review Program*, NASAA Rep. (CCH) ¶ 10,001, at 10,013 (Dec. 1998). The Policy further warns issuers that: “As the CER process does not encompass all areas of regulatory oversight, the examiners may make state specific comments.” *Id.*

91. “CER is not available for Regulation A [,] blind pool or blank check offerings. Issuers should note that CER may not be available on all offerings even if the offering fits within the initial screening criteria.” NASAA Rep., *NASAA Coordinated Equity Review Program*, (CCH) ¶ 10,001, at 10,011 (Dec. 1998).

92. This is because NSMIA preempts state authority over all securities “listed, or authorized for listing, on the New York Stock Exchange or the American Stock Exchange, or listed, or authorized for listing, on the national Market System of the Nasdaq Stock market.” 15 U.S.C. § 77r(a), (b)(1)(A) (Supp. IV 1998).

93. See Telephone interview by Herbert Stapleton with Lynn Naefech, Attorney, Pennsylvania Securities Commission (Dec. 2, 1999). The SEC previously reported that as of September, 1997, there had been only two coordinated equity reviews. See SEC Report on Uniformity, *supra* note 3, Part III.B.1.a.ii(A).

94. Reporting on the results of its surveys, the Commission stated: “Several states emphasized that state blue-sky laws have played a strong role in protecting investors in their states and promoting the stability and integrity of the states’ securities markets.” SEC Report on Uniformity, *supra* note 3,

States are unwilling, in furtherance of the cause of uniformity, to subjugate their perceived state interests in protecting their citizens from such evil acts. As a result, one should not expect anything approaching uniformity in state registration regulation.

## 2. *The Commission is Unwilling to Expand Preemption*

The Commission shows neither a desire for more preemption nor an understanding of the inefficiency in capital formation and the unfairness to which small issuers are subject in the NSMIA era.

To illuminate the Commission's apparent lack of interest in further preemption, consider the balance of power between the states on the one hand and the federal government on the other as concerns the regulation of the offer and sale of securities. Because the 1933 Act did not preempt state laws respecting capital formation, states have always had the power to neutralize any federal rule that promoted capital formation. An example of this is the Commission's 1992 amendment to Regulation D, which permitted Rule 504 offerings to be made by means of a general advertising.<sup>95</sup> The rule allowing general advertising, which, regrettably, was recently rescinded by the Commission,<sup>96</sup> could have been a benefit to small companies attempting to find capital, because, for example, small companies could have used newspapers, radio, or other media to find and solicit potential investors. This benefit, however, was entirely neutralized by state blue sky laws, due to the fact that the only state exemption from registration broadly available for such Rule 504 offerings was the small offering exemption,<sup>97</sup> and the terms of that exemption could not be met if the offering were conducted through general advertising.<sup>98</sup> Accordingly, notwithstanding the federal rule on the matter, a Rule 504 offering effectively could not be made pursuant to a general advertising. State policy respecting permissible methods of capital formation trumped the federal rule.

The preemption in NSMIA, however, changed this balance of power and

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Part III.B.1.a.ii(D).

95. Rule 504 originally was enacted with a prohibition against general advertising. *See Securities Act Release No. 33-6389*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,106 (Mar. 8, 1982). In 1992, the Commission amended Rule 504 to permit general advertising. *See Securities Act Release No. 6949* [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,439 (July 30, 1992).

96. In 1999, the Commission effectively eliminated the right to accomplish a Rule 504 offering through general advertising. *See Securities Act Release No. 7644*, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,114 (Feb. 25, 1999).

97. *See Unif. Securities Act* § 402(b)(9), 7B U.L.A. 601-02 (1985).

98. Under the Uniform Act, the small offering exemption is limited to offers to fewer than ten persons in a twelve-month period. *See Unif. Securities Act* § 402(b)(9), 7B U.L.A. 601-02 (1985).

thereby eliminated the possibility that restrictive state rules could predominate over the federal regime as concerns transactions involving covered securities. After the enactment of NSMIA, only the federal government can make rules governing the offer and sale of covered securities.<sup>99</sup>

NSMIA itself defines three classes of covered securities and delegates to the Commission the authority to define the fourth class of covered securities, which are securities offered or sold to qualified purchasers.<sup>100</sup> Thus, by delegating to the Commission the authority to define qualified purchasers, Congress authorized the Commission to expand the scope of preemption through its administrative regulations. This means that the Commission finally has the trump card in relation to the states.

In a previous article, this author argued that the Commission's delegated authority to expand preemption is quite broad, but the author predicted that the Commission was unlikely to exercise the full limits of its preemptive powers.<sup>101</sup> Unfortunately, in the three years since NSMIA, this author's prediction of Commission reticence has proven accurate. Not only has the Commission not acted expansively in its definition of qualified purchasers, indeed, it has not acted at all. Thus, as of the date of publication, the Commission has issued no proposed or final regulation expanding preemption through its delegated authority to define qualified purchaser.

Another interesting issue involves the possible administrative expansion of the marketplace preemption. The language of NSMIA's marketplace provision itself preempts state authority over the offer and sale of securities listed on certain national exchanges and ". . . on the National Market system of the Nasdaq Stock Market." NSMIA then goes on to permit the Commission by administrative rule to expand this express statutory preemption to include securities listed "on a national securities exchange (or tier or segment thereof)," if the Commission determines that the listing standards for such exchange are substantially similar to the standards of the exchanges listed in the statute itself.<sup>102</sup>

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99. 15 U.S.C. § 77r(a) (Supp. IV 1998).

100. 15 U.S.C. § 77r(b)(3) (Supp. IV 1998). *See also supra* note 20.

101. *See Campbell, supra* note 3, at 207-10.

102. NSMIA pre-empts state authority over the offer and sale of any security that is:

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

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

Acting under this delegated authority, the Commission modestly expanded the marketplace preemption to include securities listed on three smaller exchanges<sup>103</sup> and in the course of its administrative rule-making received a letter of comment requesting an expansion of the marketplace preemption to include shares traded on the Nasdaq SmallCap Market. The author of the letter of comment argued that the SmallCap listing standards met the statutory criteria of “substantially similar” and that the expansion of preemption would “further the Commission’s policy of simplifying securities regulation for small businesses and would lower the costs for small businesses in complying with federal and state regulations.”<sup>104</sup> The Commission, however, rejected the request.<sup>105</sup>

Sadly, the Commission’s lack of interest in any aggressive regulatory expansion of NSMIA’s preemption is not surprising and is consistent with this author’s view that the Commission, an otherwise fine and honorable agency, has shown over the years a lack of sensitivity to or expertise concerning small businesses. The Commission, for example, has a long history that includes significant blunders in rules affecting small issuers.<sup>106</sup>

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

15 U.S.C. § 77r(a), (b)(1)(A) (Supp. IV 1998).

103. The Commission acted by rule. Rule 146(b) states:

(1) For purposes of Section 18(b) of the Act (5 U.S.C. § 77r), the Commission finds that the following national securities exchanges, or segments or tiers thereof, have listing standards that are substantially similar to those of the New York Stock Exchange (“NYSE”), the American Stock Exchange (“Amex”), or the National Market System of Nasdaq Stock Market (“Nasdaq/NMS”), and that securities listed on such exchanges shall be deemed covered securities:

- (i) Tier I of the Pacific Exchange, Incorporated;
- (ii) Tier I of the Philadelphia Stock Exchange, Incorporated; and
- (iii) The Chicago Board Options Exchange, Incorporated.

17 C.F.R. § 230.146(b) (1999). Rule 146(b) was first proposed by the Commission in June of 1997, see Securities Act Release No. 7422, [1997 Transfer Binder] Fed. Sec.L. Rep. (CCH) ¶ 85,945 (June 10, 1997), and finally adopted in Securities Act Release No. 7494, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,001 (Jan. 21, 1998).

104. Securities Act Release No. 7494, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,001 (Jan. 21, 1998).

105. The reasons the Commission gave for its rejection include: (1) that the initial Commission release did not solicit comments on expansion of preemption to include SmallCap shares; (2) that some listing standards for SmallCap markets “differ significantly” from the other national markets; (3) that the new, more stringent SmallCap listing standards would not be in effect for some months; and (4) the Commission may revisit this matter. See Securities Act Release No. 7494, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,001, at 80,104 (Jan. 21, 1998).

Late in 1998, Ira L. Kotel, a New York attorney who made the original request to expand the marketplace exemption to include SmallCap securities, again made the same request. See *This Week’s Highlights*, Fed. Sec. L. Rep. (CCH) no. 1833, ¶ 5 (Aug. 26, 1998).

106. This author has described elsewhere the blunders from earlier periods. See generally Rutheford B Campbell, Jr., *The Plight of Small Issuers Under the Securities Act of 1933: Practical*

As a related matter, the Commission has always seemed disposed to think the worst of small businesses and the motives of their managers and, accordingly, has resolved most factual uncertainties against small businesses.

The 1999 amendment to Rule 504, previously mentioned, is a classic example of this latter point. Prior to that amendment, Rule 504 permitted general advertising and unlimited resales in connection with Rule 504 offerings.<sup>107</sup> The 1999 amendment, however, reversed the Commission's position on those matters and thus severely limited the particular Rule 504 offerings in which general advertising and unlimited resales were permitted.<sup>108</sup>

This change by the Commission in Rule 504 appears to be based on limited data respecting the breadth of harms caused specifically by general advertising and unlimited resales and amounts to a misdirected response to a problem for which society already has a complete remedy. Indeed, the Commission's proffered evidence<sup>109</sup> of abuse from general advertising and unlimited resales consists of a small number of cases that clearly involve violations of existing federal antifraud provisions.<sup>110</sup> It is difficult to see, therefore, how denying small issuers the right to advertise, for example, is the appropriate regulatory response to illegal conduct by an apparently small portion of issuers relying on Rule 504, especially when one considers that such illegal conduct presently carries significant civil penalties and criminal sanctions. Perhaps even more troublesome, the Release also shows no

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*Foreclosure from the Capital Market*, 1977 Duke L.J. 1139 [hereinafter Campbell, *Plight I*]; Ruthford B Campbell, Jr., *The Plight of Small Issuers (and Others) Under Regulation D: Those Nagging Problems that Need Attention*, 74 KY. L.J. 127, 135-62 (1985-86) [hereinafter Campbell, *Plight II*]. One old but continuing blunder and another more recent blunder are worth noting. The first is the continuing unavailability of section (k) of Rule 144 for resales of restricted securities by control persons. This author is convinced that the Commission does not understand the disproportionate and unfortunate impact this rule has on small issuers. *See id.* at 157-62. Second, the recent amendment to Regulation D basically prohibiting general advertising in connection with a Rule 504 offering is a major blunder. *See* discussion *infra* accompanying notes 106-110.

107. *See* 17 C.F.R. § 230.504 (1997).

108. *See* 17 C.F.R. § 230.504(b) (1999). The current rule permits general advertising and unlimited resales only when offers and sales are made either pursuant to applicable state law requiring registration of the offering and delivery of a prospectus or pursuant to applicable state law providing for an exemption for sales to "accredited investors" and permitting a general solicitation of such "accredited investors." *Id.*

109. The Commission cites five cases apparently involving resale problems and three cases apparently involving general advertising problems. Securities Act Release No. 7644, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,114, at 81,771 (Feb. 25, 1999). With regard to the significance of these cases to the overall use of Rule 504, the Commission reports that in 1998, 2,988 Form D's were filed for Rule 504 offerings. *Id.* ¶ 86,114, at 81,775.

110. The Commission refers to the problems in these cited cases as involving "manipulation of the over-the-counter markets" and "illegal practices," *id.*, ¶ 86,114, at 81,771, and the creation of "artificial market demand," *id.* ¶ 86,114, at 81,771.



understanding of the special difficulties faced by small issuers in finding investors for their stock and the potential benefits of allowing small issuers to advertise widely for potential investors.<sup>111</sup>

The point here is to dispel any reasonable anticipation that the Commission, driven by some sympathetic insight into the special needs of small businesses, will use its delegated authority to expand preemption. History indicates that even in its more traditional role of developing its regulatory regimes for capital formation, the Commission has been slow to understand the special circumstances and the legitimate needs of small businesses. Thus, one should not expect the Commission to take the non-traditional step of expanding preemption to benefit small issuers.

### III. THE LIKELIHOOD OF CONGRESSIONAL ACTION

Since neither the states nor the Commission appear willing and able to eliminate the insidious remnants of state blue sky laws, the focus naturally shifts once again to the United States Congress. What is the likelihood that Congress will complete its work left unfinished in NSMIA by finally

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111. Permitting general advertising in connection with Rule 504 offerings could be most beneficial to small companies attempting to raise capital. Such small companies, as everyone knows, face significant practical difficulties in raising capital from public investors. The small size of the deals and the lack of seasoning of the small companies mean that relative transaction costs are high, and traditional professional help (underwriters, for example) simply is not available. Underwriting firms cannot afford to provide professional help for a \$500,000 deal, because deals of that size will not support the costs that underwriters face in learning and selling new offerings. As a result, managers of small companies are inevitably on their own to find equity investors for their companies. Restricting these companies by not allowing them, for example, to use the public media to find and solicit offerees will sound the death knell for many small offerings.

While perhaps less important than the prohibition on general advertising, the Commission's elimination of free transferability for Rule 504 stock is nonetheless significant and once again points out the Commission's lack of sensitivity to the circumstances and importance of small businesses. Consider, for example, the fact that investors in small businesses have fewer regulatory resale opportunities for restricted securities than do investors in larger businesses. Most obvious in this regard is the limited availability of Rule 144 for resales of restricted securities of small issuers. *See* 17 C.F.R. § 230.144 (1999). Indeed, as initially enacted, Rule 144 was not available for resales by holders of securities in small issuers, because it was impossible to meet the broker's transaction requirements of the Rule. *See* Campbell, *Plight I, supra* note 105, at 1150-53. With the addition of section (k) of the Rule, 17 C.F.R. § 230.144(k) (1999), holders of securities in small issuers could utilize Rule 144, but only if they held their securities for one year beyond the holding period applied for the resale of restricted securities in larger companies. Additionally, the special provisions of section (k) of Rule 144 are not available for resales of restricted securities by control persons, another significant problem for many holders of small securities. *See* Campbell, *Plight II, supra* note 105, at 157-62.

In short, while Rule 144 will nearly always be available for resales by holders of restricted securities in larger corporations, the Rule often will not be available for resales by holders of securities in small corporations. Moreover, even when the Rule is available, the holding period is more onerous. As a result of more limited and thus onerous resale provisions, investment in such smaller corporation becomes comparatively less attractive than investment in larger corporations.

eliminating state control over capital formation?

The formidable hurdles of inertia and public choice problems are significant in this matter. Little needs to be said about inertia. Congress obviously has a perennially full plate and most recently has focused its financial attention on the repeal of the Glass-Steagall Act. At this time one simply cannot be certain whether Congress will again focus on state securities regulation.<sup>112</sup>

If Congress were to overcome its inertia and once again focus on the matter of preemption, the way in which the public choice issue might arise and its ultimate outcome may be somewhat predictable. Indeed, the ultimate outcome of NSMIA itself provides at least an indication of the pressures that will be brought to bear in such a case.

Public choice theory as applied to public rule-making is based on an economic perspective and analysis of that process<sup>113</sup> and predicts that small, cohesive groups in which each member has a lot to gain or lose will be more effective in influencing the outcome of public rule-making than will large groups in which each member has a small amount to gain or lose as a result of the outcome of the legislation. Public choice theory predicts this result even if the total gain or loss in the larger, diffuse group is greater than the total gain or loss in the smaller group.<sup>114</sup> This result is explained by the high transaction costs and the free-rider problems associated with collective action by the larger group.<sup>115</sup>

This author previously observed that public choice theory provides an explanation for the outcome in NSMIA.<sup>116</sup> Three significant groups were identifiable in the legislative process leading to NSMIA. The first of those groups consisted of investment companies; the second group was state securities administrators, functioning principally through NASAA, and the final group was small businesses. The first two of these groups were relatively compact groups in which individual group members likely

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112. *But see supra* note 26.

113. *See* Landes & Posner, *supra* note 4, at 877.

114. *See* Farber & Frickey, *supra* note 4, at 873-901; Macey, *supra* note 4, at 227-33.

115. Establishing and maintaining coordinated activities in large groups will generate high transaction costs because there are so many parties involved. Free rider problems also are significant, because each potential member of the group will be inclined to attempt to free ride on the group by holding back, in the hopes that others will form an effective group, which in turn will generate the benefits without expense to the free rider. *See* MICHAEL T. HAYES, LOBBYISTS AND LEGISLATORS: A THEORY OF POLITICAL MARKETS 69-70 (1981) ("Members of the mass public will generally find it irrational to obtain the information necessary to identify their interest on any given issue and moreover will be ill-equipped to interpret any information they obtain."); Farber & Frickey, *supra* note 4, at 892 ("The 'free rider' problem suggests that it should be nearly impossible to organize large groups of individuals to seek broadly dispersed public goods."); Macey, *supra* note 4, at 229-32.

116. *See* Campbell, *supra* note 22, at 583-85.

perceived that they had much to gain or lose in the outcome of the preemption struggle. The final group, small businesses, was huge in number, and its members seemingly had less to gain or lose individually.

The outcome of NSMIA was that the first group, investment companies, benefitted substantially as a result of the legislation, because NSMIA completely preempted state involvement in the rules respecting the registration of securities of investment companies.<sup>117</sup> The second group, the state administrators, got essentially what they wanted, which was a minimal change in function and continued broad and, indeed, primary jurisdiction over a significant portion of the capital formation market.<sup>118</sup> The third group, small businesses, which, to restate, were broadly dispersed but in total accounted for a significant part of our national economy, got essentially nothing out of NSMIA.

If Congress were to revisit the preemption matter with an eye to completing federal preemption of all capital formation rules, the previous NSMIA interest groups would be reduced by one, because investment companies have been satisfied. So, small businesses would most likely be pitted directly against the state administrators who, operating through NASAA, represent a demonstrably formidable force. In public choice terms, the challenge for small business (and the rest of us) would be to overcome the high transaction costs and free rider problems present in collective action by a group as large as small businesses.

#### IV. CONCLUSIONS

As we move into the Twenty-First Century, one might ask: What is left of state blue sky laws? My answer is: Unfortunately, quite a lot.

Today, state blue sky laws and state securities administrators continue to exert significant influence over the capital formation activities of an important portion of our economy, specifically, small businesses. As a result, small businesses engaged in capital formation are subjected to an anachronistic and discriminatory legal regime that leads to inefficiency and waste in our national economy.

While identifying this problem is simple, finding a solution is much harder, primarily because none of the empowered rule-makers appears willing or able to act. States, for example, are not going to solve this

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117. NSMIA defines a “covered security” to include “a security issued by an investment company.” 15 U.S.C. § 77r(b)(2) (Supp. IV 1998). NSMIA pre-empts state rules over registration and merit qualification with respect to “covered securities.” 15 U.S.C. § 77r(a)(1) (Supp. IV 1998).

118. *See supra* text accompanying notes 20-24.

problem. Certainly, no one would anticipate that all states are about to repeal the registration requirements of their blue sky laws. Speculating more modestly, one should anticipate nothing more than incremental gains in uniformity among the fifty-plus blue sky jurisdictions in the United States. Notwithstanding an apparent good faith effort in some quarters, the seductive force of sovereignty is simply too strong. States will continue to strike their own balances and thus continue to make their own individualized rules respecting the offer and sale of securities within their own borders.

The SEC also appears unwilling to push preemption. This is due, in the author's opinion, primarily to the Commission's failure to understand, trust, and appreciate the significance of small businesses. Such failings by the Commission are especially significant as we move into the Twenty-First Century, with the easy and cheap access to investment information and advice that is a part of today's world and the continuing importance of small businesses to our nation. It is difficult to understand why the Commission would not be a strong champion of small businesses, willing to indulge the presumption that managers of small businesses are at least as honorable as managers of large businesses and thus do not need disproportionately high levels of societal supervision and intrusion when they raise money for their companies.

Congress, therefore, appears to be the only realistic hope for the elimination of the remnants of the state blue sky laws. While an interest group analysis predicts difficulties, there are some signs of Congressional action, and, in any event, one must hope that sound economics, good sense, and desire for fair treatment will eventually carry the day.