MEMORANDUM TO THE TASK GROUP ON THE
REGULATION OF FINANCIAL SERVICES

February 24, 1983

SUBJECT: Federal Preemption of Certain State Securities Laws

I. INTRODUCTION

If the Task Group decides to consider the resolution of overlaps, duplications and conflicts between state and federal securities regulation, the areas discussed in this memorandum warrant consideration. This memorandum: (i) summarizes the four principal aspects of state securities regulation; (ii) describes the major advantages and disadvantages of each; and (iii) proposes solutions to the various regulatory problems raised by overlapping and conflicting state and securities laws.

State securities regulation pre-dates the enactment of the federal securities laws. The United States Supreme Court has held such statutes to be constitutional. 1/ Because the purpose of the early state statutes was to prevent "'speculative schemes which have no more basis than so many feet of

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1/ In three companion cases, commonly known as the Blue Sky cases, the Supreme Court rejected challenges to the constitutionality of state statutes requiring registration of securities and broker-dealers. Hall v. Geiger-Jones Co., 242 U.S. 539 (1917); Caldwell v. Sioux Falls Stock Yards Co., 242 U.S. 559 (1917); and Merrick v. N.W. Halsey & Co., 242 U.S. 568 (1917).

blue sky'" Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917), the statutes have generally been referred to as "blue sky laws."

The four distinct aspects of state securities regulation, not all of which have been adopted in every state, include: (1) prohibitions against fraud in securities transactions; (2) regulation of brokers, dealers and investment advisers; (3) regulation of new issues (state provisions in this category are generally referred to as "blue sky statutes"); and (4) state regulation of mergers and acquisitions.

State anti-fraud provisions impose relatively few burdens on legitimate business (at least when applied on an intrastate basis). By contrast, mandatory state regulation of securities offerings often imposes severe burdens without apparent compensating benefit to investors. State regulation of broker-dealers and investment advisers is less burdensome, but could be significantly lightened without harm to investors. Finally, state regulation of tender offers obstructs transactions that are national in scope and serves no legitimate state interest.

II. STATE FRAUD PROSECUTION

A. Nature of the Problem

1. Synopsis

Virtually all jurisdictions have an anti-fraud provision in their securities statutes. Most are based on the anti-fraud provision of the Uniform Securities Act which in turn is based on the SEC's Rule 10b-5. State provisions typically make it unlawful, in connection with the purchase or sale (or offer for purchase or sale) of securities, for any person

> (1) to employ any device, scheme, or artifice to defraud;
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> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading; or
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> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. (Uniform Securities Act § 101)

The statute usually charges a state official with enforcing the anti-fraud provision through various powers and remedies, including authority to deny an issuer a license to sell securities, to initiate injunctive actions, and to seek administrative cease-and-desist orders.

2. Advantages and Disadvantages of State Anti-fraud Prosecution

Advantages. State anti-fraud authority is a valuable supplement to SEC efforts. The SEC lacks the resources to investigate and prosecute all securities frauds throughout the nation. SEC officials have frequently applauded the joint efforts of federal and state authorities in combatting securities fraud.

The SEC has concentrated on the prosecution of multistate fraud while the states have focused on smaller cases, including those of an intrastate nature. While this allocation is not congressionally or judicially mandated, it reflects a determination by the SEC that the states should handle "local" fraud.

Disadvantages. State anti-fraud authority may unduly affect investors in other states, and, if used improvidently, may inhibit legitimate transactions.

B. Proposed Solutions

State fraud prosecution in tender offers is discussed in Part V. This section deals only with fraud prosecution in the area of offers and sales of securities otherwise than pursuant to a tender offer.

Limited State Regulation. State anti-fraud regulation that is purely intrastate should be preserved in its present form because it is a valuable supplement to SEC enforcement efforts. On the other hand, state enforcement efforts in one state which unduly affects residents of other states or obstructs nationwide purchase programs are unacceptable. Such extraterritorial effects are most common in state prosecution of fraud in tender offers, discussed in Part V below.

Injunctions and cease and desist orders are acceptable state fraud remedies, provided that they are subject to judicial review and do not interfere with nationwide offers and sales of securities.

III. STATE REGULATION OF BROKERS AND DEALERS AND INVESTMENT ADVISERS

A. Nature of the Problem

1. Synopsis

At the outset, it is useful to describe federal regulation of investment advisers. In a nutshell, federal law requires investment advisers who have more than fifteen clients or hold themselves out to the public as advisers to register with the SEC, keep certain books and records, and give clients a brochure setting forth important facts about their services. Some advisers must give their clients information about their financial condition and file financial reports with the SEC. In addition, federal law prohibits fraudulent acts and practices.

Most states require persons engaged in the business of buying or selling securities, or in the business of providing investment advice, to register with the state securities commission or its equivalent. State laws often contain exemptions from state registration requirements that differ in scope from federal exemptions. For example, broker-dealers who participate exclusively in sales of government securities and would thus be exempt from federal registration requirements may nevertheless be required to register if doing business in some states.

Registration forms for the registration of broker-dealers are standardized and are used by the securities commissions of virtually every state, by the SEC, by the major stock exchanges and by the National Association of Securities Dealers, Inc. ("NASD").

Although some states require the use of the SEC form, many states require the use of another form. Thus, a lack of uniformity characterizes state investment adviser regulation. In 1976, industry representatives supported express congressional preemption of state legislation in certain investment adviser areas.

Like federal law, many state statutes require broker-dealers and investment advisers to keep books and records. In addition, the statutes often empower state administrators to inspect broker-dealer operations and to review required broker-dealer financial reports. Some states have broker-dealer net capital requirements loosely modelled after SEC requirements.

State regulation of investment advisers is more varied. It may provide requirements for testing, qualifications, capital, and bonding. The testing requirement may be waived where the adviser has passed an NASD broker-dealer examination. The qualification requirement, where it exists, is often a matter of administrative discretion. Some states have minimum capital requirements, which may be related to custody of advisee funds. Few states have bonding requirements.

State securities commissions are generally empowered to deny, revoke, suspend, cancel, or withdraw registration of broker-dealers or investment advisers under specified circumstances. State laws may establish private rights of action, for example, rights of a purchaser of a security to recover the consideration paid from a person who has violated the registration requirement.

2. Advantages and Disadvantages

Advantages. State broker-dealer and investment adviser registration requirements facilitate state fraud prosecution. In addition, certain persons not covered by federal registration, *e.g.*, broker-dealers who sell exclusively exempt securities, may be subject to state regulation. In contrast to state regulation of broker-dealers, federal securities laws contain no requirements for qualification, testing, capital or bonding of investment advisers, leaving these areas to state regulation. State regulation in areas where there is no federal presence creates minimum, although varied, levels of investor protection.

The potential burdens of duplicative regulation for broker-dealers are reduced through the extensive use of standardized forms and examinations and by implementation of a central registration depository system established by the NASD. The SEC has stated that its close working partnership with the states in this area has advantages to investors and to securities professionals. 2/

Disadvantages. Notwithstanding the close coordination between state and federal systems of broker-dealer registration, state regulation does impose additional burdens. State investment adviser regulation, which is less coordinated, imposes greater burdens on advisers. Disparities in state requirements and broad administrative discretion may magnify burdens on broker-dealers and advisers.

B. Proposed Solutions

Partial Preemption; Uniform Registration Forms. Federal law should be amended to provide that states must accept SEC registration forms in satisfaction of state broker-dealer and investment adviser registration requirements. Although the use of standard forms for broker-dealer registration is common among states, the fact that each state must expressly approve the use of a form, as well as subsequent revisions, is a significant regulatory problem. If a uniform form is to be amended, the unanimous action of all states is necessary to maintain national uniformity. Federal law should be amended to provide that if a state wishes to require registration of

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2/ Brief of the Securities and Exchange Commission, Amicus Curiae, Underhill Associates, Inc. v. Junie Bradshaw, No. 81-1222 (4th Cir., filed October, 1981).

broker-dealers or investment advisers, it must require the use of the same forms mandated by the SEC and no others.

Recordkeeping, Net Capital, Customer Protection, Examination and Similar Rules. States choosing to adopt substantive regulatory requirements for broker-dealers registered with the SEC in areas such as recordkeeping, net capital, customer protection, financial statements, and examinations should be required to adopt and enforce SEC requirements. Differing regulation in this area is duplicative and costly.

In view of the lack of federal requirements for qualification, testing, capital or bonding of investment advisers, states should be permitted to maintain their minimum levels of investor protection in this area. Where there are federal requirements, such as recordkeeping requirements, states should be required to adopt and enforce only the federal requirements for investment advisers subject to federal regulation.

IV. STATE REGISTRATION OF SECURITIES OFFERINGS

A. Nature of the Problem

1. Synopsis

State statutes requiring registration of securities offerings vary from state to state. All are intended to ensure that adequate disclosure is made in connection with each offering. Many statutes also attempt to ensure that the terms of the offering are "fair, just and equitable" and that the securities meet certain standards of investment quality. In this respect, state blue sky statutes contrast sharply with federal regulation.

State blue sky statutes typically contain one or more of three basic registration procedures:

(i) Registration by "qualification". Like federal registration under the Securities Act of 1933, this procedure requires the filing of information with the state. However, this type of statute also requires that the offering meet qualitative standards and that the securities commission issue a "license," "certificate" or similar instrument prior to sales of securities.

Qualitative standards vary. Some states will not permit securities sales unless a state administrator believes that the terms of the issue are "fair, just and equitable" and the issuer agrees to transact business "fairly and honestly." The administrative application of such standards differs from state to state. Some states use objective criteria (e.g., profit history); others use subjective standards (e.g., likelihood of enterprise failure). Such regulation allows state officials to consider the securities to be offered, the terms of the offering, and the reputation and past practices of the issuer in determining whether the securities are suitable for public sale.

(ii) Registration by "notification". This type of statute permits an offering to become effective immediately, in the absence of any adverse action by the state commission, upon the lapse of a specified period after the filing of a required document. The information require to be filed is typically less elaborate than that required to be filed under registration by qualification. It may amount to a mere announcement that securities will be offered. This type of registration is generally provided for seasoned or "blue chip" issuers of securities with track records meeting objective criteria.

(iii) Registration by "coordination". This procedure was developed in the Uniform Securities Act and is available for issuers registering securities under the Securities Act of 1933. The information required to be filed by an issuer is essentially a copy of the registration statement filed with the SEC. The state registration becomes effective automatically, in the absence of adverse action by the state commission, when the registration statement filed with the SEC becomes effective.

Exemptions from state registration requirements vary widely. They may include: (1) exemptions for "isolated transactions;" (2) exemptions for offers or sales to a limited number of offerees or purchasers within a specified time period; and (3) exemptions for sales which do not result in an increase in the total number of shareholders of a corporation above a particular number.

The SEC has taken a major step toward reducing the burdens of registration for small issuers by expanding and clarifying exemptions from the federal registration requirements. Some states continue, however, to impose their own registration requirements for issues that are exempt from federal registration. Despite efforts at greater uniformity, state small offering exemptions vary widely.

Many states have rules that limit underwriter's compensation or total expenses of an offering. When the expenses of an offering surpass these levels, a state securities administrator can deny the offering a license and, in so doing, block the sale of the securities in the state.

2. Advantages and Disadvantages

Advantages. It is argued that "registration by qualification" protects investors from "poor" investments. Moreover, proponents of state regulation argue that while disclosure alone may be sufficient to protect the sophisticated investor, it may fail to protect the inexperienced investor who may be unable to understand financial statements or to withstand the selling pressure applied. Merit regulation arguably protects these inexperienced investors.

Disadvantages. It is still difficult and expensive to secure the state approvals necessary to qualify an issue of securities to be distributed to investors living across the nation. A "blue sky" survey must be performed in connection with each offering for each state in which the security is to be offered. This adds significantly to the costs of public offerings of securities without compensating benefit to investors.

Merit regulation can obstruct capital formation. Because of limitations on offering expenses or requirements for earnings histories, merit regulation particularly affects small businesses.

Merit regulation may artifically affect the pricing or terms of an issue, allowing the offering price or terms to depend on a state administrator's notion of what is "fair, just and equitable" rather than on what the market would allow.

State standards for qualitative review are vague, invite inconsistent interpretation, and differ from state to state. They substitute a government official's judgment of what is beneficial for the citizens of the state over the individual citizen's judgment. Qualitative regulation is thus antithetical to the philosophy of federal law: individual freedom of choice based on full disclosure.

B. Proposed Solutions

Set forth below are alternatives to the current division of federal-state responsibilities.

1. Total Preemption.

One option is federal preemption of all state blue sky provisions. To be sure, this approach would greatly simplify, and cut many of the costs, of the capital raising process.

Nonetheless, this approach may be perceived as extreme and may engender intense controversy. The approach discussed below achieves most of the advantages of total preemption in a less controversial manner.

2. Limited Preemption.

Merit Regulation. State merit regulation should be preempted for stock offerings by seasoned issuers, such as those permitted to register securities on the SEC's streamlined disclosure Form S-3.

Filing Requirements. States requiring the submission of filings should be required to accept documents submitted to the SEC in satisfaction of federal requirements. The use of any other forms should be proscribed.

Offerings not Registered with the SEC. Federal law contains exemptions from registration requirements. The rationale underlying the federal exemptions, namely, to limit burdens on issuers in a manner consistent with the protection of investors, applies with equal force to state regulation. Thus, the states should not be permitted to require a filing in any offering which is covered by an exemption from federal registration requirements other than the intrastate offering exemption.

The states have a valid interest in prescribing registration requirements for purely intrastate offers. Since such offers may be public, and may be made to large numbers of unsophisticated investors of modest means, a registration requirement is entirely appropriate. Since no substantial federal interest is at stake in intrastate offerings, the states' power to regulate them should be preserved.

V. STATE TENDER OFFER REGULATION

A. Nature of the Problem

1. Synopsis

Over thirty-six states have adopted statutes which expressly regulate tender offers and open-market and privately-negotiated acquisition programs. These statutes sprang from a uniform state takeover act.

The definition of the term "takeover bid" determines which transactions are subject to regulation. Generally, purchases resulting in ownership of more than a specified percentage of a class of equity securities, usually 5% or 10%, activate the disclosure and substantive provisions of the state statutes. Unless an exemption is specifically provided in the state statute, large open market purchases are treated by the state as "takeover bids," and are subjected to regulation as tender offers, regardless of whether the transaction would be a tender offer under federal law.

Once a transaction is determined to be a "takeover bid" (assuming no exemption is applicable), the typical state statute provides for anti-fraud review and also imposes the following three requirements: (i) The takeover statute requires an informational filing to be made with the state prior to the commencement of a tender offer, with a twenty-day pre-commencement filing requirement being typical. (ii) The state imposes withdrawal provisions which often differ from the seven days mandated by the Williams Act. (iii) Most jurisdictions provide that an administrative hearing may be required before a takeover bid can commence, with the target company often having the right to request a hearing. Such a hearing need not begin until several weeks after the offeror's filing and may go on indefinitely in some jurisdictions. A speedy decision is often not required by statute. The lengthy waiting period imposed by the hearing requirement also allows the management of the target company time to combat the tender offer. The state may seek to prohibit the offer or may condition any purchase on changes in the terms of the offering, with most jurisdictions basing their decision on a "full and fair disclosure" standard.

Because the typical state takeover statute is of questionable validity after Edgar v. MITE Corp., 102 S. Ct. 2629 (1982), states are seeking different types of statutory schemes that they hope will survive judicial scrutiny. The most recent attempt in this regard is the new Ohio statute (effective 11/18/82), the provisions of which apply to an Ohio corporation with fifty or more shareholders that has its principal place of business, principal executive offices, or substantial assets within Ohio. The basic concept is that shareholder authorization by majority vote is required, prior to consummation, for "control share acquisitions" which result in a person's percentage holdings passing the 20%, 33 1/3%, and 50% thresholds. Prior approval is not required for purchases within these zones (*i.e.*, a purchase raising the percentage of ownership from 24% to 32%).

2. Advantages and Disadvantages of State Takeover Regulation

Advantages. Proponents of state regulation argue that such regulation is necessary to protect local investors, domestic corporations, local jobs, and the local economy. State statutes increase the time available to incumbent management to defeat a hostile offer or to find a friendly "White Knight" who will retain their services and continue the corporation's presence in the community.

The courts have rejected these arguments as legal justification for the burdens imposed on interstate commerce. In *MITE*, the Supreme Court struck down the Illinois Take-over Act on Commerce Clause grounds, stating that insofar as a state statute burdens out-of-state transactions, "there is *nothing* to be weighed in the balance to sustain the law." *Id*. at 2642 (emphasis added).

Proponents of the new Ohio statute base their claim for its validity primarily on the grounds that Ohio has an interest in regulating the internal affairs of a corporation incorporated under its laws. This rationale is contrary to the federal policy of investor choice. Moreover, the shareholder approval requirements cause significant delay in the making of bids as well as uninformed trading during the time between the initial filing and the shareholder vote. Thus, the statute may frustrate the achievement of the Congressional objectives underlying the Williams Act. The Supreme Court in MITE decisively rejected the internal affairs doctrine as a justification for a state takeover statute with extraterratorial effect.

Disadvantages. The Supreme Court (in MITE), federal appellate courts, 3/ and even some state courts 4/ have emphasized the delays imposed on nationwide securities transactions by the imposition of state takeover statutes. The new Ohio statute is similarly flawed because of its substantial impact on interstate commerce.

A single state securities commissioner, by invoking the typical hearing procedure, can indefinitely delay or ban nationwide trading in a particular security, thereby halting a nationwide tender offer or open market purchase program.

3/ See, e.g., Telvest v. Bradshaw, Slip Op. No. 82-1882 (4th Cir. Jan. 6, 1983); Great Western United Corp. v. Kidwell, 577 F.2d 1256 (5th Cir. 1978), rev'd sub nom. on venue grounds, Leroy v. Great Western United Corp., 443 U.S. 173 (1979).

4/ See, e.g., Esmark, Inc. v. Strode, 639 S.W.2d 768 (Ky. Sup. Ct. 1982).

The effect of pre-commencement disclosure on open market purchases is particularly onerous since it forces a purchaser to publicize future buying programs. Also, the impact of state regulation may be even more pronounced if more than one state seeks to regulate the same takeover bid.

State regulatory schemes are frequently inconsistent with the Williams Act, which carefully differentiates between tender offers and open market purchases. As to tender offers, a bidder would find it impossible to comply with the states' requirement of public disclosure of the terms of the offer at least twenty days in advance of the making of the offer, and Rule 14d-2(b) under the Securities Exchange Act, which requires that a bidder commence its offer within five business days of such disclosure.

If a state treats an open market purchase program as a takeover bid, a different set of problems arise. Section 13(d) of the Securities and Exchange Act is an after-the-fact disclosure provision, and does not prohibit further open market purchases, pending the completion of hearing, by a shareholder holding more than five percent of the outstanding stock. Unlike the federal scheme, most states have advance disclosure and hearing requirements applicable to open market purchases. The SEC has filed numerous briefs taking the position that advance disclosure of open market purchase programs causes market disruptions that harm investors. The state and federal schemes with respect to open market purchases are thus clearly inconsistent.

Courts and commentators have identified several harmful economic effects of state takeover statutes, including the following: (i) state pre-commencement notification and hearing provisions cause harmful market disruptions and block indefinitely the commencement of takeover bids; (ii) advance disclosure provisions cause market disruptions and uninformed decisionmaking, and effectively preclude most open market transactions since (1) it is not possible to predict market prices twenty days in advance (the typical pre-commencement announcement time) and (2) committing one's self to purchase a large block of stock in twenty days at the then "market price" would require the putative purchaser to assume the risk of a substantial intervening increase in the market price; (iii) the volume of information required to be filed with the state by the offeror, as well as the hearing requirements imposed, may increase the costs to the offeror of proceeding with the acquisition; (iv) to the extent that the state statute reduces the likelihood of a successful tender offer being made, the incentive of the incumbent management to perform well and keep stock prices high is correspondingly reduced; and (v) extreme state regulation, it has been argued, will reduce the shareholders' opportunity to sell their shares at a premium.

B. Proposed Solutions

As the above listing of disadvantages of state takeover bid regulation makes clear, the limited state interests in this field are outweighed by the negative economic effects of such statutes. Most significantly, such state statutes place major procedural and substantive road blocks in the way of mergers and acquisitions and may bring nationwide securities trading to a halt. Some degree of preemption of state takeover statutes is necessary to ensure the achievement of federal regulatory objectives, which include the orderly operation of the Nation's securities exchanges and the maintenance of a free market for corporate shares.

The Task Force should seriously consider whether Section 28(a) of the Exchange Act should be amended to provide for total preemption of state takeover statutes except for state statutes which regulate changes of control in certain regulated industries, including (a) public utilities; (b) bank holding companies; (c) gaming industries; (d) insurance companies; and (e) the liquor industry. States have special interests in regulating the change of control of companies operating in certain specialized industries, so long as the state does not interfere with the offer's commencement, which is comprehensively regulated by federal law. There would also be a further provision stating that state change of control restrictions could not interfere with an offer's commencement and could not be inconsistent with federal law in that subject area.

While, as pointed out above, state fraud prosecution is desirable in some contexts, state anti-fraud authority over tender offers does not appear to have provided a useful supplement to federal enforcement efforts. The concept of "local" fraud does not exist when the transaction involved is a national tender offer.

Moreover, it is highly questionable whether states should be permitted to prosecute fraud in transactions that would be tender offers under federal law. State definitions of "fraud" or "manipulation" may differ from federal definitions and may incorporate substantive fairness standards. State fraud prosecution in tender offers is likely, by the time hearings are held and appellate review is completed, to cause substantial delays in national transactions, even though the SEC may have decided against enforcement action. Even a short delay can prevent a bidder from successfully proceeding. 5/ This

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5/ If a state can prohibit a tender offer from being made to its residents, the number of offerees who can sell their shares to the bidder is reduced by a finite number, which may preclude the bidder from obtaining the minimum number of shares that it is seeking. This effect distinguishes state tender offer regulation from state blue sky regulation: even if one state prevents an offering from being made to its residents, the issuer may still sell shares to residents in forty-nine other states.

result contravenes (i) the application of a single, national standard regarding fraud in tender offers and (ii) the maintenance of a regulatory neutrality between bidder and target company, both of which are important federal goals. Permitting administrative review and subsequent cease and desist orders in the tender offer context would cause even greater delays than injunctive actions and should also be preempted.