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Comments

The National Securities Market Improvement Act: How Improved is the Securities Market?

I. INTRODUCTION

Within Corporate America, corporations form, survive, and expand by bargaining for capital through issuing stocks and securities[1] to willing investors. Whether a corporation is "going

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1. The term "securities" has been broadly defined by both the Securities Act of 1933 and the Securities and Exchange Act of 1934. The Securities Act of 1933 defines "security" as:

> any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(1) (1994). The Securities Exchange Act of 1934 similarly defines the term "security" as:

> any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease,

public"[2] for the first time, or is already trading on markets, such as the New York Stock Exchange, issuers[3] offer to sell their securities to eager investors through underwriters[4] and dealers.[5] Offerings

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any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing, but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

15 U.S.C. § 78c(a)(10) (1994).

2. "Going public" is defined as "the process by which a corporation issues its first stock for public purchase. Also [includes] when a private corporation becomes a public corporation. [Describes] a business when its shares [are initially] traded to the general public, rather than being closely held by relatively few stockholders." BLACK'S LAW DICTIONARY 691 (6th ed. 1990).

3. The term "issuer" refers to the corporation issuing or offering the securities for sale to the investors, underwriters and dealers. "Issuer" is defined as:

every person who issues or proposes to issue any security; except that with respect to certificates of deposit, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors . . . or of the fixed, restricted management, or unit type, the term "issuer" means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; except that in the case of an unincorporated association which provides by its articles for limited liability of any or all of its members, or in the case of a trust, committee, or other legal entity, the trustees or members thereof shall not be individually liable as issuers of any security issued by the association, trust, committee, or other legal entity; except that with respect to equipment-trust certificates or like securities, the term "issuer" means the person by whom the equipment or property is or is to be used; and except that with respect to fractional undivided interests in oil, gas, or other mineral rights, the term "issuer" means the owner of such right or of any interest in such right (whether whole or fractional) who creates fractional interests therein for the purpose of public offering.

15 U.S.C. § 77b(4) (1994).

4. The term "underwriter" refers to:

any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission.

15. U.S.C. § 77b(11) (1994).

5. "Dealer means any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or

create new and future capital for the issuer to use in operating and expanding the corporation and improving the corporation's net worth, making it easier to obtain additional capital in the future.

The corrupt practices of some individuals within the securities market, however, prevent the efficient and professional function of capital formation. Fraud and deception are manifest when investors are lied to by the issuer and misled as to the nature and structure of the investment. Issuers may purposefully mislead investors through oral and written information. Similarly, issuers may fail to provide investors with sufficient information for a fair evaluation of the viability of the security, therefore preventing sound investment decisions. Failure to provide investors with enough "material information" is a more subtle practice than lying, but the omission has an equally damaging impact upon capital formation.

Recognizing the need for federal regulation of the securities market after the stock market crash of 1929, Franklin Roosevelt, as part of his 1932 campaign and the Democratic platform, called upon Congress to enact the Securities Act of 1933 (the "Act of 1933") and the Securities Exchange Act of 1934 (the "Act of 1934").[6] These acts were "quintessential New Deal legislation," enacted to eliminate fraud and deception in the securities market by requiring proper registration of securities and full disclosure of all "material information" to investors.[7] The federal government, however, was neither the first nor the only governmental body to recognize the need for securities regulation. Several states, some as early as 1911, recognized the need for regulation, enacting legislation requiring disclosure and registration in securities transactions.[8] Like state agencies created to enforce securities laws, Congress established the Securities and Exchange Commission (the "SEC" or "Commission") as the federal "watch dog" of the securities market to ensure that issuers complied with federal

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otherwise dealing or trading in securities issued by another person." 15 U.S.C. § 77b(12) (1994).

6. Securities Act of 1933, ch. 38, title I, § 1, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§ 77a-77bbbb (1994)); Securities Exchange Act of 1934, ch. 404, title I, § 1, 48 Stat. 881 (1994) (codified as amended at 15 U.S.C. §§ 78a-78ll (1994)). *See also* LARRY D. SODERQUIST, SECURITIES REGULATION 1 (3d ed. 1994).

7. *See generally id.* at 1-17.

8. Kansas was the first state to enact securities protection legislation in 1911. *See* KAN. STAT. ANN. §§ 17-1252 (1995). Pennsylvania did not enact its securities laws until 1972. *See* Pennsylvania Securities Act of 1972, Pub. L. No. 1280-284, §101 (1972) (effective Jan. 1, 1973) (codified as amended at 70 P.S. §§ 1-101-1-704 (1994)). State securities laws are referred to as "blue sky laws." *See infra* note 10 for a definition of "blue sky laws."

securities laws, thus protecting investors. In describing the purpose of the SEC, William O. Douglas, a former chairman of the SEC, accurately stated, "We are the investors' advocates."[9]

With the intent of preserving the integrity of the securities market and providing much needed protection to investors, Congress created a set of registration and full disclosure requirements. Congress believed providing investors with all the necessary information and requiring issuers to register securities with the SEC would create a much fairer market by placing all participants on a level playing field. The SEC does not regulate the price of securities; it merely ensures that investors are provided with adequate information when purchasing securities by subjecting issuers to a detailed registration and disclosure regime. Once an issuer satisfies these registration and disclosure requirements, it is then free to sell the securities to a willing investor at any price, no matter how outrageous and inflated.

Federal statutes and regulations require the issuer of certain types of securities to provide investors and the SEC with particularized information regarding the securities being issued and sold during a public offering. In other securities transactions, the issuer is only required to provide the investors with "material information" regarding the securities. In general, state blue sky laws,[10] like the federal securities laws, require the issuer to make certain disclosures to potential investors and to the state agency that regulates the issuance and sale of securities. The issuer is required to register the securities with the state before they are sold, thus, enabling the state to better regulate and monitor the issuer's compliance with state disclosure laws. States have also developed qualification standards the issuer must satisfy before offering securities in that particular state. These qualification standards essentially work "like consumer legislation by prohibiting sales of securities that are considered by regulators to be

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9. *See* The Securities and Exchange Commission homepage (visited December 19, 1997) <http://www.sec.gov>. Justice William O. Douglas was the chairman of the SEC from 1937 to 1939.

10. "Blue sky laws" are:

> a popular name for state statutes providing for the regulation and supervision of securities offerings and sales for the protection of citizen-investors from investing in fraudulent companies. Most blue sky laws require the registration of new issues of securities with a state agency that reviews selling documents for accuracy and completeness. Blue sky laws also often regulate securities brokers and salesmen. BLACK'S LAW DICTIONARY 173 (6th ed. 1990).

defective."[11]

This regime of compliance, disclosure, and qualification imposes upon the issuer additional expenses that are ultimately reflected in increased securities prices. The issuer must expend money, resources, and labor (mainly for accounting and legal work) to comply with both federal and state securities laws. Thus, depending on the states in which a public offering is made, issuers may be required to comply with as many as fifty state statutes (as well as those of the Territories of the United States and the District of Columbia), in addition to the federal statutes. The costs associated with full compliance often raise securities prices, making them unattractive investments. Further, compliance costs may be so great, as compared to the actual value of the securities being offered, that the offering may lose its economic benefits to the issuer.[12] Consequently, compliance generally translates into an increase in securities prices, a loss of economic benefit to the issuer, and a decrease in the pool of investors, thus, making it harder to facilitate capital formation.

Congress recognized the burdens that federal and state securities laws place on capital formation. In an effort to alleviate some of these burdens, Congress enacted the National Securities Market Improvement Act ("NSMIA") in 1996.[13] The NSMIA provides for federal preemption of state blue sky laws, and was designed 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. . . ."[14] The NSMIA has done little, however, in fulfilling this purpose.[15]

This comment focuses on several favorable methods of satisfying the registration requirements of the Act of 1933 and how The NSMIA impacts this specialized area of law. Part II discusses the language of the NSMIA to enable the reader to understand how the

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11. Rutherford B. Campbell, Jr., *Blue Sky Laws and the Recent Congressional Preemption Failure*, 22 IOWA J. CORP. L. 175 (1997) (citing Joseph C. Long, *State Securities Regulations — An Overview*, 32 OKLA. L. REV. 541, 543 (1979)).

12. For example, most of the economic benefits the issuer hopes to gain from a $250,000 offering of securities are lost when the issuer must spend $100,000 on compliance costs. The net gain is $150,000 rather than the desired $250,000.

13. National Securities Market Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996).

14. Campbell, *supra* note 11, at 179 n.17 (citing H.R. CONG. REP. No. 104-864, at 39-40 (1996)).

15. *See generally id.* at 175.

NSMIA affects state blue sky laws and preempts the states' regulation of securities in certain instances. Part III considers several of the devices issuers use to exempt an offering from SEC registration, including Rules 147, 504, 505, and 506; a Regulation A Offering; and a Registered Offering. It further considers how the NSMIA has improved (or failed to improve) the law for the issuer. Finally, Part IV discusses the Pennsylvania Securities Commission's interpretation of the NSMIA and how the NSMIA impacts and changes the blue sky laws of the Commonwealth of Pennsylvania.

II. THE NATIONAL SECURITIES MARKET IMPROVEMENT ACT

Prior to the enactment of the NSMIA, section 77r of the Act of 1933 was silent on the ability of an individual state agency to regulate the sale of securities within that state.[16] The laws governing securities regulation, however, changed dramatically for state agencies after the enactment of the NSMIA. The NSMIA was designed to eliminate a state's authority to regulate and control the sale of securities within its own boundaries in certain instances.[17]

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16. Former section 77r provided:

§ 77r. State Control of securities

Nothing in this subchapter [15 U.S.C. §§ 77a *et seq.*] shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person.

15 U.S.C. § 77r (1994).

17. The current section 77r provideds:

§ 77r. Exemption from State regulation of securities offerings

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

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

(A) is a covered security; or

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

(2) shall directly or indirectly prohibit, limit, or impose any conditions upon the use of —

(A) with respect to a covered security described in subsection (b), any offering document that is prepared by or on behalf of the issuer; or

(B) any proxy statement, report to shareholders, or other disclosure document relating to a covered security or the issuer thereof that is required to be and is filed with the Commission or any national securities organization registered under section 15A of the Securities Exchange Act of 1934 [15 U.S.C. § 78o-3], except that this subparagraph does not apply to the laws, rules, regulations, or orders, or other administrative actions of the State of incorporation of the issuer; or

State qualification standards are no longer enforceable. Moreover, states are prohibited by this federal act from enacting any legislation that requires certain registration requirements to be met before selling securities within the state. In essence, the federal government and the SEC have preempted regulation of the securities market. Existing state antifraud legislation is still valid and states are able to enact new antifraud legislation and enforce it against the issuer. The states' control over the sale of securities is limited, however, to mandating that issuers file notice copies with the state agencies of all documents the SEC requires and charging the issuers filing fees in limited situations.[18]

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(3) shall directly or indirectly prohibit, limit, or impose conditions, based on the merits of such offerings or issuer, upon the offer or sale of any security described in paragraph (1).

15 U.S.C.A. § 77r (West 1997).

18. *See* Section 77r(c) which provides:

(c) Preservation of authority

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

(2) Preservation of filing requirements.

(A) Notice filing permitted. Nothing in this section prohibits the securities commission . . . of any State from requiring the filing of any document filed with the Commission . . . together with annual or periodic reports of the value of securities sold or offered to be sold to persons located in the State . . . solely for the purposes and the assessment of any fee, together with a consent to service of process and any required fee.

(B) Preservation of fees.

(i) In general. Until otherwise provided by law, . . . of any State . . . adopted after the date of enactment of the [NSMIA], filing or registration fees with respect to securities or securities transactions shall continue to be collected in amounts determined pursuant to State law as in effect on the date [the NSMIA was enacted].

(C) Availability of preemption contingent on payment of fees.

(i) In general. During the period beginning on the date of enactment of the [NSMIA] and ending 3 years after that date of enactment, the securities commission . . . of any State may require the registration of securities issued by any issuer who refuses to pay the fees required in subparagraph (B). . . .

(D) Fees not permitted on listed securities. Notwithstanding subparagraphs (A), (B), and (C), no filing or fee may be required with respect to any security that is a covered security pursuant to subsection (b)(1), or will be such a covered security upon completion of the transaction, or is a security of the same issuer that is equal in seniority or that is a senior security to a security that is a covered security pursuant to subsection (b)(1).

(3) Enforcement of requirements. Nothing in this section shall prohibit the

Although, initially, it may appear that Congress and the SEC, through the NSMIA, have taken monopolistic control of securities regulation, federal preemption only applies to state laws dealing with what the NSMIA describes as "covered securities."[19] The definition of "covered securities" includes four types of securities offerings.[20] The first is those securities that are offered on the New York Stock Exchange, the American Stock Exchange, the National Market System of the NASDAQ Stock Market, or on a similar national securities exchange that meets standards determined by the SEC.[21] The second type of "covered security," is a security issued by an investment company satisfying the requirements of the Investment Company Act of 1940.[22] The third type includes securities sold to "qualified purchasers."[23] The NSMIA does not define the term "qualified purchaser," but instead, states that the

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securities commission . . . of any State from suspending the offer or sale of securities within such State as a result of the failure to submit any filing or fee required under law and permitted under this section.

15 U.S.C.A. § 77r(c) (West 1997).

19. *See* 15 U.S.C.A. § 77r(a)(1)(A) & (B) (West 1997).

20. *See generally* 15 U.S.C.A. § 77r(b) (West 1997).

21. Section 77r(b)(1) provides:

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

(1) Exclusive Federal registrations of nationally traded securities. A security is a covered security if such security is —

(A) listed, or authorized for listing, on the New York Stock Exchange or the American Stock Exchange, or listed on the National Market System of the NASDAQ Stock Market . . . ;

(B) listed, or authorized for listing, on a national securities exchange . . . that has listing standards that the Commission determines by rule . . . are substantially similar to the listing standards applicable to securities described in subparagraph (A); or

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

15 U.S.C.A. § 77r(b)(1) (West 1997).

22. Section 77r(b)(2) provides:

(2) Exclusive Federal registration of investment companies. A security is a covered security if such security is a security issued by an investment company that is registered, or that has filed a registration statement, under the Investment Company Act of 1940.

15 U.S.C.A. § 77r(b)(2) (West 1997). *See also* Investment Company Act of 1940, 15 U.S.C. §§ 80a-1-80b-21 (1994).

23. Section 77r(b)(3) provides:

(3) Sales to qualified purchasers. A security is a covered security with respect to the offer or sale of the security to qualified purchasers, as defined by the Commission by rule. In prescribing such rule, the Commission may define the term "qualified purchaser" differently with respect to different categories of securities, consistent with the public interest and the protection of investors.

15 U.S.C.A. § 77r(b)(3) (West 1997).

SEC is responsible for defining "qualified purchaser" by considering the types of securities being offered, the public interest, and the protection of the investor.[24] The fourth and final type of "covered security," although confusing in its description, includes those securities exempt from registration pursuant to the following sections of the Act of 1933: section 4(1) or (3),[25] section 4(4),[26] section 3(a),[27] and SEC rules and regulations issued under section 4(2).[28] The NSMIA falls short of actually improving the securities market, however, by failing to include within the definition of "covered securities" those securities that are exempt from registration under Rules 147, 504, 505, and Regulation A. Federal law does not preempt state law in these types of offerings. Therefore, issuers must continue to satisfy the registration requirements of both the state and federal regulators, and the burdens of compliance will continue to hamper the process of capital formation.

Additionally, the NSMIA prohibits states from controlling the use of proxy statements, reports to shareholders, or other disclosure

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24. *See* 15 U.S.C.A. § 77r(b)(3) (West 1997).

25. 15 U.S.C.A. § 77d(1) & (3) (West 1997). Section 4(1) and (3) provide general exemption from registration for transactions by a person other than an issuer, underwriter, or dealer; or transactions by a dealer (with certain exceptions). *See* 15 U.S.C.A. § 77(d)(1) & (3) (West 1997); 15 U.S.C.A. § 77r(4) (West 1997).

26. 15 U.S.C.A. § 77d(4) (West 1997). Section 4(4) addresses the exemption from registration of certain transactions by brokers. *See* 15 U.S.C.A. § 77(d)(4) (West 1997); 15 U.S.C.A. § 77r(4) (West 1997).

27. 15 U.S.C.A. § 77c(a) (West 1997). Section 3(a) details a list of securities that are excluded from the Securities Act of 1933. *See* 15 U.S.C.A. § 77c(a) (West 1997); 15 U.S.C.A. § 77r(4) (West 1997). Of the section 3(a) exempted securities, the most notable types *not included* under "covered securities" are subparagraphs (4) and (11). 15 U.S.C.A. § 77r(b)(4)(C) (West 1997). Section 3(a)(4) includes securities issued by:

> a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any person, private stockholder, or individual; or any security of a fund that is excluded from the definition of an investment company under section 3(c)(10)(B) of the Investment Company Act of 1940 [15 U.S.C. § 80a-3(c)(10)(B)].

15 U.S.C.A. § 77c(4) (West 1997). Section 3(a)(11) includes securities which are:

> a part of an issue and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory.

15 U.S.C.A. § 77c(11) (West 1997).

28. 15 U.S.C.A. § 77d(2) (West 1997). A state may, however, impose notice filing requirements on the issuer similar to those found in 4(2). 15 U.S.C.A. § 77r(4)(D) (West 1997). Section 4(2) governs "transactions by an issuer not involving any public offering." 15 U.S.C.A. § 77d(2) (West 1997). *See generally* 15 U.S.C.A. § 77r(4) (West 1997).

documents regarding a covered security.[29] An exception exists, however, for states in which the issuers are incorporated. In these instances, the state of incorporation may control the use of proxy statements, reports to shareholders, and disclosure documents of a covered security, and may require the issuer to satisfy additional conditions.[30]

The NSMIA did not preempt the states' rights to enact and enforce antifraud legislation, to collect filing and registration fees, or to require the filing of a consent to service of process and payment of the corresponding fee.[31] The states' retention of control over their own antifraud standards, however, may conflict with the NSMIA's preemption of state regulation of the securities market. States could counter their loss of control over "covered securities" by redefining "material" more expansively.[32] States could, therefore, continue to impose qualification standards on the issuer by requiring disclosure of certain information to insure the non-fraudulent sale of securities.

States may also require issuers of securities to file all documents which were filed with the SEC with a state agency, but states may not require the filing of more documents than the SEC requires.[33] This filing requirement merely provides the investor with notice and gives states a means by which to calculate the filing and registration fees associated with the sale of securities within the state. No state, however, is permitted to require the filing of documents and the payment of fees with regard to covered securities that are listed on the New York Stock Exchange, the American Stock Exchange, or the National Market System of the NASDAQ Stock Market.[34] This is important because the majority of stocks fit this description.

III. Life Before and After the National Securities Market Improvement Act

Section 5 of the Act of 1933 requires the issuer in an offer and sale of securities to register those securities with the SEC.[35] In

29. *See* 15 U.S.C.A. § 77r(a)(2)(B) (West 1997).
30. *Id.*
31. *See* 15 U.S.C.A. § 77r(c) (West 1997).
32. *See* Campbell, *supra* note 11, at 201.
33. *See* 15 U.S.C.A. § 77r(c)(2) (West 1997).
34. *See* 15 U.S.C.A. § 77r(c)(2)(D) (West 1997).
35. *See* 15 U.S.C. § 77e (1994). To fulfill the registration requirements, the issuer is required to provide the SEC with the information detailed in Schedule A of the Act of 1933 if

order to escape these registration requirements, the issuer often tries to classify the transaction as exempt. Some of the most common avenues of avoiding registration with the SEC are Rule 147,[36] Regulation A Offering,[37] Rule 504,[38] Rule 505,[39] Rule 506,[40] and a Registered Offering.

A. Rule 147

In an offering of securities, the issuer is usually conducting an interstate transaction through transportation or communication in interstate commerce or through the mail system. If that is the case, the issuer is required to register the securities with the SEC.[41] If, however, the transaction is solely an intrastate transaction, then an exception to registration, under section 3(a)(11), applies.[42] Section 3(a)(11) provides an exception to registration for securities sold to residents within a single state (or territory) by an issuer[43] who is a resident of that state or is incorporated within that state and doing business within that state.[44]

Rule 147 establishes objective standards for determining whether an offer complies with section 3(a)(11).[45] The elements required for compliance are: (1) the issuer is a resident of the state, (2) the issuer is doing business in the state, and (3) the offer is made only to residents of that state.[46] In order to be considered a resident of

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the issuer *is not* a foreign government or a political subdivision. 15 U.S.C. § 77(g) (1994). Alternatively, the issuer is required to provide the SEC with the information detailed in Schedule B of the Act of 1933 if the issuer *is* a foreign government or political subdivision. 15 U.S.C. § 77(g) (1994).

36. *See* 17 C.F.R. § 230.147 (1997).

37. *See* 17 C.F.R. §§ 230.251-.263 (1997).

38. *See* 17 C.F.R. § 230.504 (1997).

39. *See* 17 C.F.R. § 230.505 (1997).

40. *See* 17 C.F.R. § 230.506 (1997).

41. 15 U.S.C. § 77e (1994). The requirements for the registration statement filed with the SEC are set forth at 15 U.S.C. § 77f (1994).

42. 15 U.S.C.A. § 77c(a)(11) (West 1997).

43. Issuer is defined as "every person who issues or proposes to issue any security; . . ." 15 U.S.C. § 77b(4) (1994).

44. 15 U.S.C.A. § 77c(a)(11) (West 1997).

45. *See generally* 17 C.F.R. § 230.147 (1997).

46. Section 230.147(a) provides:

> (a) Transactions Covered. Offers, offers to sell, offers for sale and sales by an issuer of its securities made in accordance with all of the terms and conditions of this rule shall be deemed to be part of an issue offered and sold only to persons resident within a single state or territory where the issuer is a person resident and doing business within such state or territory, within the meaning of Section 3(a)(11) of the Act.

17 C.F.R. § 230.147 (1997).

the state, the issuer must be incorporated or organized in that state,[47] have its principal office in that state,[48] or have its principal residence in that state.[49] To qualify as "doing business within that state," eighty percent of the issuer's gross revenues must come from that state; prior to issuance, eighty percent of the issuer's assets must be located in that state; the issuer must use eighty percent of the net proceeds from the operation of its business or from services provided within that state; or the principal office of the issuer must be located in that state.[50] Finally, the investor is a resident of that state if, at the time of the offer: the investing corporation has its principal office within that state,[51] the individual investor has its principal residence in that state,[52] or the corporation is organized for the purpose of acquiring the securities and all of its beneficial owners reside in that state.[53]

Rule 147 also places a limitation on the resale of securities to out-of-state investors. The investor cannot resell the securities for nine months from the date of the last sale of securities by the issuer in that offer.[54] The securities also must contain a legend stating that the securities have not been registered with the SEC and that resale is limited.[55]

Prior to the enactment of the NSMIA, if the issuer met the requirements of Rule 147, it was exempt from registering those securities with the SEC and from making disclosures other than those required by antifraud legislation. The issuer, however, still

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47. The requirement that the issuer be incorporated or organized with the particular state applies only to corporations, limited partnerships, trusts, or other forms of business organizations that are organized according to the laws of that state. *See* 17 C.F.R. § 230.147(c)(1)(I) (1997).

48. The principal office must be located within the state when the issuer is a general partnership or other form of business not organized under the laws of that state. *See* 17 C.F.R. § 230.147(c)(1)(ii) (1997).

49. "Principal residence" applies to issuers who are individuals. *See* 17 C.F.R. § 230.147(c)(1)(iii) (1997).

50. *See generally* 17 C.F.R. § 230.147(c)(2)(i - iv) (1997).

51. 17 C.F.R. § 230.147(d)(1) (1997). This requirement that the principal office be located in the state at the time of the offer also applies to partnerships, trusts, and other forms of business organizations. *Id.*

52. 17 C.F.R. § 230.147(d)(2) (1997).

53. 17 C.F.R. § 230.147(d)(3) (1997). This also applies to partnerships, trusts, and other forms of business organizations which are organized for the purpose of acquiring the securities. *Id.* If the corporation, partnership, trust, or other business form was organized for the sole purpose of purchasing the securities in this offer, then the beneficial owners of that business must all be residents of that state. *Id.*

54. 17 C.F.R. § 230.147(e) (1997).

55. 17 C.F.R. § 230.147(f) (1997).

was required to register the securities with the state agency and to fully comply with the securities laws of the state in which it was making the intrastate offer. Although section 3(a)(11) and Rule 147 allowed the issuer to avoid the costs of disclosure to the SEC, the issuer, nevertheless, was subjected to the compliance costs of registering the securities with the state agency. Consequently, if the compliance costs were exorbitant and the value of the offer was small, the offering lost all economical benefit for the issuer.

Enactment of the NSMIA had virtually no effect on an issuer making intrastate offerings. Because section 3(a)(11) and Rule 147 transactions are not included within the definition of a "covered security," the NSMIA does not exempt an issuer from compliance with the securities laws of the individual state in which it wants to make the offer. Thus, the issuer is in no better position after the enactment of the NSMIA than before. By specifically excluding intrastate transactions, the NSMIA fails to increase the feasibility of capital formation. The issuer is forced to balance compliance costs against the value of the offering. If the costs outweigh the gain, the issuer has no reasonable choice but to forgo intrastate capital formation.

B. Regulation A Offerings

The issuer may also exempt offerings from registration with the SEC by means of section 3(b), classifying them as Regulation A offerings.[56] In order to make a Regulation A offering, however, the issuer must first comply with the requirements set forth by the SEC in Rules 251 through 263.[57] First, the issuer must be an entity organized under the laws of the United States with its principal place of business in the United States.[58] Second, the issuer must not be subject to section 13 or 15(d) of the Act of 1934 immediately before the offering;[59] it must not be a development stage company[60] or an investment company;[61] it must not issue

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56. 17 C.F.R. § 230.251 (1997). *See also* 15 U.S.C. § 77c(b) (1994); 15 U.S.C. § 77e (1994).

57. *See generally* 17 C.F.R. §§ 230.251-263 (1997).

58. Rule 251(a)(1) provides:

(a) Issuer. The issuer of the securities:

(1) is an entity organized under the laws of the United States or Canada, or any State, Province, Territory or Possession thereof, or the District of Columbia, with its principal place of business in the United States or Canada.

17 C.F.R. § 230.251(a)(1) (1997).

59. 17 C.F.R. § 230.251(a)(2) (1997). *See also* 15 U.S.C. §§ 78m, 78o(d) (1994).

60. 17 C.F.R. § 230.251(a)(3) (1997). The issuer cannot be a development stage

fractional undivided interests in oil or gas rights or other mineral rights;[62] and it must not be disqualified by Rule 262.[63] Third, the aggregate offering price must not exceed $5,000,000.[64] Fourth, prior or subsequent offers and sales of securities that do not satisfy the requirements of a Regulation A offering may not be integrated with a current Regulation A offering.[65]

Finally, several conditions are placed on a Regulation A offering.[66] Most importantly, the issuer must file a Form 1-A Offering Statement with the SEC, as outlined and described in Rule 252.[67] Without this filing, the issuer can neither offer the securities

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company that either has no specific business plan or purpose, or has indicated that its business plan is a merger with an unidentified company or companies. 17 C.F.R. § 230.251(a)(3) (1997).

61. 17 C.F.R. § 230.251(a)(4) (1997). An "investment company" is one "registered or required to be registered under the Investment Company Act of 1940." 17 C.F.R. § 230.251(a)(4) (1997).

62. 17 C.F.R. § 230.251(a)(5) (1997). The issuer may not be issuing "fractional undivided interests in oil or gas rights as defined in Rule 300, or a similar interest in other mineral rights." 17 C.F.R. § 230.251(a)(5) (1997).

63. 17 C.F.R. § 230.251(a)(6) (1997). An issuer may be disqualified under Rule 262 if the issuer and any of its predecessors, or any affiliated issuer, has filed a registration statement that is under investigation by the SEC, has been the subject of a refusal order refusing to permit the registration statement to become effective until properly amended, or has had a stop order suspending the effectiveness of the registration filed within the last five years. 17 C.F.R. § 230.262(a)(1) (1997). *See also* 15 U.S.C.A. § 77h (West 1994). The issuer may also be disqualified if: within the last five years, it has received a temporary suspension of its Regulation A exemption pending investigation by the SEC; it has been convicted, within the last five years, of a felony or misdemeanor connected with the purchase or sale of securities or falsifying filings with the SEC. 17 C.F.R § 230.262(a)(2) & (3) (1997). *See also* 17 C.F.R. § 230.258 (1997). Finally, disqualification may also occur when the issuer has been prohibited by court order from engaging in the practice or sale of securities or has been subjected to a United States Postal Service false representation order. 17 C.F.R. § 230.262(a)(4) & (5) (1997). Additionally, the issuer may be disqualified for the above-described actions if committed by its directors, officers, general partners, beneficial owners of ten percent or more of any class of its equity securities, any promoters presently connected with the issuer, any underwriters of the securities to be offered, or any partner, director or officer of any of these underwriters. *See* 17 C.F.R. § 230.262(b)(1)-(5) (1997).

64. 17 C.F.R. § 230.251(b) (1997). This amount includes no more than $1,500,000 offered by all selling security holders, less the aggregate offering price for all securities sold within the twelve months before the start of, and during the offering of, securities in reliance upon Regulation A. 17 C.F.R. § 230.251(b) (1997).

65. *See* 17 C.F.R. § 230.251(c)(1) & (2) (1997). A note to this subsection suggests, however, that facts and circumstances may give rise to the allowance of integration. It directs the reader to *Securities Act Release No. 4552* [27 F.R. 11316] (Nov. 6, 1962).

66. *See generally* 17 C.F.R. § 230.251(d) (1997).

67. *See* 17 C.F.R. §§ 230.251, 230.252, Form 1-A (1997). Form 1-A is an itemized packet prepared by the SEC, which outlines the necessary information the issuer must provide to the SEC as part of the registration process. It is this Form which the SEC uses in its investigation of the issuer to approve the offering of the securities. *See* 17 C.F.R. §§ 230.251; 230.252; Form 1-A (1997).

for sale nor sell the securities to the investor.[68] Once the Form 1-A is filed, but before it is "qualified"[69] by the SEC, or becomes subject to the automatic twenty-day period,[70] the issuer may make oral offers or written offers if they conform to Rule 255. The Issuer may advertise a limited amount of information in print and on radio or television.[71] After the Form 1-A Offering Statement is qualified, the issuer may make additional written offers to investors, but a copy of the Final Offering Circular must accompany or precede these written offers.[72] Prior to the actual sale[73] of the securities, the Form 1-A Offering Statement must be qualified.[74] The issuer must also provide the investor with a copy of either the Preliminary Offering Circular or the Final Offering Circular at least 48 hours before mailing the confirmation of sale. A Final Offering Circular must be delivered to the investor with the confirmation of sale if the issuer has not already distributed it to the investor.[75]

In a Regulation A offering, the issuer is only required to provide the SEC and investors with limited information. These offerings are, therefore, more economically attractive to the issuer than

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68. 17 C.F.R. § 230.251(d)(1)(i), § 230.251(d)(2)(i)(A) (1997). The only types of solicitation the issuer is permitted to make in conjunction with an offer prior to the filing of the Form 1-A are outlined in Rule 254. 17 C.F.R. § 230.251(d)(1)(i) (1997). *See also* 17 C.F.R. § 230.254 (1997). The issuer is absolutely prohibited from completing the sales transaction before filing the Form 1-A. 17 C.F.R. § 230.251(d)(2)(i)(A) (1997).

69. For Form 1-A to become "qualified," it must satisfy all of the requirements of Regulation A. *See generally* 17 C.F.R. § 230.252(g) (1997). This qualification process mirrors the concept of effectiveness of the registration statements under section 8(a) of the Act of 1933. *See* 15 U.S.C.A. § 77h (West 1994). *See also* SODERQUIST, *supra* note 6, 204-05.

70. 17 C.F.R. § 230.252(g)(1) (1997).

71. 17 C.F.R. § 230.251(d)(1)(ii)(A - C) (1997). Any written offers made immediately after the filing of Form 1-A, but before qualification of the required offering statement are restricted to preliminary offering circulars, as described in Rule 255. 17 C.F.R. § 230.251(d)(1)(ii)(B) (1997). *See also* 17 C.F.R. § 230.255 (1997). Printed or broadcast announcements must identify the party from whom a Preliminary Offering Circular or Final Offering Circular can be obtained and may only contain information regarding the name of the issuer, the title of the security, the amount being offered, the per unit offering price to the public, the general type of business the issuer is engaged in, and a brief statement regarding the general character and location of its property. 17 C.F.R. § 230.251(d)(1)(ii)(C)(1-4) (1997).

72. 17 C.F.R. § 230.251(d)(1)(iii) (1997). An "offering circular" is a packet containing the narrative and financial information required by Form 1-A. 17 C.F.R. § 230.253 (1997). Prior to being "qualified," the packet is referred to as a "Preliminary Offering Circular;" once it becomes qualified and effective, it is known as the "Final Offering Circular." *See* 17 C.F.R. § 230.255 (1997).

73. "Sale" is defined as "every contract of sale or disposition of a security or interest in a security, for value." 15 U.S.C.A. § 77b(3) (West 1994).

74. 17 C.F.R. § 230.251(d)(2)(i)(A) (1997). *See supra* note 68 and accompanying text.

75. 17 C.F.R. § 230.251(d)(2)(i)(A)-(C) (1997).

complying with the registration requirements of section 5 of the Act of 1933. Although the issuer's cost of registration is reduced on the federal level, the issuer, nevertheless, must still satisfy disclosure and qualification requirements of each state in which it is making the offer. Compliance with each state's blue sky law requirements is often the issuer's only option, but compliance may be extremely expensive. Offerings of great magnitude often involve investors from more than one state. Therefore, capital formation by this method is frequently uneconomical for both issuers and investors.

The NSMIA fails to eliminate the regulatory burdens of a Regulation A offering for the issuer because, like a Rule 147 transaction, a Regulation A offering is excluded from the definition of a "covered security."[76] Both before and after the enactment of the NSMIA, the issuer is faced with compliance on multiple levels and with multiple states. Depending on the size of the offer, the costs associated with multilevel compliance may be so great that they outweigh the economic benefits of capital formation.

C. Rule 504

The issuer may also be exempt from the registration requirements of section 5 of the Act under Rule 504. To satisfy this standard, first, the issuer cannot be subject to the reporting requirements of section 13 or 15(d) of the Exchange Act and cannot qualify as an investment company or a development stage company that either has no business plan or has a plan to engage in a merger or acquisition with an unidentified company.[77] Second, the offer and sale must satisfy the terms and conditions set forth in Rules 501 and 502.[78] Rule 501 defines the terms used throughout Regulation D.[79] Rule 502 outlines the specific information that an issuer must furnish to the investor.[80] Rule 504 provides, however, that the issuer is not required to comply with the limitations of Rule 502(c) or (d).[81] Section (c) prohibits general solicitation and general advertisement of the securities through such media as newspapers, magazines, television, and radio.[82] Section (c) also

76. *See* 17 C.F.R. § 230.251; 15 U.S.C.A. § 77r(b) (West 1997).
77. *See* 17 C.F.R. § 230.504(a) (1997).
78. 17 C.F.R. § 230.504(b) (1997). *See also* 17 C.F.R. §§ 230.501, 230.502 (1997).
79. *See* 17 C.F.R. § 230.501 (1997).
80. *See* 17 C.F.R. § 230.502 (1997).
81. 17 C.F.R. § 230.504(b)(1) (1997). *See also* 17 C.F.R. § 230.502(c) & (d) (1997).
82. 17 C.F.R. § 230.502(c) provides that securities may not be sold by general

prevents issuers from offering the securities at seminars to which investors were invited through a general invitation.[83] Section (d) places limitations on the resale of the securities by treating them as if they were acquired pursuant to section 4(2) of the Act of 1933.[84] Thus, the securities cannot be resold without first being registered or falling within an exemption.[85] Since Rule 504 expressly excludes the limitations imposed by sections (c) and (d) of Rule 502, the issuer of 504 securities may utilize newspapers and general media to solicit investors.[86] In addition, the securities are more attractive to the investors because they are not subject to the resale limitations.[87] Rule 504 has one drawback, however; the transaction amount is limited to an aggregate offering price of $1,000,000.[88]

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solicitation or general advertisement. This includes, but is not limited to:

(1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and

(2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertisement.

17 C.F.R. § 230.502(c) (1997).

83. 17 C.F.R. § 230.502(c)(2) (1997).

84. 17 C.F.R. § 230.502(d) provides:

(d) *Limitation on Resale.* Except as provided in Rule 504(b)(1), securities acquired in a transaction under Regulation D shall have the status of securities acquired in a transaction under Section 4(2) of the Act and cannot be resold without registration under the Act or an exemption therefrom. The issuer shall exercise reasonable care to assure that the purchasers of the securities are not underwriters . . . which reasonable care may be demonstrated by . . . [making] reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons.

17 C.F.R. § 230.502(d) (1997). Section (d) also requires the issuer to provide the investor with a written disclosure, stating that the securities were not registered with the SEC and that there are restrictions on their resale. In addition, the issuer must place a legend on the securities that also states that the securities have not been registered and resale is restricted. 17 C.F.R. § 230.502(d)(2) & (3) (1997).

85. 17 C.F.R. § 230.502(d) (1997).

86. 17 C.F.R. § 230.504(b) (1997). *See also* 17 C.F.R. § 230.502(c) & (d) (1997).

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

88. "Aggregate offering price" is defined in Rule 501(c) as:

[T]he sum of all cash, services, property, notes, cancellation of debt, or other consideration to be received by an issuer for issuance of its securities. Where securities are being offered for both cash and non-cash consideration, the aggregate offering price shall be based on the price at which the securities are offered for cash. . . . If securities are not offered for cash, the aggregate offering price shall be based on the value of the consideration as established by bona fide sales of that consideration made within a reasonable time, or, in the absence of sales, on the fair value as determined by an accepted standard.

17 C.F.R. § 230.501(c) (1997). Rule 504(b)(2) specifically states:

The aggregate offering price for an offering of securities under this Rule 504, as defined in Rule 501(c), shall not exceed $1,000,000, less the aggregate offering price for all securities sold within the twelve months before the start of and during the offering of securities under this Rule 504, in reliance on any exemption under section

Prior to the enactment of the NSMIA, an issuer of securities meeting the requirements of Rule 504 (and thus, exempt from registering the securities under section 5 of the Act of 1933) had more flexibility in obtaining a pool of potential investors. The issuer was able to solicit potential investors with fewer restrictions by merely placing ads in newspapers or business journals. Moreover, the issuer could be more relaxed in its disclosure of material facts to purchasers while still complying with the antifraud statutes. In addition, without cumbersome restrictions on resale, the securities were more attractive to potential investors and less expensive to sell. Because the transaction was limited to an aggregate offering price of $1,000,000, the sale often occurred face-to-face, at which time the issuer could disclose all material facts, and the investor could bargain for investment information as well as a satisfactory price.[89]

Issuers involved in Rule 504 transactions were also burdened by compliance with the blue sky laws of each state in which the issuer was selling the securities, however. In addition, an individual acting on behalf of the issuer was required to register as a broker in each state. Additional expenses imposed upon the issuer were reflected in the cost of the securities, thus, canceling any benefits gained through the ease of issuance.

Often the issuer satisfied individual state blue sky laws by classifying the transaction as a "small offering."[90] Generally, a small offering is characterized by a limited number of purchasers and by resale restrictions. Furthermore, a small offering cannot be treated as a public offering.[91] However, state laws did not provide a uniform definition of a small offering. In essence, the capital formation benefits created under Rule 504 of the federal statutes were ultimately nullified by state blue sky laws.[92] The NSMIA again proved to be of no help to the issuer in a Rule 504 offering.

3(b), or in violation of section 5(a) of the Securities Act.

17 C.F.R. § 230.504(b)(2) (1997).

89. *See* Campbell, *supra* note 11, at 191.

90. A "small offering" is a transaction exempted from registration under state blue sky laws because of the restricted number of investors and limitations on resale. The small offering exemption is not available in all states and its requirements vary among the states in which it does exist. Most notable are the differences in the maximum number of investors and the method used for calculating the number of investors. *See* Campbell, *supra* note 11, at 187-88 & 191 nn.67-71.

91. *See* Campbell, *supra* note 11, at 191.

92. *Id.*

D. Rule 505

Another method of gaining exemption from section 5 registration and disclosure with the SEC is for the issuer to satisfy the requirements of Rule 505.[93] Under this rule, an issuer, that is not an investment company, is exempted from section 5 registration by section 3(b) of the Act of 1933.[94] To qualify for this exemption, subsection (b) of Rule 505, like Rule 504, requires that the offer and sale follow the mandates of Rule 501 (the definitional rule) and Rule 502.[95] Unlike Rule 504 transactions, however, the limitations of subsections (c) and (d) of Rule 502 are applicable to Rule 505.[96] The issuer, therefore, is subject to solicitation and resale limitations placed on the securities.[97]

In addition, Rule 505 lists several specific conditions the issuer must fulfill.[98] First, the aggregate offering price is limited to a sum not exceeding $5,000,000.[99] Second, the number of purchasers of the securities cannot exceed thirty-five.[100] Finally, if the issuer

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93. 17 C.F.R. § 230.505(a) (1997). *See also* 15 U.S.C. § 77e (1994).

94. 17 C.F.R. § 230.505(a) (1997).

95. 17 C.F.R. § 230.505(b)(1) (1997).

96. 17 C.F.R. § 230.505(b)(1) (1997). *See also supra* notes 70-71 and accompanying text.

97. *See* 17 C.F.R. § 230.502(c) & (d) (1997).

98. *See generally* 17 C.F.R. § 230.505(b)(2)(i)-(iii) (1997).

99. The limitation on the aggregate offering price specifically provides:

> The aggregate offering price for an offering of securities under this Rule 505 as defined in Rule 501(c), shall not exceed $5,000,000, less the aggregate offering price of all securities sold within the twelve months before the start of and during the offering of securities under this Rule 505 in reliance on any exemption under section 3(b) of the Act or in violation of section 5(a) of the Act.

17 C.F.R. § 230.505(b)(2)(i) (1997). *See also* 17 C.F.R. § 230.501(c) (1997).

100. 17 C.F.R. § 230.505(b)(2)(ii) (1997). In calculating the number of purchasers, Rule 501(e) provides:

> (1) The following purchasers shall be excluded:
>
> (i) Any relative, spouse or relative of the spouse of a purchaser who has the same principal residence as the purchaser;
>
> (ii) Any trust or estate in which a purchaser and any of the persons related to him . . . collectively have more than 50 percent of the beneficial interest . . . ;
>
> (iii) Any corporation or other organization of which a purchaser and any of the persons related to him . . . collectively are beneficial owners of more than 50 percent of the equity securities . . . ;
>
> (iv) Any accredited investor.
>
> (2) A corporation, partnership or other entity shall be counted as one purchaser. If, however, that entity is organized for the specific purpose of acquiring the securities offered and is not an accredited investor . . . each beneficial owner . . . of the entity shall count as a separate purchaser. . . .

qualifies under Rule 262 of Regulation A as an issuer who has committed violations of the Act of 1933 or other antifraud provisions, then that issuer is disqualified from receiving Rule 505 treatment in the transaction.[101] Upon a showing of good cause that the circumstances warrant the Rule 505 exemption, however, the SEC may determine that the issuer is nevertheless entitled to the exemption.[102]

Prior to the enactment of the NSMIA, if an issuer met the requirements and conditions outlined in Rule 505 and was not denied use of the exemption by the SEC, the issuer was excused from section 5 compliance. The issuer was still faced with compliance, registration, and disclosure on the state level, however. Since Rule 505 offerings could total as much as $5,000,000, the issuer often offered the securities for sale in many, if not all, of the fifty states.

The Uniform Limited Offering Exemption ("ULOE") was a vehicle through which many issuers attempted to circumvent state blue sky laws.[103] Only four-fifths of the states had adopted some version of the ULOE, however, and statutes were not uniform among those states.[104] Thus, even if the issuer were offering in states that had adopted the ULOE, the issuer was still faced with multiple compliance laws. In addition, the ULOE did not permit a complete escape from state registration requirements. Instead, the ULOE imposed requirements in addition to those already imposed by Rule 505. As a result, the issuer was subjected to Rule 505 on the federal level, differing versions of the ULOE in those states in which it had been enacted, and individual state blue sky laws in states where the ULOE had not been enacted.[105] Compliance with all applicable federal and state laws required substantial research, which generated tremendous legal fees for the issuer. This cost, in turn, shifted to the investors, which made selling the securities more difficult and burdened the capital formation process for the issuer.

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(3) A non-contributory employee benefit plan . . . shall be counted as one purchaser where the trustee makes all investment decisions for the plan.

17 C.F.R. § 230.501(e) (1997). What may constitute an "offering" is outlined in Rule 502(a). *See* 17 C.F.R. § 230.502(a) (1997).

101. 17 C.F.R. § 230.505(b)(2)(iii) (1997). *See also* 17 C.F.R. § 230.262 (1997).

102. 17 C.F.R. § 230.505(b)(2)(iii)(C) (1997).

103. Uniform Limited Offering Exemption, NASAA Rep. (CCH) 6201 (May 1989), at 6101.

104. *See* Campbell, *supra* note 11, at 189.

105. *Id.*

The NSMIA again provided no relief from compliance for the issuer who wanted to make a Rule 505 offering. Section 3(b) exempts Rule 505 offerings from section 5 of the Act of 1933.[106] Therefore, the securities in a Rule 505 offering are excluded from the definition of "covered securities" and do not fall under the NSMIA.[107] As a result, the issuer must comply with state blue sky laws. The increased size and value of the offer, ranging as high as $5,000,000, when balanced against the cost of state and federal compliance, may, nonetheless, generate some economic benefits for the issuer. These benefits would be much greater, however, if the issuer were not burdened by compliance with state blue sky laws or the many versions of the ULOE. The NSMIA, despite its purpose of increasing the availability of capital formation options for issuers, has done nothing to improve the opportunities for the issuer of a Rule 505 offering.

E. Rule 506

Rule 506 is often regarded as similar to Rule 505, except 506 has no limitation on the aggregate offering price. Rule 506 authorizes the issuer to avoid section 5 of the Act of 1933 via section 4(2), which exempts transactions not involving public offerings.[108] A transaction qualifies as a non-public offering if the issuer satisfies the requirements of paragraph (b) of Rule 506.[109] Rule 506 requires the issuer to satisfy the conditions and requirements outlined in Rules 501 and 502.[110] In addition, the issuer must satisfy several other specific conditions.[111] Rule 506, like Rule 505, limits the number of purchasers to thirty-five.[112] Furthermore, the investor must not be an accredited investor, but must have sufficient financial knowledge and experience to evaluate the risks of the investment.[113]

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106. *See* 15 U.S.C. § 77c(b) (1994).

107. *See* 15 U.S.C.A. § 77r(b)(4) (West 1997).

108. 17 C.F.R. § 230.506(a) (1997). *See* 15 U.S.C. § 77d(2) (1994).

109. 17 C.F.R. § 230.506(a) (1997).

110. 17 C.F.R. § 230.506(b)(1) (1997).

111. *See generally* 17 C.F.R. § 230.506(b) (1997).

112. 17 C.F.R. § 230.506(b)(2)(i) (1997). *See* 17 C.F.R. § 230.501(e) (1997) for the method of calculating the number of purchasers for purposes of a Rule 506 transaction. *See also supra* note 82 and accompanying text.

113. 17 C.F.R. § 230.506(b)(2)(ii) (1997). Rule 506(b)(2)(ii) specifically provides:

> (ii) Nature of Purchasers. Each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of

The NSMIA, however, created a major difference between a Rule 506 transaction and those transactions discussed previously. Because a Rule 506 transaction escapes section 5 of the Act of 1933 via section 4(2), not section 3(b) like the others, a Rule 506 transaction involves securities that do fall within the definition of "covered securities," and thus, a 506 transaction is within the scope of the NSMIA.[114] The issuer, therefore, is not burdened by ULOE compliance or individual state blue sky laws since the issuer is within the protection of the NSMIA. The issuer is exempt from individual state regulations. States, under the NSMIA, may still impose notice filing requirements on the issuer for any securities offered in that state, however. But the costs associated with this notice filing are minimal compared to the costs of complying with each state's ULOE or blue sky laws. Finally, the NSMIA has created a situation which actually benefits the issuer and facilitates capital formation.

F. A Registered Offering

A "Registered Offering" is one that is fully registered with the SEC in accordance with the Act of 1933. Registered Offerings are public offerings traded on a major stock exchange, such as the New York Stock Exchange, the American Stock Exchange, or the National Market System of the NASDAQ Stock Market. These offerings typically involve several million dollars and are so large that the cost of state and federal compliance often poses little burden to the issuer.[115] Because of the public nature and size of the offerings, registration exemption is not available on either the federal or the state level. The issuer is obligated to satisfy all requirements of the Act of 1933, as well as individual state blue sky laws. Almost all states, however, provide a marketplace exemption. This exempts the issuer from compliance with state blue sky laws because of the national character of the market on which the securities are traded, i.e., the New York Stock Exchange or the American Stock Exchange. Additionally, the nature of this type of large transaction necessitates the filing of a federal "registration statement," which, in turn, allows the issuer to register by means of

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the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description.

17 C.F.R. § 230.506(b)(2)(ii) (1997).

114. 15 U.S.C.A. § 77r(b)(4)(D) (West 1997).

115. Campbell, *supra* note 11, at 195.

coordination if a method of coordination is available in the individual state.[116]

Due to the ease with which the issuer can comply with both the federal and state registration requirements, these offerings attempting capital formation are of benefit to the issuer. Although the issuer is faced with additional legal, compliance, and registration costs, these are often minimal in comparison to the size of the offering, and not substantial enough to outweigh the benefits the issuer derives from the offering.

The issuer under a Registered Offering is neither helped nor hurt by the enactment of the NSMIA. The issuer receives the benefits of the NSMIA because the securities, which are traded on a national stock exchange, are "covered securities."[117] By qualifying as a "covered security," the issuer is exempt from complying with individual state blue sky laws. Thus, the issuer is only required to comply with the federal registration requirements. The issuer's situation is changed little by the passing of the NSMIA, however, since prior to the Act, the issuer usually was subject to federal registration requirements. Since virtually all states had a marketplace exemption or provided for registration by coordination, the issuer was exempt from registering with each individual state. Ultimately, therefore, the NSMIA does little for the issuer except reaffirm an exemption from state blue sky laws to which it was already entitled.

IV. Pennsylvania Securities Commission's Interpretation of the NSMIA

Shortly after enactment of the NSMIA, the Pennsylvania Securities Commission (the "PSC") drafted guidelines for interpreting the NSMIA with respect to Pennsylvania securities laws. Under the Pennsylvania Securities Act of 1972 (the "Act of 1972"), the issuer is required by section 1-201 to comply with certain registration requirements before offering the securities to investors in Pennsylvania.[118] The Act of 1972 provides, however, for the exemption of certain securities and transactions from these

116. "Registration by coordination" occurs when a state has agreed to accept the SEC federal registration as equivalent to registration with the state agency. These state agencies coordinate with the SEC during the registration process to make registration easier for the issuer.

117. *See* 15 U.S.C.A. § 77r(b)(1)(A) (West 1997).

118. *See* 70 P.S. § 1-201 (1994).

registration requirements.[119] An issuer often relies upon section 1-203(d) and (e) to exempt a Rule 506 offer from registration under the Act of 1972.[120] In interpreting the NSMIA, the PSC found that the preemptive provisions of the NSMIA only apply to offers and sales of securities made pursuant to Rule 506 of the Act of 1933.[121] Accordingly, to the PSC, offers and sales pursuant to Rule 504, Rule 505, or the statutory preemption under section 4(2) of the Act of 1933 (other than a Rule 506 transaction), must comply with the registration requirements of section 1-201 of the Act of 1972.[122]

As a result of relying on sections 1-203(d) or (e) for exemption from the registration requirements of the Act of 1972, the issuer was confronted with severe limitations on the number of purchasers in a Rule 506 transaction and on resale of the securities.[123] Sections 1-203(d) and (e) have been substantially changed, however, by the enactment of the NSMIA.

Before the passage of the NSMIA, if an issuer wanted to utilize the exemption under section 1-203(d), investors were required to sign an agreement stating the investors were not permitted to resell the securities for a period of twelve consecutive months.[124] Since

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119. *See generally* 70 P.S. §§ 1-202, 1-203 (1997).

120. Effect of the National Securities Markets Improvement Act of 1996 (P.L. 104-290) on the Pennsylvania Securities Act of 1972 with respect to Offers and Sales of Securities in Pennsylvania which are Exempt from Registration under Section 5 of the Securities Act of 1933 pursuant to Rule 506 of SEC Regulation D Promulgated under Section 4(2) of the Securities Act of 1933 Act, [2A Binder] Blue Sky L. Rep. (CCH) ¶ 48,684Y (Release No. 96-CF-3, Oct. 17, 1996).

121. *Id.*

122. *Id.*

123. Section 1-203(d) provides:

> The following transactions are exempted from section 201: . . .
>
> (d) Any sales by an issuer to not more than twenty-five persons in this State during a period of twelve consecutive months if (i) the issuer shall obtain the written agreement of each such person not to sell the security within twelve months after the date of purchase; (ii) no public media advertisement is used or mass mailing made in connection with soliciting such sales; (iii) no case or securities if given or paid directly or indirectly, to any promoter as compensation in connection therewith unless such compensation is given or paid in connection with a sale made by a broker-dealer registered pursuant to section 301 and any person receiving such compensation is either such broker-dealer or an agent registered pursuant to section 301 of such broker-dealer; and (iv) the filing fee specified in section 602(b.1) is paid. . . .

70 P.S. § 1-203(d) (1997). Section 1-203(e) provides:

> The following transactions are exempted from section 201: . . .
>
> (e) Any offer to not more than fifty persons during a period of twelve consecutive months if no sales result from such offer or if sales resulting from such offer are exempt by reason of subsection (d) hereof. . . .

70 P.S. § 1-203(e) (1994).

124. 70 P.S. § 1-203(d) (1997).

the enactment of the NSMIA, investors are no longer required to sign such a written agreement and are permitted to resell the securities before the expiration of twelve consecutive months.[125] Investors are still required to comply with the federal resale restriction in Rule 506 transactions, however, and the security must bear a restrictive legend.[126] Similarly, the issuer must still conduct a reasonable inquiry into whether the investor is buying the securities for an unidentified party in violation of Rule 506.[127]

Section 1-207(m) of the Act of 1972 provides for a two-business-day withdrawal period, during which an investor in securities that are exempt from registration with the PSC may withdraw from its agreement to purchase the securities.[128] Prior to enactment of the NSMIA, a Rule 506 offering that was exempt under section 1-203(d) would have fallen into section 1-207(m), thereby resulting in a two-business-day withdrawal period for investors. Issuers are no longer required to register a Rule 506 offering, involving "covered securities," with the individual state agencies. Therefore, issuers no longer need section 1-203(d) to exempt Rule 506 offerings from registration. Since section 1-203(d) no longer applies to the offering, section 1-207(m), by its statutory language, no longer applies to the offering.[129] Consequently, the investor is no longer entitled to the two-business-day withdrawal period.[130]

The NSMIA also changed the prohibitions the Act of 1972 placed on sales compensation for promoters and on advertising and general solicitation of investors.[131] Section 1-203(d)(iii) of the Act of 1972 prohibited the payment of compensation to promoters, other than those broker-dealers registered with the PSC, in connection

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125. *See* 70 P.S. § 1-203(d) (1997).
126. *See supra* note 120.
127. *Id.*
128. Section 1-207(m)(2) provides:

> Each person who accepts an offer to purchase securities exempted from registration by section 203(d) or (p), directly from an issuer or affiliate of an issuer shall receive a written notice in such form as the commission by rule, may prescribe informing such person of his right under this subsection to withdraw his acceptance without incurring any liability to the seller, underwriter (if any) or any other person, within two business days from the date of receipt by the issuer of his written binding contract of purchase or, in the case of a transaction in which there is no written binding contract of purchase, within two business days after he makes the initial payment for the securities being offered.

70 P.S. § 1-207(m)(2) (1997) (citations omitted).
129. *See supra* note 120.
130. *Id.*
131. *Id.*

with an offering attempting to obtain exempt status under section 1-203(d).[132] The NSMIA eliminated this prohibition on payment of commissions.[133] However, the PSC still retains the right to require broker-dealers to follow the registration procedures outlined by the Act of 1972 and still retains jurisdiction over those broker-dealers, agents or investment advisors who provide services, but are not registered with the PSC.[134] To obtain exemption from registration, section 1-203(d)(ii) requires the issuer to refrain from using public media advertisement or mass mailing in connection with the offering.[135] The PSC, in its release, held that this prohibition on the use of advertising and mass mailing no longer applies to a Rule 506 offering, since such an offering no longer relies on section 1-203(d) for exemption from registration.[136] The PSC stated, however, that the prohibition imposed on the issuer by Rule 502 of the Act of 1933 still applies to a Rule 506 offering.[137]

Several aspects of Pennsylvania's blue sky laws, however, are still enforceable after the enactment of the NSMIA. Before the NSMIA, an issuer seeking exemption of its Rule 506 offering under section 1-203(d) was required to file a notice of the sale with the PSC, setting forth certain information.[138] In its release, the PSC stated it is still permitted by the NSMIA to require issuers in a Rule 506 offering to file a copy of the SEC Form D, giving notice of the sale of the securities and other detailed information, with the

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132. Section 1-203(d)(iii) provides:

> [N]o cash or securities is given or paid, directly or indirectly, to any promoter as compensation in connection therewith unless such compensation is given or paid in connection with a sale made by a broker-dealer registered pursuant to section 301 and any person receiving such compensation is either such broker-dealer or an agent registered pursuant to section 301 of such broker-dealer.

70 P.S. § 1-203(d)(iii) (1997) (citations omitted).

133. *See supra* note 120.

134. *Id. See also* 70 P.S. §§ 1-301 - 1-306 (1994).

135. 70 P.S. § 1-203(d)(ii) (1997). This section provides that "no public media advertisement is used or mass mailing made in connection with soliciting such sales." 70 P.S. § 1-203(d)(ii) (1997).

136. *See supra* note 120.

137. *Id. See supra* notes 69 and 70 and accompanying text.

138. 70 P.S. § 1-203(d) (1997). This section provides:

> A notice in the form prescribed by the commission, signed by the officers or directors of the issuer under oath and stating the name, principal business address of the issuer, proposed use of the proceeds from the sale and such facts as are necessary to establish this exemption shall be filed, together with a copy of any offering literature used in connection with such offer or sale, with the commission not later than the day on which the securities are first issued or the issuer first receives from any person, therefor, whichever is earlier.

70 P.S. § 1-203(d) (1997).

PSC.[139] The PSC also announced that it still has the right to require issuers to file other documents (in addition to the notice documents) with the PSC, which will be distributed to investors.[140] The PSC will, however, waive this additional documents filing if the PSC is able to request this information from time to time from the issuer where "it is appropriate and necessary for the protection of investors."[141] The issuer must also satisfy certain time limitations for filing.[142]

Similarly, the PSC interprets the NSMIA as allowing Pennsylvania to charge and collect the appropriate filing fees for the notice and other documents.[143] The issuer's failure to pay these filing costs is a violation of the section 1-201 registration requirements and subjects the issuer to actions by the PSC for violation of the Pennsylvania blue sky laws.[144] In addition, the issuer must indicate in its notice the amount of securities offered for sale in Pennsylvania and pay the appropriate filing fee.[145] The filing fee is determined by the amount of securities the issuer is offering to investors.[146] If the issuer submits a notice filing accompanied by a filing fee, but does not indicate the amount of securities to be sold in Pennsylvania, the PSC assumes the amount of securities to be sold corresponds to the filing fee submitted with the notice, according to the fee schedule of section 1-602(b.1).[147] If the issuer sells more than this presumed amount, the PSC treats it as an underpayment of fees, which constitutes a violation of registration requirements if not

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139. *See supra* note 120.

140. *Id.*

141. *Id.*

142. "Time limitations" include:

> 1. Filing the Notice with the PSC no later than 15 calendar days after the first sale of securities in accordance with Rule 503 of SEC Regulation D (i.e., the first sale made by the issuer); or
>
> 2. If the issuer desires to make a sale in Pennsylvania and has not filed a notice within 15 calendar days after the issuer's first sale of securities, filing the Notice no later than the day on which the issuer receives from any person in Pennsylvania an executed subscription agreement or other contract to purchase the securities being offered or the issuer receives consideration from any person in Pennsylvania therefor, whichever is earlier. . . .

Effect of the National Securities Markets Improvement Act, *supra* note 120.

143. *Id.* A schedule of the fees the PSC charges for filing of securities in a Rule 506 transaction are set forth in section 1-602(b.1). *See* 70 P.S. § 1-602(b.1) (1994).

144. *See supra* note 120.

145. *Id.*

146. *Id.*

147. *Id. See also* 70 P.S. § 1-602(b.1) (1994).

quickly rectified.[148]

It is also important to note that the PSC requires that all transactions that occurred prior to the enactment of the NSMIA (and conducted pursuant to Rule 506) satisfy all the requirements of section 1-203(d) or (e) to qualify for exemption from the Pennsylvania blue sky law registration.[149] Failure to comply with the 1-203(d) or (e) requirements constitutes a violation of section 1-201.[150]

V. Summary of the Impact of the National Securities Market Improvement Act

Generally speaking, the NSMIA does little, if anything, to help issuers. Only issuers of Registered Offerings or Rule 506 offerings actually benefit. Those issuers, however, need the least amount of assistance. Although the NSMIA now exempts Rule 506 transactions from the registration requirements of the individual states, and thus, compliance with their various blue sky laws, these Rule 506 issuers, compared to issuers under Rules 147, 504, 505 or Regulation A, are the least concerned with compliance with these state laws.

The size of Rule 506 transactions often produces compliance costs which are minimal compared to the actual amount of the offer. Compliance costs of $100,000 are more easily swallowed by an issuer of $7,000,000 of securities than by an issuer of only $250,000.

Issuers of Registered Offerings also have virtually no need for the NSMIA, since they were exempted from complying with the majority of the states' blue sky laws due to marketplace exemptions or registration by coordination. Furthermore, due to the size of the offering, the Registered Offering issuer is not concerned with the costs of complying and registering with individual states because either an exemption from the blue sky laws already existed prior to the NSMIA or the cost of registering was minimal in comparison to the size of the offering.

The issuers who needed to be included within the scope of the NSMIA are those issuers who try to use Rules 147, 504, 505, or Regulation A as a means of improving their chances at capital

148. *See supra* note 120.

149. *Id. See also* 70 P.S. §§ 1-203(d) & (e) (1997).

150. *See supra* note 120. *See also* 70 P.S. § 1-201 (1994).

formation. These issuers, due to the small size of their offerings, cannot afford to pay high compliance costs to satisfy the requirements of the state blue sky laws and need to be exempt from registration requirements under the NSMIA. Instead, the NSMIA fails to include these types of transactions in the definition of "covered securities," and thus, affords them no protection. It is these issuers that need the benefits of the NSMIA in capital formation, but Congress has done little to help them.

Congress, if it intends to facilitate the mechanism of capital formation and improve the environment of Corporate America, must consider one of two proposals. First, and easiest, Congress could enlarge the scope of the NSMIA by redefining "covered securities" to include those offerings under Rules 147, 504, 505, or Regulation A. By doing so, Congress would be helping the small businesses succeed at capital formation by decreasing the compliance costs associated with registration and by increasing the benefits the issuer receives from the offering. Issuers would still be required to comply with federal regulations regarding registration and disclosure before making the offering. This would provide investors with adequate protection against fraud and deception and provide a means of recourse for investors against issuers.

Second, and more drastic, Congress could preempt all state laws regarding the offering of securities. By totally preempting state laws, the federal government would truly be monopolizing the securities laws, an event that the NSMIA has essentially foreshadowed. Due to the complex nature of securities laws in today's technological world, perhaps the federal government should take complete control of the monitoring and regulation of securities offerings. The SEC could be expanded beyond its present size with more regional offices, converting state agency employees into federal employees. Instead of two groups of people, federal and state, both monitoring the registration and disclosure of information surrounding the offering of securities, these groups could become one entity governed by one set of laws. Perhaps this would improve the regulation of issuers and provide investors with even greater protection against fraud and deception. It would certainly make compliance easier for issuers since they would only need to learn and follow one set of rules on registration and disclosure of information. It would also make it easier for investors, since they would receive the same information required in all types of offerings and one judicial body would decide the outcome of securities claims in a more uniform manner.

Whatever Congress decides to do in the future, one thing is certain: state blue sky law compliance is a waste of resources for the issuer.[151] Blue Sky laws act as deterrents to the investor by causing the price of the securities to increase to compensate for these compliance costs. It is time Congress began to seriously examine this waste of resources. Until Congress acts, the mechanism of capital formation will continue to be hampered by federal and state securities laws.

Douglas J. Dorsch

151. *See also* Campbell, *supra* note 11, at 195-96 & n.120.