PRIVATE PLACEMENTS: A REGULATORY BLACK HOLE

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ABSTRACT

Many investors, including vulnerable senior citizens, are victimized each year in dubious securities offerings yet governmental regulators can do little to intervene. Utilizing the Rule 506 private placement exemption, promoters today can escape regulatory review by both federal and state securities officials. While states at one time served as "local cops on the beat" to protect their citizens, Congress in 1996 preempted state authority, thus creating a situation in which suspect investment schemes can proliferate below any governmental radar screen. This article questions the continued wisdom of this regulatory vacuum, especially in light of recent financial events.

This article reviews the legislative history of this preemptive statute, the National Securities Markets Improvements Act of 1996 (NSMIA), and concludes that the preemption of private placements either resulted from congressional misconceptions, back room politics arising from the conservative deregulatory agenda of the decade, or both. After analyzing the regulations and the private placement market as it existed in 1996, and as it operates today, the article concludes that NSMIA's cogent preemptive force primarily impacts state authority over the smaller, most risky private placements. Combined with the lack of federal oversight, this statutory preemption creates a regulatory abyss that permits many questionable offerings to take place. In its zeal to deregulate, Congress left many investors with little, if any, governmental protection. This article proposes a return to state supervision of designated private placements. This modest proposal would foster capital formation, protect investors, and provide for a more rational and efficient legislative framework to regulate private securities transactions.

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I. INTRODUCTION

Bernard Madoff's infamous Ponzi scheme has perhaps become the poster child for a financial era fraught with greed, excess, and fraud.[1] But Madoff is only the most notorious example of modern promoters who dupe investors with risky, or even fraudulent, investment schemes.[2] Many investors, including vulnerable senior citizens, are victimized each year in dubious securities offerings. Yet in spite of widespread investor harm, no governmental agency intervenes in the vast majority of these cases until much of the damage has already occurred. Most promoters involved in these questionable investment schemes sell securities pursuant to the so-called private placement exemption of the federal securities law, which is only available for sales to qualified investors.[3] Utilizing this exemption, promoters today can escape regulatory review by both federal and state securities officials.

At one time, federal law confined private placements to purchasers who were sophisticated in business affairs and could, in the words of the U.S. Supreme Court, "fend for themselves."[4] More recently, the idea of an "accredited investor" has supplanted the fuzzy and perhaps more narrow concept of sophistication.[5] Both the Securities Act of 1933 (1933 Act)[6] and

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[1]For a comprehensive report on the Madoff Ponzi scheme and aftermath, see WSJ.com, Madoff News, http://online.wsj.com/public/page/bernard-madoff.html (last visited Nov. 16, 2009). In the wake of the Madoff fraud is the alleged Ponzi scheme carried out by billionaire fancier Allen Stanford. *See* Complaint at 1, 5, SEC v. Stanford Int'l Bank Ltd., No. 3:09-cv-00298-L (N.D. Tex. filed Feb. 17, 2009) (alleging an $8 billion fraud).

[2]*See, e.g.*, Jayne W. Barnard, *Securities Fraud, Recidivism, and Deterrence*, 113 PENN ST. L. REV. 189, 191 (2008) (detailing fraudulent securities offerings schemes that cost retail investors hundreds of millions of dollars per year). For a recent example, see Complaint at 2-3, SEC v. Sunwest Mgmt., Inc., No. 6:09-cv-06056-HO (D. Or. filed Mar. 2, 2009) (charging developer of assisted living centers with engaging in ponzi scheme).

[3]Stanford's Group, for example, raised money for its allegedly fraudulent certificate of deposit scheme through Rule 506 offerings. Dan Jamieson, *States Pushing for Authority over Reg D Offerings*, INV. NEWS, Apr. 19, 2009, http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20090419/REG/304199985&ht=dan jamieson.

[4]SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953). For an early view of the necessity of risk disclosure even for sophisticated investors, see Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 627 (1996). Investors could also qualify as "sophisticated" under the *Ralston Purina* standard if they retain a qualified offeree representative. Joseph Shade, *Financing Exploration: Requirements of Federal and State Securities Laws*, 37 NAT. RESOURCES J. 749, 765-66 (1997).

[5]*See* William K. Sjostrom, Jr., *The Birth of Rule 144A Equity Offerings*, 56 UCLA L. REV. 409, 444 (2008) (explaining that, "for individuals, the definition of accredited investor uses net worth and income as proxies for sophistication/fending ability").

[6]15 U.S.C. § 77(b)(15) (2006).

Securities and Exchange Commission (SEC) rules[7] define "accredited investors" in concrete terms and include within the definition specified institutions and individuals deemed wealthy—at least by 1982 standards. The theory, perhaps belied by recent events,[8] is that accredited investors do not need the full protection of the federal securities laws because they have either the sophistication or the resources to obtain disclosure and evaluate the merits of private securities offerings.[9] In fact, in keeping with this self-help rationale, the SEC does not review private placement offerings for even minimal compliance with its rules.[10]

Historically, states provided the regulatory backup for private offerings that were virtually ignored by federal officials.[11] State regulators were quite effective in policing smaller offerings to protect citizens within their borders.[12] In 1996, however, Congress preempted state authority, thereby creating a situation in which suspect investment schemes can proliferate below any governmental radar screen.

This story of regulatory ignorance begins in the midst of one of the longest bull markets in history.[13] In 1996, Congress passed the National Securities Markets Improvements Act of 1996 (NSMIA).[14] NSMIA was one

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[7]17 C.F.R. § 230.501(a) (2008).

[8]For example, Madoff's investors consisted of wealthy individuals, hedge funds, and institutional investors including charities. *See, e.g.*, David Lieberman et al., *Investors Remain Amazed Over Madoff's Sudden Downfall*, USATODAY.COM, http://www.usatoday.com/money/markets/2008-12-14-ponzi-madoff-downfall_N.htm (last visited Nov. 16, 2009). These investors were all "accredited" as defined by SEC rules. *See* 17 C.F.R. § 230.501(a). Many individuals, however, suffered devastating losses as a result of Madoff's fraud. For an account of the victims and their losses, see generally Annelena Lobb, *For Victims, Downsized Lives and Many Shattered Dreams*, WALL ST. J., June 29, 2009, at C1.

[9]*See, e.g.*, Mark A. Sargent, *The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform*, 68 WASH. U. L.Q. 225, 289 (1990) (justifying the accredited investor exemption). Not all scholars, however, agree that wealth is an appropriate surrogate for sophistication. *See infra* notes 242-43 and accompanying text.

[10]*See* OFFICE OF INSPECTOR GENERAL, SEC. & EXCH. COMM'N, REP. NO. 459, REGULATION D EXEMPTION PROCESS 8 (2009) [hereinafter OIG 2009 REP.].

[11]*See* Martin Fojas, Note, *Ay Dios NSMIA! Proof of a Private Offering Exemption Should Not Be a Precondition for Preempting Blue Sky Law Under the National Securities Markets Improvement Act*, 74 BROOK. L. REV. 477, 479 (2009).

[12]Although protection extended to citizens within a given state, the regulations could be evaded simply by crossing state lines. *See, e.g.*, Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns*, 4 N.Y.U. J.L. & BUS. 1, 15-16 (2007).

[13]*See, e.g.*, John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 278 (2004) ("Beginning in 1995 and continuing until March 2000, the stock market in the United States entered its longest, most sustained bull market in U.S. history.").

[14]National Securities and Markets Improvement Act of 1996, Pub. L. No. 104-290, 110

among a number of congressional reforms in the 1990s designed to deregulate the securities markets.[15] Congress intended NSMIA to clarify and, in many cases, preempt state authority over securities professionals and certain securities transactions.[16] This article addresses a seldom-questioned provision of NSMIA that preempts state regulation of most unregistered securities offerings, particularly Rule 506 private placements.[17]

NSMIA preempts state regulation of offerings of "covered" securities.[18] If the statute deems a security "covered," it prohibits state regulation other than ex-post fraud investigation and prosecution.[19] The stated congressional purpose of these provisions was to preempt state regulation of offerings that were national in scope and to eliminate redundant or inconsistent state regulations.[20] Predictably, then, covered securities under NSMIA include those listed on national securities exchanges and the National Market System of the National Association of Securities Dealers Automated Quotations (NASDAQ).[21] The SEC generally regulates these exchange and NASDAQ offerings under federal law, making state regulation duplicative and largely unnecessary. Paradoxically, however, NSMIA also preempted state regulation of securities offerings and sales made pursuant to existing federal exemptions, including private placements exempt from federal registration under SEC Rule 506.[22]

There is very little in the legislative history of NSMIA that discusses private placements. What commentary exists defends federal preemption on the grounds that private placements, like exchange-listed securities, involve offerings that are "national in nature."[23] But preemption of state regulation of private offerings results in a very different consequence than preemption

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Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.) [hereinafter NSMIA].

[15]NSMIA continued the line of deregulation by the largely Republican Congress in the 1990s. *See infra* text accompanying notes 199-205. NSMIA followed on the heels of the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C.) (PSLRA), and was followed in turn by the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C.) (SLUSA). While NSMIA has not received the same academic attention as PSLRA or SLUSA, it has broad-reaching implications that silently impact much of the securities fraud we witness today.

[16]*See* H.R. REP. NO. 104-864, at 39-40 (1996) (Conf. Rep.), *reprinted in* 1996 U.S.C.C.A.N. 3920, 3920-21 [hereinafter CONFERENCE REPORT].

[17]*See* NSMIA, *supra* note 14, sec. 102(a), § 18(b)(4)(D).

[18]*Id.* sec. 102(a), § 18(a)(1)(A).

[19]*Id.* sec. 102(a), § 18(c)(1).

[20]CONFERENCE REPORT, *supra* note 16, at 39, *reprinted in* 1996 U.S.C.C.A.N. at 3920.

[21]NSMIA, *supra* note 14, sec. 102(a), § 18(b)(1).

[22]*Id.* sec. 102(a), § 18(b)(4)(D). Rule 506 is the SEC safe harbor provision for the private placement exemption contained in section 4(2) of the 1933 Act. *See* 17 C.F.R. § 230.506 (2008); *infra* text accompanying notes 109-13.

[23]*See* CONFERENCE REPORT, *supra* note 16, at 40, *reprinted in* 1996 U.S.C.C.A.N. at 3921.

of state regulation of public offerings subject to SEC supervision under the 1933 Act. Unlike listed securities, private placements are exempt from federal registration and for all practical purposes escape federal oversight.[24] NSMIA's preemption of state regulation of private placements, therefore, created a regulatory black hole—today, no one regulates these offerings.[25]

This article questions the continued wisdom of this regulatory vacuum, especially in light of recent financial events. Part II of this article analyzes NSMIA's legislative history with respect to private placements and concludes that the preemption of private placements resulted from congressional misconceptions, back room politics arising from the conservative deregulatory era of the decade, or both. In Part III, the article analyzes federal and state private placement regulations and examines the private placement market, both as it existed in 1996 and as it operates today. Part III concludes that Congress had little need to preempt state regulation of private placements that were truly national in scope because such offerings were already exempt under state laws. Instead, NSMIA's cogent preemptive force was the preemption of state authority over smaller private placements, creating a regulatory abyss that permits many questionable offerings to take place. Part IV attempts to place NSMIA within existing theories of preemption and suggests that the statute was motivated primarily by a deregulatory agenda rather than a considered effort to properly divide regulatory functions between federal and state securities administrators. In Part V, the article proposes to return to the states supervision of private placements by or to nonregulated persons or entities. This modest proposal would foster capital formation, protect investors, and provide for a more rational and efficient legislative framework in which to regulate private securities transactions.

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[24] *See* OIG 2009 REP., *supra* note 10, at 8.

[25] One scholar deemed "covered securities" as "one of the grandest misnomers financial legislation has ever seen," in that many covered securities such as those sold in Rule 506 transactions are not covered at all by federal or state regulation. Manning Gilbert Warren III, *Federalism and Investor Protection: Constitutional Restraints on Preemption of State Remedies for Securities Fraud*, 60 LAW & CONTEMP. PROBS. 169, 175 (1997). Congress, in preempting its own exemptions, was apparently unaware that it enacted many of these exemptions from registration at the federal level based on its own recognition that the states already provided sufficient pre-sale regulatory protection and, in the words of Justice Douglas, federal regulation was designed to "fill the gap." Travelers Health Ass'n v. Virginia *ex rel.* State Corp. Comm'n, 339 U.S. 643, 653 (1950) (Douglas, J., concurring).

II. NSMIA'S LEGISLATIVE HISTORY

According to its legislative history, Congress intended NSMIA to eliminate duplicative and unnecessary state securities regulation that hindered the capital markets.[26] State securities laws, known as blue sky laws, preceded federal securities regulation.[27] Both the federal 1933 Act and the Securities Exchange Act of 1934 (1934 Act) initially contained "savings clauses" preserving state authority over securities transactions taking place within their borders.[28] Before NSMIA, issuers potentially faced both federal and state regulations that were often duplicative and overlapping.[29] Moreover, the philosophical underpinnings of state regulation differed from the federal regime. State laws were traditionally merit based and provided

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[26] *See* CONFERENCE REPORT, *supra* note 16, at 39-40, *reprinted in* 1996 U.S.C.C.A.N. at 3920-21. The Conference Report states:

> The development and growth of the nation's capital markets has prompted the Congress to examine the need for legislation modernizing and rationalizing our scheme of securities regulation to promote investment, decrease the cost of capital, and encourage competition. . . . In particular, the system of dual Federal and state securities regulation has resulted in a degree of duplicative and unnecessary regulation . . . that, in many instances, is redundant, costly, and ineffective.

Id. at 39, *reprinted in* 1996 U.S.C.C.A.N. at 3920.

[27] *See generally* Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 359 n.59 (1991) (discussing the origins of the term "blue sky law"). Kansas enacted the first state securities law in 1911. *See* LOUIS LOSS & EDWARD M. COWETT, BLUE SKY LAW 7 (1958). By 1913, twenty-three states had followed suit. *Id.* at 10. In 1917, the U.S. Supreme Court upheld the state blue sky laws against attacks on their constitutionality under the Commerce Clause. *See* Merrick v. N.W. Halsey & Co., 242 U.S. 568, 587 (1917) (upholding Michigan blue sky laws); *see also* Caldwell v. Sioux Falls Stock Yards Co., 242 U.S. 559, 568 (1917) (upholding South Dakota blue sky laws); Hall v. Geiger-Jones Co., 242 U.S. 539, 559 (1917) (upholding Ohio blue sky laws). By 1933, every state except Nevada had enacted some kind of blue sky statute. Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1, 21 (1998).

[28] 15 U.S.C. § 77(r) (1994), *amended by* NSMIA, *supra* note 14, sec. 102(a) (1933 Act); *id.* § 78bb(a) (2006) (1934 Act). The Supreme Court stated that Congress intended these saving clauses to save the state securities statutes from claims of preemption. *See* Leroy v. Great W. United Corp., 443 U.S. 173, 182 n.13 (1979). For explanations of congressional reasoning in enacting the dual federal/state regulatory structure, see Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 280-82 (1998).

[29] Along with direct regulation of securities transactions embodied in the 1933 and 1934 Acts, Congress in 1934 vested authority in self-regulatory organizations (SROs) such as the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD). *See* 15 U.S.C. § 78c(a)(26) (2006) (defining "self-regulatory organizations"); *id.* § 78f (describing national securities exchanges). In 2007, the regulatory arms of NASD and the NYSE merged to form the Financial Industry Regulatory Authority (FINRA). *See* Financial Industry Regulatory Authority, About FINRA, http://www.finra.org/AboutFINRA/index.htm (last visited Nov. 16, 2009). The SROs are subject to SEC oversight and provide additional rules and regulations that govern publicly-traded issuers. *See* 15 U.S.C. § 78s (2006).

that a state official could prevent an offering unless it was judged to be "fair, just and equitable."[30] In contrast, federal laws were generally based upon a philosophy of full disclosure.[31] State statutes also contained registration exemptions that differed from their federal counterparts.[32] Under this dual system of regulation that persisted until 1996, the state and federal securities regulations were sometimes redundant, often inconsistent, and, for nationally registered offerings, both expensive and inefficient.[33]

In 1980, Congress amended the 1933 Act by adding section 19(d), authorizing the SEC to cooperate with associations of state securities regulators to attempt to effectuate "greater uniformity in Federal-State securities matters."[34] The 1980 statute also directed the SEC to hold an annual conference with state administrators to further the stated statutory policy of obtaining greater state/federal cooperation, uniformity, and cost reductions in securities regulations with minimum interference with the business of capital formation.[35] Section 19(d), while directing federal/state cooperation, expressly stated that it did not preempt state law.[36]

Although the voluntary coordination effort achieved some progress, it was slow and incomplete. Critics of state securities regulation intensified their calls for total federal preemption of state authority over both securities offerings and the activities of securities industry professionals, such as broker-dealers and investment advisors.[37] In the mid-1990s, these

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[30]While there is no common definition of "merit review," the term generally refers to the review of the substantive merits of a securities offering by state administrators. *See* Ad Hoc Subcomm. on Merit Regulation of the State Regulation of Sec. Comm., *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785, 801 (1986). A state official may prohibit the sale of investments that are deemed to be unfair to investors. *See id.* at 787; *see also* Roberta S. Karmel, *Blue-Sky Merit Regulation: Benefit to Investors or Burden on Commerce?*, 53 BROOK. L. REV. 105, 105 (1987).

[31]*See generally* COX ET AL., SECURITIES REGULATION 3 (6th ed. 2009); 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 29-50 (3d ed. 1989) (explaining competing philosophies between state and federal securities regulation).

[32]*See* Sargent, *supra* note 9, at 243-44. By 1996, most states had a so-called market place exemption from state registration for nationally registered securities. In fact, many state exemptions for listed securities were broader in scope than the preemptive provisions of NSMIA. *See* Mark A. Sargent, *The National Securities Markets Improvements Act—One Year Later. Introduction*, 53 BUS. LAW. 507, 507 (1998) (concluding that NSMIA preemption of listed securities ratified existing state practice and did not break new ground).

[33]*See* Manning Gilbert Warren III, *Reflections on Dual Regulation of Securities: A Case Against Preemption*, 25 B.C. L. REV. 495, 499 (1984).

[34]15 U.S.C. § 77s(c)(1) (1988) (current version at 15 U.S.C. § 77s(d)(1)(2006)). This was enacted as part of the Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, sec. 505, § 19(c)(1), 94 Stat. 2275, 2292 (codified as amended in scattered sections of 15 U.S.C.).

[35]15 U.S.C. § 77s(c)(1) (1988) (current version at 15 U.S.C. § 77s(d)(1) (2006)).

[36]*Id.* § 77s(c)(3)(C) (current version at 15 U.S.C. § 77s(d)(3)(c)(2006)).

[37]For example, from 1985 to 1995, the annual report of SEC-sponsored Government

complaints found a receptive audience in the conservative congressional leaders of the day.[38] On the surface, federal preemption of state authority seems antithetical to conservative values favoring states' rights. Even so, such bedrock conservative principles vanished when preemptive federalization meant less regulation for business interests.[39]

A. *The Fields Bill*

As originally conceived, NSMIA significantly reduced federal regulation while eliminating most state oversight. NSMIA began its life in 1995 as the "Capital Markets Deregulation and Liberalization Act of 1995,"[40] or the "Fields Bill," named after then-Representative Jack Fields (R- Tex.), who chaired the Telecommunications and Finance Subcommittee of the House Committee on Commerce (House Committee). Among its

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Business Forum for Small Business Capital Formation requested relief from blue sky regulation. Forum reports from 1993 to the present can be accessed on the SEC's website at http://www.sec.gov/info/smallbus/sbforum.shtml (follow the link for "Previous Forums"). The Forum reports continue to recommend further deregulation of private placements.

[38]*See* Diana B. Henriques, *Efforts to Harness S.E.C. Worry Agency Critics Too*, N.Y. TIMES, Oct. 23, 1995, at A1 (reporting that congressional Republicans were committed to deregulation with strong Wall Street support); Scot J. Paltrow, *How Fields' Dream to Cozy up to Wall Street Backfired*, L.A. TIMES, Sept. 14, 1995, at D1 (reporting that Representative Fields confirmed that Wall Street representatives were consulted early on in the consideration of the bill but no one, including the SEC, was consulted during the drafting itself); Michael Schroeder, *Guess Who's Gunning for the SEC*, BUS. WK., Aug. 14, 1995, at 40 (reporting that the Fields Bill capped a coordinated attack by several House leaders on securities regulation); Ruth Simon, *How Washington Could Tip the Scales Against Investors*, MONEY, Oct. 1995, at 122-28 (reporting efforts on industry representatives to deregulate the securities industry).

[39]*See* U.S. ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, FEDERAL STATUTORY PREEMPTION OF STATE AND LOCAL AUTHORITY: HISTORY, INVENTORY, AND ISSUES 1, 37-38 (1992) (noting the increase in federal preemption over past few decades and attributing the cause, at least in part, to business lobbying groups who prefer dealing with only one regulatory body); Michael S. Greve & Jonathan Klick, *Preemption in the Rehnquist Court: A Preliminary Empirical Assessment*, 14 SUP. CT. ECON. REV. 43, 53 (2006) (finding that preemption cases are overwhelmingly initiated by business or private parties); Roderick M. Hills, Jr., *Against Preemption: How Federalism Can Improve the National Legislative Process*, 82 N.Y.U. L. REV. 1, 29-30 (2007) (noting that industry interest groups will often favor regulatory uniformity even when that uniformity results in more stringent controls); Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement*, 11 CONN. INS. L.J. 107, 114 (2004) ("Ironically, conservative politicians, the purported champions of states' rights, advocated preemptive legislation that severely restricts state powers."); Thomas W. Merrill, *Preemption and Institutional Choice*, 102 NW. U. L. REV. 727, 732 (2008) (noting that business interests and those supporting free markets favor preemption because it is deregulatory). Perhaps tellingly, on September 30, 1996, the Commission for Intergovernmental Relations, which advocated for federalism, lost its congressional funding and closed. Bruce D. McDowell, *Advisory Commission on Intergovernmental Relations in 1996: The End of an Era*, 27 PUBLIUS 111, 111 (1997).

[40]H.R. 2131, 104th Cong. (1995).

many controversial provisions,[41] the Fields Bill preempted all pre-sale state regulation of securities offerings other than intrastate transactions.[42] The testimony at the House Committee hearings on the Fields Bill was largely one-sided, in favor of deregulation.[43] Industry group representatives generally favored preempting state regulation of the sale of mutual fund shares and other registered public offerings.[44]

Most witnesses who addressed non-registered offerings, however, testified that the states should have a continuing role in pre-sale disclosure regulation. For example, in both written and oral testimony, SEC Chairman Arthur Levitt acknowledged that federal and state regulators needed to better coordinate but emphasized that states are often on the "front line of defense," the "'local cops' on the beat," and that total preemption was undesirable.[45] Chairman Levitt suggested that certain categories of offerings that historically created problems of disclosure and sales practice abuses—primarily those offered to retail investors—should remain subject to dual regulation.[46] For smaller classes of offerings, Chairman Levitt suggested that, among other alternatives, an issuer should be allowed to choose review by either a state or federal regulator.[47] In response to questions from the House Committee members, Mr. A.A. Sommer, a former SEC Commissioner then in private practice, suggested that the states continue to regulate smaller, more speculative offerings and objected to preempting unregistered

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[41]Perhaps buoyed by recent success in securing the adoption of the PSLRA earlier in the year, congressional Republicans in H.R. 2131 proposed to continue to deregulate the securities markets by eliminating the Williams Act, limiting brokers' duties to recommend suitable investments, making prospectus delivery optional, and relaxing the margin rules. *Id.*

[42]*Id.* § 3(a) (proposing amendments to section 18 of the 1933 Act). H.R. 2131 also removed state authority over mutual funds, investment advisors, and brokers to the extent that the state rules were stricter than the federal rules. *Id.* § 3(b)-(d) (proposing amendments to section 15(h) of the 1934 Act, section 50 of the Investment Company Act of 1940, and section 222 of the Investment Advisors Act of 1940).

[43]*Capital Markets Deregulation and Liberalization Act of 1995: Hearings on H.R. 2131 Before the Subcomm. on Telecomm. and Fin. of the H. Comm. on Commerce*, 104th Cong. (1995) [hereinafter *H.R. 2131 Hearings*].

[44]*See, e.g.*, *id.* at 185, 242 (statement of A.B. Krongard, Chairman, Securities Industry Association) (stating he would like to see the so-called blue chip exemption codified by the federal government); *id.* at 216-19 (statement of Matthew P. Fink, President, Investment Company Institute (ICC)) (concluding states should no longer regulate mutual funds, which are comprehensively regulated at the federal level); *id.* at 208 (statement of Elaine LaRoche, Vice-Chair, Public Securities Association) ("The greatest burden on the securities markets [is] caused by the current dual regulation of the public sale of debt securities . . . .").

[45]*Id.* at 105.

[46]*Id.* at 106.

[47]*H.R. 2131 Hearings*, *supra* note 43, at 106.

offerings.[48] Committee member Representative Chris Cox of California agreed.[49]

Similarly, Dee Harris, then president of the North American Securities Administrators Association (NASAA),[50] testified in favor of continued state regulation of non-registered securities offerings.[51] Mr. Harris stated that he had little trouble with the so-called market place exemptions for federally registered offerings that trade in national markets, noting that virtually every state already exempted such offerings.[52] Harris also stated that NASAA recognized that states needed more uniformity for private placements,[53] but

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[48] *Id.* at 40, 73, 78 (statement of A.A. Sommer Jr., of Morgan, Lewis & Blockius, LLP). Sommer states:

> I think it is well that [the states] focus their resources upon those areas that are particularly of concern, which are the smaller offerings where the companies are not known, where they're highly speculative, where there have been abuses between the corporation and the insiders in the way of transactions, where there's excessive compensation to those who are selling the securities. Those are areas that I think the States should properly pay heed to. And I think that in large measure, the process is now working.

Id. at 73.

[49] *Id.* at 78. In 2005, President Bush appointed Representative Cox as the Chairman of the SEC, where he served until his resignation in 2009. *See* SEC Biography: Chairman Christopher Cox, http://www.sec.gov/about/commissioner/cox.htm (last visited Nov. 16, 2009).

[50] The North American Securities Administrators Association (NASAA) is an international investor protection organization.

> [Its] membership consists of 67 state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico. . . . NASAA members license firms and their agents, investigate violations of state and provincial law, file enforcement actions when appropriate, and educate the public about investment fraud.

NASAA, About NASAA, http://www.nasaa.org/About_NASAA (last visited Oct. 29, 2009).

[51] *H.R. 2131 Hearings*, *supra* note 43, at 298-99 (statement of Dee R. Harris, President, NASAA).

[52] *Id.* at 299. By 1995, over forty states allowed registration by coordination, largely following the procedures in section 303 of the Uniform Securities Act of 1956. *See* Joel Seligman, *The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation*, 93 MICH. L. REV. 649, 675-76 (1995). Other witnesses, however, stated that the state market place exemption was not uniform among the states and noted that it could be altered by any one state. *See, e.g.*, *H.R. 2131 Hearings*, *supra* note 43, at 189 (statement of A.B. Krongard, Chairman, Securities Industry Association); *id.* at 259 (statement of Mark A. Sargent); *see also* Alan M. Parness, *From the Chair—Random Rants and Raves*, 1 BLUE SKY BUGLE, Jan. 2009, at 3, 5 (describing timing inconsistencies among states who register "by coordination" with a registered offering under the 1933 Act).

[53] *H.R. 2131 Hearings*, *supra* note 43, at 308. By October 1995, in the wake of the Fields Bill, NASAA convened a fourteen-person task force comprised of regulators, industry representatives, and legal and academic experts. *See* N. AM. SEC. ADM'RS ASS'N, REPORT OF THE TASK FORCE ON THE FUTURE OF SHARED STATE AND FEDERAL SECURITIES REGULATION 1-2 (1997), *available at* http://www.nasaa.org/content/Files/Report%5FFuture%5Fof%5FShared%5F Securities%5FRegulat ionpdf. The task force agreed that "[t]he arena of private placements is

opposed preemption for private placements and other small offerings because, in NASAA's view, fraud occurs most often in smaller offerings.[54]

Congressman Dingell, from Michigan, submitted a letter from the Corporation and Securities Bureau of Michigan opposing federal preemption of smaller securities offerings and arguing that such preemption would create "a regulatory black hole," as federal regulators rarely scrutinized such sales.[55] Similarly, Representative Klink of Pennsylvania noted that in the opinion of the Pennsylvania Securities Commission, the state performed a valuable role in policing smaller offerings.[56]

The three academics invited to testify evidenced divided opinions on the private placement preemption issue. Professor John Coffee of Columbia Law School favored some continued state regulation.[57] With respect to blue sky preemption, he stated, "[S]ome respect must be given to federalism" for offerings that are not exchange listed.[58] Professor Mark Sargent, then a professor at the University of Maryland Law School and long-time opponent of state merit review, testified that the best use of state regulators was for fraud enforcement.[59] In response to questions from the chair, Professor Sargent stated that he doubted the efficacy of state private placement rules, labeling them "Kafkaesque."[60] Professor Rutheford B. Campbell, Jr., the final academic invited to testify and an opponent of state securities regulation in general, favored complete preemption of blue sky laws, other than for fraud prosecution, arguing that state regulation unduly impeded capital formation for small business.[61]

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unnecessarily complicated by inconsistent state regulation of [these] offerings," *id.* at 56, and concluded that "[t]he states should strive to create uniformity in the requirements for private placements by adopting a uniform private placement exemption and implementing it in a uniform manner." *Id.* at 57.

[54]*See H.R. 2131 Hearings, supra* note 43, at 300.

[55]*Id.* at 45-46 (letter from Carl L. Tyson, Director, Corporation and Securities Bureau of Michigan).

[56]*See id.* at 172-82 (testimony of Rep. Ronald Klink) (introducing a report by Robert Lam, Chairman of the Pennsylvania Securities Commission, explaining the role of the Pennsylvania Securities Commission in policing smaller offerings).

[57]*See id.* at 31, 33 (noting the need for better coordination between state and federal regulators).

[58]*H.R. 2131 Hearings, supra* note 43, at 33.

[59]*Id.* at 261.

[60]*Id.* at 294 (stating that it would be charitable to call the state private placement rules a "patchwork quilt" because they were "Kafkaesque").

[61]*Id.* at 264-65. This position is consistent with Professor Campbell's writings which suggest that small businesses are entitled to raise capital without state regulation. *See, e.g.*, Rutheford B. Campbell, Jr., *The SEC's Inglorious Role in Limiting Small Business's Access to Capital*, 9 ENGAGE 28, 28 (2009) (discussing the obstacles impeding small businesses' ability to raise capital); *see also* Rutheford B Campbell, Jr., *The Insidious Remnants of State Rules Respecting Capital Formation*, 78 WASH. U. L.Q. 407, 407-08 (2000) (arguing that only complete federal

The Fields Bill encountered heavy opposition from investor advocates and, ultimately, from the Wall Street firms the conservative lawmakers intended to protect.[62] A former finance counselor to Fields' subcommittee, Stephen A. Blumenthal, stated in a recorded conference call, "[T]he bill wasn't seriously meant to pass but was a gesture aimed at ingratiating House Republicans to Wall Street."[63] Contemporary press reports suggest this strategy may have backfired, and that Wall Street became concerned the Fields Bill was so radical that it could have sparked a backlash leading to tougher regulations.[64]

B. *NSMIA—The House*

The Fields Bill itself was not reported out of Committee. Instead, in March of 1996, Representative Fields reintroduced his bill (the House Bill) with substantial amendments as NSMIA. Gone were many objectionable components in the original 1995 bill, such as striking the Williams Act, reducing the number of SEC Commissioners, and eliminating suitability requirements for brokers. Significantly, NSMIA presented a compromise on the contentious issue of mutual fund regulation, which many viewed as a primary driver of the bill.[65] Also, unlike its predecessor, NSMIA stopped short of totally preempting state regulation of securities offerings.[66] As introduced in the House, however, NSMIA did preempt offerings of

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preemption of state regulation can produce a "modern, fair, and efficient regulatory scheme for capital formation"). Professor Campbell does not believe that the Rule 506 preemption is useful to small businesses because it requires more disclosures than are necessary under other federal exemptions and requires sophisticated or accredited investors. *See* Rutheford B Campbell, Jr., *Blue Sky Laws and the Recent Congressional Preemption Failure*, 22 J. CORP. L. 175, 184 (1997).

[62]Paltrow, *supra* note 38, at D1.

[63]*Id.* Blumenthal stated that the Fields Bill was "House Republicans' way of saying, 'Here, Wall Street, look what we want to do for you.'" *Id.*

[64]As Scot Paltrow of the *LA Times* reported:

> Unexpectedly, Fields is being rebuffed en masse by the very executives he sought to please. Although Wall Street ardently desires specific reforms of securities regulation, the executives have expressed concern that the bill is so broad and radical that it might undermine confidence in U.S. securities markets. They also fear that a backlash against it may derail the drive for more limited reforms.

Id.; *see also* Richard W. Stevenson, *Securities Bill Emerges in House as G.O.P. Drops Some Demands*, N.Y. TIMES, Mar. 8, 1996, at D1 (noting that Republicans were "forced to rein in their deregulatory agenda in the face of criticism that their original proposals go too far").

[65]Under NSMIA, as reported in the House, states would lose all authority over mutual funds other than antifraud enforcement. H.R. 3005, 104th Cong. § 102(a) (1996) (amending section 18(d)(1) of the 1933 Act); *see also* Linda M. Stevens, Comment, *The National Securities Markets Improvement Act (NSMIA) Savings Clause: A New Challenge to Regulatory Uniformity*, 38 U. BALT. L. REV. 445 (2009) (analyzing NSMIA's effects on mutual funds and investment advisors).

[66]*See* H.R. 3005, § 102(a) (setting forth the scope of preemption).

"covered securities" from the reach of state regulators.[67] "Covered securities" included securities listed on a national stock exchange or the NASDAQ National Market System,[68] securities of mutual funds,[69] securities sold to "qualified purchasers" to be defined by SEC rule,[70] and securities otherwise exempt from federal regulation under several provisions of the 1933 Act.[71] Private placements offered pursuant to SEC Rules promulgated under the auspices of section 4(2) of the 1933 Act were within the last category of preempted covered securities.[72] The House Bill also contained a list of "conditionally covered securities" which, in essence, were securities issued in smaller company initial public offerings registered with the SEC that were not disqualified due to the conduct of the issuer or the nature of the offering.[73] Ironically, while the small public offering exemption under the House Bill was subject to disqualifiers, the private placement exemption was not.[74] Under the House Bill, the only enforcement power the states retained over "covered securities," including Rule 506 private placements, was the authority to investigate and prosecute fraud.[75]

The House Commerce Committee Report (House Report) includes only a one-sentence explanation for why private placements fell within the

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[67] *Id.*

[68] *Id.* (amending section 18(b)(1) of the 1933 Act). As Representative Markey, the ranking minority member of the House Subcommittee, stated at the beginning of Fields Bill hearings: "The fact is that for most issuers, the dual regulatory system is largely irrelevant. If you're one of the thousands of companies listed on the New York Stock Exchange, the American Stock Exchange or the NASDAQ's National Market System, you are entirely exempt from any independent State registration requirement." *H.R. 2131 Hearings*, *supra* note 43, at 6.

[69] H.R. 3005, § 102(a) (amending section 18(b)(2) of the 1933 Act).

[70] *Id.* (amending section 18(b)(3) of the 1933 Act); *see also infra* text accompanying notes 85-88.

[71] H.R. 3005, § 102(a) (amending section 18(b)(4)(A) of the 1933 Act).

[72] *Id.* (amending section 18(b)(4)(D) of the 1933 Act). At present, Rule 506 is the only SEC Rule interpreting section 4(2) of the 1933 Act. *See* 17 C.F.R. § 230.506 (2008).

[73] H.R. 3005, § 102(a) (amending section 18(c) of the 1933 Act). Issuer disqualifications included "bad actor" disqualifiers similar to those found in Rule 505 of Regulation D, and included prior adjudications of securities law violations. *See* 17 C.F.R. §§ 230.505, 230.262 (2008) (Regulation D disqualifiers). Offering disqualifiers for small company IPOs under the House Bill included limited partnerships and blank check companies.

[74] The idea of adding "bad actor" disqualification provisions to Rule 506 was circulated in 1999. *See* SENATE BANKING COMMITTEE, 106TH CONG., RECOMMENDATIONS SUBMITTED FOR THE SECURITIES MARKETS ENHANCEMENT ACT (1999), *available at* http://banking.senate.gov/docs/reports/smea.htm. This idea also resurfaced in 2007. *See* Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 33-8828, 72 Fed. Reg. 45,116, 45,117 (proposed Aug. 3, 2007) (proposing rule to add disqualifiers into Rule 506).

[75] H.R. 3005, § 102(a) (amending section 18(d)(1) of the 1933 Act). The House Bill also preserved the states' authority to require copies of SEC filings and to impose pre-existing fees. *Id.* (amending section 18(d)(2) of the 1933 Act).

purview of NSMIA's preemption provisions.[76] It merely states that the private placement exemption from state regulation would facilitate private placements of securities, yet protect investors.[77] The House Report instead focuses on the preemption of state regulation of securities offerings to "Qualified Purchasers" to be defined pursuant to SEC Rule, noting that the committee expects such offerings will be national in character and generally subject to federal regulation.[78] In particular, the House Report evidences concern that sales of asset and mortgage-backed securities be free of dual federal/state regulation.[79] While the House Report strongly suggests that the definition of "Qualified Purchaser" will be more stringent than the Rule 506 definition of "accredited investor,"[80] it does not explain the necessity of a separate Qualified Purchaser exemption given the Bill's concurrent preemption of Rule 506 offerings.[81] The House Commerce Committee did not hold hearings on NSMIA, relying instead upon the testimony addressing the original 1995 Fields Bill that preempted all state regulation of offerings except local intrastate transactions.

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[76]*See* H.R. REP. NO. 104-622, at 32 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3895.

[77]*Id.*, *reprinted in* 1996 U.S.C.C.A.N. at 3895.

[78]*Id.* at 31, *reprinted in* 1996 U.S.C.C.A.N. at 3893-94. As of this writing, the SEC has yet to adopt a definition of "Qualified Purchaser." In 2001, the SEC proposed a definition to equate Qualified Purchasers under NSMIA with Accredited Investors under Rule 501 of Regulation D. *See* Defining the Term "Qualified Purchaser" Under the Securities Act of 1933, Securities Act Release No. 33-8041, 66 Fed. Reg. 66,839 (proposed Dec. 27, 2001). The Commission has since abandoned this suggestion in favor of the concept of a "large accredited investor." *See* Revisions of Limited Offering Exemptions in Regulation D, 72 Fed. Reg. at 45,122.

[79]H.R. REP. NO. 104-622, at 31, *reprinted in* 1996 U.S.C.C.A.N. at 3894. The House Report at times, however, confuses purchaser qualifications with the nature of the offerings. For example, the House Report states, "Thus, the Committee expects the Commission to craft and construe the definition so that, for example, purchasers of mortgaged-backed, asset-backed and other structured securities, as well as securities issued in connection with project financings, are generally included as qualified purchasers." *Id.*, *reprinted in* 1996 U.S.C.C.A.N. at 3895.

[80]House Report 104-622 states that it expects that the definition of "Qualified Purchaser" will be no more restrictive than the definition of "Qualified Purchaser" under NSMIA amendments to the Investment Company Act. *Id.* at 31-32, *reprinted in* 1996 U.S.C.C.A.N. at 3894. The House Bill defined "Qualified Purchaser" as natural people with $10 million of investments or institutions who own or manage $100 million. H.R. 3005, § 209(b) (amending section 2(a) of the Investment Company Act of 1940). NSMIA, as enacted, defined "Qualified Purchaser" for purposes of the Investment Company Act as natural persons with $5 million of investments or institutions that own or manage $25 million. NSMIA, *supra* note 14, sec. 209(b), § 51(A)(i)-(ii).

[81]Both section 2(15) of the 1933 Act, 15 U.S.C. § 77(b)(15) (2006), and Rule 501 of Regulation D, 17 C.F.R. § 230.501 (2008), set the wealth threshold to define "accredited" for individual investors at $1 million net worth or $200,000 annual income ($300,000 with spouse). This threshold is much lower than the Qualified Purchaser standard under the Investment Company Act as proposed by H.R. 3005, § 209(b).

C. *NSMIA—The Senate*

On May 23, 1996, Senator Philip Gramm (R-Tex.), chair of the Senate Banking Committee, introduced the Securities Investment Promotion Act of 1996[82] (the Senate Bill) as the Senate version of NSMIA. As drafted, the Senate Bill more narrowly tailored the definition of covered securities[83] and did not include Rule 506 private placements in the preemptive mix.[84] Like its House counterpart, the Senate Bill included sales to Qualified Purchasers to be defined by SEC rule within the category of covered securities.[85] The Senate Report suggests that the Qualified Purchaser category codified and standardized existing state exemptions for securities sales to those of wealth or sophistication who do not need the protections of the 1933 Act.[86] Given that the Senate Bill did not contain a separate provision preempting Rule 506 private placements, its vision of Qualified Purchasers is unclear. The Senate Committee could have viewed Qualified Purchasers as coterminous or overlapping with Rule 501 accredited investors, or it could have instead referred to a narrower group of institutional investors. Indeed, as noted in the Senate Report, at this time virtually every state had an exemption from state registration for sales solely to institutional or other accredited investors as defined by each state.[87] Alternatively, the Senate Committee might have intended that the SEC define the term "Qualified Purchaser" more restrictively in accordance with definitions of the same term used in concurrent amendments to the Investment Company Act.[88]

The Senate Banking Committee held one day of hearings on June 5, 1996.[89] No one at these hearings argued that the legislation should preempt the state regulation of Rule 506 private placements. To the contrary, Mr.

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[82]S. 1815, 104th Cong. (1996).

[83]Notably, Senate Bill 1815 contained disqualifiers to preemption even with respect to marketplace securities. *Id.* § 308 (amending section 18(b)(2) of the 1933 Act).

[84]*See id.*

[85]*Id.* (amending section 18(c) of the 1933 Act).

[86]S. REP. NO. 104-293, at 15 (1996).

[87]*Id.*; *see, e.g.*, UNIFORM SECURITIES ACT § 402(b)(8) (1956) (exempting transactions involving "any offer or sale to a bank, savings institution, trust company, insurance company, investment company as defined in the Investment Company Act of 1940, pension or profit-sharing trust, or other financial institution or institutional buyer, or to a broker-dealer").

[88]*See* S. REP. NO. 104-293, at 24 (discussing factors the SEC should consider in defining "qualified purchasers"). Under the Senate Bill, Qualified Purchasers for purpose of the Investment Company Act were those with $5 million in investments plus other purchasers defined as qualified by SEC rule. S. 1815, § 207(b).

[89]*See The Securities Investment Promotion Act of 1996: Hearing on S. 1815 Before the Comm. on Banking, Hous., and Urban Affairs*, 104th Cong. 64 (1996) [hereinafter *S. 1815 Hearing*].

Dee Harris, on behalf of NASAA, suggested that the states have sole regulatory authority over offerings under $5 million.[90] Other witnesses, including SEC Chairman Arthur Levitt, testified that the category of preempted offerings under the Senate Bill should expand to include secondary trading transactions, small federally-registered public offerings, and offerings of certain exempt securities, such as municipal securities.[91] No one, however, suggested adding Rule 506 private placements to the list of preempted transactions.

D. *NSMIA—The Conference Committee*

The bill that emerged from the Conference Committee again contained the provision preempting state regulation of Rule 506 private placements. The stated rationale for preempting certain offerings from state regulation related to the nature of the offering. Ostensibly, NSMIA preempted state regulation of offerings that were national in scope, while preserving state authority over smaller offerings.[92] With respect to private placements, the Conference Report merely noted that "certain private placements are inherently national in nature, and are therefore subject to only Federal regulation. Smaller, regional, and intrastate securities offerings remain subject to state regulation."[93] The Conference Report stressed the need to eliminate duplicative state and federal regulation and to appoint the federal government as the exclusive regulator of national securities offerings.[94] In

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[90] *Id.* Mr. Harris also testified that NASAA recognized the appropriateness of the market place exemption preempting state regulation of nationally listed securities. *Id.*

[91] *Id.* at 33. Paul Saltzman, senior vice president and general counsel of the Public Securities Association (the bond market trade association), suggested that the Committee add secondary trading, OTC debt securities, exempt securities, and asset-backed securities to the categories of preempted offerings. *Id.* at 147.

[92] The Conference Report stated, "With respect to securities offerings, the Managers have allocated regulatory responsibility between the Federal and state governments based on the nature of the securities offering." CONFERENCE REPORT, *supra* note 16, at 40, *reprinted in* 1996 U.S.C.C.A.N. at 3921. In fact, this statement, if not the legislation, was consistent with the position of the SEC. *See* Arthur Levitt, Chairman, Sec. & Exch. Comm'n, Remarks at the North American Securities Administrators Association Conference (Oct. 23, 1995), *available at* http://www.sec.gov/news/speech/speecharchive/1995/spch058.txt (recognizing states should continue to regulate certain categories of small offerings).

[93] CONFERENCE REPORT, *supra* note 16, at 40, *reprinted in* 1996 U.S.C.C.A.N. at 3921.

[94] *See id.* at 39-40, *reprinted in* 1996 U.S.C.C.A.N. at 3920-21 (describing the dual system of state and federal regulation as one "that, in many instances, is redundant, costly and ineffective"). The purpose of NSMIA, as defined by the Committee, is to "eliminate duplicative and unnecessary regulatory burdens while preserving important investor protections by reallocating responsibility over the regulation of the nation's securities markets in a more logical fashion." *Id.*, *reprinted in* 1996 U.S.C.C.A.N. at 3920-21.

spite of the Conference Report's explanation, however, NSMIA preempts state regulation of virtually all private placements,[95] not merely those that could be deemed national in scope.[96] Also missing from the Conference Report's analysis is the fact that private placements are exempt from pre-sale registration under federal law.[97] Therefore, rather than eliminating duplicative regulation over private placements, NSMIA in effect eliminated all regulation.[98]

III. PRIVATE PLACEMENTS—CIRCA 1996

A. *The Federal Regulations*

In 1996, Congress operated in the context of a private placement market and a set of federal and state regulations that had developed over many years. It is possible that NSMIA's preemption of state regulation of private placements simply represents the endgame in a three-decade long battle between state securities administrators, the securities bar, and the SEC.

Section 5 of the 1933 Act provides that all offers and sales of securities in interstate commerce must either be registered with the SEC or exempted from registration.[99] The private placement exemption is contained in section 4(2) of the 1933 Act which exempts nonpublic offerings.[100] As interpreted by the U.S. Supreme Court, however, section 4(2) only exempts offerings to sophisticated investors who can "fend for themselves."[101] The

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[95]NSMIA preempted private placements made pursuant to SEC Rules that interpret section 4(2) of the 1933 Act. The uncertain nature of private placements outside of SEC Rules, however, has made section 4(2) quite unattractive. Virtually all private placements therefore proceed under Rule 506. *See infra* text accompanying notes 151-66.

[96]With respect to the preemption of private placements, the Conference Report primarily tracks the House Committee Report. The Senate Bill did not contain a provision exempting private placements and therefore the Senate Committee Report does not speak to this issue except to note that private placements are not preempted.

[97]Moreover, in *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995), the Supreme Court eliminated a major source of civil enforcement of private placement fraud by placing private placement offering documents outside of the remedy provided by section 12(a)(2) of the 1933 Act. In his testimony on the Fields Bill, Professor Coffee urged Congress to restore section 12(a)(2) antifraud liability for private placements. *H.R. 2131 Hearings*, *supra* note 43, at 32-33.

[98]NSMIA passed in the Senate by unanimous consent and by 407 to 8 in the House of Representatives. 142 CONG. REC. 14619-20 (1996).

[99]15 U.S.C. § 77e (2006).

[100]Section 4(2) of the 1933 Act exempts "transactions by an issuer not involving any public offering." *Id.* § 77d(2). The legislative history notes that registration should not be required where there is no practical need to apply the 1933 Act or "where the public benefits are too remote." H.R. REP. NO. 73-85, at 5 (1933).

[101]SEC v. Ralston Purina Co., 346 U.S. 119, 125-27 (1953).

Court also held that to obtain the section 4(2) exemption, issuers must permit investors to access "the kind of information which registration would disclose."[102]

Unhappy with the fuzzy contours of the judicial interpretation of section 4(2),[103] small business issuers, their attorneys, and their lobbyists pressured the SEC to adopt an objective, more predictable test for the private placement exemption.[104] Although the SEC did in fact promulgate safe harbors for private offerings, they initially proved unsatisfactory to small business issuers,[105] and, in 1980, Congress added the key concept of an accredited investor to the 1933 Act.[106] In general terms, accredited investors are institutional investors of a certain size and individuals defined as wealthy.[107] Under section 4(6) of the 1933 Act, sales to accredited investors

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[102]*Id.* at 127. While initially the Eighth Circuit held that under *Ralston Purina* the issuer had to supply registration-statement-type information to investors, subsequent cases clarified that the test was disjunctive. This conclusion meant that issuers could meet the section 4(2) exemption of the 1933 Act by either disclosing or providing access to relevant information to sophisticated investors. Doran v. Petrol. Mgmt. Corp., 545 F.2d 893, 906 (5th Cir. 1977).

[103]*Ralston Purina* followed an earlier SEC interpretation of section 4(2) which stated that an offering to thirty-five purchasers does not qualify for the section 4(2) exemption. Securities Act Release No. 201, 11 Fed. Reg. 10,952 (July 20, 1934); *see also id.* ("I would call your attention to the fact that in previous opinions it has been expressly recognized that the determination of what constitutes a public offering is essentially a question of fact, in which all surrounding circumstances are of moment."). Similarly, in 1962, the SEC enumerated a multitude of factors that should be taken into account in assessing the availability of the section 4(2) exemption. *See* Non-Public Offering Exemption, Securities Act Release No. 33-4552, 27 Fed. Reg. 11,316 (Nov. 6, 1962).

[104]Attorneys were not only worried about regulatory enforcement should they "botch" an exemption, but also about strict liability to investors emanating from section 12(a)(1) of the 1933 Act. *See* 15 U.S.C. § 77l (2006) (imposing liability for violations of section 5 of the 1933 Act).

[105]*See* Sargent, *supra* note 9, at 236-42 (summarizing the SEC's attempts to craft exemptive private placement rules, discussing common criticisms of Regulation D, and suggesting that Regulation D was the culmination of a trend toward deregulation).

[106]Small Business Issuer's Simplification Act of 1980, Pub. L. No. 96-477 §§ 602-03, 94 Stat. 2275, 2294 (codified as amended at 15 U.S.C. §§ 77d(6), 77b(15) (2006)). The congressional record indicates that concern for the ability of small businesses to raise capital motivated the amendments. *See* S. REP. NO. 96-958, at 45 (1980). The concept of wealth as a surrogate for financial sophistication first appeared in 1980 in SEC Rule 242. *See* Exemption of Limited Offers and Sales by Qualified Issuers, Securities Act Release No. 33-6180, 45 Fed. Reg. 6362 (Jan. 28, 1980). Under Rule 242, accredited investor status was accorded to a limited number of institutional investors, issuer insiders, and individuals purchasing a minimum of $100,000 in securities. *Id.* For a review of the political and regulatory history surrounding this 1980 statute, see Howard M. Friedman, *On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291 (1994).

[107]Under section 2(15), added to the 1933 Act by the 1980 amendments, the definition of "accredited investor" includes specific institutional investors and individuals of a certain wealth or sophistication as permitted by SEC rules. 15 U.S.C. § 77b(15) (2006). This statutory definition is supplemented by SEC Rule 215, which defines "accredited investor" to include additional institutional investors of a certain size and wealthy individuals defined by an annual income of

are exempt from federal registration.[108] The theory underlying this exemption as applied to retail investors is that individuals of certain wealth do not need the protection of the 1933 Act either because they are themselves sophisticated or can hire sophisticated financial advisors.

On the heels of this congressional action, in 1982, the SEC adopted a parallel definition of accredited investor as part of Regulation D.[109] Rule 506 of Regulation D provides a safe harbor for private offerings under section 4(2) of the 1933 Act.[110] Under Rule 506, sales to accredited investors are exempt from federal registration[111] so long as they are nonpublic, as defined in the rule,[112] and issuers take reasonable precautions to guard against public resale.[113]

On the surface, Regulation D appears to provide a sensible, if not entirely acceptable, exemption permitting issuers to raise capital from sophisticated or wealthy investors in truly private transactions. The SEC, however, does not review Rule 506 offerings even on a sporadic basis to

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$200,000 (or $300,000 with a spouse) or joint spousal assets of $1 million. 17 C.F.R. § 230.215 (2008).

[108] 15 U.S.C. § 77d(6) (2006).

[109] The SEC first proposed Regulation D, along with its accompanying definition of "accredited investor," in Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, Securities Act Release No. 33-6339, 46 Fed. Reg. 41,791, 41,795 (proposed Aug. 7, 1981). It was adopted in 1982. *See* Revision of Certain Exemptions for Transactions Involving Limited Offers and Sales, Securities Act Release No. 33-6389, 47 Fed. Reg. 11,251 (Mar. 8, 1982).

[110] 17 C.F.R. § 230.506 (2008). The definition of accredited investor under SEC Rule 501, 17 C.F.R. § 230.501, parallels the definition adopted by the SEC in Rule 215, 17 C.F.R. § 230.215. The individual accredited investor wealth criteria has not changed significantly since 1982 (other than a 1988 amendment allowing consideration of spousal income and net worth). *See* Regulation D Revisions, Securities Act Release No. 33-6758, 53 Fed. Reg. 7866 (Mar. 3, 1988). In 2007, the SEC proposed changing the accredited investor definition and indexing the investor wealth criteria for future inflation. *See* Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 33-8828, 72 Fed. Reg. 45,116, 45,123 (proposed Aug. 3, 2007).

[111] 17 C.F.R. § 230.506. While antifraud liability concerns generally encourage issuers to provide disclosure to Rule 506 investors by means of a private placement offering memoranda, so long as sales are only to accredited investors, no specific disclosure is required. *Id.* Rule 506 also permits sales to no more than thirty-five unaccredited investors, as long as they are "sophisticated." *Id.* § 230.502(b). Sales to unaccredited investors, however, must meet disclosure requirements as set forth in Rule 502(b). *See id.* §§ 230.501-.508 (setting forth the disclosure requirements); *see also* Sargent, *supra* note 9 (providing general overview of Regulation D).

[112] 17 C.F.R. § 230.506(a). Rule 502(c) prohibits general solicitation or advertising which effectively restricts Rule 506 offerings to those investors with whom the issuer or its selling agent has a preexisting relationship. *Id.* § 230.502(c).

[113] *Id.* § 230.502(d). Privately-placed securities are "restricted" in the sense that they may not be resold without an exemption. *Id.* The most commonly utilized resale exemptions are section 4(1) of the 1933 Act, 15 U.S.C. § 77d(1) (2006), SEC Rule 144, 17 C.F.R. § 230.144, and SEC Rule 144A, 17 C.F.R.§ 230.144A.

determine compliance with the dictates of the exemption.[114] While Rule 503 requires issuers to file a Form D with the Commission to access the Rule 506 exemption,[115] failure to file is deemed an "insignificant deviation" and thus is of little consequence.[116] In any event, Form D does not give the Commission the information it would need to review the filings for compliance with Rule 506.[117]

Moreover, the Division of Corporate Finance Office of Small Business Policy, which is in charge of the Regulation D process, has a limited staff consisting of five attorneys and one secretary.[118] This small group could not possibly review the thousands of Regulation D filings each year to determine compliance.[119] As it stands, even when the Small Business Policy staff does become aware of Regulation D violations, it does not contact the violating companies and rarely refers such issues to the Division of Enforcement.[120]

The lack of federal review was not a major problem before NSMIA, as state regulators provided most of the review of private offerings. Yet in the reported congressional record surrounding NSMIA's preemption of this state authority, there is no hint of the SEC impotency over private placement regulation and no recognition of the regulatory void that Congress was about to create.

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[114]OIG 2009 REP., *supra* note 10, at 8. The Office of Inspector General (OIG) notes that the SEC depends upon the "honor system" when filers fill out Form D. *Id.* at 8-9.

[115]17 C.F.R. § 230.503.

[116]OIG 2009 REP., *supra* note 10, at 4. Rule 508 provides that the exemption will not be lost for an "insignificant" deviation from the rule, including failing to file the Form D. 17 C.F.R. § 230.508; *see also* U.S. Securities and Exchange Commission, Compliance and Disclosure Interpretations: Securities Act Rules, http://sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm (Answer to Question 257.07) (last visited Sept. 28, 2009). Rule 507, however, provides that an adjudicated failure to file a Form D will disqualify the issuer from future use of Regulation D. Regulation D; Accredited Investor and Filing Requirements, Securities Act Release No. 33,6825, 54 Fed. Reg. 11,369 (Mar. 14, 1989). To date, however, no such adjudication has occurred and the SEC has not instituted a single action against an issuer for failing to file a Form D. OIG 2009 REP., *supra* note 10, at 5.

[117]OIG 2009 REP., *supra* note 10, at 50-51. As amended in 2009, Form D only requires information concerning the date of first sale and limited information about the issuer and recipients of sales commissions. *Id.* at 6. It is not necessary to file a copy of disclosure statements. *See id.* at 20-22 (recommending improvements to Form D).

[118]*Id.* at 3.

[119]*Id.* at v. An early intervention program designed to combat fraud in securities offerings, including those under Rule 506, was terminated in 2005 due to lack of personnel. *Id.* at 14-15.

[120]*Id.* at 10. In the fifteen months ending December 2008, the SEC Corporate Finance Division referred only one issue involving Regulation D to the Division of Enforcement. *Id.* at 13. Yet in 2008, the OIG sampled forty-one Regulation D filings and found numerous violations. *Id.* at 18-20.

B. *The State Regulations*

Given the pre-NSMIA dual federal/state regulatory system, issuers needed state as well as federal exemptions from registration before they could sell securities. Before the SEC's adoption of Regulation D in 1982, states had myriad exemptions for private offerings that did not necessarily mesh with the federal rules governing private placements.[121] State blue sky laws did not generally contain generic exemptions for private placements that mirrored section 4(2) of the 1933 Act. Instead, to accommodate incidental or nonpublic transactions, state laws exempted sales to defined institutional investors and contained various exemptions for isolated transactions—exemptions not recognized under the federal statute.[122] Not only did state laws governing private securities offerings differ from the federal scheme, in many cases they differed from state to state.[123]

In the early 1980s, state administrators, represented by the NASAA, participated in the Regulation D drafting process. It was expected that states would enact exemptions at the state level to coordinate with the new federal exemption. As the dust settled over the years, the majority of states by 1996 had adopted a Uniform Limited Offering Exemption (ULOE) designed to

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[121]For a short introduction to these rules, see U.S. SEC. & EXCH. COMM'N, REPORT ON THE UNIFORMITY OF STATE REGULATORY REQUIREMENTS FOR OFFERINGS OF SECURITIES THAT ARE NOT "COVERED SECURITIES" (1997), *available at* http:www.sec.gov/news/studies/uniformy.htm#seciii.

[122]By 1996, all states provided an exemption for sales to defined "institutional buyers," although the precise definition of institutional investor varied from state to state. *See* Kenneth I. Denos, Comment, *Blue and Gray Skies: The National Securities Markets Improvement Act of 1996 Makes the Case for Uniformity in State Securities Law*, 1997 UTAH L. REV. 101, 120-21. The exemption for isolated transactions varied significantly among the states. *Id.* at 119. Examples of such idiosyncrasies include New Hampshire's limited offering exemption, which was extended to only five purchasers in any twelve month period, and Idaho's limited offering exemption, which was limited to no more than ten *offerees* in any twelve month period. IDAHO CODE ANN. § 30-1435(1)(i) (1996); N.H. REV. STAT. ANN. § 421-B:17(II)(h) (1997); *see* Denos, *supra*, at 119-20 (discussing the drawbacks of the isolated transaction exemption).

[123]*See* Denos, *supra* note 122, at 124. By 1996, forty-one states had adopted one version of the Uniform Securities Act that was initially adopted in 1956 and amended in 1985. *Id.* at 125 & n.153. Individual states, however, often varied the provisions of the Uniform Act when enacting state blue sky statutes. Furthermore, some major commercial jurisdictions such as California, New York, and Texas failed to adopt any of the provisions of the Uniform Act. *Id.* at 125.

coordinate with Regulation D.[124] Unfortunately, from the perspective of multistate issuers, there was little that was "uniform" about the ULOE.[125]

Some state securities administrators, disappointed that Regulation D as adopted did not include enough constraints, apparently reengaged the fight when promulgating their state coordination exemptions.[126] While not all states had provisions more restrictive than Rule 506, many had exemptions that were different from Rule 506,[127] and different from each other.[128] State ULOE laws varied with regard to filing and notice requirements,[129] application of "bad actor" disqualification provisions,[130] suitability standards,[131] filing deadlines,[132] and required disclosure.[133] Some states had

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[124]*See* Uniform Limited Offering Exemption § 1.D, NASAA Rep. (CCH) ¶ 6201, at 6104 (Apr. 1989) [hereafter ULOE]. In 1996, approximately forty states had adopted the ULOE, with an additional nine states adopting a non-ULOE exemption that coordinated with Regulation D. HUGH H. MAKENS, BLUE SKY PRACTICE—PART I: DOING IT RIGHT: AVOIDING LIABILITY ARISING FROM STATE PRIVATE OFFERINGS UNDER ULOE AND LIMITED OFFERING EXEMPTIONS 305, 332 (2009).

[125]Mark A. Sargent & Hugh H. Makens, *ULOE: New Hope, New Challenge*, 45 BUS. LAW. 1319, 1320 (1990). Only a few states' limited offering exemptions truly mirrored the ULOE, and, of those that did, some changed the requirements of the ULOE in subtle ways. *See* Therese H. Maynard, *The Uniform Limited Offering Exemption: How "Uniform" is "Uniform?"—An Evaluation and Critique of the ULOE*, 36 EMORY L.J. 357, 361-62 (1987).

[126]*See* Sargent, *supra* note 9, at 245-62 (describing background of the promulgation of Regulation D and suggesting that it was an SEC balancing act between state administrators who favored more regulation and the members of the securities bar who favored less regulation).

[127]For example, the ULOE permitted commissions to brokers or agents registered in the state of sale and also deviated from Regulation D by expanding "bad actor" disqualification to Rule 506 offerings, imposing suitability standards, and varying the key definition of accredited investor. *See generally* Maynard, *supra* note 125 (discussing how the uniformity of the ULOE unfolded).

[128]Exemptions ranged from statutes as broad as Minnesota's, which exempted from state regulation any transaction which qualified under Regulation D, to statutes as restrictive as Mississippi's, which only allowed sales up to ten purchasers in one year if all statutory conditions were met. *See* MINN. STAT. ANN. § 80A.15(2)(h) (West 1999); MISS. CODE ANN. § 75-71-203(9) (1999).

[129]Most states required the filing of a Form D or state equivalent with the state securities administrator, but specific additional filing requirements varied. *Compare, e.g.*, MD. CODE ANN., CORPS. & ASS'NS § 11-602(15) (LexisNexis 2007) (requiring disclosure only regarding brokers' commissions), *with* N.J. STAT. ANN. § 49:3-50(b)(12) (West 2001) (requiring detailed information about the issuer, seller, and all purchasers). Several states also require notice of termination or completion within a specified amount of time after the issuer has completed the offering. *See, e.g.*, Miss. Sec. Act Rules § 703(H) (2008) (stating notice of termination must be filed within thirty days of the completion of the issue).

[130]"Bad actor" disqualification provisions, found in Regulation A, 17 C.F.R. § 230.262 (2008), and applied in Regulation D at the federal level only to Rule 505 offerings, *id.* § 230.505, were often extended to Rule 506 offerings at the state level. Marc I. Steinberg, *The Emergence of State Securities Laws: Partly Sunny Skies for Investors*, 62 U. CIN. L. REV. 395, 404-05 (1993). But some states, such as California and New Jersey, did not adopt the ULOE and therefore do not have bad actor disqualification provisions. *See* CAL. CORP. CODE § 25102(f) (West 2006); N.J. STAT. ANN. § 49:3-50(b)(12) (West 2001).

[131]The ULOE provides for a subjective standard of suitability—that is, the issuer must itself

refused to adopt the ULOE altogether and instead continued to rely upon more idiosyncratic local exemptions.[134]

There is little question that issuers who desired to privately place securities in multiple states confronted a variety of inconsistent statutory and administrative standards. But how large of a problem was Congress, in fact, facing? Were the various state regulations unduly impeding capital formation, or were they in fact necessary to foster investor protection? The next section addresses the contours of the private placement market that Congress faced in 1996 and the market as it operates today.

C. The Private Placement Market

State laws governing private placements of securities were inconsistent in 1996 and, despite progress toward uniformity, inconsistencies remain today. Yet issuer concern over inconsistent state laws should ordinarily arise only when issuers conduct large multistate offerings. Indeed, NSMIA preempted state pre-sale regulation of all Rule 506 private placements largely on the stated rationale that such offerings were national in scope.[135] This justification for Congress's decision to preempt state laws would at least be plausible if private placements were in fact national. Available evidence, however, strongly suggests that Congress overshot the mark and preempted private offerings that were not national under any reasonable definition.

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reasonably believe that the investment is suitable for the purchaser. However, the ULOE presumes suitability of an investor if her investment is less than 10% of her net worth, and many states—even some non-ULOE states—have adopted this provision, although some have raised the amount to 20% or even 25%. Many states have adopted the suitability standards directly from the ULOE. *See, e.g.*, Miss. Sec. Act Rules § 703(A)(4); 7 TEX. ADMIN. CODE § 109.13(k)(6) (2009). Other states, however, have additional suitability requirements—for example, that investors have a preexisting relationship with the issuer or its controlling persons unless the investors are sophisticated.

[132]The time frame for filing ranges from before the offering can be commenced to sixty days after the first sale. *See, e.g.*, OHIO REV. CODE ANN. § 1707.03(Q)(4) (Lexis Nexis 2004) (requiring filing within sixty days after first sale); MD. CODE REGS. 02.02.04.12 (D)(1) (2009) (ending fifteen days after first sale).

[133]Some states required consent to service of process or any offering materials to be submitted along with a Form D, or both. *See, e.g.*, OHIO REV. CODE ANN. § 1707.03 (requiring a sales report); 70 PA. STAT. ANN. § 1-203(d) (West 1995) (offering materials); 7 TEX. ADMIN. CODE § 109.13(k)(5) (requiring consent to service of process and all information furnished to offerees); *cf.* CAL. CORP. CODE § 25102(f) (stating failure to file does not jeopardize the exemption, but may result in a penalty fee).

[134]In the aftermath of NSMIA, a few states have amended their blue sky laws to acknowledge federal preemption, but most have not excised the state-specific limited offering exemptions from their statutes. *See generally* MAKENS, *supra* note 124, at 309-10.

[135]*See* CONFERENCE REPORT, *supra* note 16, at 40.

Exact figures on the size and nature of the private placement market that Congress addressed in 1996 are not available. In 1984, the SEC published a comprehensive report on Regulation D filings during its first year of operation.[136] This study reported that Regulation D was primarily used by small business issuers, although in dollar terms its primary beneficiaries may have been larger companies and investors.[137] Since that time, however, the SEC has published no statistics concerning Form D filings and apparently has not tracked the various types of Regulation D offerings.

But there is little question that in the decade before 1996, there were private placements that could be deemed "national in scope," at least if measured by size of the issuer or size of the offering.[138] In monetary terms, the largest private placement market has historically been in debt securities, primarily corporate bonds. This private placement debt market originally provided financing for smaller companies unable to access the public bond markets and in effect substituted for commercial lending. As time went on, however, larger publicly-traded companies accessed the private placement market to sell debt securities. One study suggests that from 1985 to 1995, 23% of the $4.3 trillion in U.S. corporate bonds sold were privately placed.[139] The bonds were generally sold to a single investor or a small group of investors. For example, from 1990 to 1992, life insurance companies purchased between 50% and 80% of all private placement bond issues.[140] Other institutional investors accounted for all but 3.7% of the rest

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[136]An Analysis of Regulation D, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,631, at 86,886 (May 1984) [hereinafter SEC Analysis 1984].

[137]*Id.*

[138]*See* Letter Comment from Tom Stewart-Gordon, Editor, SCOR Report, on Securities Act Release No. 33-8041 (Feb. 12, 2002), *available at* http://www.sec.gov/rules/proposed/s72301/stewartgordon1.htm:

> '[n]ational' must mean securities of issuers who are known to investors in all parts of the country—either because it is a reporting company quoted on a widely reported market, or because the issuer's securities are traded by a large network of investors, either through brokers or through a less formal arrangement").

Id.

[139]Simon H. Kwan & William T. Carlton, *Financial Contracting and the Choice between Private Placement and Publicly Offered Bonds* 1 (Fed. Res. Bank of S.F., Working Paper No. 2004-20, 2004), *available at* http://www.frbsf.org/publications/economics/papers/2004/wp04-20bk.pdf. From 1994-95, the private placement bond market was almost 40% of the public market and by year end 1996, nonfinancial corporations had approximately $450 billion in privately placed debt securities outstanding. Stephen D. Prowse, *The Economics of Private Placements: Middle-Market Corporate Finance, Life Insurance Companies, and a Credit Crunch*, ECON. REV. (Fed. Reserve Bank of Dallas, Dallas, Tex.), Third Quarter 1997, at 12, 13.

[140]Mark Carey et al., The Economics of the Private Placement Market 28 (Dec. 1993) (unpublished study, *available at* http://www.federalreserve.gov/Pubs/StaffStudies/1990-99/ss166.pdf).

of the private placement bond purchasers in this time frame.[141] The adoption of Rule144A in 1990 added greater liquidity to private placement investments by institutional investors and helped spur further growth of this market.[142]

There are some informative statistics published by private sources that track the private placement market for equity securities of public companies in the time period contemporaneous with NSMIA. Sagient Research Systems, Inc., for example, provides market data, research, and analysis about private placements through its PlacementTracker service.[143] Sagient Research limits its statistics to private investment in public securities (PIPE),[144] Rule 144A, and Regulation S[145] transactions in which either the issuer or the purchaser is a public reporting company. Sagient Research reports that in 1995 there were 127 reported private placements in the amount of $1,870,021,044, while in 1996 there were 351 private placements valued at $9,075,905,590.[146] One study reports that the primary investors in these large equity private placements were state pension funds, large corporate pension funds, endowment funds, finance companies, and corporations.[147]

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[141] *Id.* at 27.

[142] *See* Sjostrom, *supra* note 5, at 411 (2008) (analyzing the development of Rule 144A equity offerings). Rule 144A allows issuers to market and sell securities to Qualified Institutional Buyers (QIBs) so long as the same class of securities does not trade on the public markets. QIBs are defined as institutional investors with at least $100 million of securities not affiliated with the issuer. Rule 144A also allows QIBs to trade among themselves without restriction. *See* 17 C.F.R. § 230.144A (2008). NASDAQ reports that approximately $1 trillion of debt and equity capital was raised in 2006 through Rule 144A offerings, a 300% increase over 2002. Press Release, NASDAQ Stock Market, Inc., NASDAQ's Electronic Trading Platform for the 144A Private Placement Market is Approved by the SEC; The PORTAL Market Trading System Will Begin Operating on August 15 (Aug. 1, 2007), *available at* http://ir.nasdaqomx.com/releasedetail.cfm?ReleaseID=257543. Given Rule 144A's non-fungibility rule, most U.S. issuers raise debt capital pursuant to Rule 144A, while foreign firms can raise either debt or equity. Sjostrom, *supra* note 5, at 411.

[143] Sagient Research Systems, Inc., Placement Tracker Private Placement Resources, http://www.sagientresearch.com/pt/Stats.cfm?Type=9 (last visited Nov. 18, 2009) [hereinafter Sagient Research].

[144] PIPE transactions are private investments in securities of publicly-traded companies. PIPE transactions are usually effectuated utilizing Rule 506. Marc. I. Steinberg & Emmanuel U. Obi, *Examining the Pipeline: A Contemporary Assessment of Private Investments in Public Equity ("PIPEs")*, 11 U. PA. J. BUS. L. 1, 17-18 (2008). In its PIPE figures, Sagient Research states that it includes shelf sales and equity line arrangements that "actually require a registration statement to be effective prior to the sale of the stock, technically making them public offerings. [They are tracked] as PIPEs because these structures emerged as [an] offshoot from the PIPE market." Sagient Research, *supra* note 143.

[145] Issuers conducting both PIPE transactions and Rule 144A offerings rely upon Rule 506; Regulation S is a separate issuer exemption for offshore sales. *See* 17 C.F.R. § 230.901-.905 (2008).

[146] Sagient Research, *supra* note 143.

[147] Carey et al., *supra* note 140, at 81-82. This time period also saw equity offerings by

The above evidence shows that by 1996 there was undoubtedly a national private placement market, especially if "national" offerings are defined as offerings that are issued or purchased by public, or at least reporting, companies or if "national" offerings are defined by the size of the offerings. Even these large placements, however, were usually not national in scope in the sense that they were sold to purchasers in many different states. Instead, a single or a very few institutional investors comprised the purchasers, and such offerings were traditionally exempt from state registration.[148]

The private placement market for securities issued by nonpublic companies is nearly impossible to trace because private entities need not make public reports of their stock issuances or purchases.[149] Not surprisingly, the limited available evidence suggests that private placements by nonpublic entities are rarely national in scope. Investors in private businesses tend to have a "neighborhood bias" and invest close to home.[150] It is therefore doubtful that very many small business issuers were generally subject to multiple state regulations in 1996 and thus they received little benefit from NSMIA's Rule 506 preemption provisions.

The private placement market today is not remarkably different from that which faced Congress in 1996 except that it has grown exponentially in size, as measured by private placements by public reporting issuers and investors.[151] Similar to the circumstances in 1996, the vast majority of

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private equity funds structured as limited partnerships. *Id.*

[148]While state definitions of institutional investors varied somewhat, virtually every state preempted transactions to the institutions comprising the vast majority of purchasers of large private placements.

[149]Since 1984, when it reported that Regulation D was primarily used by smaller companies, the SEC has published no statistics concerning the use of Regulation D by nonpublic companies. For the 1984 empirical analysis of the use of Regulation D by securities issuers, see SEC Analysis 1984, *supra* note 136.

[150]Stewart-Gordon, *supra* note 138.

> My comments are based on interviews with, and surveys of, more than 2,000 small business issuers who have attempted to raise money . . . .
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> . . . Ten years of tracking public Rule 504, Regulation A and Intrastate offers has shown me that investors want to know the companies they are investing in and the people who run those companies. That means they invest close to home, usually within [a] radius of 25 miles from their home. Angel and venture capital investors tend to have the same neighborhood bias. Thus the ability to sell in all states is of little, if any benefit.

Id.

[151]Since 1996, the size of this market for PIPE, Rule 144A, and Regulation S offerings have grown each year to a record $117.6 billion in 2008, before dropping off as a result of the financial crisis in late 2008. Sagient Research, *supra* note 143. The OIG, in its 2009 Report, corroborated the volume of Regulation D transactions, noting that the SEC received 28,594 and 27,107 Form D filings in 2007 and 2008 respectively. OIG 2009 REP., *supra* note 10, at 8.

private placements, as measured by dollar volume, were sales of debt securities by publicly-traded companies to institutional investors.[152] More recently, PIPE transactions[153] and sales of securitized assets have accounted for a large share of the private placement market.[154] Again, purchasers in these transactions tend to be institutional investors.[155]

Since the enactment of NSMIA, Rule 506 private placements by smaller, nonreporting firms remain quite difficult to quantify.[156] The SEC recently reported that Regulation D was "originated as an effort to assist small business capital formation and continues to play an important role in that arena,"[157] but the Commission has no statistics on the utilization of Rule 506 by nonreporting entities. While issuers are required to file a form D when they utilize Regulation D,[158] the SEC has not tracked information relating to the nature of the issuers, the size of offerings,[159] or whether the issuer is relying upon Rule 504, 505, or 506.[160] Also excluded from reported private placement statistics are sales of interests in hedge funds and private equity funds that are ordinarily structured as limited partnerships.[161] These

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[152]*See* Brian G. Cartwright, General Counsel, Sec. & Exch. Comm'n, Address at the University of Pennsylvania Law School Institute for Law and Economics: The Future of Securities Regulation (Oct. 24, 2007) (noting the increasing prevalence of institutional investors and the "deretailization" of U.S. securities markets).

[153]PIPE transactions have increased from 306 deals in 1996, representing over $4 billion, to 1,454 deals in 2007, valued at over $83 billion. Steinberg & Obi, *supra* note 144, at 5.

[154]Indeed, in an ironic twist given today's financial crisis, concern for the private placement of securitized assets unhampered by state regulation was a key component of the congressional preemption rationale in NSMIA. *See* H.R. REP. NO. 104-622, at 31 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3894 (encouraging the SEC to construe purchasers of asset and mortgage-backed securities as qualified purchasers).

[155]Sagient Research, *supra* note 143.

[156]The SEC reported that from January 2000 to March 2001, small businesses reported unregistered offerings of $1.2 trillion, but statistics from other time periods were not collected. OFFICE OF INSPECTOR GENERAL, SEC. & EXCH. COMM'N, AUDIT NO. 371, SMALL BUSINESS REGULATION D EXEMPTION PROCESS 1 (2004), *available at* http://www.sec-oig.gov/Reports/AuditsInspections/2004/371fin.pdf [hereinafter OIG 2004 REP.].

[157]Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 33-8828, 72 Fed. Reg. 45,116, 45,116 (proposed Aug. 3, 2007).

[158]17 C.F.R. § 230.503(a)(1) (2008).

[159]In monetary terms, the OIG estimated that in 2008, companies that filed Form Ds intended to raise approximately $609 billion. OIG 2009 REP., *supra* note 10, at 2.

[160]*Id.* at 8-12. In 2004, and again in 2009, the OIG recommended that the SEC track Regulation D statistics. *Id.* at 12; OIG 2004 REP., *supra* note 156, at 4. In response to the 2009 OIG Report, the Corporate Finance Division of the SEC has agreed to track such aggregate information in the future. OIG 2009 REP., *supra* note 10, at 52-53. This task is simplified by a new requirement for issuers to file Form Ds electronically. *See* Electronic Filing and Revision of Form D, Securities Act Release No. 33-8891, 73 Fed. Reg. 10,592, 10,605 (Feb. 6, 2008).

[161]OIG 2009 REP., *supra* note 10, at 9. While precise figures on hedge funds are not available, it is estimated that in July 2007 the number of U.S. hedge funds was about 9,000 with

private, pooled funds usually rely on Rule 506 in offering their limited partnership interests to investors and ordinarily limit purchasers to accredited investors.[162] Currently, however, there are no reporting requirements to enable the tracking of the use of Rule 506 by these entities.

Under NSMIA, states can still require filings of Form Ds, but NASAA does not track these filings in the aggregate.[163] State regulators, however, regularly report that since the passage of NSMIA, they have seen a large increase in Rule 506 filings.[164] Indeed, restoring state authority over Rule 506 offerings has been a centerpiece of NASAA's legislative agenda

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assets of about $1.4 trillion, a 400% increase from 1999. *Hedge Funds and Systemic Risk: Perspectives from the President's Working Group on Financial Markets: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 61-66 (2007) (statement of Robert K. Steel, Treasury Under Secretary for Domestic Finance); *see also* SEC. & EXCH. COMM'N., IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, at vii (2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf (projecting continued growth in the number of hedge funds operating in the United States); Jenny Anderson & Riva D. Atlas, *Is This the New Emerald City, or the Road to the Next Crash?*, N.Y. TIMES, Mar. 27, 2005, at 3.1 (noting amounts managed by hedge funds in the past fifteen years increased from $40 million to approximately $1 trillion).

[162]*See* JAMES M. SCHELL, PRIVATE EQUITY FUNDS: BUSINESS STRUCTURE AND OPERATION (1999); Franklin R. Edwards, *Hedge Funds and Investor Protection Regulation*, ECON. REV. (Fed. Reserve Bank of Atlanta, Atlanta, Ga.), Fourth Quarter 2006, at 35, 39. Hedge funds also indirectly rely upon Rule 506 to obtain an exemption from the Investment Company Act of 1940 (ICA) that regulates mutual funds. Section 3(c)(1) of the ICA exempts hedge funds that have fewer than 100 investors and do not engage in public offerings and section 3(c)(7) exempts funds that have only qualified investors, defined as those with $5 million in investments, a higher threshold than Rule 506. *See* 15 U.S.C. § 80a-3(c)(1), (c)(7) (2006).

[163]NASAA occasionally presents statistics from selected states. *See, e.g.*, Brief for the N. Am. Sec. Adm'rs Ass'n, Inc., as Amicus Curiae Supporting Appellees, Consol. Mgmt. Group, LLC v. Dufauchard, No. 06-17011, 2007 WL 4688895 (9th Cir. Apr. 3, 2007).

> The number of Regulation D, Rule 506 offerings 'notice filed' with the states is significant. For example, in California, 8,215 Regulation D, Rule 506 filings were submitted to the Department of Corporations in 2006. In Georgia, the number of Rule 506 offerings filed was 1788; in Tennessee the number filed was 1,288; and, in Maryland the number was 2,134.

Id. at 11 n.3. Not all states track filed Form Ds. The state filings, even if tracked, are not 100% accurate, as states report that not all issuers file with the states as required.

[164]Letter Comment from Deborah R. Bortner, Director, Sec. Div. of the Wash. Dep't of Fin. Insts., on Securities Act Release No. 33-8014 (Feb. 25, 2002), *available at* http://www.sec.gov/rules/proposed/s72301/bortner1.htm ("Following preemption, Rule 506 filings increased dramatically."); Letter Comment from Robert M. Lam et al., Pa. Sec. Comm'n, on Securities Act Release No. 33-8014 (Feb. 19, 2002), *available at* http://www.sec.gov/rules/proposed/s72301/lam1.htm (noting that after NSMIA preemption, "suddenly all phony investment programs offered by out-of-state boiler rooms were pitched as Rule 506 offerings"); Letter Comment from Matthew Nestor, Director, Mass. Sec. Div., on Securities Act Release No. 33-8014 (Feb. 25, 2002), *available at* http://www.sec.gov/rules/ proposed/s72301/nestor1.htm (noting that Massachusetts, along with other states, has seen an increasing number of Rule 506 offerings); Letter Comment from S. Anthony Taggart, Director, Utah Div. of Sec., on Securities Act Release No. 33-8014 (Feb. 25, 2002), *available at* http://www.sec.gov/rules/proposed/s72301/taggart1.htm (stating that since the passage of NSMIA, "the Division has noted a dramatic increase in problems associated with offerings that are exempt under Rule 506").

for a number of years.[165] In speeches and testimony, NASAA officials have emphasized the marked increase in Rule 506 offerings by smaller issuers after NSMIA preempted state pre-sale authority in 1996.[166]

In summary, the largest private placements in dollar volume, which could at one level be deemed national in scope, are typically marketed to a single or limited number of institutional investors, making the preemption rationale of inconsistent state laws untenable. Moreover, all states in 1996 had exemptions for these large sales to institutional investors. The typical smaller company utilizing Rule 506 did not need NSMIA preemption because such companies marketed primarily to local investors and thus contended with very few state requirements. Nonetheless, and in spite of contrary statements in the congressional record, NSMIA preempted state regulation of these smaller offerings as well.

IV. NSMIA AND THE PREEMPTION DEBATE

When Congress preempts state law, it usually displaces it in favor of a federal regulatory scheme.[167] Indeed, in adopting NSMIA, the Conference Committee stated that its goal was to eliminate duplicative state rules and to subject national offerings only to federal regulation.[168] NSMIA exemplifies

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[165] *See, e.g.*, *Special Report: A Pro-Investor Legislative Agenda*, NASAA INSIGHT (N. Am. Sec. Adm'rs Ass'n, Wash., D.C.), Winter 2009, at 4; *Special Report: A Pro-Investor Legislative Agenda*, NASAA INSIGHT (N. Am. Sec. Adm'rs Ass'n, Wash., D.C.), Winter 2008, at 3.

[166] *See, e.g.*, Fred Joseph, President, N. Am. Sec. Adm'rs Ass'n, News Conference at the National Press Club, Washington, D.C.: An Agenda for Change: How the 111th Congress Can Better Protect Investors (Jan. 29, 2009) [hereinafter An Agenda for Change] (stating that Rule 506 offerings have become the favorite Regulation D offering and that many of them are fraudulent); Fred J. Joseph, Colo. Sec. Comm'r and President, N. Am. Sec. Adm'rs Ass'n, Inc., Testimony Before the United States Senate Committee on Banking, Housing, and Urban Affairs: Enhancing Investor Protection and the Regulation of Securities Markets (Mar. 26, 2009) [hereinafter Testimony of Fred J. Joseph] (noting that since NSMIA was enacted, state regulators have witnessed a steady and significant rise in the number of fraudulent Rule 506 offerings and calling upon Congress to reinstate state regulatory authority); James B. Ropp, Comm'r, Del. Div. of Sec. and Chair of the Enforcement Section, N. Am. Sec. Adm'rs Ass'n, Inc., Testimony Before the United States House Committee on Financial Services: Federal and State Enforcement of Financial Consumer and Investor Protection Laws (Mar. 20, 2009) (detailing state enforcement actions on the front line of securities regulation and calling upon Congress to reinstate state authority over Rule 506 offerings).

[167] *See* William W. Buzbee, *Asymmetrical Regulation: Risk, Preemption, and the Floor/Ceiling Distinction*, 82 N.Y.U. L. REV. 1547, 1601-03 (2007) (discussing the normative case for federal preemption and its form as floor or ceiling preemption); Merrill, *supra* note 39, at 733 (arguing that federal preemption of state law is grounded in the Supremacy Clause of the U.S. Constitution); Caleb Nelson, *Preemption*, 86 VA. L. REV. 225, 234-45 (2000) (arguing that the Supremacy Clause is the key in understanding the modern debate over preemption).

[168] CONFERENCE REPORT, *supra* note 16, at 39-40, *reprinted in* 1996 U.S.C.C.A.N. at 3920-21.

what preemption scholars denote as "express preemption," given the explicit NSMIA language preempting state pre-sale regulation over covered securities.[169] Yet as is true with most instances of express preemption, there is still some ambiguity in the scope of NSMIA as it addresses Rule 506 private placements.[170] The major litigated issue regarding the breadth of NSMIA preemption is whether an issuer must actually meet the requirements of Rule 506 to obtain preemption or whether simply asserting to state authorities that the offering was pursuant to Rule 506 achieved the desired preemptive effect.[171] Courts initially arrived at different conclusions on this issue, but an emerging majority now finds that the issuer must meet the requirements of Rule 506 to obtain NSMIA preemption.[172]

Along with express preemptive provisions, NSMIA contains two express savings clauses: first, states continue to have the power to investigate

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[169]The other primary category of preemption is implied preemption, which can include subcategories such as field preemption, conflict preemption, and obstacle preemption. Merrill, *supra* note 39, at 738-40; Christopher H. Schroeder, *Supreme Court Preemption Doctrine*, *in* PREEMPTION CHOICE: THE THEORY, LAW, AND REALITY OF FEDERALISM'S CORE QUESTION 119, 119-43 (William W. Buzbee ed., 2009).

[170]*See* Geier v. Am. Honda Motor Co., 529 U.S. 861, 884-86 (2000) (explaining that even if an express preemption clause did not require preemption of a state tort claim, the Court could nonetheless preempt the claim on the basis of implied preemption); *see also* Freightliner Corp. v. Myrick, 514 U.S. 280, 287 (1995) (finding no merit in the argument that "implied pre-emption cannot exist when Congress has chosen to include an express pre-emption clause in a statute").

[171]Regulation D is not a self executing exemption. The availability of the exemption is preconditioned on meeting the requirements of the Rule including non-solicitation, appropriate disclosure, and a notice filing requirement. See *infra* note 172 for a list of cases that discuss the provisions of Regulation D.

[172]As of this writing, one federal appellate court, two federal district courts, and five state appellate courts have found that NSMIA does not preempt state law unless an issuer actually demonstrates compliance with Rule 506. *See* Brown v. Earthboard Sports USA, Inc., 481 F.3d 901, 911 (6th Cir. 2007); Grubka v. WebAccess Int'l, Inc., 445 F. Supp. 2d 1259, 1270 (D. Colo. 2006); Hamby v. Clearwater Consulting Concepts, LLLP, 428 F. Supp. 2d 915, 920-21 (E.D. Ark. 2006); Buist v. Time Domain Corp., 926 So. 2d 290, 297-98 (Ala. 2005); Consol. Mgmt. Group, LLC v. Dep't of Corps., 75 Cal. Rptr. 3d 795, 801-04 (Cal. Ct. App. 2008); Apollo Capital Fund, LLC v. Roth Capital Partners, LLC, 70 Cal. Rptr. 3d 199, 218-19 (Cal. Ct. App. 2007); Risdall v. Brown-Wilbert, Inc., 753 N.W.2d 723, 730-31 (Minn. 2008); *In re* Blue Flame Energy Corp., 871 N.E.2d 1227, 1243 (Ohio Ct. App. 2006).

On the other hand, three federal district courts have reached the opposite conclusion, finding that NSMIA preempts state law when an issuer merely "relies" upon Rule 506. *See* Pinnacle Commc'ns Int'l v. Am. Family Mortgage Corp., 417 F. Supp. 2d 1073, 1087 (D. Minn. 2006); Lillard v. Stockton, 267 F. Supp. 2d 1081, 1116 (N.D. Okla. 2003); Temple v. Gorman, 201 F. Supp. 2d 1238, 1242-44 (S.D. Fla. 2002). For a comprehensive analysis of this issue, see Robert N. Rapp & Fritz E. Berckmueller, *Testing the Limits of NSMIA Preemption: State Authority to Determine the Validity of Covered Securities and to Regulate Disclosure*, 63 BUS. LAW. 809 (2008); G. Philip Rutledge, *NSMIA . . . One Year Later: The States' Response*, 53 BUS. LAW. 563, 565 (1998).

and prosecute securities fraud;[173] and second, the states can require Form D filings and collect fees.[174] The Supreme Court narrowly construes savings clauses like those included in NSMIA, and these clauses do not bar the ordinary workings of conflict preemption principles.[175] Predictability, litigation emerged over the scope of the NSMIA savings clauses regarding the appropriate line between permissible fraud investigations and prohibited state pre-sale regulation.[176] The savings clause allowing states to continue to require Form D filings and collect fees has similarly engendered controversy.[177]

On one level, NSMIA simply exemplifies express preemption of state regulation with some room at the margins for judicial interpretation. Here, however, is where NSMIA departs from the norm and forces an inquiry beyond the usual rhetoric regarding congressional intent. In spite of pronouncements in the congressional record, NSMIA does not, with regard to private placements, preempt state law in favor of federal regulation but rather preempts state law in favor of no regulation. Professor Jonathan Nash recently labeled this kind of preemption "null preemption," explaining that "[n]ull preemption is a unitary federal choice—with the federal choice being a regulatory vacuum."[178] In its purest form, null preemption requires an express statutory directive that state law be preempted even in the absence of

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[173]NSMIA, *supra* note 14, sec. 102(a), § 18(c)(1).

[174]*Id.* sec. 102(a), § 18(c)(2)(B).

[175]*See Geier*, 529 U.S. at 869; *see also* Sandi Zellmer, *When Congress Goes Unheard: Savings Clauses' Rocky Judicial Reception*, *in* PREEMPTION CHOICE, *supra* note 169, at 144, 144-66 (describing the Supreme Court's doctrine of preemption as it applies to savings clauses).

[176]California appellate courts have held in two separate cases that the California attorney general's suits against broker-dealers regarding nondisclosure of shelf space agreements were not preempted by NSMIA because they fell within NSMIA's savings clause. *See* People v. Edward D. Jones & Co., 65 Cal. Rptr. 3d 130, 133, 138-39 (Cal. Ct. App. 2007); Capital Research & Mgmt. Co. v. Brown, 53 Cal. Rptr. 3d 770, 773, 776 (Cal. Ct. App. 2007). A Connecticut trial court came to the same conclusion in Papic v. Burke, 43 Conn. L. Rptr. 256 (Conn. Super. Ct. 2007) (holding that NSMIA did not preempt state authority to issue a cease and desist order and levy a civil fine on the grounds that Rule 506 offering circular was fraudulent); *see also* Energy Exploration Inc., Case No. 2009-AH-009, Ky. Dep't of Fin. Insts. 4-5 (2009) (issuing an order to suspend the offer and sale of securities under Rule 506 due to material misstatements by the offeror in a private placement memorandum).

[177]*See, e.g.*, Chamberlin v. Advanced Equities, Inc., No. CO1-502R, 2002 WL 34419450, at *1-3 (W.D. Wash. Jan. 17, 2002) (finding that NSMIA did not preempt Washington state's filing requirement and granting rescission where issuer failed to comply with it).

[178]Jonathan R. Nash, *Null Preemption*, 85 NOTRE DAME L. REV. (forthcoming 2010) (manuscript at 3, on file with author); *see also* Robert L. Glicksman, *Federal Preemption by Inaction*, *in* PREEMPTION CHOICE, *supra* note 169, at 167, 167-91 (analyzing a related concept of preemption by federal inaction and concluding that Congress should explicitly justify the regulatory void in its preemption provisions).

federal standards.[179] Professor Nash suggests legislation governing national banking institutions[180] and federal labor standards as two concrete examples of null preemption.[181] In both cases, Congress preempted state law and established a "zero" level of federal regulation.[182]

Taken at face value, however, NSMIA does not exemplify intentional null preemption. As discussed in Part II, there are numerous examples in the congressional record demonstrating that Congress intended NSMIA to eliminate duplicative regulation, not all regulation.[183] Notably, while the original Fields Bill contained a provision preempting state regulation of transactions exempt under federal law, including section 4(2) of the 1933 Act, NSMIA as finally enacted limited this preemption to transactions exempt under SEC rules interpreting section 4(2).[184] This limitation suggests that Congress intended some level of regulation of private offerings at least at the federal administrative level. Moreover, the legislative history expressly states that larger, national private placements would be subject to federal regulation while smaller offerings would remain subject to state authority.[185]

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[179]While noting that null preemption is rare, Nash suggests that it may become more common as industry groups recognize its utility. Nash, *supra* note 178 (manuscript at 27).

[180]*Id.* (manuscript at 14); *see, e.g.*, Watters v. Wachovia Bank, N.A., 550 U.S. 1, 15-21 (2007) (holding that federal law preempts state law that purports to regulate national banks, even if federal law does not fill the regulatory gaps).

[181]Nash, *supra* note 178 (manuscript at 14); *see, e.g.*, Chamber of Commerce v. Brown, 128 S. Ct. 2408, 2412 (2008) (reaffirming that under judicial interpretations of the NLRA, Congress intended for certain conduct in this area to "be unregulated [and] left 'to be controlled by the free play of economic forces.'" (quoting Machinists v. Wis. Employment Relations Comm'n, 427 U.S. 132, 140 (1976))).

[182]One example of "null preemption" in the securities arena is embodied in the Commodity Futures Modernization Act, Pub. L. No. 106-554, 114 Stat. 2763 (2000) (CFMA), which guarantees no federal or state regulation of credit default swaps. In 2000, the CFMA excluded credit default swap (CDS) from the definition of "security" under the 1933 and 1934 Acts and barred the regulation of CDS and other derivatives. Absent congressional intervention, the SEC has no legal basis to impose reporting or disclosure requirements on CDS market participants. Moreover, the CFMA severely limited state regulation of CDS. *See* Lynn A. Stout, *How Deregulating Derivatives Led to Disaster, and Why Reregulating Them Can Prevent Another* 6-7 (UCLA Sch. of Law, Law-Econ. Research Paper No. 09-13, 2009), *available at* http://ssrn.com/abstract=1432654.

[183]*See, e.g.*, CONFERENCE REPORT, *supra* note 16, at 39-40, *reprinted in* 1996 U.S.C.C.A.N. at 3920-21.

[184]*Compare H.R. 2131 Hearings*, *supra* note 43, at 184-85 (discussing the bill's elimination of duplicate state and federal regulations through broad federal preemption of state authority), *with* NSMIA, *supra* note 14, sec. 102(a), § 18(b)(4)(D) (limiting the definition of covered security to, among others, securities exempt pursuant to "Commission rules or regulations issued under section 4(2)").

[185]CONFERENCE REPORT, *supra* note 16, at 39, *reprinted in* 1996 U.S.C.C.A.N. at 3920.

Perhaps NSMIA exemplifies accidental null preemption in that Congress did not recognize the impact of NSMIA's preemptive provisions.[186] Indeed, the congressional record evidences two major miscalculations in the preemption of Rule 506 private placements: first, that NSMIA only impacted the private offerings that were national in scope; and second, that state regulation of private placements duplicated federal rules.[187] As established in Part II of this article, neither of these foundational rationales for NSMIA preemption of Rule 506 offerings were accurate.[188] Congress may have preempted state law without recognizing that its preemption would result in no regulation.

If NSMIA's preemption of Rule 506 private placements does not evidence a congressional misstep, then it may be little more than an appendage to the deregulatory fervor that dominated the political scene in the1990s. Often, Congress passes stringent regulation in times of crisis and relaxes regulation in boom times.[189] It is not surprising then that Congress passed NSMIA during a period of tremendous American economic growth and in the midst of one of the longest-running bull markets in history.[190] By 1996, significant economic indicators—the percent growth rate in real gross domestic product,[191] national unemployment rate,[192] and inflation rate[193]—

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[186]Nash labels this congressional misunderstanding as a "regulatory preemptive mismatch." Nash, *supra* note 178 (manuscript at 19).

[187]As Nash explains:

> Duplicative regulation null preemption occurs when the federal government decides to preempt state law on the ground that the state law to be preempted is duplicative of federal law. . . . Here, [in its pure form] the federal government does not understand itself to be effecting null preemption: There is federal law on point, after all. From the perspective of the states (and presumably others in society) . . . [there is] null preemption to the extent that they do not see the state law to be duplicative of federal law.

Id.

[188]*See supra* Part II.D.

[189]Amitai Aviram, *Counter-Cyclical Enforcement of Corporate Law*, 25 YALE J. ON REG. 1, 11-17 (2008) (stating that the SEC regulates only after market downturns, rather than in good economic times when investors may need added protection); Stuart Banner, *What Causes New Securities Regulation?: 300 Years of Evidence*, 75 WASH. U. L.Q. 849, 855 (1997) (arguing that economic crashes are the primary cause of new securities regulation).

[190]During the Fields Bill's hearings, representatives noted the American stock market's outstanding success. *See, e.g.*, *H.R. 2131 Hearings*, *supra* note 43, at 132 (statement of Rep. Klink, Republican, Pennsylvania) (stating that the nation had "just gone through an extraordinary week where day after day the markets keep breaking new records"); *id.* at 4 (testimony of Rep. Markey, ranking Democrat) ("Overall, the stock markets are in the midst of the longest run in this century, now about 5 years, without a 10 percent drop. This has been an unprecedented boom for companies, investors and Wall Street firms." "By virtually every statistical measure, our capital markets are vibrant and healthy").

[191]*See* ECONOMIC REPORT OF THE PRESIDENT: 2009 SPREADSHEET TABLES, tbl. B-4

evidenced an economic boom. Federal Reserve Chairman Alan Greenspan emphasized this trend, saying, "A number of fundamentals point to an economy basically on track for sustained growth."[194]

During the same period, Americans noted the economy's success and expressed optimism. The Conference Board, a nonprofit organization, released an index showing that, in 1996, consumer confidence reached its highest level since 1989.[195] Clinton administration officials corroborated the Conference Board's Report and noted the economy's outstanding performance.[196] A similar report, released by the Conference Board in 1997, led experts to conclude that "Americans remain optimistic about the economy" and to predict continued positive economic growth.[197]

Earlier, in 1994, Republicans ran on a platform of coordinated campaign pledges (Contract with America) which resulted in "a remarkable legislative flurry that largely fulfilled the campaign promises that so many Republicans made during the 1994 elections."[198] An emphasis on deregulation characterized the Contract with America and its legislative

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(2009), *available at* http://www.gpoaccess.gov/eop/tables09.html. From 1995-1998, the economy experienced a steady percent increase in real gross domestic product: 4% in 1994; 3.7% in 1996; 4.5% in 1997; and 4.2% in 1998. *Id.*

[192]The unemployment rate reached 5.4% in 1996 which demonstrated a decline from 6.1% in 1994 and 5.6% in 1995. *Id.* tbl. B-42. The employment rate continued to decline to 4.5% in 1998 and 4.2% in 1999. *Id.*

[193]Inflation remained at its lowest average since the Kennedy Administration, prompting the President's economic advisors to claim, "[e]conomic performance during the past 3 years has been exceptional. . . . [Inflation] is no longer the factor it once was in economic decisions." ECONOMIC REPORT OF THE PRESIDENT 41 (1996), *available at* http://www.gpoaccess.gov/eop/download.html. Additionally, the Consumer Price Index (CPI) for urban wage earners only rose by 2.5% in 1995 and 3.3% in 1996. ECONOMIC REPORT OF THE PRESIDENT: 2009 REPORT SPREADSHEET TABLES, *supra* note 191, tbl. B-64. The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. For more information about the CPI, please review The Bureau of Labor and Statistics website, http://www.bls.gov/cpi/ (last visited July 5, 2009).

[194]Robert D. Hershey Jr., *Testimony by Greenspan Rattles Stock and Bond Markets; Hopes of Rate Cut Dim as Economy is Termed "Basically on Track,"* N.Y. TIMES, Feb. 21, 1996, at D1.

[195]Jacob M. Schlesinger, *Americans are Largely Upbeat About Economy*, WALL ST. J., Sept. 25, 1996, at A2.

[196]*See id.*

> Clinton administration officials were quick to embrace the Conference Board report as a sign that voters are finally appreciating administration policies to bolster the economy. "The economy has been performing very well," said Joseph Stiglitz, chairman of the Council of Economic Advisors. "This just reflects a realistic assessment of a super performance."

Id.

[197]Jacob M. Schlesinger, *Consumers Remain Highly Confident on U.S. Economy*, WALL ST. J., Feb. 26, 1997, at A2.

[198]John J. Pitney, Jr. et al., *100 Days That Shook the World?*, POL'Y REV., Summer 1995, at 18.

progeny.[199] By 1996, as the economy expanded, President Clinton ran for reelection against Bob Dole and won a sweeping victory.[200] Clinton's triumph, however, coincided with legislative elections in which Republicans retained a majority in the U.S. House of Representatives and in the Senate.[201] Notably, it was the first time in sixty-six years that Republicans won the House in two consecutive elections.[202] This electoral success, combined with an expanding economy, helped to reinforce the Republicans' focus on deregulation.[203] Voters affirmed their desire for a bipartisan political center, and Congress responded with a continued emphasis on deregulation of business.[204]

Viewed through this deregulatory lens, NSMIA's preemption of state regulation of private placements may represent merely another chapter in the story of interest-group politics.[205] Public choice theory predicts that organized groups will bid for legislative outcomes that further their own self-interest and that rational legislators will reward the highest bidders with desired legislation.[206] Industry groups donated heavily to Representative

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[199] *See, e.g.*, *He Did It*, ECONOMIST, Apr. 8, 1995, at 25 ("More dramatic [than two bills signed into law restricting 'unfunded mandates'] were the bills to rein in regulation, to deter frivolous civil litigation and to refashion the welfare system.").

[200] *Northeast*, N.Y. TIMES, Nov. 7, 1996, at B9 (discussing democratic dominance in the northeastern states in recent elections).

[201] Adam Clymer, *In Early Results, Voters Give Meager Hints on the Outcome of the Battle for the House*, N.Y. TIMES, Nov. 6, 1996, at B3.

[202] *Id.*

[203] *See, e.g.*, Newt Gingrich, *Conservatism Now*, NAT'L REV., Dec. 22, 1997, at 42, 42-45.

> We want tax reform—tax reform so thorough that we can abolish the [Internal Revenue Service] as we know it. Period.
>
> I would hope that by May or June we will have introduced a bold tax-reform bill that would allow us to do two great things (in addition to saving time for the American people). It would allow us to dramatically shrink both the Internal Revenue Service (which now has 110,000 people) and the number of lobbyists on 14th Street.

Id.

[204] *See, e.g.*, *id.* A *New York Times* journalist observed, "[T]he American people actually seem to have sent a pretty clear message. They think the country is going in the right direction, toward a leaner but still active Federal Government." Editorial, *The Road Ahead*, N.Y. TIMES, Nov. 7, 1996, at A32.

[205] *See* William W. Landes & Richard A. Posner, *The Independent Judiciary in an Interest-Group Perspective*, 18 J.L. & ECON. 875, 877 (1975) ("In the economists' version of the interest-group theory of government, legislation is supplied to groups or coalitions that outbid rival seekers of favorable legislation.").

[206] For a concise explanation of public choice theory and the impact of interest groups on legislative outcomes, see Daniel A. Farber & Philip P. Frickey, *The Jurisprudence of Public Choice*, 65 TEX. L. REV. 873, 873-901 (1987); *see also* Jonathan R. Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 227-33 (1986) (discussing the economics of the interest group theory of legislation).

Fields, who chaired the House Subcommittee on Telecommunications and Finance in the two years before the introduction of the Fields Bill.[207] Representatives from the securities industry dominated the list of those invited to testify at congressional hearings. Representatives from the Investment Company Institute (ICI),[208] Securities Industry Association,[209] and the Public Securities Association[210] testified in both the House Commerce Committee hearings on the Fields Bill and in the Senate Committee hearings on NSMIA. Representatives from the American Bankers Association[211] and the Managed Futures Association [212] testified in the House Commerce Committee hearings, and representatives from the National Venture Capital

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[207]As reported by *Money*, securities, banking, and insurance political action committees contributed more than $220,000 to Representative Fields in the two years leading up to the Fields Bill's attempt to deregulate vast portions of the securities market. Top contributors included JP Morgan, Citicorp, First Boston, Nations Bank, Merrill Lynch, the American Bankers Association, Goldman Sachs, and the ICI. Similarly, House Commerce Committee Chairman, Representative Thomas Bliley, a Republican from Virginia, received tens of thousands of dollars from industry PACs. Ruth Simon, *How Washington Could Tip the Scales Against Investors*, MONEY, Oct. 1995, at 122. Data maintained by The Center for Responsive Politics indicates that from 1994-1996, PACs associated with the finance and insurance and real estate sector contributed $400,000 to Representative Fields (nearly 4x the contributions he received in the previous election cycle) and $100,816 to Representative Bliley. During this same time period, these PACs contributed $450,988 to Alfonse M. D'Amato, a Republican, who chaired the Senate Banking Committee from1995-1998. Data on file with author, courtesy of The Center for Responsive Politics, http://www.opensecrets.org/.

[208]The ICI is the national association of U.S. investment companies, including mutual funds. *See* Investment Company Institute, http://www.ici.org/ (last visited Nov. 18, 2009).

[209]The Securities Industry Association represents participants in the securities industry such as broker-dealers. On November 1, 2006, the Securities Industry Association merged with the Bond Market Association to form the Securities Industry and Financial Markets Association (SIFMA). According to its website, SIFMA is a nonprofit industry association that represents the shared interests of participants in the global financial markets. SIFMA members include international securities firms, U.S. registered broker-dealers, and asset managers. *See* SIMFA: Securities Industry and Financial Markets Association, http://www.sifma.org/about/about.html (last visited Nov. 18, 2009).

[210]In 1996, the Public Securities Association (PSA) was the bond market trade association representing securities firms and banks that underwrite, trade, and sell debt securities both domestically and internationally. In 2006, this organization was renamed the "Bond Market Association" and later merged with the Securities Industry Association to form SIFMA. *See id.*

[211]The American Bankers Association, founded in 1875 and based in Washington, D.C., unites banks of all sizes and charters in one organization. About ABA: ABA General Information Page, http://www.aba.com/About+ABA/default.htm (last visited Nov. 18, 2009).

[212]In 1996, the Managed Futures Association was a trade association primarily representing the managed futures industry. It is now known as the "Managed Funds Association." In addition to the managed futures industry, the Association now represents professionals in hedge funds and other alternative investments, as well as brokers, exchanges, and all other services that support the industry. *See* About MFA, http://www.managedfunds.org/about-us.asp (last visited Oct. 11, 2009).

Association[213] and Investment Counsel Association[214] testified in the Senate hearings.

There is no question that the industry representatives opposed continued state regulation over mutual funds and public offerings of various securities that were subject to federal requirements, but they did not generally speak to nonpublic offerings.[215] In fact, one academic who testified in favor of greater federal preemption of state securities regulation suggested that public choice theory can explain NSMIA's more limited preemptive provisions as compared to the original Fields Bill.[216] Thus, it is difficult to place NSMIA's preemption of state regulation of Rule 506 private placements at the feet of interest group politics,[217] recognizing, of course, that we are not privy to backroom lobbying that does not appear in the public record.[218]

Some combination of conservative political will fueled by Wall Street contributions and backroom lobbying, coupled with a possible misunderstanding of private placements, contributed to NSMIA's preemptive force. As discussed above, while there may be federal requirements for private

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[213]According to its website, "The National Venture Capital Association (NVCA), comprised of more than 400 member firms, is the premier trade association that represents the U.S. venture capital industry. NVCA's mission is to foster greater understanding of the importance of venture capital to the U.S. economy, and support entrepreneurial activity and innovation." National Venture Capital Association, http://www.nvca.org/index.php?option=com_content&view=article&id=67&Itemid=95 (last visited Nov. 18, 2009).

[214]The Investment Counsel Association, which was founded in 1937, is a not-for-profit organization that represents the interests of SEC-registered investment advisory firms. *See* IAA: Background and Mission, http://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=BackgroundMission (last visited Nov. 18, 2009) (noting that the Investment Counsel Association changed its name in 2005 to the "Investment Advisor Association").

[215]One exception was the testimony in the Senate hearings by Paul Saltzman, on behalf of the PSA, who argued for the expansion of the preemptive provision in the Senate Bill to include non-registered debt securities and asset backed securities, whether privately or publicly issued. *S. 1815 Hearing*, *supra* note 89, at 147. Congress attempted to address this concern by preempting state regulation of "Qualified Purchasers." *See, e.g.*, H.R. REP. NO. 104-622, at 30-31 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3893-94.

[216]*See* Rutheford B Campbell, Jr., *The Impact of NSMIA on Small Issuers*, 53 BUS. LAW. 575, 584-85 (1998) (suggesting that the mutual fund industry, represented by the ICA, and state securities administrators, who were represented by the NASAA, successfully obtained desired legislative results while diverse groups of small business owners did not).

[217]Scholars do not universally accept public choice theory. *Compare, e.g.*, Jonathan R. Macey, *Cynicism and Trust in Politics and Constitutional Theory*, 87 CORNELL L. REV. 280, 281-82, 307-08 (2002), *with* Edward L. Rubin, *Public Choice, Phenomenology, and the Meaning of the Modern State: Keep the Bathwater, but Throw Out That Baby*, 87 CORNELL L. REV. 309, 360 (2002).

[218]*See, e.g.*, S. REP. NO. 104-293, at 2 (1996) (noting that the Senate Committee had received comments, suggestions, and assistance from numerous private and public individuals).

placements to come within the scope of Rule 506, in reality there is no federal regulatory enforcement.[219] The SEC does not review Form D filings and rarely investigates Rule 506 offers.[220] Also of note is that NSMIA, as originally conceived, stripped the SEC of two commissioners and 20% of its budget.[221] Therefore, it does not take an extreme cynic to view NSMIA's preemption primarily as deregulation, rather than a systematic apportionment of appropriate responsibilities between federal and state regulators. This politically driven reality lessens the temptation to view this issue as part of the broader philosophical debate on federalism[222] and the recurring question of appropriate state and federal roles for securities regulation.[223] But regardless of motivation or cause, there is currently no federal or state regulation of private placements. This regulatory failure calls for a meaningful and substantive solution.

V. A MODEST PROPOSAL

After NSMIA, the Rule 506 offering became the exemption of choice for nonpublic issuers. More importantly, it has also become, in the words of one state regulator, a favorite vehicle for fraudulent transactions.[224] Although as a percentage the vast majority of retail investors intersect the securities markets through institutional intermediaries, many retail investors —sometimes the most vulnerable retail investors—purchase private

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[219] *See supra* note 178 and accompanying text.

[220] *See supra* notes 156-62 and accompanying text.

[221] H.R. 3005, 104th Cong. § 402 (1996) (cutting SEC fees by $680 million over five years); *H.R. 2131 Hearings*, *supra* note 43, at 279 (reducing the number of SEC Commissioners from five to three).

[222] *See* William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619, 619-20 (2006); Reza Dibadj, *From Incongruity to Cooperative Federalism*, 40 U.S.F. L. REV. 845, 878 (2006) (arguing for a principle of "co-operative" federalism as opposed to dual federalism or preemptive federalism as a framework for securities regulation); Renee M. Jones, *Does Federalism Matter? Its Perplexing Role in the Corporate Governance Debate*, 41 WAKE FOREST L. REV. 879, 911-12 (2006); Roberta S. Karmel, *Reconciling Federal and State Interests in Securities Regulation in the United States and Europe*, 28 BROOK. J. INT'L L. 495, 496, 546 (2003) (discussing regulatory competition and concluding that national regulation better protects investors). For an earlier debate on the implications of federalism and the SEC, compare Alison Grey Anderson, *The Meaning of Federalism: Interpreting the Securities Exchange Act of 1934*, 70 VA. L. REV. 813, 853-54 (1984), with Edmund W. Kitch, *A Federal Vision of the Securities Laws*, 70 VA. L. REV. 857, 857 (1984).

[223] John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 710 n.6 (2009) ("Federalism is, of course, the opium of law professors, which they can rarely avoid, even if there is nothing new to be said.").

[224] *See* Testimony of Fred J. Joseph, *supra* note 166.

placement offerings.[225] These investors, operating in a regulation-free environment, can easily become fraud victims. Indeed, over half of the complaints state regulators receive involve securities fraud resulting from nonpublic offerings directed to senior citizens.[226]

One solution to the problematic absence of regulation begins with taking the legislative history supporting the passage of NSMIA at face value.[227] The congressional record clearly states that the purpose of NSMIA was to preempt private placements that are national in scope and generally subject to federal regulation, leaving smaller offerings to the province of state regulators. But differentiating national offerings from smaller offerings immediately encounters a definitional hurdle: What does it mean for a private placement to be "national"? "National" could implicate geography, offering size, class of securities, categories of issuers, categories of purchasers, or a combination of these factors. National offerings must equate to something more than just multistate offerings.

Under NSMIA, not even all public offerings actually registered with SEC under section 5 of the 1933 Act enjoy statutory preemption. Although some who testified at the hearings, including SEC Chairman Levitt, suggested that NSMIA preemption extend to all securities registered with the SEC,[228] Congress chose a more limited definition. Registered securities are only "covered securities" subject to preemption under NSMIA when listed on specified national securities exchanges[229] or exchanges that have similar listing standards as determined by SEC rule.[230] The exchange listing standards provide a measure of quality control to protect investors even beyond

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[225] *Id.* Individual investors can also invest in intermediaries such as hedge funds which utilize the Rule 506 exemption. *See supra* notes 161-62 and accompanying text.

[226] *See* N. AM. SEC. ADM'RS ASS'N, *NASAA Survey Shows Senior Investment Fraud Accounts for Nearly Half of all Complaints Received by State Securities Regulators*, July 17, 2006, *available at* http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/4998.cfm ?CFID=19519 61&CFTOKEN=31447551&CFID=2752870&CFTOKEN=35874666.

[227] While resort to legislative history is a perilous endeavor, at least the stated rationales underlying NSMIA support this proposal to return private placements back to state regulation even if NSMIA language does not.

[228] *S. 1815 Hearing*, *supra* note 89, at 28 (statement of Chairman Levitt).

[229] NSMIA, *supra* note 14, sec. 102(a), § 18(b)(1)(A). NSMIA preempts state registration or merit regulation over securities listed or authorized for listing on the New York Stock Exchange (NYSE), the American Stock Exchange, or the National Market System of NASDAQ (collectively, the Named Markets). The preemption also applies to any national securities exchange designated by the Commission to have substantially similar listing standards to the Named Markets. *Id.* sec. 102(a), § 18(b)(1)(C). In addition, securities of the same issuer that are equal in seniority or senior to a security listed on a Named Market or national securities exchange designated by the Commission as having substantially similar listing standards to a Named Market are covered securities for purposes of section 18 of the 1933 Act. *Id.*

[230] *Id.* sec. 102(a), § 18(b)(1)(B).

the 1933 Act requirements.[231] Similarly, NSMIA preempts state regulation over mutual funds registered under, and subject to, the Investment Company Act's substantive and disclosure requirements.[232] These provisions indicate that Congress intended "national" offerings to mean, at a minimum, offerings actually regulated at the federal level. This explanation also conforms to statements in the congressional record that NSMIA's purpose was to eliminate duplicative federal and state regulation.[233]

The regulation of private placements should parallel other NSMIA provisions preempting state regulation of securities transactions. Congress should not preempt state regulation absent the availability and effectiveness of alternative federal oversight to ensure quality control. Given the lack of federal oversight, either Congress or the SEC should return the authority to regulate smaller private placements to the states. Accordingly, this article advocates federal preemption only for private placements by issuers, or to purchasers, that are defined as accredited *institutional* investors in Rule 501(a)(1) and (2) of Regulation D,[234] or entities subject to federal disclosure regulation under the 1934 Act.[235] Other private placements should be, once again, subject to state pre-sale review. For the most part, this proposal means that only qualified institutional and public company issuers and investors would enjoy NSMIA preemptive relief from state pre-sale regulation.[236] Sales by unregulated private entities such as limited partnerships to individual investors would be subject to state review.[237]

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[231] *See, e.g.*, H.R. REP. NO. 104-622, at 30 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3893. ("The Committee expects the Commission to monitor the listing requirements of these exchanges, consistent with its supervisory authority under the Exchange Act, to ensure the continued integrity of these markets and the protection of investors.").

[232] *See id.* at 30-31, *reprinted in* 1996 U.S.C.C.A.N. at 3893. Mutual Funds are regulated by the Investment Company Act of 1940 and NASD and possess strong internal compliance programs. *See generally* 15 U.S.C. §§ 80a-(1) to -(64) (2006).

[233] *See* CONFERENCE REPORT, *supra* note 16, at 39-40, *reprinted in* 1996 U.S.C.C.A.N. at 3720-21.

[234] 17 C.F.R. § 230.501(a)(1)-(2) (2008) (defining specified institutions as accredited investors). In 2007, the SEC proposed amending Regulation D to include a broader range of institutions. *See* Revisions of Limited Offerings Exemptions in Regulation D, Securities Act Release No. 33-8828, 72 Fed. Reg. 45,116, 45,122-23 (proposed Aug. 3, 2007).

[235] *See* 15 U.S.C. § 781(b), (e). While other federal regulations such as the Investment Company Act of 1940 and Employee Retirement Income Security Act contain similar disclosure requirements, entities subject to these regulations will qualify as Rule 501 accredited investors. *See generally* Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829.

[236] States, however, may exempt a broader class of investors as accredited investors for state disclosure purposes.

[237] Under this proposal, most hedge funds and private equity funds that are currently unregulated would face state review of securities they issue pursuant to Rule 506.

The limitation of preemption to defined institutional issuers is premised on the fact that such entities are otherwise subject to federal regulation.[238] Similarly, these institutions in their investor roles have both the sophistication and the means to investigate private placements. In addition, they are subject to fiduciary and other obligations under state and federal laws that protect their individual investors.[239]

No doubt, as the recent financial crisis has demonstrated, there is much room to improve the regulation of institutions that intermediate between individual investors and the securities markets.[240] Many scholars believe that the SEC should increase its oversight of these intermediaries, such as investment advisors and broker-dealers.[241] Also, there is also a growing recognition that the accredited investor standard provides insufficient protection for investors. Some argue that the accredited investor standard is deficient because the wealth criteria for individual investors have not been adjusted since 1982.[242] Others, however, contend that the concept itself is fatally flawed, and that wealth is not an appropriate surrogate for investor sophistication.[243] But even assuming the viability of an accredited

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[238]Mutual funds, for example, are regulated by the Investment Company Act of 1940. *See generally* 15 U.S.C. §§ 80a-1 to -64 (2006). Pension plans are regulated by the Employee Retirement Income Security Act of 1974.

[239]*See, e.g.*, Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (2006) (regulating investment advisors to mutual funds and those with $25 million in assets under management); MODEL BUS. CORP. ACT §§ 8.30(a), 8.42(a) (2007) (requiring that directors and officers shall act "(1) in good faith, and (2) in a manner [he or she] reasonably believes to be in the best interests of the corporation").

[240]This proposal does not impact the regulation of broker-dealers that act as placement agents for private placements. Broker-dealers are subject to FINRA regulations and incur liability for selling securities that are unsuitable for investors.

[241]*See, e.g.*, Barbara Black, *Are Retail Investors Better off Today?*, 2 BROOK. J. CORP. FIN. & COM. L. 303, 306 (2008) (arguing that the SEC does not adequately protect nonaccredited retail investors); Jill E. Fisch, *Top Cop or Regulatory Flop? The SEC at 75*, 95 VA. L. REV. 785 (2009) (recommending greater SEC oversight of financial intermediaries and arguing that even institutional investors need regulatory protection); Friedman, *supra* note 106, at 314 (arguing that brokers should be subject to stricter suitability requirements when selling private placement securities).

[242]*See* Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1058 (2009) (arguing that the wealth measure of the accredited investor standard has eroded to the point where "solidly upper-middle class investors now readily qualify"). In 2007, the SEC proposed indexing the Rule 501 wealth standard for inflation and adding an alternative investments-owned standard that excludes personal real estate. *See* Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 33-8828, 72 Fed. Reg. 45,116, 45,123 (proposed Aug. 3, 2007). With respect to investors in hedge funds and other pooled investment vehicles, the SEC noted that investors may not be able to appreciate the risks specific to private pooled offerings, such as "undisclosed conflicts of interest, complex fee structures, and the higher risk that may accompany such pools' anticipated returns," and proposed a higher wealth standard for such purchasers. *Id.* at 45,127.

[243]*See generally* Stephen Choi, *Regulating Investors Not Issuers: A Market-Based*

investor definition, there is no visible push for federal oversight of the exemption even in an amended form.

Congress could create regulatory oversight of private placements by returning the review of smaller private placements to the states. NASAA representatives recently testified to this effect before both houses in an attempt to spur federal legislative action.[244] But a congressional amendment, or repeal of legislation, is an uphill and seldom swift process, even if Congress agrees that the existing statute contains flaws.[245] Perhaps NASAA may make headway in today's political climate of regulatory reform, but its lobbying goals remain far from assured. Moreover, for some issuers, a wholesale return to state regulation of private placements means they would again face inconsistent state rules, an issue that provides a rallying point for opponents to counter a congressional fix to this problem.

The SEC is perhaps better poised to improve NSMIA by returning to the states the regulatory purview of Rule 506 private placements by private entities to largely retail investors. The Commission could amend Rule 506 to precondition the federal exemption, as applied to private entity issuers and individual investors, upon review by at least one state agency that mandates disclosure absent a state exemption. There is precedent for this approach in Rule 504, which conditions the ability to advertise and to sell unrestricted stock upon compliance with the registration and disclosure laws of least one state.[246] Under this proposal, issuers could choose the regulatory regime of

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Proposal, 88 CAL. L. REV. 279 (2000) (arguing that regulations should only permit unsophisticated investors to purchase index funds, not in individual securities); Friedman, *supra* note 106, at 299-301 (detailing the failings of a system which equates wealth with sophistication); Manning Gilbert Warren III, *A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933*, 33 AM. U. L. REV. 355, 382 (1984) (arguing that the wealthy often do not have the sophistication to evaluate the merits and risks of private placement investments nor does satisfaction of such criteria necessarily mean they can bear the risk of loss); Wallis K. Finger, Note, *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition Under the 1933 Act*, 86 WASH. U. L. REV. 733, 748 (2009) (arguing that the SEC should not use a wealth-based proxy to define "accredited investor" and proposing an investor licensing scheme); Letter Comment from Sheldon M. Jaffe on Securities Act Release No. 33-8828 (Oct. 29, 2007), *available at* http://www.sec.gov/comments/s7-18-07/s71807-59.pdf ("The proposed amendment to Rule 501 will simply serve as an additional license for promoters to prey upon the elderly.").

[244] *See* Testimony of Fred J. Joseph, *supra* note 166; *see also* Ropp, *supra* note 166 (detailing the specific requests NASAA is making to Congress). This article advocates a proposal far less ambitious than NASAA's agenda to return regulation of all private placements back to the states.

[245] *See* Roberta Romano, *Does the Sarbanes-Oxley Act Have a Future?*, 26 YALE J. ON REG. 229, 234 (2009) ("The core lesson to be learned from federal financial-market regulation is that modification or repeal of poorly conceived legislation can take years, if not decades, to accomplish, despite the best judgment of those best informed—the academic and business community—that the legislation is, in significant parts, profoundly flawed.").

[246] 17 C.F.R. § 230.504(b) (2008). The analogy to Rule 504 is not perfect, as issuers selling securities pursuant to Rule 504 remain subject to the securities laws of each state in which they

at least one state in which they wish to sell securities. This state review would qualify the issuers to sell securities under Rule 506 in other states with the concomitant NSMIA preemption. This approach would help solve the remnants of state nonuniformity for exemptions regarding private placements. At worst, issuers would only have to contend with one state's disclosure regime. At best, states with idiosyncratic exemptions may join with the vast a majority of states in adopting the Uniform Securities Act, largely eliminating an issuer's opportunity for regulatory arbitrage.[247]

Does the SEC possess the institutional will to make such a change?[248] The Commission recently recognized the necessity of adding some quality control into Rule 506 by proposing to expand the so-called bad-actor disqualifiers to Rule 506 offerings.[249] "Bad actors" are issuers or their affiliates whom federal and state authorities previously have disciplined for securities law violations.[250] Although disqualifiers are now part of both the Regulation A exemption[251] and exempt offerings pursuant to Rule 505 under Regulation D,[252] there are currently no disqualifiers for Rule 506 offerings. Before NSMIA, state disqualification provisions excluded most recidivists. Almost immediately after the passage of NSMIA, state regulators began to witness promoters with significant disciplinary histories associating with issuers who wanted to raise capital.[253] State regulators have argued for years that the absence of Rule 506 disqualifiers coupled with NSMIA preemption

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intend to sell securities. However, Rule 504 provides that compliance with the disclosure regime of one state will allow an issuer to advertise and sell unrestricted securities in additional states that do not have registration or disclosure requirements.

[247]Roberta Romano has made a more ambitious proposal that all firms should be able to "select their securities regulator from among the fifty states and the District of Columbia, the SEC, or other nations." Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2427 (1998).

[248]Donald Langevoort has intensively studied the institutional behavior of the SEC. *See* Langevoort, *supra* note 242; *see also* Donald C. Langevoort, *The SEC as a Lawmaker: Choices About Investor Protection in the Face of Uncertainty*, 84 WASH. U. L. REV. 1591 (2006) (discussing what drives and constrains the SEC as a federal corporate lawmaker). For additional work on this theme, see John C. Coates IV, *Private vs. Political Choice of Securities Regulation: A Political Cost-Benefit Analysis*, 41 VA. J. INT'L L. 531 (2001); Anne M. Khademian, *The Securities and Exchange Commission: A Small Regulatory Agency with a Gargantuan Challenge*, 62 PUB. ADMIN. REV. 515 (2002); Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909 (1994); Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 1035; A.C. Pritchard, *The SEC at Seventy: Time for Retirement?*, 80 NOTRE DAME L. REV. 1073 (2005).

[249]Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 33-8828, 72 Fed. Reg. 45,116, 45,130 (proposed Aug. 3, 2007).

[250]"Bad actors" are defined in Rule 262, 17 C.F.R. § 230.262 (2008).

[251]*See id.*

[252]17 C.F.R. § 230.505 (2008).

[253]*See* Rutledge, *supra* note 172, at 565-66.

of state review allowed many fraudulent transactions to occur at investors' expense.[254] More than ten years later, the SEC proposed to apply the disqualifiers uniformly to Regulation D offerings in conformance with NASAA's agenda, but has yet to adopt the Rule.[255] While the SEC's recent initiative, if adopted,[256] would keep many repeat offenders off the road, states argue that the proposed rule fails to go far enough.[257] Moreover, it does nothing to address SEC apathy toward supervising Rule 506 offerings.

Unfortunately, the SEC's willingness to establish some boundaries for Rule 506 offerings does not necessarily mean that it supports returning some control back to states. For example, in the same release proposing to add disqualifiers to Rule 506 offerings, the SEC proposed to adopt Rule 507, a new exemption based on the concept of a "large accredited investor."[258] The SEC proposal defines "large accredited investors" as "Qualified Purchasers" under NSMIA and would therefore result in federal preemption of any state pre-sale regulations now covering such sales[259] The Commission notes in its release that the policy rational for preempting Rule 507 offers is the same as that for Rule 506 offerings, and cites the NSMIA House Report.[260] In what can best be described as unprincipled reasoning, the SEC does not mention that the NSMIA House Report contains very meager support for rationalizing private placement preemption. In fact, in the entire House Report, there is but one sentence even mentioning private placements. This lone phrase fails to provide a cogent explanation for why Congress included private placements as covered securities.[261] Similarly, the Conference

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[254]*See* An Agenda for Change, *supra* note 166.

[255]Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 33-8828, 72 Fed. Reg. 45,116, 45,130 (proposed Aug. 3, 2007).

[256]*See* OIG 2009 REP., *supra* note 10, at 15-16 (stating that revision and adaption of the changes proposed in Securities Act Release No. 33-8828 would assist both federal and state authorities in regulating private placements).

[257]NASAA, acting on behalf of state regulators, has stated that it favors this SEC proposal but differs with the states on the appropriate parameters of the disqualifiers provisions. *See* Letter Comment from Karen Tyler, President, NASAA, on Securities Act Release No. 33-8828 (Oct. 26, 2007), *available at* http://www.sec.gov/comments/s7-18-07/s71807-57.pdf.

[258]Under the Proposed Rule 507, to qualify as "large accredited investors," most legal entities would be required to have $10 million in investments. Individuals generally would be required to own $2.5 million in investments or have annual income of $400,000 (or $600,000 with one's spouse). Revisions of Limited Offering Exemptions in Regulation D, 72 Fed. Reg. at 45,117. Issuers would be allowed limited advertising to large accredited investors. *Id.* at 45,118.

[259]*Id.*

[260]*See id.* at 45,112 & n.80 (noting that the policy rationales "for making securities in Rule 506 transactions 'covered securities' also support making securities in Rule 507 transactions 'covered securities'" and are "contained in the legislative history of NSMIA, especially H.R. Rep. No. 104-622, at 159-65 (1996)").

[261]H.R. REP. NO. 104-622, at 32, *reprinted in* 1996 U.S.C.C.A.N. 3877, 3895. ("The

Report only mentions private placements once and, far from justifying preemption, it states that smaller private offerings should remain subject to local control.[262] Therefore, while the proposal for a preemptive "large accredited investor" exemption may have merit,[263] it derives no support from NSMIA's legislative history.

Even if reticent to return control to the states, the fact is that the SEC simply does not have the resources, even if it had the will, to police smaller private placements.[264] State regulators, on the other hand, as "local cops on the beat," are well positioned to fill this regulatory gap. While states currently have enforcement powers under NSMIA,[265] state regulators argue that this residual authority is too little, too late. State regulators may be not become aware of serious problems involving Rule 506 offerings until after injured investors contact them. While states may be able to prosecute the perpetrators of fraud, they cannot prophylactically protect future victims.[266]

Committee intends that the section 4(2) exemption from State regulation facilitate private placement of securities consistent with the public interest and the protection of investors.").

[262]CONFERENCE REPORT, *supra* note 16, at 40, *reprinted in* 1996 U.S.C.C.A.N. at 3921. ("Some securities offerings, such as those made by investment companies, and certain private placements are inherently national in nature, and are therefore subject to only Federal regulation. [Meanwhile, smaller], regional, and intrastate securities offerings remain subject to state regulation.").

[263]If the SEC eventually adopts its current proposal to create the category of "large accredited investors," it seems logical to include such sales in the category of transactions entitled to NSMIA preemption without state review.

[264]*See supra* notes 114-20 and accompanying text; *see also* Dibadj, *supra* note 222, at 857 (noting that federal institutions simply lack the capacity to be the sole arbiters of securities regulation).

[265]Even this residual state power has been attacked as counterproductive when applied to federally regulated institutions such as investment banks. There have been proposals to eliminate or constrain such state actions. *See, e.g.*, THE DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 172 (2008). Others argue, however, that state antifraud enforcement, even for federally regulated institutions, is an important "gap filler" that benefits investors. *See, e.g.*, Coffee & Sale, *supra* note 223, at 763-66 (noting that state regulators have incentives to prosecute fraud, are more stringent than the SEC, and often are faster than the SEC in investigating and prosecuting fraud); Fisch, *supra* note 241, at 798 ("[R]ecent and continuing history of securities-related scandals and SEC failures offers little reason to cut back even minimally on state enforcement efforts."); William Francis Galvin, States' Demonstrated Record of Effectiveness in Their Investor Protection Efforts Underscores the Need to Avoid Further Preemption of State Enforcement Authority (Dec. 10, 2008) (White Paper, *available at* http://www.sec.state.ma.us/sct/sctwhitepaper/Secretary_Galvin_Enforcement_White_Paper.pdf) (describing the role of the states in initiating enforcement actions and providing recovery to injured investors).

[266]At least one state regulator has used the state's residual antifraud power to try to prevent a Rule 506 offering from going forward. *See* Energy Exploration Inc., Case No. 2009-AH-009, Ky. Dep't of Fin. Insts. 4-5 (2009) Such efforts are difficult and likely to face serious preemption challenges. *See* Stevens, *supra* note 65, at 447 (arguing that the pre-sale use of the NSMIA antifraud savings clause violates NSMIA).

We must also ask whether state regulation of private placements would actually help investors. If state regulators once again had pre-sale review authority, could they effectively police these offerings? State regulators answer emphatically yes and provide examples where state authorities, utilizing their residual enforcement powers, have proven themselves more facile than the SEC.[267] While we do not know if states can achieve similar success in pre-sale review, certainly state regulators on the ground can scrutinize dubious offers more effectively than the understaffed SEC headquartered in Washington, D.C.[268] Moreover, unless these smaller private offerings are to remain largely unregulated, it only makes sense that they should be policed at the local level as suggested by both the SEC chairman and NASAA's president at the NSMIA hearings.[269]

So what are the impediments to this proposal? The most expected criticism is that any state role in policing private placements would impede capital formation by small business.[270] Preserving an efficient system for small business to raise capital is, after all, an important public policy issue. But this does not mean that small operating businesses and other unregulated entities such as limited partnerships formed for investment purposes should be free from all regulation.[271] It is no secret that investments in small businesses are very risky and that small business failure rates are extraordinarily high.[272] The public policy imperative must be to adopt sensible policies to ease the burdens of capital formation in a manner consistent with investor protection. State review would also hamper the predatory activities of unscrupulous promoters, such as Bernie Madoff, who lured in victims that

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[267] *See, e.g.*, Galvin, *supra* note 265; *see also* PROCEEDINGS OF THE NASAA FINANCIAL SERVICES REGULATORY REFORM ROUNDTABLE: A MAIN STREET AGENDA FOR WALL STREET REFORM (2008), *available at* http://www.nasaa.org/content/Files/Proceedings_NASAA_Regulatory_Reform_Roundtable.pdf (noting that state regulators are more accessible to local investors, inspire local investor confidence, and can often act more quickly than the SEC).

[268] *See* An Agenda for Change, *supra* note 166. Most states have their own exemptions for sales to accredited investors so state review would ensure compliance with the terms of the exemptions.

[269] *See, e.g.*, *H.R. 2131 Hearings*, *supra* note 43, at 105 (testimony of Arthur Levitt, Chairman, Securities and Exchange Commission); *S. 1815 Hearing*, *supra* note 89, at 11-12, 124-26 (testimony of Dee R. Harris, President, NASAA).

[270] The proposal adequately deals with the related issue of the continuing problem of inconsistent state regulatory schemes.

[271] *See* Friedman, *supra* note 106, at 301-02 (arguing that SEC Rules demonstrate that its concern for capital formation is greater than its concern for investor protection).

[272] While statistics across industry groups vary, approximately 33% of new employer firms do not survive two years, 66% do not survive four years, and 70% do not survive seven years. *See* U.S. SMALL BUS. ADMIN. OFFICE OF ADVOCACY, FREQUENTLY ASKED QUESTIONS (2008).

by all measures need the protection of the securities laws.[273] Subjecting these Rule 506 offerings to the regulations of at least one state is a reasonable compromise between the needs of issuers and the equally important rights of investors.[274] This is particularly true given our recent history with largely unregulated markets.

Also, it must be noted that it is not always the states that hamper capital formation by small businesses. For example, in 1997, in the aftermath of NSMIA, NASAA released its Model Accredited Investor Exemption (MAIE) for state review.[275] Within a few years, over forty states had adopted some version of MAIE that allowed limited advertising of sales to accredited investors defined in accordance with SEC definitions in Regulation D.[276] The MAIE, however, has not been widely utilized largely because of the lack of a corresponding federal exemption.[277] This failure gives credence to arguments that it is the federal prohibition of advertising that is a major impediment to financing by smaller business entities,[278] and not necessarily whether the prohibition emanates from federal or state regulators.

VI. CONCLUSION

As presently constituted, the private placement market now operates as an "antifraud-only market" where issuers are constrained primarily by the dictates of antifraud rules prohibiting intentional wrongdoing.[279] Such antifraud-only markets may be acceptable for institutional players, but they

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[273] *See* Lobb, *supra* note 8 (discussing the Madoff fraud).

[274] Others have suggested that an appropriate state role may be to enforce regulations set by the federal government. *See, e.g.*, Dibadj, *supra* note 222, at 866 (proposing state enforcement of federal securities law standards); Fisch, *supra* note 241, at 797-98 (noting preemption is not an inevitable consequence of national standard in securities regulation). This idea provides a plausible alternative to this proposal if the SEC enacts proposed amendments to Regulation D.

[275] U.S. GEN. ACCOUNTING OFFICE, SMALL BUSINESS: EFFORTS TO FACILITATE EQUITY CAPITAL FORMATION 65-66 (2000).

[276] *Id.*

[277] *See* Tyler, *supra* note 257.

[278] *See* Cohn & Yadley, *supra* note 12, at 31 (noting that proposed Rule 507 "is a small step in the right direction insofar as it will permit 'limited advertising' for a defined set of 'large accredited investors'"); *see also* FINAL REPORT OF THE ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES, Recommendation IV.P.5, at D-3 (2006) (recommending a new private placement exemption that allows advertising); Letter Comment from Keith F. Higgins et al., Am. Bar Ass'n Section of Bus. Law, on Securities Act Release No. 33-8828 (Oct. 12, 2007), *available at* http://www.sec.gov/comments/s7-18-07/s71807-52.pdf (critiquing federal limitations on advertising securities offerings).

[279] *See, e.g.*, 15 U.S.C § 78j(b) (2006); 17 C.F.R. § 240.10b-5 (2008) (prohibiting intentional or reckless misstatements or omissions in connection with the purchase or sale of securities).

are not designed for individual investors.[280] In spite of the increasing "deretailization" of the national securities markets, individual investors do invest in private placements either upon their own initiative or because of advice from broker-dealers or investment advisors. While such individuals may in fact qualify as accredited investors under the wealth standard formulated in 1982, there is a growing recognition that such individuals need some protection from the schemes of the unscrupulous. Perhaps Madoff's accredited investors best prove this axiom. The SEC is not currently positioned to regulate private placements and, given the present financial crisis and concomitant regulatory reforms that are now under consideration, it is unlikely that small offerings will return to the SEC radar screen in the foreseeable future. Therefore, either Congress or the SEC should return to the states the power to enforce private placement standards. We have an extensive regulatory apparatus geared towards the public markets; certainly we should allow states some meaningful measure of authority to protect investors in the more dangerous private markets.

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[280] *See* Cartwright, *supra* note 152 (observing the increasing "need to focus on the consequences of the concentration of the ownership of our public companies in ever-fewer institutional hands"); *see also* Langevoort, *supra* note 242 (making the case for an antifraud-only market closed to retail investors).