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## REFLECTIONS ON DUAL REGULATION OF SECURITIES: A CASE AGAINST PREEMPTION†

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Shortly after the turn of the century, a state legislator from the Midwest declared that "if securities legislation was not passed, financial pirates would sell citizens everything in his state but the blue sky."<sup>1</sup> These financial pirates were engaged in the widespread sale of "pieces of paper" representing ownership in various corporate enterprises,<sup>2</sup> many of which were valueless or nonexistent.<sup>3</sup> The rural states, "having a large proportion of agriculturists not versed in ordinary business methods," had become "hunting ground[s]"

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<sup>1</sup> PARRISH, *SECURITIES REGULATION AND THE NEW DEAL* 5 n.1 (1970).

<sup>2</sup> The fraudulent practices of "financial pirates" were "made possible through the creation, under legal sanction, of artificial corporate entities which enable individuals to avoid personal responsibility for many of their acts. . . ." *Federal Securities Act: Hearings on H.R. 4314 Before the House Committee on Interstate and Foreign Commerce, 73d Cong., 1st Sess., 93 (1933)* (Dept. of Commerce Study of the Economic and Legal Aspects of the Proposed Federal Securities Act) [hereinafter cited as *Securities Act Hearings*].

Due in large part to the dynamics of the industrial revolution, the use of the corporation as a form of doing business had become predominant by the early years of the twentieth century. BERLE AND MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 2-3, 13. This development included an increasingly wider dispersion of stock ownership, with a significant shift in ownership "from the rich to the less well to do." *Id.* at 62. "The position of stock ownership," as evidenced by "pieces of paper representing a set of rights and expectations," was "changed from that of an active to that of a passive agent." *Id.* at 66. The shareholder of a publicly held corporation, unlike the business owner of the past, was "powerless" with respect to the underlying corporate property. *Id.* This evolution of the corporate system, involving a separation between ownership and control, was an important "law-shaping" antecedent to securities regulation. 1 L. LOSS, *SECURITIES REGULATION* 19 (1961).

<sup>3</sup> *Securities Act Hearings*, *supra* note 1, at 93. See also Note, *The Blue Sky Law*, 3 MARQ. L. REV. 142 (1918-19).

There is the salesman whose specialty is the sale of worthless or dubious stock. . . . His tales of turning the money over quick, doubling and trebling the same, take very well with the unsuspecting man, who previous to [World War I] had not ventured into such investments as stocks and bonds . . .

It has been estimated in responsible quarters that as much as \$400,000,000 of Liberty Bonds placed with investors have already fallen into the hands of dishonest brokers in the exchange for wildcat oil or mining issues . . .

*Id.* at 142.

for securities swindlers.<sup>4</sup> In response, the State of Kansas enacted the first "blue sky law"<sup>5</sup> in 1911 to protect investors from fraudulent and abusive practices in connection with the purchase and sale of securities.<sup>6</sup> Forty-six other states passed similar laws before any action was taken at the federal level to regulate securities transactions.<sup>7</sup>

The state blue sky laws, during the first two decades of their enforcement, were responsible for saving investors millions of dollars that otherwise would have been lost in fraudulent securities.<sup>8</sup> The states, however, by themselves, were unable to stop an unprecedented deluge of worthless securities<sup>9</sup> during the 1920's.<sup>10</sup> Because of variations among

<sup>4</sup> Mulvey, *Blue Sky Law*, 36 CAN. L. TIMES 37 (1916).

<sup>5</sup> The term "Blue Sky" apparently originated in connection with securities frauds perpetrated in Kansas. "This state was the hunting ground of promoters of fraudulent enterprises; in fact their frauds became so barefaced that it was stated that they would sell building lots in the blue sky in fee simple. Metonymically they became known as blue sky merchants, and the legislation intended to prevent their frauds was called Blue Sky Law." Mulvey, *supra* note 4. See also *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917). "The name that is given to the law indicates the evil at which it is aimed; that is . . . 'speculative schemes which have no more basis than so many feet of 'blue sky'." *Id.* at 550.

Kansas, apparently, is still a hunting ground for promoters of fraudulent schemes. Several years ago, the town of Johnson, Kansas was invaded by salesmen marketing investment contracts for a Salt Lake City company called Universal Clearing House. *Wall St. J.*, November 28, 1983, at 1, col. 1. The contracts, promising an 8.4% monthly return, attracted over twenty-five investors who collectively placed approximately \$400,000 at risk. *Id.* Presently, the Johnson residents and other investors have little or no chance of recovering their investments. *Id.* The company is in bankruptcy and there are no assets to satisfy the claims of the investors. *Id.* Universal's business was not that of a clearing house, but, rather, was a "Ponzi" scheme which pays profits to early investors from money paid in by later investors. *Id.*

<sup>6</sup> See L. LOSS & E. COWETT, *BLUE SKY LAW* 7 (1958). Professor Loss points out that "the Kansas experience had a profound effect upon the development of Blue Sky Laws elsewhere . . ." *Id.*

The first effort in Kansas to combat the securities fraud dilemma was instigated by a bank commissioner who, aware of the fact that investors were taking their money out of banks and placing it in worthless securities, established a department in his office to investigate securities being sold in Kansas. *Id.* If the investigations uncovered worthless securities, potential investors would receive warnings. *Id.* at 8. Through his efforts to develop a licensing scheme for the issuance of securities, the Kansas statute was passed in 1911. *Id.*

<sup>7</sup> S. REP. NO. 47, 73d Cong., 1st Sess 2 (1933).

<sup>8</sup> See *Securities Act Hearings*, *supra* note 2, at 92, 98 (Dept. of Commerce Study of the Economic and Legal Aspects of the Proposed Federal Securities Act) ("[Blue Sky] Laws have resulted in the suppression of many fraudulent securities and have saved the public untold sums of money"); Gadsby, *Historical Development of the SEC — The Government View*, 28 GEO. WASH. L. REV. 6, 8 (1959) (In the first eighteen months under the Kansas statute only 100 out of 1500 proposed offerings were licensed because 75% were deemed potentially fraudulent and half of the remaining 25% were deemed dangerously speculative).

See also *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568 (1917), in which the court stated:

Counsel, indeed, frankly concedes the evil of 'get-rich-quick' schemes and quotes the banking commissioner of the state of Kansas for the statement that the 'Blue Sky' law of that state had saved the people of the state \$6,000,000 since its enactment, and that between 1,400 and 1,500 companies had been investigated by the department and less than 400 of the number granted permits to sell securities in the state. 242 U.S. at 586.

<sup>9</sup> See H.R. REP. NO. 85, 73d Cong., 1st Sess. 2 (1933). It was estimated that over one-half of the fifty billion dollars worth of securities floating in the United States during the post World War I decade were worthless. *Id.* See also *Securities Act Hearings*, *supra* note 2, at 80 (statement of Walter L. Miller, Dept. of Commerce). ("[W]e believe that half of the securities sold were either undesirable or worthless").

<sup>10</sup> *Securities Act Hearings*, *supra* note 2, at 10 (statement of Huston Thompson, Attorney at Law, Washington, D. C.).

the states in both the substance and enforcement of their laws,<sup>11</sup> clever promoters took advantage of these differences to conduct interstate schemes beyond the reach of state authorities.<sup>12</sup> Consequently, a majority of state administrators advised Congress that "a supplemental federal law [was] needed to stop this gap."<sup>13</sup> The Securities Act of 1933 (1933 Act)<sup>14</sup> and the Securities Exchange Act of 1934 (1934 Act)<sup>15</sup> were designed to fill this "gap" left by the pre-existing regulatory schemes adopted by the states.<sup>16</sup> Since the enactment of federal legislation, investors in securities have been protected by a dual regulatory system administered by the Securities and Exchange Commission (SEC) at the federal level and securities commissions or similar agencies at the state level.

The dual system of securities regulation has flourished and developed into an interdependent protective scheme. It provides investors and their marketplace: (1) pre-issuance protection through registration of securities to assure full disclosure of material facts; (2) post-issuance protection through civil and criminal antifraud provisions; and (3) continuing protection through the regulation and supervision of brokers, dealers, and salesmen of securities. In recent years, federal and state administrators have commenced efforts to coordinate their respective regulatory schemes in order to reduce any unnecessary obstacles to capital formation without a corresponding reduction in investor protection.<sup>17</sup> This coordination has been essential in achieving a balance between state and federal regulatory interests and in accommodating current notions of federalism.<sup>18</sup>

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<sup>11</sup> *Id.* at 99 (Dept. of Commerce Study of the Economic and Legal Aspects of the Proposed Federal Securities Act).

<sup>12</sup> *Id.* See also Gadsby, *Historical Development of the SEC — The Government View*, 28 GEO. WASH. L. REV. 6, 8 (1959); PARRISH, *SECURITIES REGULATION AND THE NEW DEAL* 29 (1970). See also *Traveler's Health Ass'n v. Virginia*, 339 U.S. 643 (1950) (Douglas, J., concurring), discussed *infra* notes 94-96 and accompanying text.

<sup>13</sup> *Securities Act Hearings*, *supra* note 2, at 101 (Dept. of Commerce Study of the Economic and Legal Aspects of the Proposed Federal Securities Act). See also PARRISH, *SECURITIES REGULATION AND THE NEW DEAL* 29 (1970) (the greatest problem from the standpoint of some state administrators concerned interstate securities offerings).

<sup>14</sup> 15 U.S.C. §§ 77a-77bbbb(1976).

<sup>15</sup> 15 U.S.C. §§ 78a-78kk(1976).

<sup>16</sup> See *Traveler's Health Ass'n v. Virginia*, 339 U.S. 643, 653 (1950) (Douglas, J., concurring).

<sup>17</sup> See, e.g., Securities Act Release No. 6474 (July 22, 1983), [Current] FED. SEC. L. REP. (CCH) ¶ 83,403. See also *infra* note 242 and accompanying text.

<sup>18</sup> The term "federalism" defies any concise definition. In its broadest sense, it refers to the dual political system created by the Constitution, which, "in all its provisions, looks to an indestructible Union, composed of indestructible States." *Texas v. White*, 74 U.S. (7 Wall) 700, 725. See also *National League of Cities v. Usery*, 426 U.S. 833, 844 (1976). In this connection, it has been characterized as "a restraint on federal power." L. TRIBE, *AMERICAN CONSTITUTIONAL LAW* 310 (1978). The premise for this restraint has been summarized in the following manner:

Congressional action which treats the states in a manner inconsistent with their constitutionally recognized independent status . . . should be void, not because it violates any specific constitutional provision . . . , but because it would be contrary to the structural assumptions of the Constitution as a whole.

*Id.*

The term has been employed in a wide variety of contexts, with its meaning varying almost as frequently as its proponent. The judicial construction given the term, as interpreted by one writer, is illustrative:

[T]he concept of federalism, which Marshall identified with plenary national power, Taney with concurrent sovereignty, Holmes, Brandeis and Frankfurter with state experimental legislation, and Jackson with expanded national regulation of the economy, came to serve yet another purpose of Harlan: a justification for the preservation of values infringed by bold judicial definitions of citizens' rights.

Despite the success of the dual regulatory system, it has been subjected to extensive criticism.<sup>19</sup> Investment bankers have been the most frequent critics. Their views have been expressed primarily by their trade association, the Securities Industry Association.<sup>20</sup> They opposed the development of state blue sky laws on the ground that simple fraud laws, which did not require registration, full disclosure or administrative review, afforded adequate protection.<sup>21</sup> In addition, they argued that state securities laws were "crude, paternalistic measures,"<sup>22</sup> were "unworkable,"<sup>23</sup> and placed "intolerable . . . restrictions upon interstate commerce."<sup>24</sup> Unable to prevent the proliferation of these laws, they were successful, however, in modifying certain state regulatory schemes to comport with their position.<sup>25</sup> Because of this success, they withdrew their initial support of a federal blue sky

G. WHITE, *THE AMERICAN JUDICIAL TRADITION* 344 (1976). This writer concluded that federalism, as an ideological term, "ha[s] had different meanings at different times. . . . ha[s] been identified with judicial responses pointing in a variety of directions, . . . and may connote either strength in the national government or a balance of strength between that government and the states." *Id.* at 373. See also S. SHUMAN, *THE FUTURE OF FEDERALISM* 12 (1968) (federalism represents "a continuum of views along [a] spectrum" which includes "uncooperative," "cooperative," "necessary," "anti-vacuum," and "creative" or "centripetal" federalism).

The so-called "New Federalism" espoused by President Reagan is marked, according to one commentator, by "its insistence that the federal government is too big, too costly, too unwieldy, and that it should relinquish to the states many of the functions and responsibilities it has assumed in this century." McGowan, *Federalism — Old and New — and the Federal Courts*, 70 *Geo. L.J.* 1421, 1425 (1982). Although the term federalism cannot be defined with any precision, it is clear that it is a constitutional postulate which has served as an essential guide in the accommodation of a dual system of government. *Id.* at 1432.

See also Friendly, *Federalism: A Foreword*, 86 *Yale L.J.* 1019, 1034 (the admirable design of the Constitution leaves to the states the regulatory power over "the bulk of day-to-day matters that can best be decided by those who are closest to them").

<sup>19</sup> See generally MOFSKY, *BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS* (1971); Armstrong, *The Blue Sky Laws*, 44 *VA. L. REV.* 713 (1958) (calling for preemption of state blue sky laws); Millonzi, *Concurrent Regulation of Interstate Securities Issues: The Need for Congressional Reappraisal*, 49 *VA. L. REV.* 1438 (1963) (advocating preemption because of alleged burden on interstate commerce); Bloomenthal, *Blue Sky Regulation and the Theory of Overkill*, 15 *WAYNE L. REV.* 1447 (1969) (state regulation should be limited if it affects economic growth, restricts competition, allocates regulatory resources inappropriately or attempts to protect investors in one state at the expense of others). Smith, *State Blue Sky Law and the Federal Securities Act*, 34 *MICH. L. REV.* 1135 (1936) (state securities laws should exempt securities registered under either federal act or require minimal registration for such securities). Smith, *The Relation of Federal and State Securities Laws*, 4 *LAW & CONTEMP. PROB.* 241 (1937) (state jurisdiction over interstate securities transactions should be withdrawn); Bateman, *State Securities Regulation: An Unresolved Dilemma and a Suggestion for the Federal Securities Code*, 27 *Sw. L.J.* 759 (1973) (state regulation should be preempted to extent it covers securities registered with SEC).

<sup>20</sup> The Securities Industry Association, formerly the Investment Bankers Association, represents over 500 securities firms in the United States and Canada. The organization was formed by a group of reputable investment bankers who were "alarmed by the activities of both unscrupulous promoters and zealous legislatures." PARRISH, *SECURITIES REGULATION AND THE NEW DEAL* 5 (1970). Their purpose was "to resist unwanted regulation, to promote professional status, and to insure legitimate profits." *Id.*

<sup>21</sup> PARRISH, *supra* note 20, at 8.

<sup>22</sup> *Id.* at 10.

<sup>23</sup> *Id.* at 11.

<sup>24</sup> *Id.* at 12.

<sup>25</sup> *Id.* at 21-24. The Association worked especially hard to prevent legislation in New York which would require licensing or registration. *Id.* at 21. In addition, it was successful in persuading other states to exempt from registration securities listed on national exchanges. *Id.* at 24. By 1929, the

law,<sup>26</sup> claiming that state blue sky laws had eliminated the need for national regulation.<sup>27</sup>

Since enactment of federal securities legislation, their criticism has been directed at the dual regulatory system which emerged. The primary focus of this criticism is two fold: (1) the absence of uniformity among the federal and state schemes makes compliance difficult and expensive, and (2) the federal and state schemes are needlessly duplicative.<sup>28</sup> The Securities Industry Association now complains that the dual regulatory system "has grown in duplication and burden to the point where the negative impact on the securities industry far outweighs the benefits to investors."<sup>29</sup> Indeed, the group now questions whether the states should have any role in the regulation of securities.<sup>30</sup> It has called on the SEC to seek legislation to establish "a national uniform system of regulation" or, alternatively, "to preempt states from concurrent regulation."<sup>31</sup>

This call for preemption<sup>32</sup> was voiced during recent hearings on the need for uniformity and coordination in state and federal securities laws,<sup>33</sup> as mandated by Congress in the Small Business Investment Incentive Act of 1980.<sup>34</sup> The preemption issue is currently being used to encourage, if not frighten, the states to adopt uniform regulatory schemes.<sup>35</sup> One SEC commissioner has harnessed a recent decision of the Supreme Court, *Edgar v. MITE Corporation*,<sup>36</sup> in support of the notion that "the best way [for the states] to avoid preemption is to redouble . . . efforts to achieve uniformity."<sup>37</sup> The *MITE* decision,

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Association could state that sixteen states had modified their laws to conform to the Association's recommendations. *Id.*

<sup>26</sup> *Id.* at 21.

<sup>27</sup> *Id.* at 20.

<sup>28</sup> Letter from the Securities Industry Association to George A. Fitzsimmons, Secretary, Securities and Exchange Commission (September 9, 1983). This letter was submitted in response to an SEC request for comments on effectuating increased uniformity in state and federal regulation of securities. Securities Act Release No. 6474 (July 22, 1983), [Current] FED. SEC. L. REP. (CCH) ¶ 83,403. The comments of the Securities Industry Association and others can be found in SEC File No. S7-985.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> The doctrine of preemption is premised on the supremacy clause of the Constitution which provides that state law must yield to federal law to the extent that they conflict. U.S. CONST., art. VI, § 2. Courts and commentators have recognized four contexts in which state law will be deemed preempted by federal law:

- 1) Congress expressly prohibited state legislation in the field. *Rice v. Santa Fe Elevator*, 331 U.S. 218, 234 (1947);
- 2) Congress impliedly prohibited state legislation because the pervasiveness of the federal scheme makes state law incompatible. *Fidelity Federal Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. 141, 153 (1982);
- 3) compliance with both state and federal law is impossible. *Florida Lime and Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142-43 (1963);
- 4) state law frustrates the purposes and objectives of the federal law. *Jones v. Rath Packing Co.*, 430 U.S. 519, 540-41 (1977).

See generally Note, *A Framework for Preemption Analysis*, 88 YALE L.J. 363 (1978).

<sup>33</sup> See 15 SEC. REG. & L. REP. (BNA) No. 40, p. 1924 (October 14, 1983).

<sup>34</sup> Pub. L. No. 96-477, 94 Stat. 2275 (1980).

<sup>35</sup> Panel presentation by SEC Commissioner John R. Evans, *Federal Preemption of State Blue Sky Laws*, 66th Annual Fall Conference of the North American Securities Administrators Association, Inc. [hereinafter referred to as NASAA] (September 21, 1983).

<sup>36</sup> 457 U.S. 624 (1982).

<sup>37</sup> Panel presentation by SEC Commissioner John R. Evans, *Federal Preemption of State Blue Sky Laws*, 66th Annual Fall Conference of NASAA (September 21, 1983).

however, should not be hailed as an harbinger of ultimate triumph over state securities regulation.

In *MITE*, the Court held that an Illinois statute which sought to regulate interstate corporate takeovers<sup>38</sup> violated the commerce clause of the Constitution.<sup>39</sup> Although the Court's holding was limited to the commerce clause issue, three of the Justices opined that the statute also should fall due to its preemption by the Williams Act.<sup>40</sup> Because the Illinois law applied to interstate purchases of securities,<sup>41</sup> the plurality's position in *MITE* has served to mobilize forces already encouraged by recent political emphasis on deregulation at the federal level.<sup>42</sup> Furthermore, lower courts have interpreted the *MITE* decision broadly, applying it to a variety of state takeover statutes,<sup>43</sup> an unfair competition provision,<sup>44</sup> and a state blue sky law.<sup>45</sup> The Supreme Court's opinion in *MITE*, however,

<sup>38</sup> ILL. ANN. STAT. ch. 121½, ¶¶ 137.51-.70 (Smith-Hurd Supp. 1983-1984).

<sup>39</sup> 457 U.S. at 645.

<sup>40</sup> *Id.* at 634-39.

<sup>41</sup> ILL. ANN. STAT. ch. 121½, ¶ 137.52-9 (Smith-Hurd Supp. 1983-1984) (takeover offer is an offer to acquire or the acquisition of any equity security of a target company pursuant to a tender offer).

<sup>42</sup> Interview with Michael Unger, Director, Massachusetts Securities Division (September 18, 1983). *Cf.* Panel presentation by SEC Commissioner John R. Evans, *Federal Preemption of State Blue Sky Laws*, 66th Annual Fall Conference of NASAA (September 21, 1983):

There is an increasing number of individuals and organizations openly critical of the existing system. Proposals are being made that would result in outright or de facto preemption . . .

. . . .

. . . Accordingly, it is imperative that we intensify our efforts to achieve a level of uniformity and coordination that will forestall momentum to preempt state securities laws.

*Id.*

<sup>43</sup> *See* *Mesa Petroleum Co. v. Cities Service Co.*, 715 F.2d 1425 (10th Cir. 1983) (Oklahoma statute violates commerce clause); *Telvest v. Bradshaw*, 697 F.2d 576 (4th Cir. 1983) (Virginia statute limited to domestic companies violates commerce clause); *Martin-Marietta Corp. v. Bendix Corp.*, 690 F.2d 558 (6th Cir. 1982) (Michigan statute limited to resident shareholders violates commerce clause); *National City Lines v. LLC Corp.*, 687 F.2d 1122 (8th Cir. 1982) (Missouri statute violates commerce clause *and* is preempted by the Williams Act).

<sup>44</sup> *See* *Conkling v. Moseley, Hallgarten, Estabrook, & Weeden, Inc.* 575 F. Supp. 760 (1983). In this case, a group of securities customers brought an action against a stock brokerage house alleging that the brokers overtraded their accounts. *Id.* at 760-61. The plaintiffs claimed that the broker's actions were violative of a Massachusetts statute prohibiting unfair or deceptive acts or practices. *Id.* The court disagreed, stating that "federal law has largely superseded state regulation of securities transactions" and that "securities transactions traditionally have been subject to federal control." *Id.* at 761-62. In support of these propositions, the court cited *MITE* and then stated that the Supreme Court's decision held that "a state law regulating securities transactions was unconstitutional under the commerce clause." *Id.* The court's reasoning led it to the conclusion that the Massachusetts fair trade practices statute did not extend to transactions involving securities. *Id.* at 762. It is clear that the Supreme Court in *MITE* did not intend that its decision be employed to prevent state law from being used to seek redress against fraudulent or dishonest broker-dealers. This application of the *MITE* decision contravenes the broad remedial purposes of the federal securities acts. *See* 15 U.S.C. §§ 77 p and 78bb(a) (1976 & Supp. 1982). *See also* *Herman & MacLean v. Huddleston*, \_\_\_ U.S. \_\_\_, 103 S. Ct. 683 (1983) (remedies under securities acts are cumulative); *Independence Shares Corp. v. Deckert*, 108 F.2d 51 (3d Cir. 1939) (defrauded individuals may seek recovery under state law).

<sup>45</sup> *See* *Martin-Marietta Corp. v. Bendix Corp.*, 690 F.2d 558 (6th Cir. 1982) (antifraud provisions of Michigan's blue sky law constitute impermissible burden on interstate commerce as applied in the tender offer context). *But see* *People v. Florentino*, BLUE SKY REP. (CCH) ¶ 71,789 (N.Y. 1982)

expressly confirmed the constitutional validity of state securities regulation generally, pointing specifically to a trilogy of its decisions commonly referred to as the *Blue Sky Cases*<sup>46</sup> and to the savings clauses in the 1933<sup>47</sup> and 1934<sup>48</sup> Acts.<sup>49</sup>

This article first addresses the judicial, congressional and executive recognition that has been extended to the states in the field of securities regulation. The Supreme Court, both prior and subsequent to the development of the dual system, has affirmed the validity of state securities regulation.<sup>50</sup> In passing federal securities legislation, Congress acted primarily to fill regulatory gaps which the states could not fill because of jurisdictional limits on their authority.<sup>51</sup> The executive branch during recent administrations has implemented deregulatory policies in numerous areas of business regulation.<sup>52</sup> This trend has been particularly apparent in the field of securities regulation, where budget allocations have been restricted and a greater role for the states encouraged.<sup>53</sup> After reviewing these sources of support for state regulation, a response is made to the claim that duplication and the absence of uniformity have undermined the advantages, if any, of the dual regulatory system. In addressing this criticism, the different regulatory philosophies of the state and federal regulatory schemes and the resulting benefits to investors are explored. This article concludes that the complementary policies inherent in the present system establish a persuasive case against preemption of state securities laws.

#### I. JUDICIAL RECOGNITION OF STATE SECURITIES REGULATION

The Supreme Court has consistently affirmed the validity of state securities laws during a period spanning seven decades. The respect accorded by the Court to state blue sky laws began with the *Blue Sky Cases* in 1917, when constitutional assaults were leveled at the laws then in effect in the states of Ohio, South Dakota and Michigan.<sup>54</sup> Since enactment of the federal securities scheme, these cases have served as a reference point for the

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(application of New York antifraud provision to transactions involving corporate takeovers not unconstitutional as statute did not purport to regulate the takeover process and was protected by savings clause).

<sup>46</sup> *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917); *Caldwell v. Sioux Falls Stock Yards Co.*, 242 U.S. 559 (1917); *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568 (1917).

<sup>47</sup> 15 U.S.C. § 77r (1976).

<sup>48</sup> 15 U.S.C. § 78bb(a) (Supp. 1982).

<sup>49</sup> 457 U.S. at 631 and 641.

<sup>50</sup> *See, e.g.*, *Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Ware*, 414 U.S. 117 (1973) (Congress did not adopt a regulatory system apart from and exclusive of state regulation of securities); *SEC v. Nat'l Sec., Inc.*, 393 U.S. 453 (1969) (state regulation may co-exist with federal securities laws); *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917) (Ohio blue sky law not violative of commerce clause); *Caldwell v. Sioux Falls Stock Yards Co.*, 242 U.S. 559 (1917) (South Dakota blue sky law not violative of commerce clause); *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568 (1917) (Michigan blue sky law not violative of commerce clause).

<sup>51</sup> *See* H.R. REP. NO. 85, 73d. Cong., 1st Sess. 10-11 (1933); *Securities Act Hearings*, *supra* note 2, at 101 (Dept. of Commerce Study of the Economic and Legal Aspects of the Proposed Federal Securities Act). *See also* *Traveler's Health Ass'n v. Virginia*, 339 U.S. 634, 653 (1950) (Douglas, J., concurring).

<sup>52</sup> *See infra* note 244 and accompanying text.

<sup>53</sup> *See* Final Report of the SEC Transition Team, SEC. REG. & L. REP. (BNA) No. 587, p. K-1 (January 21, 1981).

<sup>54</sup> *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917) (Ohio blue sky law); *Caldwell v. Sioux Falls Stock Yards Co.*, 242 U.S. 559 (1917) (South Dakota blue sky law); *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568 (1917) (Michigan blue sky law).



Court.<sup>55</sup> In its most recent statement, the Court in *MITE* reaffirmed the authority of the states to develop their own schemes for the regulation of securities transactions.<sup>56</sup> This unbroken line of decisions is addressed to demonstrate the Supreme Court's historical recognition of state power in the field.

The contest in the first of the three *Blue Sky Cases*, *Hall v. Geiger-Jones Co.*,<sup>57</sup> was instigated by an Ohio corporation acting as a broker-dealer in numerous states, an individual trader licensed to do business in Ohio and Pennsylvania, another conducting business in Ohio, and an issuer incorporated under the laws of West Virginia with its principal place of business in Ohio.<sup>58</sup> Each party contested the constitutional validity of the Ohio statute, which, among other things, subjected dealers and issuers in securities to stringent licensing requirements.<sup>59</sup> The Ohio statute also required, as a licensing condition, that the state securities commissioner "be satisfied of the good repute in business of such applicant and named agents."<sup>60</sup> Under the statute, the state commissioner had the power to revoke the license or refuse renewal upon a finding that the licensee "is of bad business repute, has violated any provision of the act, or has engaged or is about to engage, under favor of such license, in illegitimate business or fraudulent transactions."<sup>61</sup>

<sup>55</sup> See *Edgar v. MITE Corp.*, 457 U.S. 624, 641 (1982); *Paris Adult Theatre I v. Slaton*, 413 U.S. 49, 62 (1973); *Traveler's Health Ass'n v. Virginia*, 339 U.S. 643, 646 (1950).

<sup>56</sup> 457 U.S. at 641.

<sup>57</sup> 242 U.S. 539 (1917).

<sup>58</sup> *Id.* at 541-42. Each party brought a separate action in the District Court for the Southern District of Ohio. *Id.* at 540. The district court disposed of the cases in one opinion, enjoining enforcement of the Ohio blue sky law. *Id.* at 544. Three appeals ensued and were submitted together to the Supreme Court. *Id.*

<sup>59</sup> The Ohio statute provided that an application must be filed with the state commissioner containing the following information:

(a) The names and addresses of the directors and officers if such applicant be a corporation or association, and of all partners if it be a partnership, and of the person if the applicant be an individual, together with names and addresses of all agents of such applicant assisting in the disposal of such securities;

(b) Location of the applicant's principal office and of his principal office in the state, if any;

(c) The general plan and character of the business of said applicant, together with references which the 'commissioner' shall confirm by such investigation as he may deem necessary, establishing the good repute in business of such application, directors, officers, partners, and agents.

If the applicant be a corporation organized under the laws of any other state, territory, or government, or have its principal place of business therein, it shall also file a copy of its articles of incorporation, certified by the proper officer of such state, territory, or government, and of its regulations and by-laws; and if it be an unincorporated association, a certified copy of its articles of association, or deed of settlement.

*Hall v. Geiger-Jones Co.*, 242 U.S. at 549-50.

<sup>60</sup> 242 U.S. at 553.

<sup>61</sup> *Id.* Interestingly, it was this aspect of the Illinois takeover statute in *Edgar v. MITE Corp.* which the lower court and at least one commentator found to be most repugnant to the Constitution. *MITE Corp. v. Dixon*, 633 F.2d 486 (7th Cir. 1980), *aff'd sub nom. Edgar v. MITE Corp.*, 457 U.S. 624 (1982) (provision disapproved because it substitutes administrative review for judgment of investors). See Note, *A Failed Experiment: State Takeover Regulation After Edgar v. MITE Corp.*, 1983 U. ILL. L. REV. 457, 463 (1983) (perhaps the most "egregious" problem with the Illinois Act was the provision for administrative review). Although the majority opinion in *MITE* did not address merit regulation of tender offers, it is not clear whether *MITE* will adversely affect this aspect of state blue sky laws. One state court, however, determined that Michigan's regulation of Western Union's securities imposed

In challenging these provisions, the parties contended that this aspect of the Ohio law conferred arbitrary power upon the state commissioner, and thus violated the due process clause of the fourteenth amendment;<sup>62</sup> that the separate classifications, and, hence, different treatment of certain securities violated the equal protection clause of the fourteenth amendment;<sup>63</sup> and that the entire licensing scheme imposed an unconstitutional burden on interstate commerce.<sup>64</sup>

The Supreme Court framed the issue in *Hall* as "an asserted conflict between national power and state power, and [the] power of the state as limited or forbidden by the National Constitution."<sup>65</sup> The Court agreed with the state's contention that the regulatory scheme adopted by Ohio was a valid exercise of the state's police power, that power being "the least limitable of the exercises of government."<sup>66</sup> Reemphasizing the power of the states to prevent frauds,<sup>67</sup> the Court proceeded to determine whether the manner in which the state sought to achieve this goal was constitutionally permissible.

The Court rejected contentions that the statute violated the due process and equal protection clauses of the Constitution and then focused on whether the Ohio statute violated the commerce clause.<sup>68</sup> Although the Court noted the absence of federal legislation in the field, thereby pretermittting any preemption issues under the supremacy

an impermissible burden on interstate commerce. See *Western Union Telegraph Co. v. Michigan Public Service Commission*, — Mich. App. —, 338 N.W.2d 731 (1983). See also *United Airlines, Inc. v. Illinois Commerce Commission*, 32 Ill.2d 516, 207 N.E.2d 433 (1965) (Illinois statute permitting plaintiff to issue stock only upon state's approval violates commerce clause).

<sup>62</sup> 242 U.S. at 551.

<sup>63</sup> *Id.* at 555. The Ohio statute exempted certain securities and dealers from the licensing requirements, e.g. securities of non-profit corporations, national banks, and owners of stock selling their own shares. *Id.* The Court upheld the state's classification system, stating that it was within the state's police power to carve out exceptions in pursuit of legislative goals. *Id.* at 556-57. The court opined that:

A state 'may direct its law against what it deems the evil as it actually exists without covering the whole field of possible abuses, and it may do so none the less that the forbidden act does not differ in kind from those that are allowed. . . .'

*Id.*

It is interesting to note that the Court in *Edgar v. MITE Corp.* used the Illinois statute's issuer exemption to rebut the state's argument that the Illinois statute protected investors from fraudulent or unfair tender offers. 457 U.S. at 644. The Court did not explore the reasons for the exemption or explain why classifications of certain securities or transactions as exempt could be used to determine that a valid state interest was absent.

<sup>64</sup> *Id.* at 557.

<sup>65</sup> *Id.* at 548.

<sup>66</sup> *Id.*

<sup>67</sup> *Id.* at 552. The Court stated:

We have lately decided . . . the principle of the power of the state to prevent frauds and impositions . . . [citation omitted]. The principle applies as well to securities as to material products. . . . [The] integrity of the securities can only be assured by the probity of the dealers in them and the information which is given of them. This assurance the state has deemed necessary for its welfare to require; and the requirement is not unreasonable or inappropriate. It extends to the general market something of the safeguards that are given to trading [on the National Exchanges] — safeguards that experience has adopted as advantageous. Inconvenience may be caused and supervision and surveillance, but this must yield to the public welfare.

*Id.*

<sup>68</sup> *Id.* at 554-58.

clause<sup>69</sup> of the Constitution, it held that the Ohio blue sky law affected interstate commerce only incidentally and did not constitute an impermissible burden on interstate commerce.<sup>70</sup> The Court emphasized that the law applied "to dispositions of securities within the state, and while information of those issued in other states, and foreign countries [was] required to be filed,"<sup>71</sup> the statute's primary impact was realized only when disposition of securities was to be made *within* the state.<sup>72</sup>

Similar issues were raised in the Supreme Court's second opinion dealing with the validity of state blue sky laws. In *Caldwell v. Sioux Falls Stock Yards Co.*,<sup>73</sup> a Colorado corporation and two individual traders residing in Iowa brought suit to enjoin enforcement of South Dakota's securities laws.<sup>74</sup> The corporation had been attempting to raise capital for the construction of a stock yard in Sioux Falls, South Dakota, and the Iowa traders had been selling stock in the project to various farmers and other purchasers without first complying with the South Dakota statute.<sup>75</sup> The statute in question imposed registration and licensing requirements on foreign and domestic dealers and investment companies, including listing of securities to be sold, and made it unlawful to offer or sell securities not approved by the state securities commission or securities which "would tend to work a fraud upon purchasers."<sup>76</sup> In other words, South Dakota, like most other states,<sup>77</sup> had imposed "merit regulation"<sup>78</sup> on distributions of securities within the state.

<sup>69</sup> U.S. CONST., art. VI, § 2. provides:

This Constitution, and the Laws of the United States which shall be made in pursuance thereof; and all treaties made . . . shall be the supreme law of the Land; and the judges in every state shall be bound thereby, anything in the Constitution or laws of any state to the contrary notwithstanding.

*Id.*

<sup>70</sup> 242 U.S. at 557.

<sup>71</sup> *Id.*

<sup>72</sup> *Id.* at 559. The Court's language concerning the "interstate" nature of securities is especially important. Recognizing that securities often cross state boundaries before coming to rest in a state, the Court said,

. . . regarding the securities as still in interstate commerce after their transportation to the state is ended and they have reached the hands of dealers in them, *their interstate character is only incidentally affected by the statute.*

*Id.* (emphasis added).

This language expressly sanctions state regulation of securities as long as any aspect of a transaction is conducted within the state's borders.

The Court recently expressed its agreement with this conclusion as to blue sky laws generally in *Edgar v. MITE Corp.*, but distinguished an Illinois takeover statute which could be applied to securities transactions conducted wholly *outside* of the state. 457 U.S. 624, 641.

<sup>73</sup> 242 U.S. 559 (1917).

<sup>74</sup> *Id.* at 563.

<sup>75</sup> *Id.* at 564-67. The South Dakota licensing and registration requirements were almost identical to those at issue in *Hall v. Geiger-Jones Co. Id.* at 567.

<sup>76</sup> *Id.* at 567.

<sup>77</sup> Within two years following enactment of the Kansas blue sky law in 1911, twenty three states followed the Kansas approach to securities regulation. L. LOSS & E. COWETT, *BLUE SKY LAW* 10 (1958). The Kansas statutes imposed merit regulation. *Id.* at 8 n.24.

<sup>78</sup> The term "merit regulation" refers to statutory authority granted a state securities administrator to approve or deny registration of a proposed securities offering based on *qualitative* standards of review. See Goodkind, *Blue Sky Law: Is There Merit in The Merit Requirements?*, 1976 WIS. L. REV. 79, 80 (1976). The standard employed by a majority of the states is whether the proposed offering is "fair, just or equitable," while other states have utilized the "tend to work a fraud" standard set forth in the Uniform Securities Act. See Tyler, *More About Blue Sky*, 39 WASH. & LEE L. REV. 849, 902-03

Noting that the South Dakota statute did not differ significantly from the Ohio statute in *Hall*, the Court incorporated its previous decision by reference and upheld the constitutionality of the South Dakota blue sky law.<sup>79</sup>

The last case in the trilogy of the *Blue Sky Cases* involved the Michigan blue sky law, which, according to the Court, was almost identical to the statutes considered in *Hall* and *Caldwell*.<sup>80</sup> In *Merrick v. N.W. Halsey & Co.*,<sup>81</sup> various securities traders, including non-residents and residents of Michigan, challenged the statute as violative of the due process, equal protection and commerce clauses of the Constitution.<sup>82</sup> Although the Supreme Court upheld the constitutionality of the statute, as it had the statutes at issue in *Hall* and *Caldwell*, the Court supplemented its previous decisions, stating, *inter alia*:

[W]e think [the Michigan Blue Sky Law] under review is within the power of the state. It burdens honest business, it is true, but burdens it only that under its forms, dishonest business may not be done . . . . Expense may thereby be caused and inconvenience, but to arrest the power of the State by such considerations would make it imprudent to discharge its function. It costs something to be governed.<sup>83</sup>

In concluding that the regulation was a valid exercise of the state's police power, the Supreme Court observed that while "every new regulation of business or conduct meets challenge,"<sup>84</sup> it is within the province of the states to make the varying policy judgments (which twenty-seven states at that time had done) in determining that the business of dealing in securities must have adequate supervision.<sup>85</sup>

Although the *Blue Sky Cases* were decided prior to federal intervention in the securities field, they have been used following enactment of the 1933 and 1934 Acts to affirm

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(1982). While regulatory provisions in those states imposing merit regulation vary, the most common involve a substantive review of underwriting commissions, offering expenses, offering price, promoters' investment, dilution, cheap stock, debt and interest coverage, voting rights, and options and warrants. *Id.* at 903. See also Goodkind, *supra*, at 87-105; Makens, *A State Regulatory Perspective of the Report of the Advisory Committee on Corporate Disclosure to the SEC*, 26 U.C.L.A. L. REV. 147, 149-51 (1978).

Merit regulation, subject to enduring criticism as unduly paternalistic, is based on the regulatory philosophy that the disclosure approach to securities regulation does not adequately protect investors. See Tyler, *supra*, at 904. Congress, in opting for the disclosure approach in its enactment of the federal securities law, was reluctant to intrude "into a phase that [was] covered by the State blue sky laws." *Securities Act Hearings*, *supra* note 2, at 53, (statement of Huston Thompson, Attorney at Law, Washington, D.C.). See *infra* note 189 and accompanying text.

<sup>79</sup> 242 U.S. at 567-68.

<sup>80</sup> *Id.* at 584.

<sup>81</sup> 242 U.S. 568 (1917).

<sup>82</sup> *Id.* at 569-70. Significantly, one of the complainants against whom the Michigan blue sky law was applied was a New York investment banking firm which had no place of business in Michigan and had not sent any of its agents into Michigan. *Id.* at 572-73. It was engaged, nevertheless, in the solicitation of Michigan residents, presumably through mail, telegraph or telephone communications. At least one commentator has concluded that a major effect of the Supreme Court's holding in *Merrick* was that a state, through its blue sky law, could prohibit any offer or sale of securities effected within the state, whether or not the activity was initiated completely outside that state. Smith, *State "Blue-Sky" Laws and the Federal Securities Acts*, 34 MICH. L. REV. 1135, 1153-54 (1936). See also *infra* note 91 and accompanying text.

<sup>83</sup> *Id.* at 586.

<sup>84</sup> *Id.*

<sup>85</sup> *Id.*

the constitutionality of state blue sky legislation. For example, in *Traveler's Health Association v. Virginia*,<sup>86</sup> the Supreme Court considered a due process challenge to the application of a Virginia blue sky law.<sup>87</sup> The Virginia statute required a company to obtain a permit from state authorities before offering or selling securities, including certificates of insurance, in Virginia.<sup>88</sup> An insurance company, which was incorporated and had its sole place of business in Nebraska, undertook to offer and sell insurance certificates, without the required permit, to Virginia residents.<sup>89</sup> When the State Corporation Commissioner instituted cease and desist proceedings to restrain these activities, the Nebraska company challenged the state's power to enforce the statute.<sup>90</sup> Although the Supreme Court rejected this challenge under the "minimum contacts" test enunciated in *International Shoe Co. v. Washington*,<sup>91</sup> Justice Black observed in the majority opinion that the appellants did "not question the validity of the Virginia blue sky law to the extent that it [provided] that individual and corporate residents of other states [could not do business in the state] without first submitting to the regulatory authority of the state."<sup>92</sup> The power of the states to apply their blue sky laws to out-of-state corporations was reaffirmed by Justice Black, who simply referred to the Court's decision in *Hall v. Geiger-Jones Co.*<sup>93</sup>

In a concurring opinion, Justice Douglas, a former chairman of the SEC,<sup>94</sup> agreed with the majority in *Traveler's Health* that the Virginia statute should be upheld, but based his reasoning on the state's police power rather than minimum contacts analysis.<sup>95</sup> His opinion is especially instructive concerning the relationship between state and federal

<sup>86</sup> 339 U.S. 643 (1950).

<sup>87</sup> *Id.* at 644-45.

<sup>88</sup> *Id.* at 644.

<sup>89</sup> *Id.* at 645.

<sup>90</sup> *Id.* at 646-47.

<sup>91</sup> 326 U.S. 310 (1945). The Court held that the Nebraska corporation had sufficient contacts with the State of Virginia to permit the state's commissioner to bring the corporation within the jurisdiction of Virginia. 339 U.S. at 649. However, "*Traveler's Health* . . . is not a square holding that the law of the state of the buyer's residence could be constitutionally applied to a single isolated transaction." L. LOSS & E. COWETT, BLUE SKY LAW 219 (1958). It has been suggested that "if the questions of police power and interference with interstate commerce and the mails are divorced from the question of jurisdiction through substituted service, there seems to be no good constitutional reason against applying the [Virginia] statute." *Id.* Nonetheless, *Traveler's Health* stands for the proposition that "it is not unconstitutional to apply the blue sky law of a state to a sale effected in that state by a person who is not within its boundaries either physically or through agents — at least where there is some continuity to the selling effort." *Id.* See also *supra* note 82.

<sup>92</sup> 339 U.S. at 646.

<sup>93</sup> *Id.*

<sup>94</sup> Justice Douglas served as chairman from 1937 to 1939 and has been hailed as one of the major architects of the SEC's administrative and regulatory ideology. PARRISH, SECURITIES REGULATION AND THE NEW DEAL 181 (1970); SELIGMAN, THE TRANSFORMATION OF WALL STREET 156-212 (1982). See also 28 GEO. WASH. L. REV. 1 (1959) (Foreword by Justice Douglas).

<sup>95</sup> 339 U.S. at 654-55. Defining the state's police power to regulate transactions within its borders, Justice Douglas stated:

Through these people appellant has realistically entered the state, looking for and obtaining business. Whether such solicitation is isolated or continuous, it is activity which Virginia can regulate. The requirements of due process may demand more or less minimal contacts than are present here . . . [but] [w]here the corporate project entails the use of one or more people in the state for the solicitation of business, in my view it does no violence to the traditional concept of due process to provide protective measures governing that solicitation.

*Id.* (emphasis added).

securities regulation. Justice Douglas recognized that federal intervention in the field of securities regulation was not intended to displace existing state laws, but to "fill a gap" created by the employment of instrumentalities of interstate and foreign commerce to evade state regulation.<sup>96</sup>

As the *Blue Sky Cases* and *Traveler's Health* indicate, the Supreme Court has respected the role of the states in securities regulation, even in the presence of a highly developed federal regulatory scheme. Moreover, the Court has recognized and deferred to the traditional role of the states in the regulation of corporations generally.<sup>97</sup> That role has meant that each state, through its grant of charters to those corporations which choose it as their place of incorporation, empowers, as well as restrains, corporations in the exercise of their economic functions. These functions include the authorization, issuance, transfer, and voting of securities, as well as the declaration of dividends and implementation of structural changes through recapitalizations, combinations and dissolutions.<sup>98</sup> Furthermore, shareholders are afforded protection against various types of managerial abuse.<sup>99</sup> It is difficult, if not impossible, to slice away the securities aspects of corporate law when the securities themselves are the corporate pieces that form the whole. Accordingly, state regulation of corporations inherently regulates transactions involving the disposition of securities.<sup>100</sup>

When confronted with litigation predicated on purported remedies under the federal securities acts or other federal statutes, the Supreme Court has refused to undermine state power to regulate corporate activity and the underlying transactions in securities. In *Cort v. Ash*,<sup>101</sup> the Court considered the issue of whether a federal elections statute prohibiting corporations from contributing to federal election candidates<sup>102</sup> gave shareholders a private right of action against corporate directors.<sup>103</sup> The Court set forth a four-prong test to determine whether a private remedy could be implied from a federal statute, where not expressly provided by Congress.<sup>104</sup> Under this test, a court must consider the following questions: (1) is the plaintiff a member of the class for whose especial benefit the statute was enacted; (2) are there any indications of legislative intent to

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<sup>96</sup> *Id.* at 653.

Blue sky laws are a well recognized exercise of the police power of the states. The wiles of the salesman had been many; the devices to avoid state regulation had been clever and calculated. . . . Instrumentalities of interstate and foreign commerce were extensively employed by those beyond the reach of a state to sell securities to its citizens. . . .

The Securities Act of 1933 . . . was passed to fill a gap.

*Id. Cf. Kaminsky v. Abrams*, 281 F. Supp. 501, 504 (S.D.N.Y. 1968) (federal securities laws are incomplete and interstitial, superseding state corporate law only when there is direct conflict).

<sup>97</sup> See cases cited *infra* note 117.

<sup>98</sup> See *e.g.*, MODEL BUSINESS CORP. ACT (MBCA) §§ 15-20, 23-26, 31-34 (1979).

<sup>99</sup> See MBCA § 35 (director's duty to shareholders), § 41 (conflicts of interests), § 48 (liability for violations of MBCA). See generally Goldstein & Shepherd, *Director's Duties and Liabilities Under the Securities Act and Corporation Law*, 36 WASH. & LEE L. REV. 759 (1979).

<sup>100</sup> See *Santa Fe Indus. v. Green*, 430 U.S. 462, 479 (1977) ("[a] substantial portion of the law of corporations . . . deals with transactions in securities . . ."). See also Sargent, *On the Validity of State Takeover Regulation: State Responses to MITE and Kidwell*, 42 OHIO ST. L.J. 689, 724 (1981) ("State corporate law protects investors by defining their rights as *shareholders* in certain transactions in the corporation's securities . . .").

<sup>101</sup> 422 U.S. 66 (1975).

<sup>102</sup> 18 U.S.C. § 610 (1976), *repealed by* Pub. L. No. 94-283, Title II, § 201(a), 90 Stat. 496.

<sup>103</sup> 422 U.S. at 68.

<sup>104</sup> *Id.* at 78.

create or deny a remedy; (3) would allowing a remedy be inconsistent with the purpose of the federal legislative scheme; and (4) is the cause of action in question traditionally relegated to state law.<sup>105</sup> Applying its test to the federal elections statute at issue, the Court held that the law did not create a remedy for shareholders of a corporation whose directors had violated its provisions.<sup>106</sup> The Court was reluctant to establish a federal cause of action, reasoning that it was doubtful Congress intended to vest corporate shareholders with rights broader than those provided by state law.<sup>107</sup>

Similarly, in *Santa Fe Industries v. Green*,<sup>108</sup> the Court was equally reluctant to "federalize the substantial portion of the law of corporations that deals with transactions in securities."<sup>109</sup> The complainants, minority shareholders of a Delaware corporation, sought to set aside a short-form merger on the grounds that they did not receive notice of the merger and that the merger was effected for the sole purpose of freezing out minority shareholders.<sup>110</sup> Although Delaware law provided minority shareholders with an appraisal remedy,<sup>111</sup> the complainants attempted to bypass state law and seek recovery under the 1934 Act.<sup>112</sup> Applying the test established in *Cort v. Ash*, the Supreme Court determined that rule 10b-5,<sup>113</sup> a broad antifraud provision in the 1934 Act, did not create a private right of action for breach of corporate fiduciary duties.<sup>114</sup> Although the Court noted that even if the language of the federal statute were not sufficiently clear to preclude implying a private right of action, it refused to imply one.<sup>115</sup> The Court refused to interfere with

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<sup>105</sup> *Id.* (emphasis added).

<sup>106</sup> *Id.* at 69.

<sup>107</sup> *Id.* at 85. The Court observed that "corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, *except where federal law expressly requires certain responsibilities of directors with respect to stockholders*, state law will govern the internal affairs of the corporation." *Id.* at 84. See also *Burks v. Lasker*, 441 U.S. 471 (1979), in which the Court not only refused to undermine state law governing the authority of directors to discontinue derivative suits (application of "business judgment rule"), but also held that federal courts must apply state law to the extent that it is consistent with the policies underlying the Investment Company Act and the Investment Advisors Act. *Id.* at 478.

<sup>108</sup> 430 U.S. 462 (1977).

<sup>109</sup> *Id.* at 479.

<sup>110</sup> *Id.* at 467. Under the Delaware short-form merger statute, a parent company owning at least 90% of the stock of a subsidiary can effect a merger with the subsidiary upon approval of the parent company's board of directors. Advance notice to the minority shareholders of the subsidiary is not required and any dissatisfied shareholder may petition a state court to obtain payment of the fair value of his shares as determined by a court appointed appraiser. DEL. CODE ANN., tit. 8 § 253, 262 (1983). The Supreme Court noted that some states require a "valid business purpose" for the elimination of the minority interest through a short-form merger while others do not. 430 U.S. at 478 n.16. At the time suit was brought in *Santa Fe*, Delaware law permitted majority shareholders to eliminate minority interests through short-form mergers, subject only to the statutory appraisal remedy. See *Stauffer v. Standard Brands, Inc.*, 41 Del. Ch. 7, 187 A.2d 78 (1962). The Delaware Supreme Court changed its position in 1977, holding that a long-form merger effected solely for the purpose of freezing out minority interests is an abuse of the corporate process. See *Singer v. Magnavox Co.*, 380 A.2d 969, 980 (Del. 1977). However, in 1983, the Delaware Supreme Court reconsidered *Singer* and its progeny, holding that the traditional fairness test, which includes fair dealing and fair price aspects, must be substituted for the business purpose test. *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

<sup>111</sup> See *supra* note 110.

<sup>112</sup> 430 U.S. at 466-67.

<sup>113</sup> 17 C.F.R. § 240.10b-5 (1983).

<sup>114</sup> 430 U.S. at 477.

<sup>115</sup> *Id.*

state corporation law and bring within the federal securities statute a wide variety of corporate conduct traditionally left to state regulation.<sup>116</sup> *Santa Fe* is only one case in a series of decisions in which the Supreme Court has disapproved of the extension of federal securities laws into areas concerning state corporation law, even though the matters at issue involved transactions in securities.<sup>117</sup>

The Supreme Court's most recent affirmation of the constitutionality of state blue sky laws arose in connection with a challenge leveled at a state takeover statute. In *Edgar v. MITE Corporation*,<sup>118</sup> a Delaware corporation with its principal place of business in Connecticut initiated a cash tender offer<sup>119</sup> for all outstanding shares of Chicago Rivet and Machine Company,<sup>120</sup> an Illinois corporation with twenty-seven percent of its shareholders residing in Illinois.<sup>121</sup> Although MITE Corporation complied with the federal filing requirements imposed by the Williams Act,<sup>122</sup> it made no attempt to comply with the Illinois Business Takeover Act.<sup>123</sup> The Illinois statute required that any tender offer for

<sup>116</sup> *Id.* at 478. The Court stated:

[W]e are reluctant to federalize the *substantial* portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden.

*Id.* at 479.

<sup>117</sup> See *Burks v. Lasker*, 441 U.S. 471 (1979) (Court refused to ignore state law governing corporate directors' authority to discontinue derivative suits even though plaintiff's claims were brought under the Investment Advisors Act and Investment Company Act); *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1 (1977) (unsuccessful tender offeror does not have a cause of action for damages under § 14(e) of the 1934 Act); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (proof of scienter, not mere negligence, required under rule 10b-5); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (availability of rule 10b-5 limited to actual purchasers and sellers of securities). See also *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964), in which the Court found that an implied right of action existed for violations of the proxy rules under the 1934 Act. Central to the Court's decision was the fact that most states did not have proxy rules, and, therefore, to avoid frustrating the purpose of the federal scheme it was necessary to grant a federal remedy. *Id.* at 434-35. Compare *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 41-42 (1977) (plaintiff relegated to state law remedy).

For a discussion of this judicial trend, see Whitaker & Roich, *The Supreme Court and the Counter-Revolution in Securities Regulation*, 30 ALA. L. REV. 335 (1979).

<sup>118</sup> 457 U.S. 624 (1982).

<sup>119</sup> A tender offer is "a public offer or solicitation by a company, an individual or a group of persons to purchase during a fixed period of time all or a portion of a class or classes of securities of a publicly held corporation at a specified price or upon specified terms for cash and for securities." E. ARANOW, H. EINHORN & G. BERLSTEIN, *TENDER OFFERS FOR CORPORATE CONTROL* 70 (1973).

<sup>120</sup> 457 U.S. at 627.

<sup>121</sup> *Id.* at 642.

<sup>122</sup> 15 U.S.C. §§ 78m(d)-(c), 78n(d)-(f) (1976 & Supp. V 1981). The Williams Act amended the 1934 Act to provide for comprehensive federal regulation of corporate tender offers. Its primary purpose was to protect the shareholders of a target company by requiring disclosures pertaining to the background and plans of the offeror and other information related to the tender offer. See *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 22-32 (1977). On tender offers generally, see E. ARANOW, H. EINHORN & G. BERLSTEIN, *TENDER OFFERS FOR CORPORATE CONTROL* (1973).

<sup>123</sup> ILL. ANN. STAT. ch. 121½ ¶¶ 137.51-70 (Smith-Hurd Supp. 1983-1984) (repealed 1983).

The Illinois statute, similar to the business takeover statutes enacted in 36 other states, differed from the Williams Act in many respects. The extreme deviations, however, were found in the provisions which required that: (1) tender offers could not be effected until 20 days after a filing was made with the Illinois Secretary of State; *Id.* at ¶ 137.54E, and (2) the Secretary must instigate a hearing on the merits of the tender offer if (a) he considered it necessary for the protection of the Illinois shareholders of the target company; *Id.* at ¶ 137.57E, or (b) one was requested by a majority of the outside directors of the target company; or (c) one was requested by Illinois residents who



the shares of a target company be registered with the Illinois Secretary of State.<sup>124</sup> The statute broadly defined the term "target company" to bring within its ambit any corporation of which Illinois shareholders owned ten percent of its equity securities subject to the tender offer, as well as any corporation who met any two of the following criteria: (1) a corporation with its principal executive offices in Illinois, (2) a corporation organized under the laws of Illinois, or (3) a corporation with at least ten percent of its stated capital and paid-in surplus represented within the state.<sup>125</sup> MITE Corporation did not register with the Illinois Secretary of State.<sup>126</sup> Instead, it sought declaratory and injunctive relief against enforcement of the Illinois statute, contending that the state law was preempted by the Williams Act and imposed an unconstitutional burden on interstate commerce.<sup>127</sup> The District Court for the Southern District of Ohio agreed with MITE Corporation,<sup>128</sup>

owned at least 10% of the class of stock to be tendered. *Id.* at ¶ 137.57A. The statute imposed no restraints on the length of the hearings, but required the Secretary to rule on the issues within 15 days following the hearings, unless he found that the interests of the Illinois shareholders warranted an extension. *Id.* at ¶ 137.57C. D. If the Secretary found, however, that the offer was inequitable or fraudulent, registration would be denied. *Id.* at ¶ 137.57E.

Basically, the statute imposed merit regulation on tender offers. *See supra* note 78. This aspect of state blue sky laws has been sanctioned by Congress. *See infra* note 189 and accompanying text.

<sup>124</sup> ILL. ANN. STAT. ch. 121½, ¶ 137.54A (Smith-Hurd Supp. 1983-1984) (repealed 1983).

<sup>125</sup> *Id.* at ¶ 137.52-10.

<sup>126</sup> 457 U.S. at 628.

<sup>127</sup> *Id.* MITE Corporation's contentions did not constitute the first attack on the constitutionality of state takeover statutes. Prior to the Supreme Court's decision in *MITE*, many state takeover statutes had been invalidated under the commerce clause or the supremacy clause of the Constitution. *See, e.g.*, *Kennecott Corp. v. Smith*, 637 F.2d 181 (3d Cir. 1980) (New Jersey statute violates supremacy clause); *MITE Corp. v. Dixon*, 633 F.2d 486 (7th Cir. 1980) (Illinois statute violates commerce and supremacy clauses), *aff'd sub nom. Edgar v. MITE Corp.*, 457 U.S. 624 (1982); *Great W. United Corp. v. Kidwell*, 577 F.2d 1256 (5th Cir. 1978) (Idaho statute violates commerce and supremacy clauses), *rev'd on other grounds sub nom. Leroy v. Great W. United Corp.*, 443 U.S. 173 (1979); *Natomas Co. v. Bryan*, 512 F. Supp. 191 (D. Nev. 1981) (Nevada statute violates commerce and supremacy clauses); *Crane Co. v. Lam*, 509 F. Supp. 782 (E.D. Pa. 1981) (Pennsylvania statute violates commerce and supremacy clauses); *Seagram & Sons, Inc. v. Marley*, [1981-82 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,246 (W.D. Okla. 1981) (Oklahoma statute violates commerce clause); *Empire, Inc. v. Ashcroft*, 524 F. Supp. 898 (W.D. Mo. 1981) (Missouri statute violates commerce and supremacy clauses); *Hi-Shear Indus. v. Campbell*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,804 (D.S.C. 1980) (South Carolina statute violates commerce and supremacy clauses); *Brascam Ltd. v. Lassiter*, [1981-82 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,247 (E.D. La. 1979) (Louisiana statute violates supremacy clause); *Dart Indus. v. Conrad*, 462 F. Supp. 1 (S.D. Ind. 1978) (Delaware statute violates commerce and supremacy clauses); *Kelly v. Beta-X Corp.*, 103 Mich. App. 51, 302 N.W.2d 596 (Mich. Ct. App. 1981) (Michigan statute violates supremacy clause); *Eure v. Grand Metropolitan Ltd.*, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,694 (N.C. Super. Ct. 1980) (North Carolina statute violates supremacy clause). *But see City Investing Co. v. Simcox*, 476 F. Supp. 112 (D. Ind. 1979) (Indiana statute not violative of commerce or supremacy clauses), *aff'd on other grounds*, 633 F.2d 56 (1980); *AMCA Int'l Corp. v. Krouse*, 482 F.Supp. 929 (S.D. Ohio 1979) (Ohio 1979) (Ohio statute not violative of commerce or supremacy clauses); *Sharon Steel Corp. v. Whaland*, 121 N.H. 607, 433 A.2d 1250 (1981) (New Hampshire statute not violative of commerce or supremacy clauses), *vacated and remanded*, 458 U.S. 1101 (1982) (vacated and remanded for consideration in light of *Edgar v. MITE Corp.*), *rev'd*, *Sharon Steel Corp. v. Whaland*, 466 A.2d 919 (N.H. 1983) (New Hampshire statute violates commerce clause); *Wylain, Inc. v. TRE Corp.*, 412 A.2d 338 (Del. Ch. 1980) (Delaware statute not violative of commerce or supremacy clauses).

<sup>128</sup> 457 U.S. at 629.

and the Seventh Circuit affirmed the lower court's order permanently enjoining enforcement of the statute.<sup>129</sup>

The Supreme Court's decision produced six separate opinions.<sup>130</sup> Justice White, writing for the Court, could only secure a plurality, not a majority, as to that portion of his opinion which held that the Illinois statute was preempted by the Williams Act.<sup>131</sup> A majority of the Court joined in that portion of his opinion which held that the Illinois statute, while indirect in its effect on interstate commerce, was excessively burdensome when balanced against the state's interests served by the statute.<sup>132</sup> The State of Illinois asserted interests in protecting its resident shareholders from inequitable and fraudulent tender offers and in regulating the internal affairs of its domestic corporations.<sup>133</sup> However, the Court reasoned that the state had no interest at all in protecting the non-resident shareholders to whom the statute extended protection.<sup>134</sup> The Court also determined that takeover statutes did not serve to regulate corporate internal affairs, reasoning that the internal affairs doctrine<sup>135</sup> is a conflict of laws principle which recognizes that only the

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<sup>129</sup> *MITE Corp. v. Dixon*, 633 F.2d 486 (7th Cir. 1980), *aff'd sub nom.*, *Edgar v. MITE Corp.*, 457 U.S. 624 (1982).

<sup>130</sup> Justice White, joined by Chief Justice Burger, delivered the Court's opinion. Justices Stevens, O'Connor and Powell each wrote separate concurring opinions. Justices Marshall and Rehnquist filed separate dissenting opinions.

<sup>131</sup> 457 U.S. at 634. Justices White, Blackmun and Burger were the only Justices who found that the Illinois Act was preempted by the Williams Act. Their finding was based on a conclusion that the Illinois Act frustrated the purposes and objectives of the federal regulatory scheme. *Id.* The Court identified the objectives of the Williams Act as "investor protection while maintaining the balance between management and the bidder." *Id.* Agreeing with the Seventh Circuit, these Justices concluded that the Illinois Act favored target management and created delay which was inconsistent with congressional objectives to protect investors while maintaining neutrality. *Id.* at 639. In addition, they concluded that merit regulation of tender offers was inconsistent with congressional intent that investors make their own decisions. *Id.* at 639-40.

<sup>132</sup> *Id.* at 643. The Court applied the test in *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970). Under that test, a state statute will survive a commerce clause challenge if the local interests served by the statute outweigh the indirect burden imposed on interstate commerce. *Id.*

Justice White was also successful in securing a majority as to the portion of his opinion which held that MITE Corporation's withdrawal of the tender offer did not render the case moot. *Id.* at 630.

<sup>133</sup> *Id.* at 644.

<sup>134</sup> *Id.* Only 27% of the target company's shareholders were Illinois residents. *Id.* at 642. Furthermore, Justice White noted in another part of his opinion (not adopted by the majority) that because the Illinois statute applied to offers for the stock of companies maintaining their principal place of business in Illinois, or 10% of its stated capital and paid-in surplus within the state, the Act could apply to a tender offer which would not affect a single Illinois shareholder. *Id.*

<sup>135</sup> The internal affairs doctrine is a choice of law rule which provides generally that the law of the state of incorporation governs the internal affairs of a corporation, regardless of where a lawsuit is brought. See *Shaffer v. Heitner*, 433 U.S. 186 (1977). In an effort to protect its citizens, however, a state may apply some or all of its own corporate law rules to corporations which are incorporated elsewhere if the corporation has substantial contacts with the state. See *Western Airlines, Inc. v. Sobieski*, 191 Cal. App.2d 399, 12 Cal. Rptr. 719 (1961) (applying California law requiring cumulative voting to Delaware corporation with substantial contacts in California); *Wilson v. Louisiana-Pacific Resources, Inc.*, 138 Cal. App. 3d 216, 187 Cal. Rptr. 852 (1982) (court upheld constitutionality of California provision requiring cumulative voting as applied to a Utah corporation); *German-American Coffee Co. v. Diehl*, 216 N.Y. 57, 109 N.E. 875 (1915) (foreign corporation doing business in New York subject to liability for unlawful dividends even though dividends were lawful in state of incorporation). California and New York have statutes subjecting foreign corporations with certain

state of incorporation should have authority to regulate a corporation's internal affairs.<sup>136</sup> Stating that the doctrine was of little use to the state in the context of tender offers involving the transfer of stock to third parties, the Court observed that the Illinois statute applied to corporations which were not incorporated in Illinois and did not maintain their principal place of business within the state.<sup>137</sup> The Court concluded that Illinois did not have any interest in regulating the internal affairs of foreign corporations.<sup>138</sup>

The Court in *MITE* did not question the authority of the states to regulate tender offers *per se*. The essential weakness in the Illinois statute, according to the Court, was that part of its regulatory scheme which had a sweeping extraterritorial effect.<sup>139</sup> The implication of the majority opinion, despite subsequent lower court decisions to the contrary,<sup>140</sup> is

contacts to their state corporation laws. CAL. CORP. CODE § 2115 (West 1984); N.Y. BUS. CORP. LAW, §§ 1317, 1318, 1319 (McKinney 1983). See also Sobieski, *State Blue Sky Jurisdiction Over Foreign Corporations*, 14 HAST. L.J. 75 (1962). For a general discussion of state jurisdiction over foreign corporations, see HENN & ALEXANDER, LAWS OF CORPORATIONS § 98 (3d ed. 1983). See also Latty, *Pseudo-Foreign Corporations*, 65 YALE L.J. 137 (1955).

<sup>136</sup> *Id.* at 645. There are a few proponents of the proposition that takeover statutes are within the traditionally state regulated area of corporate internal affairs. See Shipman, *Some Thoughts About The Role of State Takeover Legislation: The Ohio Takeover Act*, 21 CASE W. RES. L. REV. 722 (1970). Shipman argues that a takeover bid is analogous to a merger or proxy fight and directly affects the internal affairs of the target company because of the resulting change in corporate control. *Id.* at 754-55. See also Sargent, *On The Validity of State Takeover Regulation: State Responses to MITE and Kidwell*, 42 OHIO ST. L.J. 689 (1981). Discussing the hybrid character of tender offers, Sargent presents a persuasive argument against preemption of state regulation of corporate takeovers:

Congress has been able to regulate tender offers as securities transactions, but the far-reaching character of this regulation should not obscure the fact that tender offers are more than securities transactions. They are devices by which a frequently irreversible change in the ownership and structure of a corporation is effected; their amenability to federal regulation as securities transactions does not eliminate the possibility of or the need for state regulation of them as instruments of fundamental corporate change.

*Id.* at 725.

<sup>137</sup> 457 U.S. at 645.

<sup>138</sup> *Id.* at 645-46.

<sup>139</sup> *Id.* at 643. The Court stated that the statute purported "to give Illinois the power to determine whether a tender offer may proceed anywhere." *Id.*

<sup>140</sup> See, e.g., *Telvest, Inc. v. Bradshaw*, 697 F.2d 576 (4th Cir. 1983) (Virginia takeover statute limited to Virginia companies struck down as violative of the commerce clause); *National City Lines, Inc. v. L.L.C. Corp.*, 687 F.2d 1122 (8th Cir. 1982) (Missouri takeover statute preempted by Williams Act and violative of commerce clause); *Martin-Marietta Corp. v. Bendix Corp.* 690 F.2d 558 (6th Cir. 1982) (even if Michigan takeover statute attempted to protect only Michigan residents it would still burden interstate commerce); *Conkling v. Moseley, Hallgarten, Estabrook & Weeden, Inc.*, 575 F. Supp. 760 (D. Mass. 1983) (state securities regulation is a burden on interstate commerce and federal securities law has superseded state securities law); *Occidental Petroleum Corp. v. Cities Service Co.*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,064 (W.D. Okla. 1982) (even if Oklahoma Takeover Act protection was limited to Oklahoma residents it would still unduly burden interstate commerce).

These decisions indicate that *MITE* is not being followed. Most of the post-*MITE* decisions do not limit review to whether the statute has extraterritorial effect. See, e.g., *National City Lines, Inc. v. L.L.C. Corp.*, 687 F.2d 1122 (8th Cir. 1982) (court reviewed substantive provisions of state statute and held that it was preempted). The majority in *MITE* did not strike down the substantive provisions of the Illinois act, but only its extraterritorial application.

The North American Securities Administrators Association, Inc. (NASAA), *infra* note 242, has concluded that the Supreme Court's decision in *MITE* does not preclude all state regulation of tender offers. Statement of Position of NASAA Relating to Changes in Federal Law and Regulation Concerning Takeovers, 1 BLUE SKY L. REP. (CCH) ¶ 5295 (1983). NASAA has criticized subsequent court decisions involving state takeover laws as "add[ing] to the confusion by, in knee-jerk fashion, merely citing *MITE* and striking down any state law that had effect outside the state without careful analysis of the facts and law of each individual case." *Id.*

that Illinois' legitimate interest in regulating tender offers would not have been *excessively* burdensome on interstate commerce if the statute had been tailored to protect only Illinois shareholders.<sup>141</sup> Justice White, in that portion of his plurality opinion which addressed the *direct*, as opposed to the *indirect*, burden on interstate commerce,<sup>142</sup> noted that the Supreme Court has upheld the authority of states to enact blue sky laws without exceeding the limitations imposed by the commerce clause.<sup>143</sup> Citing the *Blue Sky Cases*, he observed that "[t]he Court's rationale for upholding blue sky laws was that they only regulated transactions occurring *within* the regulating states."<sup>144</sup> The Court focused on the Illinois law's extraterritorial effect, not on any substantive characteristics which might distinguish it from state blue sky laws.<sup>145</sup>

Although the adoption of state takeover legislation is a relatively recent development,<sup>146</sup> state blue sky laws traditionally have included antifraud provisions applicable to both offers to purchase, including tender offers, and offers to sell securities.<sup>147</sup> State

<sup>141</sup> The Court stated that, "[w]hile protecting local investors is plainly a legitimate state objective, the state has no legitimate interest in protecting non-resident shareholders. Insofar as the Illinois law burdens out-of-state transactions, there is nothing to be weighed in the balance to sustain the law." 457 U.S. at 644 (emphasis added).

<sup>142</sup> 457 U.S. at 641-43. In this part of his opinion, Justice White concluded that the Illinois statute was a *direct* restraint on interstate commerce since the statute attempted to assert extraterritorial jurisdiction over persons and property wholly outside of the State of Illinois. *Id.* at 643. Justices O'Connor, Burger, and Stevens joined in this part of White's opinion. *Id.* at 626 n.\*.

<sup>143</sup> *Id.* at 641.

<sup>144</sup> *Id.*

<sup>145</sup> *Id.* at 640-46.

<sup>146</sup> The first state takeover statute was enacted in Virginia in 1968. See L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 601 (1983). Following enactment of this statute and the Williams Act, thirty-six states followed suit. See ALASKA STAT. §§ 45.57.010-.120 (1980) ARK. STAT. ANN. §§ 67-1264 to 1264.14 (1980); COLO. REV. STAT. §§ 11-51.5-101 to -108 (Supp. 1983) CONN. GEN. STAT. ANN. §§ 36-457 to -468 (West Supp. 1984); DEL. CODE ANN. tit. 8, § 203 (Supp. 1982); FLA. STAT. ANN. §§ 517.35-.363 (West Supp. 1978) (repealed 1979); GA. CODE ANN. §§ 22-1901 to -1915 (1977 & Supp. 1982); IDAHO CODE §§ 30-1501 to -1513 (1980 & Supp. 1983); ILL. ANN. STAT. ch 121½, ¶¶ 137.51-70 (Smith-Hurd Supp. 1982-1984), repealed by Act No. 83-365, 1983 Ill. Legis. Serv. 2628; IND. CODE ANN. §§ 23-2-3.1-1 to 3.1-11 (West Supp. 1983-1984); IOWA CODE ANN. §§ 502.211-.215 (West Supp. 1983-1984); KAN. STAT. ANN. §§ 17-1276 to -1284 (1981); KY. REV. STAT. ANN. §§ 292.560-.991 (Bobbs-Merrill 1981 & Supp. 1982); LA. REV. STAT. ANN. §§ 51:1500-.1512 (West Supp. 1984); ME. REV. STAT. ANN. tit. 13, §§ 801-817 (Supp. 1983-1984); MD. CORPS. & ASS'NS CODE ANN. §§ 11-901 to -908 (Supp. 1983); MASS. GEN. LAWS ANN. ch. 110C, §§ 1-13 (West Supp. 1983-1984); MICH. COMP. LAWS ANN. §§ 451.901-.917 (West Supp. 1984); MISS. CODE ANN. §§ 75-72-101 to -121 (Supp. 1983); MO. ANN. STAT. §§ 409.500-.565 (Vernon 1979); NEB. REV. STAT. §§ 21-2401 to -2417 (1977); NEV. REV. STAT. §§ 78.376-.3778 (1979) (amended 1981); N.H. REV. STAT. ANN. §§ 421-A:1 to :15 (Supp. 1983) (amended 1983); N.J. STAT. ANN. §§ 49:5-1 to :19 (West Supp. 1983-1984); N.Y. BUS. CORP. LAW §§ 1600-1614 (McKinney Supp. 1983-1984); N.C. GEN. STAT. §§ 78B-1 to -11 (1981); OHIO REV. CODE ANN. § 1707.041 (Baldwin 1979) (amended 1982); OKLA. STAT. ANN. tit. 71 § 431-450 (West Supp. 1983-1984); PA. STAT. ANN. tit. 70, §§ 71-85 (Purdon Supp. 1983-1984); S.C. CODE ANN. §§ 35-2-10 to -110 (Law Co-op. Supp. 1983); S.D. CODIFIED LAWS ANN. §§ 47-32-1 to -47 (Supp. 1983); TENN. CODE ANN. §§ 48-2101 to -2114 (1979 & Supp. 1983); UTAH CODE ANN. §§ 61-4-1 to -13 (1978) (repealed 1983); VA. CODE §§ 13.1-528 to -541 (1978 & Supp. 1983) (amended 1983); WIS. STAT. ANN. §§ 552-.01 -.25 (West Special Pamphlet 1983); TEX. ADMIN. CODE FOR MINIMUM STANDARDS IN TENDER OFFERS tit. 7, § 129, reprinted in 3 BLUE SKY L. REP. (CCH) ¶¶ 55,671-55,682.

For a discussion of the future of state takeover legislation, see Profusek & Gompf, *State Takeover Legislation After MITE: Standing Pat, Blue Sky, or Corporation Law Concepts*, 7 CORP. L. REV. 3 (1984).

<sup>147</sup> See UNIF. SECURITIES ACT § 101, 7A U.L.A. 568 (1978).

It is unlawful for any person in connection with the offer, sale, or purchase of any security, directly or indirectly

takeover statutes, exemplified by the Illinois law considered in *MITE*, merely supplement existing blue sky laws by adding various substantive and procedural requirements tailored to the tender offer process.<sup>148</sup> They impose formal disclosure and fairness standards upon offers to purchase similar to those generally imposed by blue sky laws upon offers to sell securities.<sup>149</sup> Both types of offers, if extended to residents of a regulating state, should be subject to a state's constitutional authority to regulate securities transactions involving dispositions of securities *within the state*. In *MITE*, Justice White emphasized that "[t]he Illinois Act differs substantially from state blue sky laws in that it directly regulates transactions which take place across state lines, even if wholly outside the State of Illinois."<sup>150</sup> Justice Stevens, concurring with the *MITE* majority, expressly rejected a preemption holding in favor of Justice White's commerce clause rationale because it "leaves some room for state regulation of tender offers."<sup>151</sup> Certainly, *MITE* cannot be harnessed for the proposition that state regulation of securities should be preempted or, alternatively, that state blue sky laws constitute an unconstitutional burden on interstate commerce.<sup>152</sup>

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- (1) to employ any device, scheme, or artifice to defraud,
  - (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading, or
  - (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

*Id.*

<sup>148</sup> See NASAA Uniform Take-Over Act, 1 BLUE SKY L. REP. (CCH) ¶ 5295 (October 28, 1981).

<sup>149</sup> See, e.g., ILL. ANN. STAT. ch. 121½, ¶ 137.57E (Smith-Hurd Supp. 1983-1984); MO. ANN. STAT. § 409.515 (Vernon 1979); N.Y. BUS. CORP. LAW § 1604 (McKinney Supp. 1983-1984); TENN. CODE ANN. § 48-2104(5) (1979). Compare UNIF. SECURITIES ACT § 306(a); 7A U.L.A. 620 (1978) (state securities commissioners authority to deny registration of securities offerings).

<sup>150</sup> 457 U.S. at 641.

<sup>151</sup> *Id.* at 646.

<sup>152</sup> See *North Star Int'l v. Ariz. Corp. Comm'n*, 720 F.2d 578 (9th Cir. 1983). The court in *North Star* rejected contentions that Arizona's blue sky law violated the supremacy and commerce clauses of the Constitution. *Id.* Although the Arizona law imposed merit requirements, see *supra* note 78, the court found no preemptive conflict with the federal securities laws. *Id.* at 583. In rejecting the commerce clause claim, the court looked to *MITE* and the *Blue Sky Cases* and observed that "[t]he Supreme Court has consistently upheld the authority of states to enact 'blue-sky' laws against commerce clause challenges." *Id.*

But see *Conkling v. Moseley, Hallgarten, Estabrook, & Weeden, Inc.*, 575 F. Supp. 760 (D. Mass 1983), discussed *supra* note 44. Despite the implications of *MITE*, some commentators have called for preemption of state takeover statutes. See Langevoort, *State Takeover Legislation: Interests, Effects and Political Competency*, 62 CORNELL L. REV. 213, 253 (1977); Wilner & Landy, *The Tender Trap: State Takeover Statutes and Their Constitutionality*, 45 FORDHAM L. REV. 1, 32 (1976); Note, *A Failed Experiment: State Takeover Regulation After Edgar v. MITE Corp.*, 1983 U. ILL. L. REV. 457, 474-75; Note, *Edgar v. MITE Corp.: The Death Knell for the Indiana Takeover Offers Act*, 16 IND. L. REV. 517, 537 (1983). For well reasoned arguments against preemption, see Sargent, *On The Validity of State Takeover Regulation: State Responses to MITE and Kidwell*, 42 OHIO ST. L.J. 689, 729 (1981) and Note, *Securities Law and The Constitution: State Takeover Offer Statutes Reconsidered*, 88 YALE L.J. 510, 532 (1979).

Recently, the SEC Advisory Committee on Tender offers recommended that state regulation of tender offers be limited to local companies. SEC Advisory Committee on Tender Offers, Report of Recommendations, [Special Report] FED. SEC. L. REP. (CCH) (July 15, 1983). Moreover, the committee recommended that state corporation law be preempted "to the extent necessary to eliminate abuses or interference with . . . federal takeover regulation." *Id.* at 18 (Recommendation 9(a)).

## II. CONGRESSIONAL RECOGNITION OF STATE SECURITIES REGULATION

Congress created the system of dual regulation of securities by enacting federal securities legislation over fifty years ago. It deliberately preserved for investors the protections afforded by state securities laws by adding savings clauses to its securities statutes.<sup>153</sup> In addition, Congress exempted from its scheme various types of securities and securities transactions, leaving regulation of these matters primarily to the states.<sup>154</sup> It demonstrated its continuing support for protection at the local level of government by establishing a blue sky law for the District of Columbia thirty years later.<sup>155</sup> More recently, Congress has encouraged greater coordination of the state and federal participants in the dual system, disclaiming any desire to preempt state laws.<sup>156</sup> These legislative developments demonstrate Congress' high regard for the working partnership between state and federal governments in the regulation of securities.

When Congress adopted the 1933 Act, each state except Nevada had enacted blue sky laws<sup>157</sup> under its assumed responsibility to protect its citizens from wide-ranging fraud and abuse at the hands of unregulated promoters, issuers and broker-dealers. By requiring disclosures in connection with securities offerings, the blue sky laws prevented the sale of millions of shares of worthless stock.<sup>158</sup> These laws provided significantly more protection to investors than had public and private actions based on state common law remedies for deceit.<sup>159</sup> This success, however, led unscrupulous promoters to develop schemes to

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<sup>153</sup> See 15 U.S.C. §§ 77r & 78bb(a) (1976 & Supp. IV 1982).

<sup>154</sup> See *infra* note 192-98 and accompanying text.

<sup>155</sup> D.C. CODE ANN. §§ 2-2601 to 2619 (1966).

<sup>156</sup> 15 U.S.C. § 77s(c)(3)(C) (Supp. 1982).

<sup>157</sup> *Securities Act Hearings*, *supra* note 2, at 94.

<sup>158</sup> See *supra* note 8.

<sup>159</sup> The action of deceit, one of several torts falling within the common law of misrepresentation, generally requires proof by clear and convincing evidence of five essential elements, including (1) a false representation, (2) made with knowledge of its falsity or without sufficient basis in fact ("scienter"), (3) with an intent to induce action or inaction, (4) upon which a party justifiably relies, and (5) to his resulting damage or injury. W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 100 (4th ed. 1971). Assuming that a defrauded investor could marshal sufficient evidence, usually only circumstantial in nature, to prove each of these elements, several obstacles would remain which could frustrate a recovery of the lost funds. First, he had to utilize his then depleted resources to finance the litigation, and, second, he was faced with the frequently insurmountable difficulty of locating the perpetrator after the fact and obtaining jurisdiction over him. *Cf. Securities Act Hearings*, *supra* note 2, at 101 (Dept. of Commerce Study of the Economic and Legal Aspects of the Proposed Federal Securities Act) (sellers using means of interstate commerce and never entering state cannot be said to have "fled" from the state, precluding state jurisdiction over him). If these burdens could be overcome, the defrauded investor may have achieved only a pyrrhic victory — the securities swindler usually had disposed of or concealed the invested funds and had no other discoverable assets available to satisfy a judgment. Moreover, many victims were willing to forego prosecution if the dealers agreed to refund a portion of the investor's money. *Id.* at 100. Fraudulent promoters often set aside a percentage of the funds in order to placate their more powerful investors. *Id.*

The blue sky laws, in addition to providing general supervision of those engaged in the securities business, were intended to prevent the fraudulent activity at its inception, to "nip it in the bud" before the losses were sustained, through registration, disclosure and merit review. L. LOSS & E. COWETT, BLUE SKY LAW 21-39 (1958). They were to protect the investing public generally, "with provisions which were preventive rather than remedial." *Id.* at 21. See also PARRISH, SECURITIES REGULATION AND THE NEW DEAL 22 (1970). In response to the 1921 enactment of a registration-free fraud law in New York, "one incredulous" attorney general, cognizant of the basic defect in fraud laws, remarked: "Just how [we are] to discover in advance who is going to perpetrate fraud is not made clear in the act." *Id.*

elude the reach of process through the use of interstate facilities.<sup>160</sup> As Justice Douglas noted in *Traveler's Health*,<sup>161</sup> the states were unable to acquire jurisdiction over companies which "operate[d] beyond the borders, establishe[d] no office in the state, and ha[d] no agents, salesmen, or solicitors to obtain business for it within the state."<sup>162</sup> Similarly, defrauded investors were faced with the legal and practical difficulties inherent in any effort to obtain redress from sellers of securities operating in other states.<sup>163</sup> As a result, state securities administrators joined in the call for federal legislation to complement their efforts at the state level, expressing "the need of federal assistance in their campaign against the deluge of fraudulent securities that had been flooding the country."<sup>164</sup>

It was against this background that the "gap" was filled by the 1933 Act,<sup>165</sup> underscoring not only the symbiotic duality of state and federal securities regulation, but also the interstitial nature of congressional power exercised under the commerce clause of the Constitution.<sup>166</sup> In passing the 1933 Act, as well as the other federal securities statutes,<sup>167</sup> Congress was careful to preserve, not preempt state blue sky laws,<sup>168</sup> which not only

<sup>160</sup> See *Securities Act Hearings*, *supra* note 2, at 99-101 (Dept. of Commerce Study of the Economic and Legal Aspects of the Proposed Federal Securities Act). See also PARRISH, *SECURITIES REGULATION AND THE NEW DEAL* 29 (1970).

<sup>161</sup> 339 U.S. 643 (1950).

<sup>162</sup> *Id.* at 654. See also *Securities Act Hearings*, *supra* note 2, at 10 (statement of Huston Thompson, Attorney at Law, Washington, D.C.).

Although the Court in *Traveler's Health* held that the out of state corporation had the requisite minimum contacts with the state to confer jurisdiction, the "minimum contacts" at issue involved a continuing effort to sell securities within the state. 339 U.S. at 647-48. If the corporation's activities had involved only a single or few isolated transactions, it is unlikely that the Court would have found that the requisite contacts existed. See *supra* note 91.

<sup>163</sup> See Cohen, *Federal Legislation Affecting the Public Offering of Securities*, 28 GEO. WASH. L. REV. 119, 124 (1958).

<sup>164</sup> *Securities Act Hearings*, *supra* note 2, at 110 (Dept. of Commerce Study of the Economic and Legal Aspects of the Proposed Federal Securities Act).

<sup>165</sup> See *Traveler's Health Ass'n v. Virginia*, 339 U.S. 643, 653 (1950) (Douglas, J., concurring).

<sup>166</sup> See P. BATOR, P. MISHKIN, D. SHAPIRO & H. WECHSLER, *HART AND WECHSLER'S THE FEDERAL COURTS AND THE FEDERAL SYSTEM* 470 (2d ed. 1973).

Federal law is generally interstitial in its nature. It rarely occupies a legal field completely, totally excluding all participation by the legal systems of the states. This was plainly true in the beginning when the federal legislative product (including the Constitution) was extremely small. It is significantly true today, despite the volume of Congressional enactments, and even within areas where Congress has been very active. Federal legislation, on the whole, has been conceived and drafted on an *ad hoc* basis to accomplish limited objectives. It builds upon legal relationships established by the states, altering or supplanting them only so far as necessary for the special purpose. Congress acts, in short, against the background of the total *corpus juris* of the states in much the way that a state legislature acts against the background of the common law, assumed to govern unless changed by legislation.

*Id.* at 470-71.

See also *Kaminsky v. Abrams*, 281 F. Supp. 501, 504 (S.D.N.Y. 1968) (federal securities laws are incomplete and interstitial, superseding state corporation law only when there is a direct conflict). *Cf.* *Arkansas Elec. Coop. v. Arkansas Pub. Serv. Comm'n*, \_\_\_ U.S. \_\_\_, 103 S.Ct. 1905 (1983) (REA applicable within the "constraints" of existing state regulatory schemes).

<sup>167</sup> See Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1976); Public Utility Holding Company Act of 1935, 15 U.S.C. § 79-2-6 (1976); The Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-zzz (1976); Investment Company Act of 1940, 15 U.S.C. §§ 80a-1-52 (1976); Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-1-21 (1976).

<sup>168</sup> H.R. REP. No. 85, 73d Cong., 1st Sess. 10 (1933).

antedated the federal legislation, but were generally broader in scope.<sup>169</sup> The initial bill which passed the House contained a provision making it a federal crime to transmit or offer in interstate commerce securities that failed to comply with the laws of any state where they were to be sold.<sup>170</sup> This provision was intended in part "to assure the states that [the 1933 Act] was not an attempt to supplant their laws, but an attempt to supplement their laws and to assist them in enforcing their laws in those cases where they have no control. . . ."<sup>171</sup> This provision was questioned, however, because it worked a federalization of present and future laws enacted by state legislatures over which Congress had no control.<sup>172</sup> Although the purpose of this provision was to "complement . . . amplify or assist"<sup>173</sup> the states, it was eliminated by Senate amendment and, ultimately, by the conference committee.<sup>174</sup> The House and Senate conferees presumably were satisfied that state interests were protected adequately by another provision in the bill, a savings clause, designed to preserve control of securities at the state level:

Nothing in this chapter shall effect 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 securities or any person.<sup>175</sup>

In effect, the savings clause, adopted as Section 18 of the 1933 Act,<sup>176</sup> established the dual system of securities regulation by formulating a regulatory scheme at the federal level, while carefully preserving the role of the states in the development of their own regulatory schemes at the local level. Since enactment of the 1933 Act, Congress has amended the statute on numerous occasions, but has never tampered with the language of the savings clause. It remains a "clear statement"<sup>177</sup> that Congress wanted no ambiguity to

<sup>169</sup> See Cowett, *Federal-State Relationships in Securities Regulations*, 28 GEO. WASH. L. REV. 287, 293 (1959); Wright, *Correlation of State Blue Sky Laws and The Federal Securities Acts*, 26 CORNELL L.Q. 258, 262 (1941).

<sup>170</sup> H.R. REP. NO. 85, 73d Cong., 1st Sess. 25 (1933). Section 18(a) of the bill proposed: It is made unlawful for any person to make use of the mails or any means or instruments of interstate commerce to sell or deliver any security to any person in any state, where such sale or delivery if it had taken place wholly within such state, would be in violation of the laws thereof relating to the sale of securities.

<sup>171</sup> *Securities Act Hearings*, *supra* note 2, at 117 (statement of Ollie M. Butler, Foreign Serv. Div., Dept. of Commerce).

<sup>172</sup> *Securities Act Hearings*, *supra* note 2, at 41 (statement of Huston Thompson, Attorney at Law, Washington, D.C.).

<sup>173</sup> *Id.*

<sup>174</sup> H.R. REP. NO. 152, 73d Cong., 1st Sess. 27 (1933).

<sup>175</sup> 15 U.S.C. § 77r (1976). One commentator reluctantly conceded that this savings clause made it clear "that Congress had no intention . . . of superseding state regulation in any particular," accomplishing, in effect, the same end as the deleted provision which made a violation of state blue sky law a federal offense. "[O]therwise [the savings clause was] a mere *brutum fulmen*, since obviously Congress could not 'affect the jurisdiction' of the states over intrastate matters." Smith, *State "Blue-Sky Laws" and the Federal Securities Acts*, 34 MICH. L. REV. 1135, 1160 (1936). Accordingly, Smith stated it was beyond "serious question" that "the power of the states to regulate interstate securities transactions" was preserved explicitly by Congress. *Id.* at 1158.

<sup>176</sup> 15 U.S.C. § 77r (1976).

<sup>177</sup> The "clear statement rule" is a rule of statutory construction which provides that a "law will not be held to affect all the activities Congress in theory can control unless statutory language or legislative history constitutes a *clear statement* that Congress intended to exercise its commerce power



exist regarding its recognition of coexisting state and federal control in the field of securities regulation.<sup>178</sup> In preserving the role of the states, Congress unequivocally accommodated the local and national interests bearing on the balance of federal and state power in this field.<sup>179</sup>

Although the savings clause of the 1933 Act established dual regulation generally, Congress reserved certain important areas of securities regulation completely to the states. It chose to regulate securities transactions primarily through the vehicle of full disclosure.<sup>180</sup> The statute requires a statutory prospectus,<sup>181</sup> as part of a registration statement,<sup>182</sup> to be filed with the SEC in advance of any securities offering.<sup>183</sup> The prospectus must be delivered to investors prior to or at the time of any sale.<sup>184</sup> Although the prospectus must state all material<sup>185</sup> facts pertaining to the offering,<sup>186</sup> the 1933 Act does not require the securities offered for sale to be a "fair, just or equitable" investment or otherwise to comply with any qualitative standards. In drafting the 1933 Act, Congress refused to give the SEC any power to pass upon the merits of any offering of securities,<sup>187</sup> but only required that essential facts be disclosed.<sup>188</sup> In exercising this restraint, Congress apparently was aware that "merit regulation" was central to the protective schemes afforded by most of the states<sup>189</sup> and was understandably cautious to avoid any assump-

in full." L. TRIBE, *AMERICAN CONSTITUTIONAL LAW* 243 (1978). The purpose of the rule is to prevent Congress "from resorting to ambiguity as a cloak for its failure to accommodate the competing interests bearing on the federal-state balance." *Id.* at 244.

<sup>178</sup> The existence of a savings clause "restrict[s] the sphere of judicial inquiry." Note, *A Framework for Preemption Analysis*, 88 *YALE L.J.* 363, 366 (1978). The courts cannot find that Congress expressly or impliedly preempted the field. See *Leroy v. Great W. United Corp.*, 443 U.S. 173, 182 n.13 (1979). However, a savings clause will not prevent a court from finding preemption if the state law conflicts with or frustrates the purposes and objectives of the federal regulatory scheme. See *Edgar v. MITE Corp.*, 457 U.S. 624, 631 (1982). *But see Union Brokerage Co. v. Jensen*, 322 U.S. 202, 209 (1944) ("where the government has provided for collaboration the courts should not find conflict").

<sup>179</sup> See *supra* note 177.

<sup>180</sup> H.R. REP. NO. 85, 73d Cong., 1st Sess. 3 (1933). Congress, in enacting the 1933 Act, followed the approach of the British Companies Act, which, since 1844, had compelled disclosure through the registration of securities offerings. See *Securities Act Hearings*, *supra* note 2, at 108 (Dept. of Commerce Study of the Economic and Legal Aspects of the Proposed Federal Securities Act) and L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 3, 35-36 (1983).

<sup>181</sup> 15 U.S.C. § 77b(10) (1976).

<sup>182</sup> *Id.* at § 77b(8). Section 5 of the 1933 Act makes it unlawful for any person to engage in the interstate offer or sale of securities unless a registration statement is in effect. *Id.* at § 77e.

<sup>183</sup> *Id.* at § 77f(a) (1976).

<sup>184</sup> 15 U.S.C. § 77e(b)(2) (1976).

<sup>185</sup> The term "material" has been defined by the SEC in rule 405. 17 C.F.R. § 230.405 (1983). See also *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 445-50 (1976).

<sup>186</sup> 15 U.S.C. § 77j(b) (1976).

<sup>187</sup> *Id.* at § 77w (1976). *Cf.* 15 U.S.C. § 79z-2 (1976) (unlawful to represent that public utility company securities are recommended by any federal agency).

<sup>188</sup> See *supra* note 110.

<sup>189</sup> See *Securities Act Hearings*, *supra* note 2, at 53. During the hearings on the 1933 Act, Congress considered the issue of whether a disclosure oriented scheme, unsupplemented by merit review, would provide sufficient protection to investors. *Id.* One Congressman was concerned that disclosure requirements alone would, in effect, "lock the stable door after the horse has been stolen." *Id.* at 52. The answer given was that the theory upon which the 1933 Act was based was "not to prevent the issuance of worthless stock, but merely to give such facts as will enable a purchaser to recognize it as worthless stock." *Id.* at 53. Although it was acknowledged that Congress could go further, to do so would have been "getting over into a phase that is covered by the state blue sky laws." *Id.*

tions by investors that SEC review worked "a guarantee or approval of any particular securities issue."<sup>190</sup> If investors were to be protected from securities deals which had no economic substance, were unreasonably speculative or simply unfair, they were told, in effect, to look to the states, not the federal government, for any such protection. Accordingly, the states have continued to afford such protection, largely through a combination of disclosure and fairness requirements.<sup>191</sup>

Congress further demonstrated its lack of intent to preempt state securities laws by the exemptive scheme it included in the 1933 Act. Congress specifically exempted from the federal registration provisions numerous types of securities and securities transactions which, in its view, did not demand investor protection at the federal level by means of any formal disclosure and SEC review prior to issuance. These exemptions include, among others, state and local government securities,<sup>192</sup> certain state financial institution securities,<sup>193</sup> insurance policies and annuity contracts issued by corporations subject to state supervision,<sup>194</sup> all intrastate offerings of securities,<sup>195</sup> certain offerings of small amounts (now \$5,000,000 or less) or of a limited character where the SEC deems federal protection unnecessary<sup>196</sup> and private placements of securities.<sup>197</sup> Accordingly, the burden of pre-issuance investor protection through registration provisions was posited solely with the states, most significantly in those transactions falling within the intrastate, small offering and private placement exemptions.<sup>198</sup> The exclusion of these various types of securities transactions from the scope of the 1933 Act did not imply in any sense that protection was not needed at the state level. Indeed, the opposite conclusion may be reached. As one blue sky law specialist observed, "... perhaps the greatest measure of protection [for the residents of the respective states] is warranted in the case of such securities or transactions."<sup>199</sup>

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<sup>190</sup> H.R. REP. NO. 85, 73d Cong., 1st Sess. 4 (1933). See also, 15 U.S.C. § 77w (1976) which provides:

Neither the fact that the registration statement for a security has been filed or is in effect nor the fact that a stop order is not in effect with respect thereto shall be deemed a finding by the Commission that the registration statement is true and accurate on its face or that it does not contain an untrue statement of fact or omit to state a material fact, or be held to mean that the Commission has in any way passed upon the merits of, or given approval to, such security. It shall be unlawful to make, or cause to be made to any prospective purchaser any representation contrary to the foregoing provisions of this section.

*Id.*

<sup>191</sup> See Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements?*, 1976 WIS. L. REV. 79 (1976). Goodkind discusses the variations among the states and addresses blue sky regulation generally. See also Tyler, *More About Blue Sky*, 39 WASH. & LEE L. REV. 899, 902-904 (1982).

<sup>192</sup> 15 U.S.C. § 77c(a)(2) (1976).

<sup>193</sup> *Id.* at § 77c(a)(2), (5).

<sup>194</sup> *Id.* at § 77c(a)(8).

<sup>195</sup> *Id.* at § 77c(a)(11). See also 17 C.F.R. § 230.147 (1983).

<sup>196</sup> 15 U.S.C. § 77c(b) (1976). See also 17 C.F.R. § 230.504-505 (1983); 17 C.F.R. § 230.251-264 (1983).

<sup>197</sup> 15 U.S.C. § 77d(2) (1976). See also 17 C.F.R. § 230.506 (1983).

<sup>198</sup> See Cowett, *Federal-State Relationships in Securities Regulation*, 28 GEO. WASH. L. REV. 287, 293 n.36 (1959); Wright, *Correlation of State Blue Sky Laws and the Federal Securities Acts*, 26 CORNELL L.Q. 258, 271 (1941) ("there arises here a group of securities in the regulation of which the [states] must continue to be vigilant if adequate investor protection is to be rendered . . .")

<sup>199</sup> Cowett, *supra* note 198.

Securities regulation at the state level was fostered not only by congressional delimitation of the 1933 Act, but also by Congress' specific enlistment of state assistance in enforcing and supplementing the federal scheme. Congress added another savings clause at Section 16 of the 1933 Act,<sup>200</sup> which provides that the federal rights and remedies set forth in the statute are "in addition to any and all other rights and remedies that may exist at law or in equity."<sup>201</sup> These other "rights and remedies" clearly include those provided by the corporation laws, blue sky laws and the common law of each of the states.<sup>202</sup> Congress also granted jurisdiction to state courts, concurrent with federal district courts, over all suits at law or in equity, to enforce all duties and liabilities arising under the 1933 Act.<sup>203</sup> In preserving the remedies provided by the states and the jurisdiction of their courts, Congress furthered "the broad remedial purposes" of its securities laws.<sup>204</sup> Consequently, the protections afforded investors at the state level formed an integral part of a dual system of securities regulation.

In addition to placing savings clauses in the 1933 Act, applicable to distributions of securities, Congress included virtually identical savings clauses in the 1934 Act.<sup>205</sup> Section 28(a) of the 1934 Act was intended to protect state blue sky laws as they related to the trading markets in securities.<sup>206</sup> Similarly, under the 1934 Act, "the rights and remedies" provided by state laws are expressly cumulative.<sup>207</sup> Although an investor's recovery under

<sup>200</sup> 15 U.S.C. § 77p (1976).

<sup>201</sup> *Id.*

<sup>202</sup> *See Independence Shares Corporation v. Deckert*, 108 F.2d 51 (3rd Cir. 1939), *rev'd on other grounds*, 311 U.S. 282 (1940), in which the Court stated, "Congress by the language employed [in § 16] sought only to make it abundantly clear that it was not pre-empting this field to the federal jurisdiction, thereby prohibiting recovery to defrauded individuals under the law of the states as that existed prior to the passage of the Securities Act." *Id.* at 54. *Cf. Herman & MacLean v. Huddleston*, — U.S. —, 103 S. Ct. 683 (1983) (remedies provided by federal securities laws are cumulative in nature). *See also SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963).

<sup>203</sup> 15 U.S.C. § 77v(a) (1976). It is important to note, however, that state courts do not have concurrent jurisdiction over claims arising under the Securities Exchange Act of 1934. *See* 15 U.S.C. § 78aa (1976). The primary purpose for granting exclusive jurisdiction to the federal courts was to enable suits under the 1934 Act to be brought wherever a defendant could be found and insure that there was wide accessibility to federal courts. *See Radzanower v. Touche Ross & Co.*, 426 U.S. 148, 156 (1976). This purpose is consistent with the position that, although the federal courts have exclusive jurisdiction over claims initiated under the 1934 Act, "nothing . . . prevents the state court from considering questions . . . which are introduced by way of defense, and failure to do so would violate the supremacy clause." *Aetna State Bank v. Alheimer*, 430 F.2d 750, 754 (7th Cir. 1970) (quoting, *II LOSS, SECURITIES REGULATION* 977 (1961)).

<sup>204</sup> *See Herman & MacLean v. Huddleston*, — U.S. —, 103 S. Ct. 683, 687 (1983). *See also SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963) (Congress codified the common law action for fraud "remedially," and not technically as it had traditionally been applied in arms length transactions involving land or ordinary chattels).

<sup>205</sup> 15 U.S.C. § 78bb(a) (Supp. 1982).

<sup>206</sup> *Id.* While the purpose of the 1933 Act was to regulate distributions of securities, the purpose of the 1934 Act was to regulate post-distribution trading of securities. Its primary regulatory themes were: (1) the requirement of continuous disclosure by publicly held companies, periodically and in connection with proxy solicitations and tender offers; (2) the regulation of the exchange and over-the-counter markets; (3) the prevention of fraud and market manipulation; and (4) the control of securities credit by the Board of Governors of the Federal Reserve System. *See LOSS, FUNDAMENTALS OF SECURITIES REGULATION* 39 (1983).

<sup>207</sup> 15 U.S.C. § 78bb(a) (Supp. 1982).

the 1934 Act is limited to the total of "actual damages" sustained,<sup>208</sup> courts have held that state law remedies providing for punitive damages to deter the same misconduct are left intact.<sup>209</sup> Section 28(a) further provides that nothing in the 1934 Act affects the jurisdiction of state securities commissions, with the additional phrase, "insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder."<sup>210</sup> Interpreting the 1934 Act's saving clause, the Supreme Court, in *Leroy v. Great Western United Corporation*,<sup>211</sup> recognized that it "was plainly intended to protect, rather than limit, state authority" and "was designed to save state blue sky laws from preemption."<sup>212</sup> When Congress recently amended this section of the 1934 Act to proscribe state law invalidation of certain puts and calls and other related securities,<sup>213</sup> it did not tamper with its original language preserving state regulation of securities. Furthermore, after its adoption of the 1933 and 1934 Acts, Congress added similar savings clauses to each of the other federal securities statutes — the Public Utility Holding Company Act of 1935,<sup>214</sup> the Trust Indenture Act of 1939,<sup>215</sup> the Investment Company Act of 1940,<sup>216</sup> and the Investment Advisers Act of 1940.<sup>217</sup> These statutes expressly provide that, in the absence of conflict with state law, they do not affect the jurisdiction of any commission, board or agency of the states.<sup>218</sup>

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<sup>208</sup> 15 U.S.C. § 78bb(a) provides in pertinent part that:

... but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. . . .

*Id.*

<sup>209</sup> See *Young v. Taylor*, 466 F.2d 1329, 1338 (10th Cir. 1972); *Burkhart v. Allson Realty Trust*, 363 F. Supp. 1286, 1291 (N.D. Ill. 1973); *In Re Caesars Palace Securities Litigation*, 360 F. Supp. 366, 394 (S.D.N.Y. 1973). *But see* *Schaefer v. First Nat'l Bank of Lincolnwood*, 326 F. Supp. 1186, 1193 (N.D. Ill. 1970) (punitive damages may not be recovered under common law doctrines for conduct actionable under the federal securities laws). See generally *Comment Section 28(a) of the Securities Exchange Act: Punitive Damages and Pending State Claims*, 46 U. COLO. L. REV. 59 (1974); *Comment, The Availability of Variant State Remedies for Pending State Fraud Claims Actionable under the Federal Securities Acts*, 47 S. CAL. L. REV. 1213 (1974).

<sup>210</sup> 15 U.S.C. § 78bb(a) (Supp. 1982). One commentator has stated that this additional language was unnecessary because the supremacy clause of the Constitution would render federal law paramount in the event of any actual conflict of state law with provisions of the 1933 or 1934 Act. *Smith, State "Blue-Sky" Laws and the Federal Securities Acts*, 34 MICH. L. REV. 1135, 1161 (1936). He concluded:

Indulging the fair presumption that Congress intended . . . to accomplish something, its intention must have been that neither act should have the effect of withdrawing from the states their jurisdiction over transactions in securities. . . . The states may, therefore, to the extent possible before the enactment of the federal acts, legislate in this field subject only to the usual qualification that in the event of any actual incompatibility between a federal and state regulation, the former shall prevail.

*Id.* For a general discussion of savings clauses and preemption, see Note, *A Framework For Preemption Analysis*, 88 YALE L.J. 363, 365 (1978).

<sup>211</sup> 443 U.S. 173 (1979).

<sup>212</sup> *Id.* at 182 n.13. See also *Underhill Assoc., Inc. v. Coleman* [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,624 (E.D. Va. 1981) ("purpose of [savings clause] is to preserve state regulatory authority to the full extent permissible under the supremacy clause").

<sup>213</sup> 15 U.S.C. § 78bb(a) (Supp. 1982).

<sup>214</sup> 15 U.S.C. § 79u (1976).

<sup>215</sup> 15 U.S.C. § 77zzz (1976).

<sup>216</sup> 15 U.S.C. § 80a-49 (1976).

<sup>217</sup> 15 U.S.C. § 80b-18a (1976).

<sup>218</sup> See, e.g., 15 U.S.C. § 77zzz (1976). "[Nothing] in this subchapter [shall] affect the jurisdiction

After over thirty years experience with the federal regulatory scheme it had established in the 1933 and 1934 Acts, Congress has continued to recognize the vital role of state involvement in protecting investors in securities. Despite plenary coverage by the federal statutes of securities transactions within the District of Columbia, an "interstate jurisdiction,"<sup>219</sup> Congress became aware in the early 1960's that regulatory needs there were not being met satisfactorily.<sup>220</sup> It identified several problem areas which had arisen in "the absence of effective securities regulatory law in the District of Columbia."<sup>221</sup> These regulatory deficiencies had resulted in accelerated failure rates of securities businesses and consequent public losses.<sup>222</sup> Largely due to initiatives taken by the SEC,<sup>223</sup> an implicit admission of the SEC's own limitations, in 1964 Congress passed the District of Columbia Securities Act.<sup>224</sup> The statute, modeled after the Uniform Securities Act,<sup>225</sup> provides for the registration and supervision of brokers, dealers and salesmen of securities<sup>226</sup> and sets forth general antifraud provisions applicable to any offer, sale or purchase of securities within the District of Columbia.<sup>227</sup> Although the District of Columbia's blue sky law does not require registration of securities, an amendment to the statute to provide limited registration is now considered necessary for effective enforcement of the antifraud and other provisions of the statute.<sup>228</sup> By enacting its own blue sky law for the District of Columbia, Congress evidenced its fundamental belief that the difficult task of regulating

... of any State or political subdivision of any State, over any person or security, insofar as such jurisdiction does not conflict with any provision of this subchapter . . ." *Id.*

<sup>219</sup> 15 U.S.C. § 77b(7) (1976) defines the term, "interstate commerce" and includes "trade or commerce in securities or any transportation or communication relating thereto among the several states . . . or within the District of Columbia." *Id.*

<sup>220</sup> S. REP. NO. 1376, 88th Cong., 2d Sess. 3 (1964). See also *Securities Act Hearings*, *supra* note 2 at 99 (Dept. of Commerce Study of the Economic and Legal Aspects of the Proposed Federal Securities Act).

<sup>221</sup> S. REP. NO. 1376, 88th Cong., 2d Sess. 3 (1964).

<sup>222</sup> *Id.* See also *Securities Act Hearings*, *supra* note 2 "[A] report of the District Committee of the Senate covering an investigation made early in 1932 shows an unrestrained sale of millions of dollars worth of securities on the basis of gross misrepresentation by the issuers." *Id.*

<sup>223</sup> Telephone interview with James F. Whitescarver, Jr., Director of Securities, Public Service Commission, District of Columbia (October 19, 1983).

<sup>224</sup> D.C. CODE ANN. § 2-2601-2619 (1966).

<sup>225</sup> 1 BLUE SKY L. REP. (CCH) ¶ 5501 (1982).

The Uniform Securities Act, drafted principally by Professor Louis Loss, was approved in 1956 by the National Conference of Commissioners on Uniform State Laws, the American Bar Association and the National Association of Securities Administrators, now the North American Securities Administrators Association, Inc. (NASAA). L. LOSS & E. COWETT, *BLUE SKY LAW* 233-35 (1958). It was intended to provide a uniform state blue sky law reasonably coordinated with the federal securities laws, which, if adopted by the states, could minimize the existing diversity in state securities regulations. *Id.* at 233. Divided into four parts, the Uniform Securities Act reflects each of the three traditional blue sky approaches: Part I covers fraudulent and other prohibited practices; Part II covers registration of broker-dealers, agents and investment advisers; Part III covers registration of securities; and Part IV covers definitions, exemptions, judicial review, criminal and other provisions of general applicability. *Id.* at 236. It has been adopted with modifications by 36 states, the District of Columbia, Guam, and Puerto Rico, while numerous other states have borrowed extensively from its provisions. 1 BLUE SKY L. REP. (CCH) ¶ 5501 (1982).

<sup>226</sup> D.C. CODE ANN. § 2-2603 (1966).

<sup>227</sup> *Id.* at § 2-2602.

<sup>228</sup> Telephone interview with James F. Whitescarver, Jr., Director of Securities, Public Service Commission, District of Columbia (October 19, 1983). The limited registration envisioned would be similar to New York's Martin Act, N.Y. GEN. BUS. LAW § 359 (McKinney 1980), which imposes a simplified notice filing identifying the securities to be offered in the jurisdiction and including the

securities to protect investors from fraud and abuse requires local, as well as national, control.<sup>229</sup>

The "last word" from Congress on the dual system of securities regulation was expressed in the Small Business Investment Incentive Act of 1980.<sup>230</sup> After acknowledging a significant reduction in the flow of capital to small business during the preceding decade, Congress conducted extensive hearings to determine and alleviate the most significant impediments to capital formation.<sup>231</sup> Notwithstanding its conclusion that the slow-down was the product of many economic forces apart from government regulation,<sup>232</sup> Congress sought to reduce the burdens *federal* securities regulation imposed on the capital formation process, "to the extent it [could] be done without sacrificing necessary investor protection."<sup>233</sup> The statute which resulted amended the 1933 Act to

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name, address and state of incorporation of the issuer. *Id.* According to the District of Columbia Director of Securities, James F. Whitescarver, Jr., this modification, by requiring identification of persons offering securities in the District of Columbia at a given time, would enhance enforcement of existing antifraud provisions designed to protect resident investors. Telephone interview, *supra*.

The IBA, now the Securities Industry Association, *supra* note 20, was involved extensively in passage of the Martin Act as an antifraud measure, but successfully opposed amendments which would have required registration of securities issues. PARRISH, SECURITIES REGULATION AND THE NEW DEAL 22 (1970). As a result, "[t]he Martin Act, in short, enabled the IBA, its corporate clients and the New York Stock Exchange to enjoy the best of two worlds. It helped to police bucket shops and fraudulent dealers who drained away business. At the same time, [it] allowed the IBA, corporations, and Exchange members to avoid the responsibility of registration or disclosure." *Id.*

<sup>229</sup> The fact that Congress enacted the District of Columbia blue sky law has saved the statute from a preemption attack based on the supremacy clause. In *Levin v. Dean Witter Reynolds, Inc.*, 3 BLUE SKY L. REP. (CCH) ¶ 71,812 (D.D.C. 1983), the defendant broker-dealer contended that the anti-waiver provision of the District of Columbia blue sky law, D.C. CODE ANN. § 2-2613(g) (1966), was preempted by the Federal Arbitration Act, 9 U.S.C. § 3 (1976). The court rejected this argument on the ground that both were acts of Congress and, in view of Congressional intent to protect investors, it could not be implied that Congress did not intend for the anti-waiver provision to be enforced as written. 3 BLUE SKY L. REP. (CCH) ¶ 71,812.

A similar anti-waiver provision in the Wisconsin blue sky law, however, failed to withstand the same supremacy clause attack solely because it was enacted by a state legislature. *Kroog v. Mait*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,418 (D. Wis. 1983). Despite the Supreme Court's holding in *Wilko v. Swann*, 346 U.S. 427 (1953), that the anti-waiver provisions in the federal securities acts were not subject to the Federal Arbitration Act, the court in *Kroog* refused to extend the exception to state anti-waiver provisions. *Id.* It held that a "lateral balance of diametrically opposed federal policies . . . would [not] be applied vertically to restrict the Arbitration Act's impact on conflicting state procedure." *Id.*

If the Court in *Kroog* had been made aware of the *Levin* decision, it is unlikely that they could have reached the same conclusion. Whether an anti-waiver provision is part of the federal securities acts or a state blue sky law, Congressional intent to protect investors should not be undermined solely because that intent is reiterated in a state blue sky law.

Recently, the SEC adopted rule 15c2-2, which prohibits broker-dealers from including predispute arbitration clauses in their customer agreements. 17 C.F.R. § 240.15c2-2 (1984). The rule codified the SEC's "longstanding view that such clauses are inconsistent with the deceptive practice prohibitions of sections 10(b) and 15(c) of the Securities Exchange Act of 1934." Securities Exchange Act Release No. 20397 (November 18, 1983), [Current] FED. SEC. L. REP. (CCH) ¶ 83,452.

<sup>230</sup> Pub. L. No. 96-477, 94 Stat. 2275 (1980).

<sup>231</sup> *Small Business Investment Incentive Act: Hearings on H.R. 3991 Before the Subcommittee on Consumer Protection and Finance of the Committee on Interstate and Foreign Commerce*, 96th Cong., 1st Sess. (1979).

<sup>232</sup> *Id.* at 12. Other factors identified by Congress as contributing to the difficulty experienced by small business included general economic conditions, existing tax structure, and capital gains tax. *Id.*

<sup>233</sup> H.R. REP. NO. 1341, 96th Cong., 2d Sess. 20 (1980).

liberalize its exemptive scheme,<sup>234</sup> and, importantly, to impose a mandate on the SEC to cooperate more fully with the states in the regulation of securities matters.<sup>235</sup> This mandate, set forth in section 19(c) of the 1933 Act,<sup>236</sup> is premised on a declaration of policy requiring greater federal and state cooperation and maximizing the effectiveness and uniformity of regulatory standards, while minimizing interference and reducing regulatory costs incident to capital formation.<sup>237</sup> The statute specifically requires cooperation between the SEC and any association of state securities officials<sup>238</sup> in sharing information regarding state registration or exemptions of securities, developing uniform forms and procedures, and developing a uniform small issuer exemption.<sup>239</sup> Congressional deference to the regulatory role of the states and the dual system of securities regulation also was evidenced by language in the Act which provides the SEC with authority to adopt any uniform small issuer exemption "which can be agreed upon among several states or between the states and the federal government."<sup>240</sup> Congress' "last word" on the dual system of securities regulation was even more specific than the savings clauses originally enacted: "Nothing in this subchapter shall be construed as authorizing preemption of state law."<sup>241</sup> The full benefits of the increased communication among the SEC and the states, as demanded by Section 19(c), have not yet been realized. It is clear, however, from the results thus far that major improvements in the dual system of securities regulation have been accomplished through a better coordinated regulatory scheme.<sup>242</sup>

<sup>234</sup> The Small Business Investment Incentive Act of 1980 amended § 3(b) of the 1933 Act, 15 U.S.C. § 77(c)(b) (Supp. 1981), to increase the maximum aggregate offering amount thereunder from \$2,000,000 to \$5,000,000. It also amended the 1933 Act to add § 4(6), 15 U.S.C. § 77(d)(6) (Supp. 1981), a registration exemption for offers or sales of securities in the aggregate amount of \$5,000,000 or less if made solely to accredited investors. The statute added a definition of the term, "accredited investor," at § 2(15) of the 1933 Act, 15 U.S.C. § 77b(15) (Supp. 1981).

<sup>235</sup> 15 U.S.C. § 77s(c) (Supp. 1981).

<sup>236</sup> *Id.*

<sup>237</sup> *Id.* at §§ 77s(c)(2)(A)-(D).

<sup>238</sup> *Id.* at §§ 77s(c)(1), (3).

<sup>239</sup> *Id.* at §§ 77s(c)(3)(A)-(C).

<sup>240</sup> *Id.* at § 77s(c)(3)(C).

<sup>241</sup> *Id.*

<sup>242</sup> The association of state securities officials with which the SEC has worked pursuant to the mandate of § 19(c) is the North American Securities Administrators Association, Inc. (NASAA), the oldest and largest association of state regulators. Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements*, 1976 WIS. L. REV. 79, 85. It is a voluntary organization whose membership includes the securities regulatory agencies in all 50 states, Puerto Rico, Mexico and 13 Canadian provinces. *Id.* Since passage of the Small Business Investment Incentive Act of 1980, the SEC coordinated with NASAA both the proposal and adoption of Regulation D, 17 C.F.R. §§ 230.501-506. See Securities Act Release No. 6389 (March 8, 1982), [1981-82 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,106. Regulation D, a series of rules providing registration exemptions for certain limited offerings, was intended to provide a basis for a federal-state uniform limited offering exemption. See generally Warren, *A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933*, 33 AM. U.L. REV. 355 (1984). The SEC and NASAA have continued their efforts to secure approval by the states of the Uniform Limited Offering Exemption (ULOEE) that will coordinate with Regulation D, the final version of which was approved by NASAA on September 21, 1983. 1 BLUE SKY L. REP. (CCH) ¶ 5294. NASAA and the National Association of Securities Dealers, Inc. (NASD), with the support of the SEC, have developed a centralized registration system (CRD) for securities agents and broker-dealers, with a resulting cost savings to the securities industry estimated at \$20 to \$40 million annually. See 1 BLUE SKY L. REP. (CCH) ¶¶ 5131-5134 and Securities Act Release No. 6474 (July 22, 1983), [Current] FED. SEC. L. REP. (CCH) ¶ 83,403. The SEC and NASAA have announced plans to coordinate their efforts to establish a uniform registration exemption, to expand the use of CRD and to cooperate in the issuance of rules and interpretations. See 15

## III. EXECUTIVE RECOGNITION OF STATE SECURITIES REGULATION

The dual system of securities regulation has remained stable despite the changes in economic regulatory policies which have occurred in the transition of successive Presidents. The regulatory policies proposed and implemented by the President, however, do have a profound effect on the regulatory balance between state and federal schemes which address similar areas of concern.<sup>243</sup> When the President adopts a deregulatory approach to business regulation at the federal level, any resulting gaps in regulatory protection must be filled, if at all, by the states. In recent years, a succession of Presidents has adopted deregulatory policies, calling for a retreat or total withdrawal of the federal government from various fields of business regulation.<sup>244</sup> The current Administration, in applying its deregulatory policy to federal securities regulation, has encouraged a correspondingly greater role for the states.<sup>245</sup> Its "regulatory reforms" result not only in a reduced risk of preemptive conflict,<sup>246</sup> but also underscore the role of state blue sky laws in assuring continuity in investor protection.

The Administration of President Reagan has furthered considerably a recent trend toward deregulation of business at the federal level of government.<sup>247</sup> Prior to commencement of his term, President Reagan appointed a transition team to review the operations of the SEC and to develop recommendations to effectuate his "deregulatory policy objectives."<sup>248</sup> The transition team recommended a significant and far-reaching diminution of the federal role in the dual regulatory system.<sup>249</sup> It urged a thirty percent

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SEC. REG. & L. REP. (BNA) No. 40, p. 1924 (October 14, 1983). Recently, they have issued a report regarding implementation of these plans, which sets forth their respective agreements. See 16 SEC. REG. & L. REP. (BNA) No. 17, p. 715 (April 27, 1984).

<sup>243</sup> See Final Report of the SEC Transition Team, SEC. REG. & L. REP. (BNA) No. 587, P. K-1, K-25 (January 21, 1981). "Emerging state securities activity coupled with federal deregulation makes helpful a full appreciation and understanding of the relationship of state securities laws to the federal Acts. The President should encourage the SEC to coordinate and cooperate with state securities regulatory authorities." *Id.* Cf. Hector, *Problems of the CAB and the Independent Regulatory Commissions*, 69 YALE L.J. 931, 954 (1960). This commentator, although not addressing the effect of regulatory policies on the balance between state-federal schemes, observed that:

Although Congress exercises a legislative oversight over the regulatory agencies, [it] . . . is often concerned with specific . . . problems and not with substantive policy. Because of its . . . diverse responsibilities, the machinery of Congress is not adapted to day-by-day detailed policy coordination. The only possible source of detailed coordination of economic regulatory policy is the Executive.

*Id.*

<sup>244</sup> See L. WEISS & M. KLAUSS, *CASE STUDIES IN REGULATION: REVOLUTION AND REFORM* 6-9 (1981). The Nixon, Ford and Carter Administrations took active roles in the deregulation of the airline, telecommunications, trucking, and oil and gas industries, among others. *Id.* See also Nerenberg, *Regulatory Reform in a Nutshell*, 62 A.B.A.J. 121 (1976).

<sup>245</sup> See Final Report of the SEC Transition Team, SEC. REG. & L. REP. (BNA) No. 587, p. K-1, K-25 (January 21, 1981).

<sup>246</sup> Although "[f]ederal regulations have no less preemptive effect than federal statutes," *Fidelity Federal Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. 141, 153 (1982), their repeal or dilution as a result of deregulation reduces the risk of conflict with similar state regulations. In other words, a federal scheme which has been weakened significantly through modified provisions and reduced appropriations is less likely to be "so pervasive as to make reasonable the inference that Congress left no room to supplement it." *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947).

<sup>247</sup> See *infra* note 261.

<sup>248</sup> Final Report of the SEC Transition Team, SEC. REG. & L. REP. (BNA) No. 587, p. K-1 (January 21, 1981) [hereinafter cited as SEC Transition Team Report].

<sup>249</sup> *Id.*



reduction in the SEC's budget and staff over a three year period.<sup>250</sup> Such a reduction would have a devastating impact on the three major operating divisions of the SEC. The transition team recommended that the SEC Division of Market Regulation, then with 130 employees, be converted into merely a "think tank," with fifty employees, devoted to "regulatory reforms which might deregulate the securities industry."<sup>251</sup> The team further proposed that the SEC Enforcement Division be decentralized with a staff reduction of its Washington office from 200 to 50 employees.<sup>252</sup> In addition, the Enforcement Division was to limit its focus to "major cases" and to eliminate its frequent use of consent injunctions and public disclosure of investigations.<sup>253</sup> Similarly, the transition team recommended that the Division of Corporation Finance limit its role to a five percent "spot-check" of periodic filings and proxy statements, with only a "sampling" review of initial registration statements.<sup>254</sup> Instead of providing review of required disclosures in documents filed with the SEC, its function would be limited to that of a central public repository of filings.<sup>255</sup> The transition team expressly disclaimed the notion that its deregulatory efforts were based on a "make-do-with-less" philosophy,<sup>256</sup> and emphasized that the proposed metamorphosis of the SEC could be accomplished without harm to the agency's statutory mandate.<sup>257</sup> Nevertheless, the report the transition team developed on behalf of the Reagan Administration indicates a policy of "make-do-with-more" state regulation, a policy totally inconsistent with the position that state securities regulation should be preempted.

The Reagan Administration policy of federal deregulation, as enunciated by the transition team in its report, clearly was not intended to establish a vacuum in the field of securities regulation. A significant part of the report was devoted to the relationship between the SEC and state securities regulators, concluding that "enhancement of the state authority is a desirable goal and could permit some phasing down of the federal role at some future time."<sup>258</sup> The report not only urged further coordination and cooperation at the two levels, but also urged that state administrators be appointed to the SEC, as well as others with an appreciation of the federal-state relationship in the field, because of the importance of "emerging state securities activities coupled with federal deregulation."<sup>259</sup> The report concluded that policy statements regarding federal deregulation generally should emphasize the responsibilities of state authority in those regulatory areas affected.<sup>260</sup> Consistently emphasizing a corresponding expansion of state regulation, the transition team developed, in effect, an *equation of continuity*. In other words, the recommended reduction of power vested in the SEC would increase the states' power to regulate in the securities field.

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<sup>250</sup> *Id.* at K-1.

<sup>251</sup> *Id.* at K-3 to K-4.

<sup>252</sup> *Id.* at K-7 to K-8.

<sup>253</sup> *Id.* at K-7 to K-9. The report noted that the SEC had been criticized for settlement of major cases by permitting defendants deserving harsher penalties to "consent" to permanent injunctions against unlawful conduct. *Id.* at K-8.

<sup>254</sup> *Id.* at K-10 to K-12.

<sup>255</sup> *Id.* at K-11.

<sup>256</sup> *Id.* at K-18.

<sup>257</sup> *Id.* at K-1.

<sup>258</sup> *Id.* at K-25.

<sup>259</sup> *Id.*

<sup>260</sup> *Id.* at K-27.

The Reagan Administration has pursued vigorously its efforts to implement the deregulatory policies announced in its transition team report.<sup>261</sup> Although the budgetary reductions recommended have not been achieved, it is instructive to note the results thus far. The report indicated that the authorized and approved budget estimates for fiscal years 1981, 1982, and 1983 were, respectively, \$85,500,000, \$98,000,000 and \$108,000,000, and recommended corresponding reductions to \$71,000,000, \$60,000,000, and \$53,000,000.<sup>262</sup> The actual appropriations for the SEC during those fiscal years have been \$80,200,000 for 1981,<sup>263</sup> \$83,300,000 for 1982,<sup>264</sup> and \$88,000,000 for 1983.<sup>265</sup> The SEC's current Chairman has supported fully these budgetary reductions, causing one congressman to remark that the SEC is now undergoing "deregulation by attrition."<sup>266</sup> Deregulation at the federal level obviously has placed an increased regulatory burden on the states at a time when critics of their role in the dual system are holding "preemption" over their heads.<sup>267</sup>

#### IV. A RESPONSE TO THE CRITICISM OF STATE SECURITIES REGULATION

State blue sky laws have been criticized most often as needlessly duplicative of the federal scheme and unduly burdensome because they lack uniformity.<sup>268</sup> Although judicial precedent, congressional action and executive implementation frequently are ignored when assaults are leveled at state regulation, these factors are critical to an understanding of the federal-state relationship in the regulation of securities. The background developed by the preceding sections of this article provides the essential context for this response to the major criticisms of state securities regulation.

##### A. Duplication

Central to the issue of duplication is the question why there should be one set of securities laws at the federal level and another set in each of the states. This basic issue

<sup>261</sup> See Hudson, *The Deregulator*, Wall St. J., Jan. 12, 1984 at 1, col. 6. As a result of "the most sweeping deregulation in the agency's fifty years," the SEC has been criticized for "a lowering of government safeguards against stock-market fraud." *Id.* In addition, one study of recent SEC enforcement activities supports charges that the SEC has become "soft on big business." *Id.* See also Lublin & Conte, *The Rule Slashers*, Wall St. J., Dec. 7, 1983 at 1, col. 6; Dec. 9, 1983, at 1, col. 6; Dec. 14, 1983 at 1, col. 6.

<sup>262</sup> SEC Transition Team Report, *supra* note 248, at K-2.

<sup>263</sup> Act of October 1, 1980, Pub. L. No. 96-369, 94 Stat. 1351 (1980) (Joint Resolution continuing appropriation by reference to lesser amount in H.R. REP. NO. 1472, 96th Cong., 2d Sess. 16 (1980)); Act of June 5, 1981, Pub. L. No. 97-12, 95 Stat. 14, 94 (1981) (supplemental appropriation).

<sup>264</sup> Act of December 15, 1981, Pub. L. No. 97-92, 95 Stat. 1183, 1191 (1981); Act of September 10, 1982, Pub. L. No. 97-257, 96 Stat. 818, 821 (1982) (supplemental appropriation).

<sup>265</sup> Act of October 2, 1982, Pub. L. No. 97-276, 96 Stat. 1186 (1982) (Joint Resolution continuing appropriation by reference to lesser amount in S. REP. NO. 584, 97th Cong., 2d Sess. 29 (1982)); Act of July 29, 1983, Pub. L. No. 98-63, 97 Stat. 301, 361 (1983) (supplemental appropriation).

<sup>266</sup> Noble, *Shad's SEC Impact: Opinions Are Mixed*, N.Y. Times, Nov. 7, 1983, at 33, col. 3 (quoting Rep. Timothy Wirth). Representative Timothy Wirth, Chairman of the House Energy and Commerce Telecommunications, Consumer Protection and Finance Subcommittee which oversees the SEC, has been a frequent critic of the SEC's deregulatory policies. *Id.* In his view, the SEC should focus on the protection of investors and not the deregulation of securities markets. Hudson, *The Deregulator*, Wall St. J., Jan. 12, 1984 at 1, col. 6. Wirth has criticized SEC Chairman John Shad for his "lack of commitment to fight for sufficient funding for the [SEC] to carry out its statutory mission" and for creating a "public perception" that the SEC has become lax on enforcement. 15 SEC. REG. & L. REP. (BNA) No. 11, p. 557 (March 18, 1983).

<sup>267</sup> See *supra* notes 28-37 and accompanying text.

<sup>268</sup> See Letter from the Securities Industry Association, *supra* note 28.

raises most of the other major criticisms, including those directed at merit regulation, paternalism, undue complexity and, finally, the absence of uniformity. Any response to the duplication issue must first consider the interstitial nature of the action taken by Congress when it enacted the federal securities laws.<sup>269</sup> Congress chose not to preempt the field, but simply to fill the regulatory gap created by due process limitations on a state's ability to regulate interstate securities transactions effectively.<sup>270</sup> Accordingly, the federal scheme was limited purposefully in both *scope* and *philosophy*. In superimposing federal regulation on the laws of the various states, Congress not only preserved state regulatory power,<sup>271</sup> but also, as previously discussed, exempted numerous types of securities and securities transactions from registration at the federal level.<sup>272</sup> The states have been free to choose to what extent these federally exempted offerings should be regulated, and their decisions have varied depending on their respective public policies.<sup>273</sup> Experience indicates, however, that offerings exempted from advance SEC scrutiny are more likely to be fraudulent or highly speculative than offerings subject to registration.<sup>274</sup> Given the large number and the tremendous volume of securities exempted from federal registration, investor protection cannot be maintained without review of these offerings by authorities at the state level.<sup>275</sup> Consequently, substantial areas of regulation exist where there is little, if any, duplication.

In addition to imposing these significant limitations on the *scope* of coverage under the 1933 Act, Congress restricted its scheme by adopting a regulatory *philosophy* different from that underlying most blue sky laws.<sup>276</sup> Congress chose to regulate securities distributions through disclosure requirements and not through merit review.<sup>277</sup> Its approach may have been based on its fear of granting that kind of power to a federal agency or on its belief that the states, which traditionally had imposed merit review, possessed a greater

<sup>269</sup> See *supra* notes 165-69 and accompanying text.

<sup>270</sup> The due process limitations on the states' ability to regulate interstate transactions stemmed from the use of instrumentalities of interstate commerce to effect transactions within the state. See *supra* notes 12 and 13. For a general discussion of the issues concerning jurisdiction, extradition and the constitutionality of state attempts to regulate transactions instigated by issuers and promoters operating outside of the state's borders, see L. LOSS & E. COWETT, *BLUE SKY LAW* 210-224 (1958).

<sup>271</sup> 15 U.S.C. § 77r (1976).

<sup>272</sup> See *supra* notes 192-98 and accompanying text.

<sup>273</sup> See *infra* note 288.

<sup>274</sup> Interview with Thomas L. Krebs, former Director, Alabama Securities Commission; former President, NASAA (November 21, 1983).

<sup>275</sup> Wright, *Correlation of State Blue Sky Laws and The Federal Securities Acts*, 26 *CORNELL L.Q.* 258 (1941). "[T]here arises here a group of securities of which State Commissions must continue to be vigilant if adequate investor protection is to be rendered in the interstate distributions of such issues." *Id.* at 271.

See also Cowett, *Federal-State Relationships in Securities Regulation*, 28 *GEO. WASH. L. REV.* 287 (1959). Cowett agrees that the various exemptions from federal registration "are apt to require registration at the state level." *Id.* at 293.

This is as it should be — for the fact that a particular security or transaction is outside the scope of the federal legislation is no guarantee that some measure of protection for the residents of the respective states is not in order. In fact, perhaps the greatest measure of protection is warranted in the case of such securities or transactions. *Id.* at 293 n.36.

<sup>276</sup> See *supra* note 180 and accompanying text.

<sup>277</sup> See *Securities Act Hearings*, *supra* note 2, at 52-53 (statement of Huston Thompson, Attorney at Law, Washington, D.C.).

ability to develop and apply standards of fairness to securities offerings.<sup>278</sup> Whether sufficient investor protection can be achieved by disclosure alone, or in conjunction with qualitative review, must be determined by the states based on local policies and needs.<sup>279</sup>

Although merit regulation has been criticized for various reasons,<sup>280</sup> state legislatures and securities administrators have recognized the wisdom of this regulatory philosophy.<sup>281</sup> Its beneficial results have been substantiated by empirical evidence.<sup>282</sup> Many would condemn the imposition of fairness standards as unduly paternalistic.<sup>283</sup> Investors, however, like other consumers, not only demand the benefits of state paternalism, but actually need legislative protection from fraud and other inequitable practices.<sup>284</sup> The needs of these constituents must be addressed by the legislators they elect. When consumers have demanded protection, whether in connection with their purchase of securities, real estate, insurance, or household goods, state legislators have responded with laws designed to

<sup>278</sup> Makens, *A State Regulatory Perspective of the Report of the Advisory Committee on Corporate Disclosure to the SEC*, 26 U.C.L.A. L. REV. 147, 150 (1978).

<sup>279</sup> See, e.g., 15 SEC. REG. & L. REP. (BNA) No. 39, at 1882 (October 7, 1983) (summary of debate by competing interests on issue of merit regulation in Iowa).

<sup>280</sup> The various criticisms leveled at merit regulation include: (1) it discriminates against new business; (2) it affects the offering price of securities; (3) it allows state administrators too much discretion; (4) it increases the cost of public offerings; (5) it limits the number of securities issued to promoters, discouraging their use of public financing; (6) it doesn't prevent fraudulent offerings; and (7) it lulls investors into a false sense of security. See Tyler, *More About Blue Sky*, 39 WASH. & LEE L. REV. 899, 904-10 (1982).

<sup>281</sup> It may be significant that every writer who was formerly employed by a state securities commission has concluded that merit regulation provides substantial protection to investors and the securities markets in their states. See Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements?*, 1976 WIS. L. REV. 79 (former Wisconsin Commissioner of Securities); Hueni, *Application of Merit Requirements in State Securities Regulation*, 15 WAYNE L. REV. 1417 (1969) (former Director of Securities Bureau, Dept. of Commerce, State of Michigan); Makens, *A State Regulatory Perspective of the Report of the Advisory Committee on Corporate Disclosure to the SEC*, 26 U.C.L.A. L. REV. 147 (1978) (former Director, Michigan Corporation & Securities Bureau); Tyler, *More About Blue Sky*, 39 WASH. & LEE L. REV. 899 (1982) (former Minnesota Assistant Commissioner of Securities).

<sup>282</sup> See Goodkind and Hueni, *supra* note 281. Hueni has stated:

Our files in Michigan and undoubtedly the files in most other states, are replete with cases where securities applications were withdrawn or never filed because of objections involving soundness or fairness and where the issuer subsequently met financial disaster. Moreover, in countless instances, the issuer had conformed to merit requirements imposed, resulting in benefits to the investor that might otherwise have been denied him. On the other hand, there are also instances of offerings not made in certain states because of merit requirements, which nevertheless may have proved very rewarding to investors. While I know of no sure way of measuring the effectiveness of securities regulation, I am convinced that on balance, merit tests, reasonably and consistently applied, are definitely worth imposing. They afford much added investor protection and inspire greater investor confidence in the integrity of the securities market without unduly impeding the marketing of securities generally.

15 WAYNE L. REV. at 1445.

See also Walker & Hadaway, "Merit Standards Revisited: An Empirical Analysis of the Efficacy of Texas Merit Standards," 7 J. CORP. L. 651 (1982). The authors concluded from empirical study that "there is sufficient and significant evidence to indicate that the fair, just, and equitable standards as applied by the State Securities Board of Texas do indeed equiponderate the position of new and existing investors." *Id.* at 681.

<sup>283</sup> See, e.g., Smith, *The Relation of Federal and State Securities Laws*, 4 LAW & CONTEMP. PROB. 241, 242 (1937).

<sup>284</sup> See *Securities Act Hearings*, *supra* note 2, at 92 (Dept. of Commerce Study of the Economic and Legal Aspects of the Proposed Federal Securities Act).

safeguard their interests.<sup>285</sup> Indeed, the blue sky laws were among the earliest consumer protection statutes.<sup>286</sup> These laws, like most legislative decisions, generally take the form of a compromise between the competing interests of industry representatives and consumers. When such laws are administered arbitrarily or require reform, businessmen, particularly those engaged in the issue or sale of securities, have not been hesitant in their efforts to effect legislative revisions.<sup>287</sup> In the securities field, these compromises have involved a balancing of the legitimate interests of business in the facilitation of capital formation against the interests of investors requiring protection. Many states now recognize that certain classes of investors do not require pre-issuance protection, and, accordingly, permit them to conduct their own qualitative review.<sup>288</sup> The accommodation of these competing interests at the local level is the genius of pluralism.

In addition to differences in regulatory scope and philosophy, state regulation performs vital functions which have not been and probably cannot be accomplished by a federal agency. For example, the state securities commission serves as the complaint bureau for its resident investors — persons who simply could not achieve satisfaction from a telephone call, or series of calls, to a switchboard in Washington or at one of the SEC's scattered regional offices.<sup>289</sup> The state securities commission is not only more accessible, but also more visible to local investors as the agency charged with their protection.<sup>290</sup> It is able to respond to local concerns more rapidly and effectively than a centralized Washington bureaucracy. Probably the most plausible explanation for this accessibility is:

The state regulators have a higher regard for the small investor, perhaps because he is a voter who reaches local legislators and administrators more easily than congressmen or federal commissioners, or perhaps because the localized nature of the activity makes it easier for the state administrator to

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As indicated by the common law, from time immemorial, persons with funds to invest were considered capable of determining the soundness of business ventures but recent developments in the field of business have been so rapid and so gigantic that even persons trained in one field are incapable of determining values in a related business. Even trained accountants are unable to determine, without detailed investigation, the intrinsic value of securities of corporations whose property and activities extend into many states and foreign countries.

*Id.*

<sup>285</sup> See, e.g., UNIF. SECURITIES ACT, 7A U.L.A. 567 (1978); UNIF. LAND SALES PRACTICES ACT, 7A U.L.A. 372 (1978); and UNIF. CONSUMER CREDIT CODE, 7 U.L.A. 233 (1978).

<sup>286</sup> See Long, *State Securities Regulation — An Overview*, 32 OKLA. L. REV. 541, 543 (1979) (state securities acts were the first consumer protection statutes). See also Letter from Securities Industry Association, *supra* note 28.

<sup>287</sup> See *supra* notes 20-31 and accompanying text.

<sup>288</sup> The Uniform Limited Offering Exemption (ULOE), *supra* note 242, adopted by NASAA, has been enacted or promulgated with modifications by a majority of the states. See Goodkind, *Report of the Subcommittee on Liaison with Securities Administrators and NASD*, State Regulation of Securities Committee, A.B.A. Section on Corporation, Banking and Business Law (August 2, 1983). The ULOE incorporated by reference a substantial portion of the SEC's Regulation D, 17 C.F.R. §§ 230.501-506 (1983), including its definition of "accredited investor," a term applied to categories of investors having certain qualifications. *Id.* at § 230.501(a). These investors, because of their sophistication or wealth, have been deemed not to require as much regulatory protection as investors generally. Securities Act Release No. 6180 (January 17, 1980), [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,246.

<sup>289</sup> Address by Michael Unger, 66th Annual Fall Conference of NASAA (September 21, 1983).

<sup>290</sup> *Id.*

personalize the adverse consequences of an improper securities sale. Whatever the reason, state regulators tend to be as conscious of the needs of small investors as the federal system seems designed for sophisticated buyers. This may be an appropriate balance.<sup>291</sup>

A responsive agency is essential to investor confidence, and consequently, investor participation in our capital markets. Access to a protective authority is especially critical to the small investor, "the plateosaurus of the securities industry,"<sup>292</sup> whose protection rests largely with state securities regulators.<sup>293</sup>

Furthermore, each state securities commission serves as an information bank for investors, businessmen and lawyers. The state administrator compiles information from numerous sources, including filings made by issuers and broker-dealers, complaints from investors, investigative reports and constant communications with other state and federal regulatory agencies.<sup>294</sup> As a result, responses can be made expeditiously to inquiries regarding the "track records" of issuers, promoters, broker-dealers and salesmen. Securities lawyers, in order to protect their clients and themselves, frequently must rely on the wealth of information accumulated by state securities commissions in order to conduct "due diligence" investigations.<sup>295</sup> Because many fraudulent schemes are directed at one particular state or region of the country,<sup>296</sup> state administrators are able not only to monitor these schemes more closely than their federal counterpart, but also are able to warn potential investors by publicizing the fraudulent activity being perpetrated.<sup>297</sup> By providing information that sometimes goes far beyond the prolix disclosures of prospectuses and offering memoranda, state securities commissions make a significant contribution to an informed marketplace.

The differences in regulatory scope, philosophy and function between the state and federal approaches demonstrate the minimal nature of the duplication at issue. To the extent duplication exists, it is more accurately described as an *overlap* — regulation that fills in the cracks where regulatory protection would not otherwise be provided.<sup>298</sup> Con-

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<sup>291</sup> Makens, *A State Regulatory Perspective of the Report of the Advisory Committee on Corporate Disclosure to the SEC*, 26 U.C.L.A. L. REV. 147, 155 (1978).

<sup>292</sup> *Id.*

<sup>293</sup> *Id.*

<sup>294</sup> Section 413 of the Uniform Securities Act requires the state administrator to maintain and make available to the public a register of all denial, suspension and revocation orders. 7A U.L.A. 689 (1978).

See also Empirical Research Project, *Blue Sky Laws and State Takeover Statutes: New Importance for an Old Battleground*, 7 J. CORP. L. 689, 797 (1982) (violations are detected through investor complaints and communications from other regulatory agencies).

<sup>295</sup> For an explanation of due diligence, see Folk, *Civil Liabilities Under the Federal Securities Laws: The Bar-Chris Case*, 55 VA. L. REV. 1 (1969). For the historical basis of the defense, see H.R. REP. NO. 85, 73d Cong., 1st Sess. 9 (1933).

<sup>296</sup> See Final Report of SEC Transition Team, SEC. REG. & L. REP. (BNA) No. 587, p. K-25, K-26 (January 21, 1981).

<sup>297</sup> Telephone interview with R. Frank Ussery, Director, Alabama Securities Commission (April 24, 1984). See also UNIF. SECURITIES ACT § 407(a), 7A U.L.A. 660 (1978) (administrator has discretion to publish information concerning any violation of state securities laws).

<sup>298</sup> The Supreme Court has recognized that overlap exists within the federal scheme itself. See SEC v. National Sec., Inc., 393 U.S. 453, 468 (1969) ("the fact that there may well be some overlap is neither unusual nor unfortunate"). See also *Herman & MacLean v. Huddleston*, — U.S. —, 103 S. Ct. 683 (1983) (different remedies under federal securities laws are available for same wrongful conduct).

gress preserved this advantage when it added savings clauses to the federal securities laws. The need for overlap in a dual system of securities regulation is illustrated continuously by the shifting trends of regulatory intensity at both levels due to the dynamics of federalism and the evolving regulatory atmosphere. In particular, the new federal role recommended in the report prepared by President Reagan's transition team<sup>299</sup> illustrates well the need for regulatory overlap. It demands it. Without the flexibility this overlap provides, a substantial degree of investor protection would be sacrificed. In other words, regulatory overlap prevents the very loss of investor confidence in securities markets which triggered federal intervention in the field fifty years ago.<sup>300</sup>

The need for regulatory overlap is clear given the available resources. The SEC's resources, as observed previously, have been reduced significantly in recent years due to inflationary effects on its annual appropriations from Congress.<sup>301</sup> In fact, the SEC will employ a smaller staff in 1984 than it did ten years ago.<sup>302</sup> Moreover, it is highly unlikely that Congress would ever be willing to appropriate sufficient funds to the SEC to fulfill the regulatory role traditionally performed by the states. One SEC commissioner has stated that preemption of state blue sky laws, without a corresponding increase in federal resources, "would work to the detriment of the investor."<sup>303</sup> The SEC, even under the dual system, "does not have the resources to assure proper regulation of all the participants in the burgeoning securities market."<sup>304</sup> Although state securities commissions are also funded insufficiently to do their respective jobs, they frequently are able to call on numerous state investigative and enforcement personnel for assistance.<sup>305</sup> In addition, state resources have increased due to cooperation between the states through multistate enforcement efforts.<sup>306</sup> One former state regulator has stated that "the states, on a

<sup>299</sup> *Id.* See *supra* notes 250-62 and accompanying text.

<sup>300</sup> H.R. REP. NO. 85, 73d Cong., 1st Sess. 2-3 (1933). See generally GALBRAITH, *THE GREAT CRASH* (3d ed. 1972) and SELIGMAN, *THE TRANSFORMATION OF WALL STREET* (1982).

<sup>301</sup> See *supra* notes 263-65 and accompanying text.

<sup>302</sup> Panel presentation by SEC Commissioner John R. Evans, *Federal Preemption of State Blue Sky Laws*, 66th Annual Fall Conference of NASAA (September 21, 1983).

<sup>303</sup> *Id.*

<sup>304</sup> *Id.* The Commodity Futures Trading Commission (CFTC), which shares certain enforcement responsibilities with the SEC in the field of commodities regulation, 7 U.S.C. § 6m(2) (1978), has recognized the critical need for pooling its limited resources with those of the states. 16 SEC. REG. & L. REP. (BNA) No. 6, p. 243 (February 10, 1984). The CFTC recently created a state-federal liaison unit to combat off-exchange commodities fraud. *Id.* The CFTC's Enforcement Director, Dennis Klejna, stated that "only through a coordinated and cooperative use of scarce state [and] federal . . . resources can we hope to put the illegal operators not only out of business, but also in jail." *Id.* See also 7 U.S.C. § 12(g) (1983) (CFTC required to provide information to state agencies); and 7 U.S.C. § 13a-2 (1983) (state agencies may enforce federal and state laws applicable to off-exchange commodities fraud).

<sup>305</sup> See *supra* note 296. See also Empirical Research Project, *Blue Sky Laws and State Takeover Statutes: New Importance for an Old Battleground*, 7 J. CORP. L. 689, 797 (1982) (because of resource limitations, states pool their resources and share regulatory experiences).

<sup>306</sup> *Id.* One classic example of the multistate enforcement activities of state regulators is the Leviticus Project, in which fourteen regulatory agencies in the states of Alabama, Georgia, Kentucky, Indiana, Pennsylvania and New York have pooled resources to investigate and prosecute securities fraud and other crimes affecting the Appalachian coal industry. See Final Report of the SEC Transition Team, SEC. REG. & L. REP. (BNA) No. 587, p. K-1, K-25 — K-26 (January 21, 1981). The SEC has cooperated with these state agencies through the exchange of information and enforcement assistance in non-participating states. Interview with Thomas L. Krebs, former Director, Alabama Securities Commission; former President, NASAA (November 21, 1983). The SEC also has served as liaison for the states to other federal and international regulatory agencies. *Id.*

combined national basis, are involved in significantly more enforcement activities than the [SEC] itself."<sup>307</sup> Clearly, the combined resources of state and federal regulatory agencies serve to assure that their mutual goal of investor protection is not compromised. The regulatory overlap, instead of creating two identical systems, has been conducive to the preservation and development of different, but necessary, functions performed at each level.

### B. Uniformity

The critics of state regulation claim that the blue sky laws, because they vary from state to state, place an undue burden on a securities industry which has become "inherently interstate in scope."<sup>308</sup> In a federalist system, however, it is common for the states, under their police power, to regulate an infinite variety of matters in non-uniform ways.<sup>309</sup> State regulatory schemes differ significantly in such diverse business fields as insurance,<sup>310</sup> real estate<sup>311</sup> and public utilities.<sup>312</sup> These and other state regulated areas of commerce are conducted, like securities, through both intrastate and interstate transactions.<sup>313</sup> Nevertheless, the absence of uniformity in securities regulation has become the battle cry of every critic of state blue sky laws.<sup>314</sup>

Uniformity in securities regulation is an issue related closely to the duplication issue. It posits two questions. The first is whether each of the states should have different sets of regulations based on differing local needs. The second is whether the states should have sets of laws, which, collectively, are not identical to those portions of the federal regula-

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<sup>307</sup> Makens, *supra* note 291, at 148. See generally Long, *A Guide to the Investigative and Enforcement Provisions of the Uniform Securities Act*, 37 WASH. L. REV. 739 (1980) (enforcement mechanisms include administrative sanctions, civil injunctions and criminal prosecutions).

<sup>308</sup> Bateman, *State Securities Regulation: An Unresolved Dilemma and a Suggestion for the Federal Securities Code*, 27 S.W.L.J. 759, 783 (1973).

<sup>309</sup> Although the object of the National Conference of Commissioners on Uniform State Laws is "to promote uniformity in state laws on all subjects where uniformity is deemed desirable and practicable," the state responses to their legislative proposals have ranged from outright rejection to adoption with significant revisions and supplementation. 7A U.L.A. IV-V (1978). For example, the Uniform Residential Landlord and Tenant Act was proposed in 1972 and subsequently adopted by twelve states. *Id.* at 499. However, two of these states, Nebraska and Oregon, added numerous substantive provisions and the other ten states enacted the legislation with "numerous variations, omissions and additional matter." *Id.* at 499-502. Another example is the Uniform Insurers Liquidation Act, which was proposed in 1939. 13 U.L.A. 429 (1980). It has been adopted by thirty-two states, but with substantial modifications which vary widely from state to state. 13 U.L.A. 429 (1980 & Supp. 1984).

<sup>310</sup> See generally Best, *Statutes and Regulations Controlling Life and Health Insurance Claim Practices*, 29 DEF. L.J. 115 (1980); Lamel, *State Regulation of the Insurance Industry*, 1978 INS. L.J. 336.

<sup>311</sup> See, e.g., 1982 Legislation Affecting Real Property, 18 REAL PROP. PROB. & TR. J. 244 (1983) (Report of ABA Comm. on Significant Current Legislation, Real Prop. Div., Section of Real Prop., Prob. and Trust Law).

<sup>312</sup> See Levy, *Deregulation of Electric Power from a State Perspective*, 110 PUB. UTIL. FORTNIGHTLY, Sept. 16, 1982, at 30 (state public utility commissions were established to ensure that monopoly privileges are not abused and to allow utility companies a reasonable rate of return for providing quality service).

<sup>313</sup> See, e.g., *McGee v. Int'l Life Ins. Co.*, 355 U.S. 220 (1957) (California had lawful jurisdiction to adjudicate claims of its resident against an insurance company located in Texas).

<sup>314</sup> See, e.g., Smith, *The Relation of Federal and State Securities Laws*, 4 LAW & CONTEMP. PROB. 241 (1937). See also Letter from Securities Industry Ass'n. to SEC, *supra* note 28.



tory scheme which purport to regulate similar subject matter. Ironically, those who have complained about duplication also have complained about the lack of uniformity in securities regulation.<sup>315</sup> Taken to the extreme, if there is an absence of uniformity, there can be little duplication; if there is duplication, there must be uniformity. Perhaps the intent of some critics is to force complete uniformity, and, consequently, achieve pure duplication. Assuming that the benefits derived from localism can be ignored, congressional preemption of state blue sky laws could rest more comfortably on the premise that state securities regulation is unnecessary since it is purely duplicative of the federal scheme. Although from the critic's vantage this circular argument may appear productive, the benefits that investors derive from having a legislative choice at the state level cannot be ignored.

The desirability of *practicable* uniformity cannot be debated seriously. It is a goal that has had significant and continuing success since the establishment of the dual regulatory system. Among other benefits, uniformity reduces the complexities of compliance with various state laws and creates more flexibility through the application of interjurisdictional precedent to common terms and conditions utilized at the federal and state levels of regulation.<sup>316</sup> Efforts to encourage uniformity among the states were first initiated by the National Conference of Commissioners on Uniform State Laws and the American Bar Association (ABA), culminating with their approval in 1956 of the Uniform Sale of Securities Act.<sup>317</sup> After the federal securities laws were passed, it became apparent that further coordination between the states necessarily involved coordination with the federal regulatory scheme.<sup>318</sup> The result was the Uniform Securities Act,<sup>319</sup> the purpose of which was "to make uniform the laws of those states which enacted it and to coordinate the interpretation and administration of this Act with related federal regulations."<sup>320</sup> The Uniform Securities Act has been adopted with modifications by over two-thirds of the states and has served as a model in a number of other jurisdictions.<sup>321</sup> In addition, the North American Securities Administrators Association, Inc. (NASAA),<sup>322</sup> on its own initiative or in cooperation with the ABA and the National Association of Securities Dealers, Inc.,<sup>323</sup> has approved forms and policy guides for uniform use by the states in connection with the registration of securities issues, broker-dealers, and salesmen.<sup>324</sup> Since

<sup>315</sup> *Id.*

<sup>316</sup> *See, e.g.*, Letter from Securities Industry Ass'n. to SEC, *supra* note 28.

<sup>317</sup> *See* L. LOSS & E. COWETT, *BLUE SKY LAW* 230-31 (1958).

<sup>318</sup> *Id.*

<sup>319</sup> 7A U.L.A. 567 (1978 & Supp. 1984).

<sup>320</sup> UNIF. SECURITIES ACT § 415, 7A U.L.A. 695 (1978).

<sup>321</sup> *See* 1 BLUE SKY L. REP. (CCH) ¶ 5501.

<sup>322</sup> *See supra* note 242.

<sup>323</sup> The National Association of Securities Dealers, Inc. (NASD) is a self-regulatory organization engaged in the supervision of over-the-counter brokers and dealers in securities and is a registered securities association pursuant to § 15A of the 1934 Act, 15 U.S.C. § 780-3 (1976). For a discussion of the NASD and its role in securities regulation, see White, *National Association of Securities Dealers, Inc.*, 28 GEO. WASH. L. REV. 250 (1959).

<sup>324</sup> *See, e.g.*, ABA Uniform Application to Register Securities (Form U-1), 1 BLUE SKY L. REP. (CCH) ¶ 5103; ABA Uniform Consent to Service of Process (Form U-2), *Id.* at ¶ 5113; ABA Uniform Form of Corporate Resolution (Form U-2A), *Id.* at ¶ 5114; NASD Revised Forms U-4 and U-5 for registration and termination of securities agents, respectively, *Id.* at ¶ 5132; NASAA Statement of Policy on Publication or Distribution of Preliminary Prospectuses and Preliminary Summary Prospectuses, *Id.* at ¶ 5151; NASAA Statement of Policy for Registration of Oil and Gas Programs, *Id.* at ¶ 5221; NASAA Statement of Policy for Offerings of Church Bonds, *Id.* at ¶ 5251; NASAA Statement of Policy on Real Estate Investment Trusts, *Id.* at ¶ 5293; NASAA Statement of Policy on Variable

adoption of the Small Business Investment Incentive Act of 1980,<sup>325</sup> NASAA and the SEC have worked together to an unprecedented degree to promote a practicable uniformity consistent with investor protection.<sup>326</sup>

These cooperative advances toward greater coordination of the state and federal regulatory schemes have not been accomplished to effect uniformity for uniformity's sake. Instead, this progress has resulted from *voluntary* consultation among state administrators, the SEC, and industry representatives.<sup>327</sup> These and further reforms are based on a developing *consensus* which reflects the combined policy judgments of numerous state administrators and legislators. It is a consensus which makes the dual regulatory system workable in an increasingly complex industry. The development of this consensus in achieving a greater degree of uniformity among the states with the federal scheme has minimized the effects of "leveling up" or "leveling down" of the regulatory standards of one state to meet the different standards of another.<sup>328</sup> Workable uniformity has been achieved without frustrating the power of the individual states to make policy choices in the securities field.

Complete uniformity, to a limited extent, would reduce the complexities of dual regulation. The process of governance in any field, however, is necessarily a complex undertaking. Simplicity in governance always has been recognized as overly idealistic, for the simple answers to difficult questions are usually the wrong ones. Although the

Annuities Companies and Trusts, *Id.* at ¶ 5301; NASAA Statement of Policy on Cheap Stock, *Id.* at ¶ 5311; NASAA Statement of Policy on Preferred Stock and Debentures, *Id.* at ¶ 5321; NASAA Statement of Policy on Options and Warrants, *Id.* at ¶ 5331; NASAA Statement of Policy on Registration of Commodity Pool Programs, *Id.* at ¶ 5335; NASAA Statement of Policy on Dishonest or Unethical Business Practices, *Id.* at ¶ 5345; NASAA Guidelines on Registration of Publicly-Offered Cattle-Feeding Programs, *Id.* at ¶ 5351; NASAA Statement of Policy Regarding Real Estate Programs, *Id.* at ¶ 5352; and NASAA Statement of Policy for Equipment Programs, *Id.* at ¶ 5371; and NASAA Model Business Opportunity Sales Act, 16 SEC. REG. & L. REP. (BNA) No. 21, p. 934 (May 25, 1984). See also *supra* note 242.

<sup>325</sup> See *supra* notes 231-41.

<sup>326</sup> See *supra* note 242.

<sup>327</sup> Although section 19(c) of the 1939 Act, 15 U.S.C. § 77s(c), authorizes the SEC to cooperate with state regulators in promoting uniformity, it does not impose any mandatory requirements upon the states to accommodate the SEC by participating in cooperative efforts. The states, primarily through NASAA, have voluntarily given their strong support to a policy of cooperation between federal and state administrators in order "to improve the existing scheme of regulation." Securities Act Release No. 6474 (July 22, 1983), [Current] FED. SEC. L. REP. (CCH) ¶ 83,403. See also Bartell, *Federal-State Relations under the Federal Securities Code*, 32 VAND. L. REV. 457, 464-69 (1979) (history of federal-state cooperation in securities field).

<sup>328</sup> In coordinating the registration of any public offering of securities with the various states, lawyers for the issuer or underwriter must prepare the registration statement not only in accordance with the requirements of the 1933 Act, but also with the requirements of each state in which the offering is to be made. See Tyler, *More About Blue Sky*, 39 WASH. & LEE L. REV. 899, 923-25 (1982). These lawyers, who maintain familiarity with the applicable federal and state laws, do not prepare different registration statements for each jurisdiction where the offering is to be made, but prepare only one which meets the requirements imposed at both levels. *Id.* After the registration statement is filed with the SEC, but before it becomes effective, it is also filed with each of the states where the offering is to be made. *Id.* After comments are received from federal and state administrators, the terms of the offering may be modified and any necessary revisions made to the registration statement before its delivery to investors. *Id.* Consequently, there is *leveling up* to meet the requirements of the states with the more stringent standards, resulting in *de facto* uniformity. Cf. Brainin & Davis, *State Regulation of the Sale of Securities — Some Comments*, 14 BUS. LAW. 456, 467 (1959) (uniformity produces compromised standards which result in either a leveling up or down of regulatory standards).

executive branch has sought diligently to simplify federal regulations in recent years,<sup>329</sup> no one realistically can question that in each field of government regulation, be it banking, communications, transportation, labor or natural resources, the body of regulatory law has developed to the point of mystery and obscurity for all but the experienced specialist. Federal regulation of securities, involving a virtually unlimited number of complicated securities transactions, is no exception. Even securities lawyers who view state regulation as a nuisance readily would admit that compliance with the federal scheme is the primary effort in any public securities offering. They would agree that the incidental compliance with state regulations is the lesser of the two burdens. To the experienced securities lawyer, blue sky law compliance is a routine matter, and, "where he has done his job properly . . . at the moment federal registration is declared effective by the SEC, or within a matter of minutes thereafter, the underwriter can commence distribution activities in each of the states."<sup>330</sup> The extra cost of compliance with state laws is typically only a small fraction of the legal and accounting costs associated with federal registration.<sup>331</sup> Although occasionally compliance may result in delays or even a bar to distribution in certain states, experience supports the conclusion that state regulation has not been a major impediment to capital formation.<sup>332</sup> Indeed, even Congress recognized recently that the difficulties encountered by small business in raising capital was due largely to factors other than government regulation.<sup>333</sup> The burden imposed on honest businesses by regulation designed to protect against dishonest ones, as the Supreme Court recognized in *Merrick*, is the necessary cost of governance, and clearly an insufficient reason "to arrest the power of the state."<sup>334</sup>

Each state has a legitimate interest in protecting its resident investors and the marketplace from fraudulent and inequitable practices. Each must be permitted to develop and implement policies to further that interest. To deny the states their right to

<sup>329</sup> See Exec. Order No. 12,191, 46 Fed. Reg. 13,193 (1981); Exec. Order No. 12,044, 43 Fed. Reg. 12,661 (1978).

<sup>330</sup> Cowett, *Federal-State Relationships in Securities Regulation*, 28 GEO. WASH. L. REV. 287, 296 (1959). See also Tyler, *More About Blue Sky*, 39 WASH. & LEE L. REV. 899, 924-25 (1982). Tyler similarly observes:

[O]ver the years and through participation in large numbers of underwritings, counsel for the underwriters become very familiar with the idiosyncracies of the various states' blue sky laws and regulations. They also become more or less acquainted with the operational personnel of the various state securities administrators' offices. . . .

[In offerings which are not underwritten], to the extent that . . . counsel is not familiar with the requirements of the various securities laws, [he] may be at a slight additional handicap. Such issues tend to be smaller in size, however, and tend to be primarily of local interest. . . . It does not seem to be imposing too high a standard to expect an attorney who undertakes to assist a corporate client in selling its securities to the public to become familiar with the securities law of his own state, or even of one or two neighboring states.

*Id.*

<sup>331</sup> For a discussion of costs and expenses in connection with a public offering, see H. MAKENS & M. HALLORAN, *STATE REGULATION OF PUBLIC OFFERINGS* 385 (1982). See generally Schneider, Manko & Kant, *Going Public: Practice, Procedure, and Consequences*, 27 VILL. L. REV. 1 (1981).

<sup>332</sup> See Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements?*, 1976 WIS. L. REV. 79 (Wisconsin study of registration rules rebuts argument that state regulation restricts free enterprise); Hueni, *Application of Merit Requirements in State Securities Regulation*, 15 WAYNE L. REV. 1417, 1445 (1969) (merit requirements afford investor protection and inspire investor confidence in securities market without impeding marketing of securities generally).

<sup>333</sup> See *supra* note 231-32 and accompanying text.

<sup>334</sup> *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568, 587 (1917).

make differing policy decisions is repugnant to our traditional and developing notions of federalism.<sup>335</sup> Coerced uniformity is simply undesirable. As two commentators have noted:

Clearly, reasonable men can and do differ as to the degree of protection to be afforded to widows, orphans and other allegedly unsophisticated investors. The issue is not 'who is right' but whether the decision should be made on a national or a state level. The fact that neither Nevada nor Delaware prohibits the sale of the 'blue sky' (within common law limits), while in New Hampshire, as a rule, only seasoned securities may be offered for sale, seems to us an acceptable — and even a healthy — reflection of Federalism.<sup>336</sup>

The ultimate issue is how power to regulate should be allocated in a federalist system, whether the states are better able to regulate corporate and securities matters to protect their residents or whether the power should be vested *solely* in a centralized federal bureaucracy. Congress, following the lead of the states, "intentionally established a two-tiered regulatory system in which the federal government would set broad minimum standards, while allowing more stringent state requirements."<sup>337</sup> The current executive and congressional policies are directed toward less reliance on federal regulation and a corresponding assumption of more responsibility by the states.<sup>338</sup>

#### CONCLUSION

This article has sought to develop a legal and policy foundation for the case against preemption. The dual regulatory system has worked efficiently due largely to its accommodation of the many diverse and interrelated state and national interests at stake. This accommodation has been critical to the protection of investors and the development of strong local and national markets for securities. In any regulatory system reforms are continuously necessary for its viability. It would be irrational, however, to utilize the need for reform as a basis for any substantial reduction in the protections now afforded investors. Deregulation at the federal level, or at the state level through preemption or otherwise, is essentially "an industry concept" not demanded by the investors essential to a functional and secure marketplace.<sup>339</sup> Preemption of state securities laws would erase

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<sup>335</sup> See *supra* note 18.

<sup>336</sup> Brainin & Davis, *State Regulation of the Sale of Securities — Some Comments*, 14 BUS. LAW. 456, 456-57 (1959).

In this article, the authors reject both uniformity and preemption as practical solutions to the regulatory burdens incident to the dual system. *Id.* In their treatment of the demand for more uniformity, they state:

"This reaction we think more instinctively normal than necessarily desirable as a matter of social policy or practicable from the point of view of those concerned with the public offering of corporate securities."

*Id.* at 456.

The authors refuse to accept preemption as a solution because the dual regulatory system reflects a healthy balance of state and federal power to regulate and because Congressional acceptance of preemption would be unlikely, leading to debates which would frustrate efforts toward reform. *Id.* at 456-57.

<sup>337</sup> Panel presentation by SEC Commissioner John R. Evans, *Federal Preemption of State Blue Sky Laws*, 66th Annual Fall Conference of NASAA (September 21, 1983).

<sup>338</sup> *Id.*

<sup>339</sup> Address by Michael Unger, 66th Annual Fall Conference of NASAA (September 21, 1983).

decades of progress in the development and coordination of regulatory standards to protect the economic environment for securities, locally and nationally. This diminution in protection would be compounded by each and every deregulatory step at the federal level, with a deleterious effect on our securities markets. Those who seek concentration of all regulatory power in the SEC are the same group who demand federal and state deregulation in the securities field. Their nearsighted goals would take us back to the doctrine of *caveat emptor*,<sup>340</sup> a notion which has no place in a workable regulatory system that has been tempered by the lessons of experience.

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Opponents of state regulation may believe that in fact all that is good and righteous and *profitable* emanates from Washington, no doubt because of the *deregulation fever* currently afflicting that city. But, do not forget for a moment that if a different administration, with different policies about business regulation, occupied the Oval Office, there would be a headlong rush to Congress to limit federal authority, arguing along the way that the states do the job well. There is no groundswell of public support for the concept of deregulation. There are no investors crying 'give me less protection.' Deregulation is an industry concept.

*Id.*

<sup>340</sup> In connection with its passage of the 1933 Act, Congress was made aware that "the doctrine of *caveat emptor* (let the buyer beware) of the old common law is not applicable to modern conditions." *Securities Act Hearings*, *supra* note 2, at 92 (Dept. of Commerce Study of the Economic and Legal Aspects of the Proposed Federal Securities Act). See also H.R. REP. NO. 85, 73d Cong., 1st Sess. 2 (1933). "This proposal adds to the ancient rule of *caveat emptor*, the further doctrine 'let the seller also beware'." *Id.* (Message from President Franklin D. Roosevelt).