Vanderbilt Law Review

Volume 32
Issue 2 *Issue 2 - March 1979*

Article 2

3-1979

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Recommended Citation
Jeffrey B. Bartell, Federal-State Relations Under the Federal Securities Code, 32 *Vanderbilt Law Review* 457 (1979)
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Federal-State Relations Under the Federal Securities Code

*Jeffrey B. Bartell**

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I. INTRODUCTION

There is little in the recorded history of the American Law Institute's Federal Securities Code to indicate that a major rearrangement of regulatory responsibilities between the federal government and the states was a primary object. Milton Cohen's thoughtful article *"Truth in Securities" Revisited,*[1] probably the principal catalyst of the codification project, described a new world of securi-

* Commissioner of Securities, State of Wisconsin. B.A., University of Wisconsin, 1965; J.D., University of Wisconsin, 1968. Adviser to the Reporter for the ALI Federal Securities Code Project.

1. Cohen, *"Truth in Securities" Revisited,* 79 HARV. L. REV. 1340 (1966).

ties regulation involving coordinated disclosure and continuous reporting,[2] without any mention of federal-state relations or the blue sky laws. Indeed, when the American Bar Association's Committee on Federal Regulation of Securities first discussed the project in 1966,[3] a suggestion that concurrent consideration be given to preemption of state law was dismissed as politically infeasible.[4]

Nevertheless, as the American Law Institute began to design the project's parameters, one area to which the Reporter's attention was specifically directed was that of establishing a "rationalization" of the state and federal roles in the regulation of securities.[5] In the first tentative draft of the Code covering the subject of federal-state relations, the Reporter outlined his approach to the subject:

> However delicate the political considerations—indeed, precisely because the federal-state jurisdictional line *is* so fundamental—this once-in-a-lifetime codification project would be subject to justifiable criticism if it ignored the preemption problem.
>
> . . . .
>
> . . . There are basically three possibilities so far as federal-state relations are concerned:
>
> (a) The first is complete preemption, as in §20a of the Interstate Commerce Act. 49 U.S.C. §20a; see 1 Loss 418-19. If the period 1890-1914 had seen the enactment of federal securities laws along with the antitrust and ICC legislation, there might never have been any blue sky laws. Nevertheless, it is impossible to ignore the more than 60 years of blue sky history. Moreover, the blue sky authorities can continue to serve an important (if not indispensable) function with respect to essentially local offerings as well as local broker-dealers and investment advisers. And even with respect to nationwide offerings, there is no reason to assume that Congress would have been satisfied with a disclosure statute in 1933 if the blue sky laws had not already gone further in most states: That is to say, their complete replacement now would require that serious consideration be given to the insertion of substantive standards, at least along the lines of the Uniform Securities Act's, in Part V of the Code. For all these reasons, the Reporter does not recommend complete preemption.
>
> (b) The second possibility is a continuation of the *status quo*: duplicate regulation except in the rare instance of an actual conflict. . . . But, whatever the claims of history, they must be balanced against a decent regard for the

2. Cohen's thesis was that if the Securities Exchange Act of 1934, with its scheme of continuous disclosures for issuers of actively traded securities, had preceded the Securities Act of 1933, and the question of special disclosures in connection with public offerings had been faced in this setting, the combined disclosure requirements of the two Acts would have been quite different. He called for creation of a "new coordinated disclosure system having as its basis the continuous disclosure system of the 1934 Act and treating '1933 Act' disclosure needs on this foundation." *Id.* at 1341-42.

3. Conference on Codification of the Federal Securities Laws, Chicago, Illinois (Nov. 18-19, 1966), *reprinted in* 22 BUS. LAW. 793 (1967) (edited form) [hereinafter cited as Conference on Codification].

4. *Id.*, *reprinted in* 22 BUS. LAW. at 803-04. The Code's Reporter likened the possibility of achieving preemption of the field to that of repealing the income tax.

5. *See* Remarks of Professor Louis Loss to the American Law Institute, Washington, D.C. (May 22, 1969), *reprinted in* 25 BUS. LAW. 27, 36-37 (1969).

> principles of federalism in a country of 50-odd jurisdictions with a view to both the legitimate needs of capital formation and the maximum effectiveness of the federal-state regulatory apparatus as a whole.
>
> (c) What remains is the limited use of the Supremacy Clause to achieve what the Reporter prefers to view not as partial preemption (except in a technical sense) but as federal-state integration or harmonization.[6]

The Code's "harmonization" of the federal and state securities laws, as presented in the Proposed Official Draft,[7] is more accurately a rounding of the roughest edges of the two statutory schemes in places where they most obviously rub. The final design certainly is as much a reflection of political realities as it is a visionary image of coordinated regulation. While the Code does not solve all the problems inherent in a pattern of dual regulation that evolved over the course of more than forty years, this does not diminish the importance of its reforms. The Code presents, for the first time in a federal statute, a reasoned allocation of state and federal authority over commerce in securities that, in several important respects, reduces unnecessary and duplicative regulation.

II. History of Dual Regulation

One may question the Reporter's conjecture that blue sky laws might never have existed had the federal government preceded the states in regulating this area.[8] The alacrity with which the states enacted securities statutes, once the movement began, evidences their strong regulatory "herding instinct." Unless a pre-blue sky federal law had been broadly preemptive, the spread of state securi-

6. ALI Fed. Sec. Code § 1603, Comments (1) & (2), at 137-39 (Tent. Draft No. 3, 1974) [hereinafter cited as TD-3].

7. The Proposed Official Draft [hereinafter cited as 1978 Draft] was approved by the American Law Institute on May 19, 1978, and is essentially the form of the legislation to be introduced in the Ninety-Sixth Congress. Some changes will be required by (a) subsequent legislation (such as the Bankruptcy Reform Act of 1978), (b) comments of the Securities and Exchange Commission, which had not formally reviewed the 1978 Draft before adoption by the Institute, and (c) previously unnoticed drafting errors. These likely will be included in official ALI amendments.

8. Certainly, the federal antitrust legislation did little to inhibit the states in their later enactment of similar regulation. Nearly all states now have antitrust laws of some variety, many patterned after the Sherman Act. They are applied concurrently with the federal laws, and in fact draw on federal precedent for purposes of judicial construction. *See* Orion's Belt, Inc. v. Kayser-Roth Corp., 433 F. Supp. 301 (S.D. Ind. 1977); General Communications Eng'r, Inc. v. Motorola Communications & Elecs., Inc., 421 F. Supp. 274 (N.D. Cal. 1976). *But see* State v. Milwaukee Braves, Inc., 31 Wis. 2d 699, 144 N.W.2d 1 (1966). Moreover, the reason the states did not enter the Interstate Commerce Commission's area to any significant extent was Congress' clear design to occupy the field. *See* City of Chicago v. Atchison, T. & S.F. Ry., 357 U.S. 77 (1958). *But see* 16 U.S.C. § 821 (1976) (a part of the Federal Power Act, which established a dual system of control over water use and distribution). *See also* California v. Oroville-Wyandotte Irrigation Dist., 411 F. Supp. 361 (E.D. Cal. 1975), *aff'd*, 536 F.2d 304 (9th Cir.), *cert. denied*, 429 U.S. 922 (1976).

ties regulation was probably inevitable. It is likely, however, that a federal presence at the turn of the century would have altered substantially the form of the early state legislation.

A. *Development of State Securities Laws*

State regulation of securities in this country began in the latter half of the nineteenth century with a scattering of statutes designed to deal with specific aspects of securities trading, including the issuance of securities by certain issuers such as common carriers[9] and mining or oil corporations,[10] installment securities sales,[11] and brokers' records and confirmations.[12] But in 1911 Kansas became the first state to adopt legislation providing for comprehensive securities regulation comparable to that of present state securities laws. Unlike statutes that had preceded it, the Kansas Act employed an array of regulatory tools to prevent fraud in the general sale of securities, and to bar the sale of the securities of any company whose organizing instruments, plan of business, or any proposed contract included any provisions that was "unfair, unjust, inequitable or oppressive," or if the investment did not "promise a fair return."[13] This is the so-called "merit review" authority. The Act's failure to define any of these decisional terms enhanced the administrator's broad discretional powers.

Within two years after enactment of the Kansas securities law, twenty-three states had passed some form of blue sky legislation.[14] Though resembling the modern laws in some respects, the early securities statutes were crude by comparison. Most lacked or were deficient in definitions, provided no logical scheme of exemptions, and granted the administrator essentially unchecked discretion.[15]

The constitutionality of the new state laws was the subject of a great deal of litigation. Some of the laws were found to contravene various provisions of the federal constitution;[16] other courts upheld

9. 1852 Mass. Acts, ch. 303.

10. 1903 Conn. Pub. Acts, ch. 196.

11. 1904 Ga. Laws, No. 592.

12. 1907 Mo. Laws, S.B. 109. *See* L. LOSS & E. COWETT, BLUE SKY LAW 3-5 (1958).

13. 1911 Kan. Sess. Laws, ch. 133, § 5.

14. Arizona, Arkansas, California, Connecticut, Florida, Georgia, Idaho, Iowa, Maine, Michigan, Missouri, Montana, Nebraska, North Carolina, North Dakota, Ohio, Oregon, South Carolina, South Dakota, Tennessee, Vermont, West Virginia, and Wisconsin.

15. *See* Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements?* 1976 WIS. L. REV. 79, 83.

16. *E.g.*, Bracey v. Darst, 218 F. 482 (N.D. W. Va. 1914); William R. Compton Co. v. Allen, 216 F. 537 (S.D. Iowa 1914); Alabama & New Orleans Transp. Co. v. Doyle, 210 F. 173 (E.D. Mich. 1914) (holding the Michigan blue sky statute violative of the due process and commerce clauses of the United States Constitution).

the statutes or refused to rule on the issue.[17] The first United States Supreme Court test of the state laws under the federal constitution came in 1917 with the Court upholding the securities laws of Ohio, South Dakota, and Michigan in three related cases.[18] In one of these cases, Justice McKenna answered the criticism, heard yet today, that the blue sky laws create substantial roadblocks to capital formation:

> [W]e think the [blue sky law] is within the power of the State. It burdens honest business, it is true, but burdens it only that, under its forms, dishonest business may not be done. This manifestly cannot be accomplished by mere declaration; there must be conditions imposed and provision made for their performance. Expense may thereby be caused and inconvenience, but to arrest the power of the State by such considerations would make it impotent to discharge its function. It costs something to be governed.[19]

Nevertheless, constitutional challenges to the state laws continued, the attacks coming principally under the fourteenth amendment and the commerce clause, and (more frequently) under state constitutional provisions. Some of the latter were successful.[20] In recent years, however, federal constitutional questions concerning the state securities laws have become increasingly rare.[21]

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17. *E.g.*, Standard Home Co. v. Davis, 217 F. 904 (E.D. Ark. 1914); McKinney v. Watson, 74 Or. 220, 145 P. 266 (1915).

18. Merrick v. N.W. Halsey & Co., 242 U.S. 568 (1917); Caldwell v. Sioux Falls Stock Yards Co., 242 U.S. 559 (1917); Hall v. Geiger-Jones Co., 242 U.S. 539 (1917). It was in *Hall v. Geiger-Jones Co.* that the term "blue sky laws" gained common usage:

> The name that is given to the law indicates the evil at which it is aimed, that is, to use the language of a cited case, "speculative schemes which have no more basis than so many feet of 'blue sky;' " or, as stated by counsel in another case, "to stop the sale of stock in fly-by-night concerns, visionary oil wells, distant gold mines and other like fraudulent exploitations."

242 U.S. at 550. For a further discussion of the blue sky cases, see Laylin, *The Ohio "Blue Sky" Cases,* 15 MICH. L. REV. 369 (1917), and Smith, *State "Blue Sky" Laws and the Federal Securities Acts,* 34 MICH. L. REV. 1135, 1148-55 (1936).

19. 242 U.S. at 587.

20. *E.g.*, Boyer v. Black, 154 Fla. 723, 18 So.2d 886 (1944) (in which the court held that the title of the Florida Act did not properly put the public on notice that instruments by which oil and gas rights are transferred were included in the definition of "security" and regulated as such); Klein v. Barry, 182 Wis. 255, 196 N.W. 457 (1923) (in which part of Wisconsin's Act was struck down because the rights and remedies under the Act were dependent upon the administrator's determination as to whether the violator acted in good faith).

21. *See* L. Loss & E. COWETT, *supra* note 12, at 13-17. But one might wonder whether a commerce clause challenge to the state securities laws would be more potent now in an era of a developing national market system (*see* 15 U.S.C. § 78k-1(a)(1) (1976)), a national clearing and transfer system (*see* 15 U.S.C. § 78q-1(a)(1) (1976)), and Congress' recent reinforcement in the Securities Acts Amendments of 1975 (Pub. L. No. 94-29, 89 Stat. 97 (codified in scattered sections of 15 U.S.C. §§ 77a to 80b)) of the concept of industry self-regulation. *See* S. REP. No. 75, 94th Cong., 1st Sess. 2 (1975).

B. *Enter: Federal Regulation*

In the twenty-two years following the birth of blue sky laws, every state except Nevada began regulating securities. Thus, when the federal government entered the field in 1933, Congress had the benefit of a well-established "laboratory" of state experimentation on which to build.[22] Instead of following the state pattern, however, the Securities Act of 1933 (Securities Act) was modeled on the relatively mild disclosure philosophy of the English Companies Act, requiring full and effective disclosure of all material facts to public investors.[23] In contrast to approximately forty of the blue sky statutes existing at the time, the Securities Act did not provide for a registration review of the merits of a securities offering, nor did it grant authority to a regulatory agency to deny registration of the securities on the basis of substantive standards.[24]

A system of dual regulation was clearly contemplated by the enactment of the Securities Act.[25] Congress deferred to the state laws, not only by choosing not to duplicate their "merit review" philosophy, but also by expressly preserving state regulation in the Act. This reservation of state jurisdiction in section 18 of the Securities Act was broad and unequivocal: "Nothing in this Subchapter shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person."[26]

Likewise, section 28(a) of the Securities Exchange Act of 1934 (Exchange Act) reserved to the states jurisdiction to regulate securities in the areas covered by the Act: "Nothing in this title shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State over any security of any person insofar as it does not conflict with the provisions of this title or the rules and regulations thereunder."[27]

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22. *See* New State Ice Co. v. Liebmann, 285 U.S. 262, 310-11 (1931) (Brandeis, J., dissenting).

23. 15 U.S.C. § 77q (1976).

24. The federal Securities and Exchange Commission (SEC), of course, was not created until 1934. 15 U.S.C. § 78d (1976). Before that, filings were made with the Federal Trade Commission.

25. *See* H.R. REP. No. 152, 73d Cong., 1st Sess. 27 (1933).

26. 15 U.S.C. § 77r (1976).

27. 15 U.S.C. § 78bb(a) (1976). The additional "conflict" language of this section was intended merely to restate the supremacy clause requirements of the Constitution. *See Proposed National Securities Exchange Act of 1934: Hearings on S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 (73d Cong.) pt. 15, Before the Senate Committee on Banking and Currency, Stock Exchange Practices,* 73d Cong., 1st Sess. 6577 (1934).

Similarly broad residual state powers clauses are found in each of the four other federal securities laws enacted between 1935 and 1940.[28] In fact, nearly all of the federal securities statutes evidence a congressional intent to leave certain aspects of securities regulation *wholly* to state control, even though federal jurisdiction (in a constitutional sense) probably could have been claimed.[29] Undeniably, Congress designed federal regulation of securities to supplement rather than supplant state regulation.

C. *Judicial Response to Dual Regulation*

In the few cases examining the relationship between state and federal securities regulation that followed the 1933 and 1934 legislation, the courts confirmed this principle of dual and complementary jurisdiction, holding that the blue sky laws had not been displaced in any respect by federal law. Although the state laws were similar in purpose to the federal law, they were regarded as distinct both in scope and operation.[30] Moreover, the courts observed that Congress did not intend to limit the application of the federal law to interstate securities activities, but instead contemplated fully concurrent federal and state authority.[31] The need for federal law in the field was said to result from state jurisdictional limitations rather than a congressional desire to replace state regulation with a different system.[32] Perhaps the most authoritative statement of the federal legislative purpose with regard to the existing blue sky laws was that given by the Virginia Supreme Court:

28. 15 U.S.C. § 79u (1976) (Public Utility Holding Company Act of 1935); 15 U.S.C. § 77zzz (1976) (Trust Indenture Act of 1939); 15 U.S.C. § 80a-49 (1976) (Investment Company Act of 1940); 15 U.S.C. § 80b-18a (1976) (Investment Advisers Act of 1940). The provision in the Investment Advisers Act was added in the 1960 amendments. Pub. L. No. 86-750, § 16, 74 Stat. 888 (1960).

29. *E.g.*, § 3(a)(11) of the Securities Act (intrastate offerings of securities); § 15(a)(1) of the Exchange Act (intrastate broker-dealers); §§ 7(g), 8, 9, 10(f), and 20(b) of the Public Utility Holding Company Act (requiring the SEC to accept or give effect to certain rulings, regulations, and interpretations of state regulatory authorities); § 304(a)(4) of the Trust Indenture Act (intrastate debt offerings); § 203(b)(1) of the Investment Advisers Act (advisers whose clients are all intrastate).

30. *E.g.*, SEC v. Hoover, 25 F. Supp. 484 (N.D. Ill. 1938).

31. *E.g.*, SEC v. Timetrust, Inc., 28 F. Supp. 34 (N.D. Cal. 1939).

32. One court stated:

> The chief reason for the passage of the [Securities Act] was that the State acts, commonly referred to as 'Blue Sky Laws,' were not adequate, due to the fact that a security dealer could sometimes successfully claim that his transactions were in interstate commerce and that the States could not regulate the same and thus avoid any regulation whatsoever.

Crosby v. Weil, 382 Ill. 538, 541, 48 N.E.2d 386, 388 (1943). *See also* SEC v. Wickham, 12 F. Supp. 245 (D. Minn. 1935); First Nat'l Sav. Foundation v. Samp, 274 Wis. 118, 80 N.W.2d 249 (1956).

> It was clearly the intention of Congress to leave the States free to exercise such regulatory control over the sale of securities as does not conflict with the provisions of the Federal Act, and, in the absence of such a conflict, it is contemplated the States and the Federal Government shall exercise concurrent jurisdiction in this field.[33]

III. THE PRESENT SYSTEM: "COOPERATIVE FEDERALISM"

A. *Federal-State Regulatory Coordination*

Increasingly over the period of their concurrent jurisdiction, the SEC and the state securities administrators have sought means of fostering cooperation and reducing the burdens and waste of duplicative regulation. Certainly, as the securities markets developed a more national character and state boundaries grew less important in the process of capital formation, coordination between state and federal authorities became imperative.[34] Frequent contact, joint projects, and mutual staff training programs are among the reasons for a working relationship between the Commission and the states that is now both cooperative and productive. In addition, harmony between the federal and state securities laws has been promoted by three important developments:

(1) Registration by Coordination

On August 25, 1956, the National Conference of Commissioners on Uniform State Laws approved the Uniform Securities Act.[35] The Act was drafted at the request of the Conference by Professor Louis Loss of Harvard Law School (assisted by Edward M. Cowett) following a two-year study of state securities regulation made in cooperation with the American Bar Association, the National Association of Securities Administrators, the Securities and Exchange Commission, the Investment Bankers Association of America, and

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33. Travelers Health Ass'n v. Commonwealth, 188 Va. 877, 897, 51 S.E.2d 263, 271 (1949), *aff'd,* 399 U.S. 643 (1950). *See also* Grenader v. Lefkowitz, 47 A.D. 2d 359, 367 N.Y.S.2d 17 (1975), *modified on other grounds,* 42 N.Y.2d 907, 397 N.Y.S.2d 1003, 366 N.E.2d 1357 (1977). It is interesting that there are so few reported cases involving the assertion that a state law conflicts with provisions of the federal securities laws and is hence preempted under the supremacy clause (article VI) of the Constitution. *But see* Public Serv. Comm'n v. SEC, 166 F.2d 784 (2d Cir. 1948), *cert. denied,* 334 U.S. 838 (1948); Investors Diversified Servs. v. Diggles, 272 Wis. 66, 74 N.W.2d 805 (1956) (holding that a provision of Wisconsin's savings and loan regulatory law applicable to investment companies conflicted with and was preempted by the Investment Companies Act of 1940). *See also* text accompanying note 58 *infra.*

34. *See* 1 L. LOSS, SECURITIES REGULATION 90-93 (2d ed. 1961) [hereinafter cited as LOSS].

35. NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, HANDBOOK AND PROCEEDINGS 83-88, 134-35 (1956). *See* L. LOSS, COMMENTARY ON THE UNIFORM SECURITIES ACT (1976).

the National Association of Securities Dealers. It has now been adopted in varying degrees in at least thirty-one states.[36]

The Act's purpose was to bring some uniformity and consistency to state securities regulation, and to integrate that system as much as possible with the federal securities laws.[37] One of the most important provisions with respect to the latter objective was section 303, which established procedural coordination between the state and federal regulatory agencies through the use of simultaneous registration effectiveness.[38] All but fourteen states[39] presently employ a coordination procedure comparable to that prescribed by the Uniform Act. Of those, six states[40] do not register general national securities offerings. Thus, to a large degree, a registration procedure coordinated between state and federal agencies has been achieved without sacrificing the state's traditional merit review philosophy to the disclosure philosophy of the federal law.[41]

(2) Uniform Forms

The North American Securities Administrators Association (NASAA) (previously the National Association of Securities Administrators) is the oldest and largest association of state securities regulators. Even before the advent of the Uniform Act, NASAA adopted a uniform registration application form and a uniform rule and form for the filing of broker-dealer financial information.[42] More recently, the organization has adopted or approved a number of uniform forms designed to coordinate the federal and state regulatory processes: Form BD—Uniform Application for Registration, License or Membership as a Broker-Dealer or to Amend such an Application[43]—was adopted by NASAA in 1974 (effective October 1, 1975), and is now accepted by forty-eight states, the SEC, and the self-regulatory organizations; Form U-4—Uniform Application for Securities and Commodities Industry Representative and/or Agent[44]—also was adopted in 1974 and is presently accepted by the SEC and every state except New Hampshire and New Jersey; the

36. Goodkind, *supra* note 15, at 83.

37. 1 Loss, *supra* note 34, at 102-05.

38. *See* Tompkins, *The Uniform Securities Act—A Step Forward in State Regulation*, 77 W. VA. L. REV. 15, 29-30 (1974).

39. Arizona, Florida, Georgia, Illinois, Louisiana, Maine, Mississippi, Nevada, New Hampshire, New Jersey, New York, North Dakota, Rhode Island, and Vermont.

40. Florida, Georgia, Nevada, New Hampshire, New Jersey, and New York.

41. *See* L. Loss, *supra* note 35, at 47.

42. 3 FED. SEC. L. REP. (CCH) ¶¶ 33,921-33,930Z (1967).

43. 3 FED. SEC. L. REP. (CCH) ¶ 32,702 (1975).

44. 3 FED. SEC. L. REP. (CCH) ¶ 33,191 (1975).

FOCUS Report—Financial and Operation Combined Uniform Single Report[45]—adopted in 1975, is accepted in all states and by the Commission; and Form U-5—Uniform Termination Notice for Securities Industry Representative and/or Agent—was adopted in 1976 and is accepted by nearly all states.[46]

Two additional NASAA uniformity projects deserve mention. In cooperation with the Securities Industry Association, the National Association of Securities Dealers (NASD), and the Investment Company Institute, NASAA is presently designing a uniform state securities agent examination to be administered by the NASD. This examination is intended to satisfy the qualification standards of the twenty-one states[47] that now administer separate securities agent exams. In addition, NASAA is working on a project to develop a centralized depository to receive, process, and store registration materials of securities agents (Forms U-4 and U-5). This program is designed to permit a broker-dealer to file the registration forms for its representatives, together with a single check for registration fees and a list of the states and self-regulatory organizations with which its representatives are to be registered or licensed. The central registration depository then will transmit the appropriate information and registration fee to each state and self-regulatory organization, thereby reducing expensive and time-consuming duplication of filing forms and related materials. Both the central registration depository and the uniform state securities agent examination are expected to commence in 1979.

(3) Operational Coordination

Through various state securities administrators organizations—NASAA, the Midwest Securities Commissioners Association (MSCA), and the Central Securities Administrators Council (CSAC)—state securities regulators have been able to coordinate their activities with those of the Securities and Exchange Commission. Periodic meetings of these associations include active liaison with the staff of the Commission, especially in the enforcement area. Most recently, jointly sponsored regional enforcement conferences have brought together staff members of the Commission and state securities administrators for the exchange of information and a discussion of enforcement procedures. It is also through these

45. 3 FED. SEC. L. REP. (CCH) ¶ 33,921 (Exchange Act Form X-17A-5) (1967).

46. Form U-5 had not, at the time of this writing, been formally adopted by the SEC.

47. Arizona, Arkansas, Florida, Georgia, Hawaii, Iowa, Indiana, Kansas, Kentucky, Michigan, Minnesota, Missouri, New Mexico, North Dakota, Ohio, Oklahoma, Pennsylvania, Rhode Island, Tennessee, Texas, and Wisconsin.

organizations that special federal-state cooperative projects have been undertaken.[48]

B. *Deferral of Regulatory Authority*

Another factor mitigating the undesirable effects of dual regulation is the deferral of regulatory authority in certain circumstances. When regulation is more appropriate or more effective on another level, both state and federal laws have provided means by which they may defer to the other.

Sections 4(2) and 3(a)(11) of the Securities Act, along with the SEC's rules adopted under these sections, provides a degree of deference to state regulation. Securities Act Rule 147, particularly, is founded on the theory that purchasers of securities offered and sold solely intrastate are protected both by their proximity to the issuer and by state regulation.[49] And although this Rule has been criticized as being too restrictive and unacceptably dangerous, it reflects an important federal policy to defer to the states for investor protection in what is essentially "local financing."[50] No express deference to state regulation is found in Securities Act Rule 146,[51] but the nonpublic offering exemption under most state blue sky laws is far more limited than under the federal Rule.[52] Thus, despite the existence of a federal exemption under Rule 146 or section 4(2), registration of private placements is often required under state law.[53]

The states likewise have foregone regulatory control when ade-

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48. A recent project of this type was the NASAA/MSCA/SEC/ICI Investment Company Expense Limitation Study Project (1978) (unpublished). In an effort to design a policy regarding investment company expenses supportable by a reliable data base, these organizations jointly undertook to gather information on investment company costs, the relationship between these costs and a variety of investment company characteristics, and means of reducing cost and increasing return to investors. As a result of the study, NASAA adopted a resolution urging those states that impose expense limitations on investment companies, as a condition of registration, to consider eliminating or suspending such limitations because their utility cannot be supported by empirical evidence. Resolution of the North American Securities Administrators Association, Innisbrook, Florida (1978).

49. "Rule 147 reflects this Congressional intent and is limited in its application to transactions where state regulation will be most effective." SEC Securities Act Release No. 5450 (Jan. 7, 1974) *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶ 2340, at 2611-2; [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,617, at 83,649; *see* Emens & Thomas, *The Intrastate Exemption of the Securities Act of 1933 in 1971*, 40 U. CIN. L. REV. 779, 781-82 (1971).

50. *See* Chapman v. Dunn, 414 F.2d 153, 158-59 (6th Cir. 1969). *See also* SEC Securities Act Release No. 4434 (Dec. 6, 1961), *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶¶ 2270-2277.

51. SEC Securities Act Release No. 5487 (Apr. 23, 1974), *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶ 2710.

52. *See* UNIFORM SEC. ACT § 402(b)(9).

53. Note, *State Exemptions from Securities Regulation Coextensive with S.E.C. Rule 146*, 61 CORNELL L. REV. 157, 166 (1975).

quate federal oversight exists. Section 402(a)(8) of the Uniform Act prescribes an exemption for securities "listed or approved for listing upon notice of issuance" on certain designated exchanges. The rationale for this exemption, which is followed in nearly every state that registers securities, is that registration under the Securities Act provides an adequate disclosure review of the offering, and the listing and surveillance activities of the exchanges presumably serve as a satisfactory substitute for application of the state substantive standards.[54] A few states have gone so far as to eliminate state registration entirely for offerings that are registered under the Securities Act.[55] Moreover, some states grant secondary trading exemptions and other privileges under state law for the securities of companies registered under section 12 of the Exchange Act.[56]

C. *Recent State-Federal Disharmony*

There is at least one area in which state laws recently have been found to conflict with the federal securities laws. In *Great Western United Corp. v. Kidwell*,[57] the court held that a portion of the Exchange Act regulating tender offers[58] preempts the state of Idaho's corporate takeover law because the state statute "presents a serious conflict with the administration of the federal program for the regulation of tender offers."[59] The two-to-one majority also found that personal jurisdiction over the Idaho securities administrator was proper in the United States District Court for the Northern District of Texas because the impact of his regulatory activities was felt, and was intended to be felt, in the state of Texas. This decision, which has been appealed to the United States Supreme Court, could have far-reaching implications with respect to blue sky laws and other state regulatory statutes.[60]

54. *But see* Jennings, *The Role of the States in Corporate Regulations and Investor Protection*, 23 L. & CONTEMP. PROB. 193, 216-17 (1958).

55. *E.g.*, FLA. STAT. ANN. § 517.061(19) (West Supp. 1978); GA. CODE ANN. § 97-109(e) (1976).

56. *E.g.*, COLO. REV. STAT. § 11-51-114(2)(b)(II) (1973); IND. CODE ANN. § 23-2-1-2(b)(3)(C)(ii) (Burns Supp. 1978); MASS. GEN. LAWS ANN. ch. 110A, § 402(b)(2)(C) (West Supp. 1978).

57. 577 F.2d 1256 (5th Cir. 1978).

58. Williams Act, 15 U.S.C. §§ 78m(d), 78m(e), 78n(d), 78n(e), 78n(f) (1976).

59. 577 F.2d at 1262 (quoting SEC amicus brief at 47).

60. Although the *Great Western* court expressly distinguished between state tender offer regulation and the blue sky laws, its analysis of conflict between the Idaho takeover statute and the federal Williams Act appears to have application in the blue sky area as well:

> In § 13(d) of the Williams Act Congress delegated to the SEC the task of specifying what data is material to an investor considering a tender offer. The SEC has attempted to write disclosure requirements that provide enough material information without producing reports so detailed and complicated that few shareholders would want to read

But until the *Great Western* case (and with the exception of a very limited express preemption recently included in section 28 of the Exchange Act relating to transfer taxes),[61] the state laws regulating transactions in securities were considered in substantial harmony with the federal securities laws. Any disfunctions of dual regulation have been of a practical rather than a legal character.

IV. FEDERAL-STATE RELATIONS UNDER THE CODE

If the Code did nothing but preserve the status quo, it nonetheless had to include a section describing its effect on state law. The question faced by the Reporter was whether to use this "once-in-a-lifetime" opportunity to accomplish something more than that. There are, and always have been, a great many securities practitioners who advocate elimination of state regulation, at least with respect to the registration of federally reviewed offerings.[62] The arguments for total preemption are strongly worded:

> These [securities] markets are not susceptible to regulation by the states. Indeed, state regulation in this day and age is an anachronism. Broadly speaking it is ineffective, except in a few instances, and it constitutes an unnecessary interference with the interstate securities markets.
>
> . . . .
>
> . . . The "blue sky" laws had come to have a special meaning—a meaning full of complexities, surprises, unsuspected liabilities for transactions normal and usual—in short, a crazy-quilt of state regulations no longer significant or meaningful in purpose, and usually stultifying in effect, or just plain useless.[63]

Others have urged less-than-total preemption, but with the same vigor:

> In the last analysis, the merit standard system [of the blue sky laws] seriously overrates and overrelies on the wisdom and judgment of a single public official and creates inherently dangerous obstacles to free access to public capital markets and to a free choice of public investment opportunities. The result, in practical experience, is that the public investor receives far less actual protection from the merit standard system than it pretends to afford.

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them. That judgment is a legislative one. Idaho's effort to second guess that judgment cannot stand. This is particularly true because Idaho's additions to the federal disclosure requirements reduce the utility of federally required disclosure and produce an obstacle to the accomplishment of the federal objective to enable investors to make an informed choice about a tender offer.

577 F.2d at 1280-81 (citations omitted).

61. 15 U.S.C. § 78bb(d) (1976).

62. *See, e.g.,* Remarks of Kenneth J. Bialkin, Conference on Codification, *supra* note 3, *reprinted in* 22 BUS. LAW. at 803.

63. Armstrong, *The Blue Sky Laws,* 44 VA. L. REV. 713, 713-15 (1958). At least one commentator has gone further to argue that the blue sky laws do a serious disservice to the nation's economy by crippling venture capital formation and impairing the efficient market without providing any appreciable benefit to investors. J. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS (1971).

> It is equally clear that so long as the merit standard system is retained by the states, uniformity is highly unlikely, since it is reasonable to assume that state administrators applying discretionary, subjective criteria to each registered securities distribution will not all think alike all of the time.[64]

Writings by proponents of state regulation, on the other hand, have been few and far between.[65] But theoretical arguments concerning the efficacy of dual regulation aside, the most compelling factor involved in drafting the Code was the realization that total preemption of state law in the current context is simply a practical impossibility—most thought it better to seek the more limited objective of establishing minimum standards of state coordination and uniformity than to redesign the entire regulatory system and present to Congress a major states' rights issue.[66]

The Reporter, therefore, chose a middle ground for the Code—limited preemption as to certain regulatory functions and procedures performed more effectively on the federal level, together with greater reliance on the states with regard to essentially local distributions, and express preservation of state merit review powers. This "treaty," as the Reporter calls it,[67] has been endorsed by NASAA, which has urged favorable congressional action on these parts of the Code.[68]

A. *Procedural Coordination with Respect to Distributions*

As has been mentioned,[69] the coordinated registration proce-

64. Bateman, *State Securities Registration: An Unresolved Dilemma and a Suggestion for the Federal Securities Code*, 27 Sw. L.J. 759, 778-79 (1973). Bateman proposes that the Code preempt state regulation to the extent it is based on the "inconsistent" merit standards philosophy. He would preserve the states' authority, however, "to explore new and different methods of achieving full disclosure," presumably as Brandeisian laboratories. Public disclosure of the state administrator's opinion concerning the merits of the securities offering is one such method, he suggests. *Id.* at 785-86. *See also* Note, *State Securities Regulation: Investor Protection Versus Freedom of the Marketplace*, 29 U. Fla. L. Rev. 947 (1977).

65. *E.g.*, Jennings, *supra* note 54. Professor Jennings was a member of the Code's advisory committee. Milton H. Gray, a lawyer with considerable experience with the blue sky laws who served as an ad hoc consultant to the Reporter, urged the preservation of state jurisdiction subject to enforced coordination with the federal law. *See* Gray, *Blue Sky Practice—A Morass?*, 15 Wayne L. Rev. 1519 (1969).

66. *See* 1 Loss, *supra* note 34, at 102-05. In 1974, a representative of the NASAA was invited to serve as an adviser on the Code with the primary responsibility of communicating to the Reporter the state regulators' viewpoints concerning federal-state relations and assisting in the drafting of those parts of the Code.

67. "Treaty" is probably an inaccurate appellation, there never having been a declared war. From the beginning the state administrators were supportive of the Code in general, and supportive of a reasonable allocation of regulatory authority between the SEC and the states in particular.

68. Resolution of the North American Securities Administrators Association, Anaheim, California (Oct. 12, 1977), *reprinted in* 1978 Draft, *supra* note 7, at 719-20.

69. *See* text accompanying note 38 *supra*.

dure of section 303 was probably the most important reform of the Uniform Securities Act. The purpose of the section was to "regularize" the process of state review of registration statements filed under the Securities Act by streamlining the content of the registration statement and the procedure by which it becomes effective.[70] The concept is relatively simple: If the SEC prospectus, together with such additional information filed with the Commission as the state administrator may require, is timely filed with the state, the registration statement becomes automatically effective with the state the moment it becomes effective in Washington, unless the state administrator issues a stop order. By placing on the state administrator the burden of acting affirmatively to prevent effectiveness, coordinated registration permits a greater degree of certainty among issuers, underwriters, and their counsel. Most states that have adopted the Uniform Act have not altered this provision.[71]

There remain fourteen states, however, that have no coordinated registration procedure,[72] six of which do not register general national securities offerings.[73] In order to achieve a fully coordinated federal-state procedure in this area, the Code requires these remaining states, if they wish to register general national securities offer-

70. 1 Loss, *supra* note 34, at 99.

71. Thirty-six states now have a registration procedure that is coordinated, to a substantial degree, with the federal procedure. Among these are a number of states that adopted the coordinated registration machinery without accepting the entire Uniform Act. The following states currently provide for simultaneous state and federal effectiveness: Alabama (ALA. CODE § 8-6-6 (1975)); Alaska (ALASKA STAT. § 45.55.090 (1962)); Arkansas (ARK. STAT. ANN. § 67-1243 (1966)); California (CAL. CORP. CODE § 25111 (West 1977)); Colorado (COLO. REV. STAT. § 11-51-109 (1973)); Connecticut (CONN. GEN. STAT. § 17 (1977)); Delaware (DEL. CODE ANN. tit. 6, § 7305 (1974)); Hawaii (HAW. REV. STAT. § 485-11 (1976)); Idaho (IDAHO CODE §§ 30-1420 to -1421 (Supp. 1977)); Indiana (IND. CODE ANN. § 23-2-1-4 (Burns Supp. 1978)); Iowa (IOWA CODE ANN. § 502.206 (West Supp. 1978)); Kansas (KAN. STAT. ANN. § 17-1257 (1977)); Kentucky (KY. REV. STAT. § 292.360 (Supp. 1978)); Maryland (MD. CORP. & ASS'NS CODE ANN. § 11-503 (1975)); Massachusetts (MASS. GEN. LAWS ANN. ch. 110A, § 302 (West Supp. 1978)); Michigan (MICH. COMP. LAWS § 303 (eff. Apr. 1, 1979)); Minnesota (MINN. STAT. ANN. § 80A.10 (West Supp. 1977)); Missouri (MO. ANN. STAT. § 409.303 (Vernon Supp. 1978)); Montana (MONT. REV. CODES ANN. § 15-2009 (1947)); Nebraska (NEB. REV. STAT. § 8-1106 (1974)); New Mexico (N.M. STAT. ANN. § 48-18-19.4 (Supp. 1975)); North Carolina (N.C. GEN. STAT. § 78A-26 (1975)); Ohio (OHIO REV. CODE ANN. § 1707.091 (Page Supp. 1978)); Oklahoma (OKLA. STAT. ANN. tit. 71, § 303 (West 1965)); Oregon (OR. REV. STAT. § 59.065(2) (1971)); Pennsylvania (PA. STAT. ANN. tit. 70, § 1-205 (Purdon Supp. 1978)); South Carolina (S.C. CODE §§ 35-1-840 to -860 (1976)); South Dakota (S.D. COMPILED LAWS ANN. §§ 47-31-18.1-.3 (Supp. 1978)); Tennessee (TENN. CODE ANN. §§ 48-1610-1611 (1964)); Texas (TEX. REV. CIV. STAT. ANN. art. 581-7(C) (Vernon 1964)); Utah (UTAH CODE ANN. § 61-1-9 (1978)); Virginia (VA. CODE § 13.1-509 (1978)); Washington (WASH. REV. CODE ANN. § 21.20.180 (1978)); West Virginia (W. VA. CODE § 32-30303 (1975)); Wisconsin (WIS. STAT. ANN. § 551.25 (West 1978)); Wyoming (WYO. STAT. § 17-117.9 (1965)).

72. *See* note 39 *supra*.

73. *See* note 40 *supra*.

ings, to adopt within two years after the Code's enactment[74] a procedure for registration substantially coordinated with that of the Code.[75] A state whose procedure is not substantially coordinated will be totally preempted with respect to that function.

Section 1904(a) of the Code[76] requires, with respect to a distri-

74. *See* 1978 Draft, *supra* note 7, § 2011(a)(1).

75. The term "registration," while descriptive of the state procedure for reviewing and approving securities offerings, has a different meaning in the Code. Under the Code there is no more registration of *securities*. Instead, a *company* will "register" as such when it attains sufficient public company characteristics. *See id.* § 402. The federal procedure with which state registration must be coordinated is the filing of an "offering statement" in connection with a distribution. *See id.* § 502.

76. Section 1904(a) of the 1978 Draft provides:

[*Relation to State law.*] (a) [*Procedural coordination with respect to distributions.*] (1) Part V is exclusive and plenary, so far as a distribution subject to section 502 is concerned, with respect to a State securities commission whose procedure for registering the distribution is not substantially coordinated with the procedure under that section. See also section 2011(a)(1).

(2) A State securities commission's procedure is substantially coordinated within the meaning of section 1904(a)(1) if

(A) it accepts the registration statement and offering statement filed on the Commission's forms (but including only whatever exhibits the State securities commission requires), together with any amendments (including posteffective amendments), in satisfaction of whatever comparable requirements the State securities commission has, and

(B) the State filing becomes effective when the offering statement becomes effective, except that this condition need not be satisfied unless (i) the offering statement (as well as the registration statement when the person filing the offering statement is not already a registrant) was filed with the State securities commission within five business days after the filing under section 502 and has been on file with that commission for at least ten business days, (ii) all amendments except the price amendment have been on file with that commission for at least seven business days, and (iii) a statement of the maximum and minimum proposed offering prices and the maximum underwriting discounts and commissions has been on file with that commission for at least two business days (in the absence of a waiver of any of those requirements by that commission).

(3) A State securities commission's procedure is not prevented from being substantially coordinated within the meaning of section 1904(a)(1) by reason of the fact that it

(A) requires a registrant promptly (i) to notify it by telephone or telegram of the date and time when the federal offering statement became effective and the content of any price amendment, and (ii) to file with it a posteffective amendment containing the information and documents in the price amendment;

(B) requires the submission of whatever information, financial statements, or other documents it considers necessary or appropriate in light of a substantive standard (but it may not require any other material to be included in a prospectus for a distribution that is subject to section 502 without the acquiescence of the Commission unless the State securities commission considers it necessary or appropriate in light of a substantive standard);

(C) enters a stop order or comparable order on the basis of a substantive bution subject to both federal and state review, that the state securities commission's[77] procedure provide that the state will accept the registration or offering statement on SEC forms in satisfaction of its own comparable filing requirements, and that it will permit the state filing to become effective when the federal filing becomes effective, provided the state has had sufficient time to complete its review. The section goes on to prescribe "safe harbor" criteria for substantial coordination, adopted in large part from section 303 of the Uniform Securities Act.[78] Thus, the two essential elements of the Code's procedural coordination are (a) acceptance of the SEC's registration and offering statement forms, and (b) simultaneous effectiveness.[79] But the states are permitted, within prescribed limits, to add conditions to these elements and still remain "substantially coordinated:"

1. The SEC's forms need satisfy only those filing requirements of the state that are "comparable" to those of section 502 of the Code.[80] A state's consent to service of process filing requirement, for example, since it is incomparable to any filing requirement under section 502, is not displaced.[81]

2. Furthermore, a state may require the filing of any additional information, financial statements, or other documents it considers "necessary or appropriate in light of a substantive standard,"[82] and may also require the submission of sales literature.[83]

3. At its discretion, the state may ask for all, some, or none of

standard or a failure to submit, or to include in a prospectus, material that it may require under section 1904(a)(3)(B), or

(D) requires the filing with it of, or prohibits the use of, sales literature.

(4) "Price amendment" means the final Federal amendment that includes a statement of the offering price, underwriting and selling discounts or commissions, amount of proceeds, conversion rates, call prices, and other matters dependent on the offering price.

(5) "Substantive standard" means one other than the disclosure standard of section 1808(d).

77. "State securities commission" is defined to mean "a State agency or official, however designated, insofar as it or he has jurisdiction (otherwise than as a State utility commission) in an area covered by this Code." 1978 Draft, *supra* note 7, § 299.63.

78. *See* L. Loss, Commentary on the Uniform Securities Act 46-55 (1976).

79. The Code's procedural coordination mandate, of course, applies only with respect to a state's procedure for registering a distribution subject to 1978 Draft § 502. 1978 Draft, *supra* note 7, § 1904(a)(1). If the distribution is exempted from § 502 (*see, e.g., id.* §§ 512, 514), or not subject to registration in the state, the section is inapplicable.

80. *Id.* § 1904(a)(2)(A) (last clause).

81. *See* L. Loss, *supra* note 78, at 162-63 (regarding the rationale for the Uniform Act's consent to service of process requirement). *See also* 1978 Draft, *supra* note 7, § 1905(e)(1).

82. *Id.* § 1904(a)(3)(B). "Substantive standard" is defined as any standard other than the disclosure standard of 1978 Draft § 1808(d). *Id.* § 1904(a)(5). *See* note 93 *infra*.

83. 1978 Draft, *supra* note 7, § 1904(a)(3)(D).

the federal filing exhibits.[84]

4. The coordination procedure chosen by a state may prescribe certain filing-time requirements. The state may demand that the federal offering statement (and the federal registration statement in the case of a nonregistrant)[85] be filed in the state within five business days after the federal filing and at least ten business days before federal effectiveness.[86] It may also require that all amendments except the "price amendment"[87] be on file at least seven business days (and the price amendment, two business days) before the federal offering statement becomes effective.[88] The purpose of these provisions is to assure the state adequate time to review the filing. The state administrator may, of course, waive any of these filing-time requirements in specific cases or in general.[89]

5. Finally, a state is permitted to demand (as in the Uniform Act) that the registrant promptly send notification of federal effectiveness and the content of the price amendment, and file with it the post-effective pricing information.[90]

The Code expressly preserves the traditional merit review authority of the states in connection with a coordinated registration. Specifically, states are permitted to require submission of information, financial statements, or other documents they consider necessary or appropriate in light of a substantive standard,[91] and may require that this material be included in the prospectus.[92] The states may enter a stop order or comparable order upon a failure to submit or to include in the prospectus this required material, or on the basis of the state's substantive standard alone.[93] Thus, states may con-

84. *Id.* § 1904(a)(2)(A) (first parenthetical).

85. *Id.* § 403.

86. *Id.* § 1904(a)(2)(B)(i).

87. *Id.* § 1904(a)(4) (defining "price amendment").

88. *Id.* § 1904(a)(2)(B)(ii)-(iii).

89. It should be noted that the filing-time requirements that may be imposed by a "substantially coordinated" state relate only to the federal offering statement (and registration statement, if applicable) and federal amendments, and not to the other permitted state filing requirements such as sales literature. *See id.* § 1904(a)(3)(D).

90. *Id.* § 1904(a)(3)(A).

91. *Id.* § 1904(a)(3)(B).

92. *Id.* § 1904(a)(3)(B) (parenthetical clause).

93. *Id.* § 1904(a)(3)(C). The term "substantive standard" is broadly defined in § 1904(a)(5) to include anything that is not a disclosure standard of the type as to which the SEC may issue a stop order pursuant to § 1108(d) (misrepresentation or omission of a material fact or document). Moreover, it is the state securities commission that makes the determination under § 1904(a)(3)(B) whether particular materials are "necessary or appropriate in light of a substantive standard." Presumably such a determination, so long as it is not clearly unreasonable, concludes the matter. The Reporter comments, however, that a substantive standard should not be used as an indirect device for obtaining additional disclosure

tinue to apply all of the common "fair, just and equitable" requirements of the blue sky laws,[94] as well as whatever standards they may have under the Uniform Act's less expansive "tend to work a fraud" language.[95]

Notwithstanding the considerable latitude given the states to continue to review the merits of a proposed offering, the Code imposes a rather significant limitation on the states with respect to pure disclosure.[96] If it is to remain "substantially coordinated," a state may not require material unrelated to the application of a substantive standard to be included in the prospectus, without the "acquiescence" of the SEC.[97] The purpose is to prevent a state from second-guessing the SEC so far as pure disclosure is concerned. On the other hand, should a state examiner come upon a misleading piece of information or a material omission, he or she could bring the matter to the SEC examiner's attention and, provided that the examiner does not disagree, the state may require a revised disclosure.

In sum, the 1978 Draft section 1904(a) does two things: it makes universal the coordinated registration procedure of the Uniform Securities Act,[98] and it grants to the SEC predominant authority as to disclosure, leaving the states free to carry out their substantive regulation. Enactment of the section is likely to encourage immediate legislative action in the remaining eight uncoordinated states,[99]

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in a prospectus, and that the state commission's authority under that clause should be narrowly construed. *See* TD-3, *supra* note 6, Comment (5)(b), at 142 (1974).

94. These include restrictions relating to offering price, underwriting commissions and offering expenses, cheap stock, promoters' equity investments, options and warrants, shareholder democracy rights, interest and dividend coverage, issuers' capitalizations, preemptive rights, and so forth.

95. UNIFORM SEC. ACT § 306(a)(2)(E). *See* Goodkind, *supra* note 15, at 87.

96. Pure disclosure is that which cannot reasonably be considered appropriate in light of a substantive standard. *See* 1978 Draft, *supra* note 7, §§ 1904(a)(5), 1808(d).

97. *Id.* § 1904(a)(3)(B) (parenthetical clause). The term "acquiescence" was chosen to imply that there need be no formal or official action of the Commission on such a question. All that is required is that the SEC examiner accept the disclosure, even if done tacitly or passively. *See* RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 13 (1969).

98. It is interesting that the idea of using the Code to enforce registration by coordination may well have had its genesis in the Reporter's impromptu response to Ken Bialkin's query about total preemption at the ABA Committee's 1966 meeting:

> [T]o suggest that we can practically achieve preemption of the field here is a little bit like talking about repeal of the income tax. . . . We might even, conceivably, have a provision in the code preempting the field after five years or so in the case of a state that didn't go over to a system of registration by coordination or something of that sort. But beyond that, I think we would be really wasting our time talking about preemption.

Conference on Codification, *supra* note 3, *reprinted in* 22 BUS. LAW. at 804.

99. Arizona, Illinois, Louisiana, Maine, Mississippi, North Dakota, Rhode Island, and Vermont. Four of these states—Arizona, Louisiana, Maine, and North Dakota—already accept the SEC prospectus in lieu of their own requirements. In addition, six states that

and should lead to greater rationality in obtaining regulatory approval for a national securities distribution.

B. *Nonprocedural Preemption with Respect to Sales*

Milton H. Gray should probably receive credit for the idea of preempting state registration of the securities of a "blue chip" class of issuers. Nearly thirty years ago, in addressing the annual convention of the state securities administrators, he called for "carving out a high grade class of securities which could be made the subject of automatic state registration . . . ."[100] Gray proposed that a number of criteria be used to identify securities eligible for automatic registration: continuous operation of the issuer for a specified number of years; absence of defaults in the payment of principal and interest on debt, and dividends on fixed dividend securities; absence of underwriter's options; an offering price related to current market price or based on a specific earnings multiple; and a limitation on underwriters' commissions and discounts.[101] Although the Code did not follow each of his suggested criteria, Gray's prescience is apparent in the federal-state relations section.

Section 1904(b) of the Code[102] gives the SEC plenary jurisdic-

presently employ a coordinated registration procedure have filing-time requirements longer than those permitted by § 1904(a)(2)(B). These would have to be revised, either by statutory amendment or administrative rule or order, if these states are to be coordinated in the Code sense. IOWA CODE ANN. § 502.206(3)(b) (West Supp. 1978); MICH. COMP. LAWS ANN. § 303(c)(2) (1969); MINN. STAT. ANN. § 80A.10 (3(b)) (West Supp. 1977); MO. ANN. STAT. 409.303(c)(2) (Vernon Supp. 1978); OHIO REV. CODE ANN. § 1707.091(C)(2) (Page Supp. 1978); S.D. COMPILED LAWS ANN. § 47-31-18.3(2) (Supp. 1978).

100. Address by Milton H. Gray, National Association of Securities Administrators, 32d Annual Convention, Richmond, Virginia (1949).

101. *See* Gray, *supra* note 65, at 1532-33.

102. Section 1904(b) of the 1978 Draft provides:

[*Nonprocedural preemption with respect to sales.*] Whether or not a State's procedure is substantially coordinated within the meaning of section 1904(a), part V is exclusive and plenary to the extent that all of the following conditions are satisfied:

(1) the issuer is organized under the laws of the United States, a State, Canada, or a Canadian province, and does business primarily in the United States or Canada;

(2) the issuer is a three-year registrant (that term being defined as it would be if section 299.16 specified three years rather than one);

(3) neither the issuer nor a controlled person has defaulted during the last ten years (or during the issuer's or controlled person's existence if less than ten years) in the payment of principal, interest, dividend, or sinking fund installment on preferred stock or indebtedness for borrowed money;

(4) the issuer and its consolidated subsidiaries had net income (after taxes but before extraordinary items, net of tax effect, and the cumulative effect of accounting changes) of at least (A) $1,000,000 for each of its last five fiscal years, and (B), if the distribution is of interest-bearing securities, one and one-half times the annual interest charges on those securities (together with all other outstanding securities ranking at least on a parity, except any such securities that are to be refunded with the proceeds of the

tion over certain blue chip distributions on the theory that (a) most are presently exempt from the state registration process by virtue of their listing status on a national securities exchange, (b) nearly all would satisfy the states' substantive standards were they to be subjected to a registration review, and (c) even as to those that are now subject to state registration, the benefits of that review are substantially outweighed by the burdens of multiple jurisdiction paper shuffling and the diversion of limited blue sky resources from more productive tasks.[103] Furthermore, several of the most fundamental state substantive standards are made qualifying criteria for the section. Therefore, SEC review of these offerings, together with the continuous disclosure requirements of the Code, is thought to constitute an adequate substitute for state registration.[104]

Thus, whether or not a state's procedure is "substantially coordinated" as discussed previously, Part V of the Code[105] is exclusive and plenary to the extent that each of nine prescribed conditions is satisfied:

1. *Place of organization and business.* The issuer must be organized and do its primary business in the United States (or a state) or in Canada (or a province).[106] This requirement presumes that security holders of an issuer organized under local law will at least be entitled to the protections of familiar business corporation statutes, and will have some proximity, both geographically and in a personal jurisdiction sense, to the issuer.

2. *Three-year registrant.* Securities Act Form S-7 is available only if the registrant has been subject to the requirements of section

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securities being distributed) for its last fiscal year;

(5) the distribution is of a debt security or stock;

(6) if the distribution is of stock, there were outstanding, on a date within six months before the distribution, at least 750,000 shares of the class, with a quoted market value of at least $5 per share, owned either beneficially or of record by at least one thousand persons;

(7) any common stock that is the subject of the distribution has at least equal voting rights with all outstanding stock (except for any voting rights that may attach to preferred stock in the event of a default in payment of dividends);

(8) the distribution is for cash; and

(9) the issuer is not an investment company.

103. *See* TD-3, *supra* note 6, § 1603, Comment (7), at 144 (1974).

104. The preemption invoked by this section relates only to the state registration process, leaving untouched other aspects of state jurisdiction such as broker-dealer regulation, antifraud proscriptions, filing requirements, and so forth.

105. Part V deals with the requirements for a distribution.

106. Several of the blue chip criteria in this section, including the "place of business" condition, were taken from the Form S-7 eligibility requirements. *See* Securities Act Form S-7, para. A(a)(2), *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7190, at 6311. The term "primarily" replaces Form S-7's "principal" as part of an intra-Code uniformity campaign. *See, e.g.*, 1978 Draft, *supra* note 7, § 514(a)(1)-(2).

12 or 15(d) of the Exchange Act and has submitted all the prescribed material for a period of at least thirty-six calendar months immediately preceding the filing of the registration statement on this form.[107] This provision is carried over into the "blue chip" section of the Code. A "three-year registrant" is one that has been a registrant without interruption for three years, meaning it has complied with the Code's new continuous disclosure system for publicly held companies during that period.[108] The requirement assures not only that prospective purchasers will have the benefit of substantial historical data concerning the issuer and its securities, but also that the issuer has proven its amenability to regulation.[109]

3. *No defaults.* The issuer and all controlled persons must be default free for the lesser of ten years or the period of their existence. This is another of the S-7 criteria,[110] providing some evidence of the issuer's financial stability. "Controlled person" has been substituted for today's "subsidiary" and expressly defined,[111] again as a part of the codification process. "Default" is left to elaboration by rule.

4. *Adequate earnings and interest coverage.* Net earnings of $1,000,000 in each of the prior five years are required as another, though not too stringent, measure of the issuer's financial strength.[112] While the issuer need be a registrant for only three years, this subsection requires that the issuer be in existence and meet the income test for at least five years.[113] The second half of the test,

107. Securities Act Form S-7, para. A(b)(1), *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7190, at 6311.

108. *See* 1978 Draft, *supra* note 7, §§ 299.40, 299.16.

109. *E.g., id.* §§ 402-06 (filing of registration statements), 602 (dissemination of annual and quarterly reports), 603 (proxy regulation), 605(a) (insider filing requirements).

110. *See* Securities Act Form S-7, para. A(c), *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7190, at 6311-12.

111. The Code defines "control" as

> power, directly or indirectly, to exercise a controlling influence over the management and policies of a company or the activities of a natural person (either alone or pursuant to an arrangement or understanding with one or more other persons), whether through the ownership of voting securities, through one or more intermediary persons, by contract, or otherwise.

1978 Draft, *supra* note 7, § 230(a). A presumption of control is established when a person or group owns or has the power to vote more than 25 percent of the voting securities (or equity), with the reverse presumption arising in the contrary situation. *Id.* § 230(b)(1)-(2).

112. Again the test is taken from Form S-7, although that figure is now $250,000. Securities Act Form S-7, para. A(d), *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7190, at 6311-12. A sampling of S-7 registration statements filed in 1973 revealed that 269 of those 275 registrants would have satisfied the $1,000,000 test (as opposed to the then current $500,000 test) in each of the prior five years. *See* ALI FED. SEC. CODE § 1603(e) (Reporter's Revision of Text of Tent. Drafts Nos. 1-3, 1974) [hereinafter cited as RD 1-3], Comment (2), at 230 (1974).

113. Successions by merger or otherwise during the period (and the 10 years of subsec-

applicable only with respect to a distribution of interest-bearing securities, is a general substitute for a substantive standard applied by approximately one-half of the states in their registration of debt securities.[114] This provision calls for the issuer to demonstrate in its last fiscal year net income of at least one and one-half times the annual interest charges on the securities to be issued, together with all other interest-bearing securities ranking at least on a parity, with the exception of any securities that are being retired with the proceeds.[115]

5. *Debt or stock only.* The blue chip preemption provision is not applicable to the distribution of any security other than a debt security or stock. Limited partnership interests, options, oil and gas participations, investment contracts which are not stock, and other more esoteric forms of investment securities will remain subject to state regulation regardless of the blue chip character of the issuer. The rationale is that the states presently impose a great many substantive standards in the review of these offerings[116] for which the blue chip criteria are not intended to be a substitute.

6. *Developed market.* State registration is not displaced unless the issuer of stock can show a market breadth and depth for the securities sufficient to indicate widespread public interest in a secondary market. The figures for this subsection—750,000 shares with a quoted market value of at least $5 per share, owned by at least 1000 persons—are taken, with some modifications, from the Federal Reserve Board's requirements for marginable over-the-counter securities.[117]

7. *Equal voting rights.* At least fifteen states have requirements for the registration of securities relating to shareholder voting rights.[118] Comparable requirements are found in the listing criteria of the New York Stock Exchange.[119] This subsection mandates equal

tion 1904(b)(3)) may be dealt with by rule. *See* TD-3, *supra* note 6, § 1603 Comment (9), at 144-45 (1974).

114. *See* Goodkind, *supra* note 15, at 101-03.

115. Since the net income computation is *after* interest expense, this requirement may be rather stiff if the issuer has a considerable amount of outstanding senior or *pari passu* debt.

116. *E.g.*, North American Securities Administrators Association, Guidelines for the Registration of Oil and Gas Programs, *reprinted in* 1 BLUE SKY L. REP. (CCH) ¶ 4582; Midwest Securities Commissioners Association, Statement of Policy Regarding Real Estate Programs, *reprinted in* 1 BLUE SKY L. REP. (CCH) ¶ 4821; Midwest Securities Commissioners Association, Guidelines for Registration of Publicly-Offered Cattle-Feeding Programs, *reprinted in* 1 BLUE SKY L. REP. (CCH) ¶ 4811.

117. *See* Board of Governors of the Federal Reserve System, Credit by Brokers, Dealers, and Members of National Securities Exchanges (Regulation T), 12 C.F.R. § 220.8(h), (i) (1974).

118. *See* Goodkind, *supra* note 15, at 99-100.

119. *See New York Stock Exchange Company Manual,* § A 15, at A-280.

voting rights as a condition of blue chip preemption.

8. *Cash only.* The blue chip provision is applicable only to those transactions involving cash offers. Exchange offers will continue to be subject to the states' registration authority. Although such transactions are currently exempt from registration in some states,[120] they are only conditionally exempt and are carefully scrutinized in others.[121]

9. *No investment companies.* The regulation of investment companies is an area in which many states are active, imposing substantive standards beyond those of the Investment Company Act of 1940, such as expense limitations, diversification requirements, and portfolio investment limitations. Because there is room for regulatory experimentation here,[122] and because there is presently no universal state exemption for investment company shares, the blue chip section excludes these issuers.

There may not be a great deal of difference, so far as most blue chip issuers are concerned, between their present exempt status under the blue sky laws and their situation once the Code preempts state registration authority with respect to their distributions. The principle established by this section of the Code is quite important, however, for here is an area of regulation traditionally within the states' blue sky jurisdiction in which the efficacy of federal regulation, bolstered by the Code's reforms, will be relied on exclusively for the protection of investors.

C. *Preemption with Respect to Tender Offers*

Much has been written about state tender offer statutes—their propriety, their constitutionality, and indeed, the purity of their motives.[123] As previously noted, at least one court has examined a state takeover statute in each of these respects and found it lacking.[124] When the first draft of this section of the Code was completed in 1974, only five states[125] had adopted legislation in this area. The

120. *E.g.*, OKLA. STAT. ANN. tit. 71, § 401(b)(11) (West 1965); TENN. CODE ANN. § 48-1632(B) (1964).

121. *E.g.*, CAL. CORP. CODE § 25103(b)-(c) (West 1977); WIS. STAT. ANN. § 551.23(12) (West 1977).

122. *See* note 48 *supra*.

123. *E.g.*, E. ARANOW, H. EINHORN & G. BERLSTEIN, DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL 225-33 (1977); Gould & Jacobs, *The Practical Effects of State Tender Offer Legislation*, 23 N.Y.L. SCH. L. REV. 399 (1978); Moylan, *State Regulation of Tender Offers*, 58 MARQ. L. REV. 687 (1975); Sommer, *The Ohio Takeover Act: What Is It?*, 21 CASE W. RES. L. REV. 681 (1970); Wilner & Landy, *The Tender Trap: State Takeover Statutes and Their Constitutionality*, 45 FORDHAM L. REV. 1 (1976).

124. Great Western United Corp. v. Kidwell, 577 F.2d 1256 (5th Cir. 1978).

125. Minnesota, Nevada, Ohio, Virginia, and Wisconsin.

Reporter characterized the statutes at that time as pro-management and unnecessary in light of the Williams Act, and he suggested that the Code should preempt this area "before this sort of state legislation spreads."[126]

There are now thirty-seven states that regulate transactions involving tender offers,[127] most of them having entered the field in the last three years. Much has been learned about regulating these transactions through the application of the state laws. Still, there are some basic problems with state regulation of tender offers, not the least of which is a regulating state's rather tenuous relationship to a transaction of national or even international proportions.[128] Many critics have argued that state regulation reflects an anti-take-over philosophy, as compared with the neutrality sought by the Williams Act, and that it inhibits tender offers for the benefit of a target company's management.[129] Others have suggested, however, that the state takeover laws were prompted by a sincere dissatisfaction with the regulatory provisions of the federal law which they view as insufficiently protective of shareholders' interests, and that the state laws have resulted in an advantage to the Nation's shareholders amounting to millions of dollars.[130]

126. TD-3, *supra* note 6, § 1603 Comment (10).

127. ALASKA STAT. §§ 45.57.010-.120 (Supp. 1978); ARK. STAT. ANN. §§ 67-1264 to -1264.14 (Supp. 1977); COLO. REV. STAT. §§ 11-51.5-101 to -108 (Supp. 1973); CONN. GEN. STAT. ANN. §§ 36-347a to -347m (West Supp. 1978); DEL. CODE ANN. tit. 8, § 203 (Supp. 1977); FLA. STAT. ANN. §§ 517.351-.363 (West Supp. 1979); GA. CODE ANN. §§ 22-1901 to -1915 (1977); HAW. REV. STAT. §§ 417E-1 to -15(1976); IDAHO CODE §§ 30-1501 to -1513 (Supp. 1977); ILL. ANN. STAT. ch. 121-½, §§ 137.2-23, 137.11 (Smith-Hurd Supp. 1978); IND. CODE ANN. §§ 23-2-3-1 to -12 (Burns Supp. 1978); Iowa: Commercial Bribery, Senate File 376, 1978 Iowa Legis. Serv. (West) §§ 502.211-.215, 502.407, 502.501-.502, 502.610; KAN. STAT. ANN. §§ 17-1276 to -1285 (1974); KY. REV. STAT. §§ 292.560-.630 (Supp. 1978); LA. REV. STAT. ANN. §§ 51:1500-1512 (West Supp. 1978); ME. REV. STAT. tit. 13, §§ 801-817 (Supp. 1978-1979); MD. CORP. & ASS'NS CODE ANN. §§ 11-901 to -908 (Supp. 1978); MASS. GEN. LAWS ANN. ch. 110C, §§ 1-13 (West Supp. 1979); MICH. COMP. LAWS ANN. §§ 451.901 -.917 (Supp. 1978-1979); MINN. STAT. ANN. §§ 80B.01-.13 (West Supp. 1978); MISS. CODE ANN. §§ 75-72-1 to -23 (Supp. 1978); Missouri: Take-Over Bid Disclosure Act, Senate Bill No. 820, 1978 Mo. Legis. Serv. (Vernon) §§ 409.500-.565; 1977 NEB. REV. STAT. §§ 21-2401 to -2417 (Supp. 1977); NEV. REV. STAT. §§ 78.376 -.3778; N.H. REV. STAT. ANN. §§ 421-A:1 to -A:15 (Supp. 1977); N.J. STAT. ANN. §§ 49.5-1 to -19 (West Supp. 1978-1979); N.Y. BUS. CORP. LAW §§ 1600-1613 (McKinney Supp. 1978-1979); N.C. GEN. STAT. §§ 78B-1 to -11 (Supp. 1977); OHIO REV. CODE ANN. § 1707.04.1 (Page 1978); PA. STAT. ANN. tit. 70, §§ 71-85 (Purdon Supp. 1978-1979); S.C. CODE §§ 35-2-10 to -110 (Supp. 1978); S.D. COMPILED LAWS ANN. §§ 47-32-1 to -47 (Supp. 1978); TENN. CODE ANN. §§ 48-2101 to -2114 (Supp. 1978); Tex. Reg. Code No. 065.15.00.100 (Admin. Rule XV); UTAH CODE ANN. §§ 61-4-1 to -13 (1978); VA. CODE §§ 13.1-528 to -541 (1978); WIS. STAT. ANN. §§ 552.01 -.25 (West Supp. 1978).

128. *See* Great Western United Corp. v. Kidwell, 577 F.2d 1256, 1284 (5th Cir. 1978).

129. Moylan, *supra* note 123, at 689-90.

130. *See* Mishkin & Moloney, *Great Western United Case: End of State Takeover Laws?* N.Y.L.J., Aug. 29, 1978; Ehrbar, *Corporate Takeovers Are Here to Stay*, FORTUNE, May

The Code's solution to this argument is to strengthen the federal provisions relating to tender offers,[131] adding several of the provisions characteristic of the state laws such as a preeffective filing requirement,[132] publication of a notice,[133] extended offer periods,[134] and expanded withdrawal and proration rights,[135] and to preempt general state takeover legislation except in the case of a limited category of "target companies."

Section 1904(c)[136] establishes the Code's primacy in tender offer regulation, except in the following limited situations:

1. Since section 606 of the Code is applicable only to tender offers for the securities of a "registrant,"[137] a state's law is *not* displaced when the target company is not a Code registrant. Indeed, to the extent that nonregistrants are not publicly held companies, at least in the Code sense, there is no reason for federal law to preempt.

2. Furthermore, section 1904(c) does not displace the regulatory authority of a state over a tender offer involving even a registrant provided the registrant's principal place of business and more than fifty percent of the record or beneficial holders of its outstanding voting securities, holding more than fifty percent of those securities, are residents of that state.[138] Such a state would certainly have

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8, 1978, at 91; The Changing Takeover Rules, DUN'S REV., Dec. 1976, at 53; Chatlos, *The SEC vs. Investors on Tender Offers*, HARV. BUS. REV., Sept.-Oct. 1978, at 6-8.

131. 1978 Draft, *supra* note 7, §§ 606-607.

132. *Id.* § 606(d)(1). *See also* Hart-Scott-Rodino Antitrust Improvements Act of 1976, 15 U.S.C. § 18a (1976).

133. 1978 Draft, *supra* note 7, § 606 (d)(2).

134. *Id.* § 606(e).

135. *Id.* § 606(h), (j).

136. Section 1904(c) of the 1978 Draft provides:

[*Preemption with respect to tender offers.*] (1) Section 606, together with section 607 insofar as it applies for purposes of section 606, is exclusive and plenary, to the extent that those sections apply to a particular registrant, with respect to any State law that regulates tender offers or takeover bids (as those terms are generally understood) as such and that is not limited to a regulated industry, except with respect to the law of any State in which (A) the registrant to whose security holders the tender offer is directed has its principal place of business and (B) more than 50 percent of the record or beneficial holders of its outstanding voting securities holding more than 50 percent of those securities are residents.

(2) Any registrant that is so identified with a State shall disclose that fact in a report filed with the Commission within thirty days after it becomes so identified and in every annual report filed thereafter so long as it remains so identified, and within ten days after it ceases to be so identified it shall file a report to that effect.

(3) Any person who in good faith relies on the fact that a registrant has not so identified itself is not considered to be a participant in any violation of the relevant State law that may occur.

137. 1978 Draft, *supra* note 7, § 606(a). "Registrant" means, generally, a person having an effective registration statement under Part IV of the Code. *Id.* § 299.40.

138. *Id.* § 1904(c)(1)(A)-(B).

a predominant interest in the transaction,[139] and thus its regulatory participation must be considered constitutionally sound.[140]

3. The only state laws displaced by section 1904(c) are those regulating such transactions *qua* tender offers. The section's reference to tender offers or takeover bids "as such" is intended to avoid the inference that the Code preempts application of ordinary blue sky law requirements to the *sale* side of an exchange tender offer. Likewise, the section leaves untouched a state's authority to apply other blue sky provisions, including broker-dealer regulation and antifraud provisions, to the transaction.

4. Only state takeover laws of general application are affected by the Code. The "regulated industry" reference is meant to exclude from the section's preemptive effect laws governing acquisitions of companies in particular industries such as insurance and banking.

5. Also unaffected are the requirements, now imposed by approximately six states, relating to the filing of ownership information materials upon the acquisition of a specified percentage of the target company's equity securities.[141]

Subsections (2) and (3) of section 1904(c) simply implement these limited exceptions to the Code's general preemption of state takeover laws applicable to a registrant strongly identified with that state. Any registrant that seeks to claim the protection of a state takeover law under this section must identify itself in its reports to the Commission, reliance on which forgives a violation of state law.

D. *Preemption with Respect to Extraterritorial Transactions*

The theory behind the Code's section dealing with extraterritoriality[142] is (a) to codify rules of international law regarding the extraterritorial application of the most significant areas of the Code, (b) to permit the undefined limits of international law to govern much of the remainder, and (c) to designate certain limited areas in which the Code could, but chooses not to, apply extraterritorially.

139. The state's jurisdictional basis is directly related to investor protection (as opposed to preserving local industry, employment, and so forth) and this test assures that no more than one state, along with the SEC, will regulate the tender offer. *See* Great Western United Corp. v. Kidwell, 577 F.2d 1256, 1284 (5th Cir. 1978). It might well be argued, in fact, that such a state's legitimate interest in regulating the transaction surpasses even that of the SEC.

140. With the explicit reservation of state authority in § 1904(c)(1) and the potent local interest of the regulating state, it must be concluded that the state law is safe from attack, at least under the supremacy and commerce clauses. In *Great Western*, for example, the court intimated that a state tender offer statute of a type preserved by § 1904(c) would survive a commerce clause challenge. 577 F.2d at 1283.

141. *Compare* 15 U.S.C. § 78m(d) (1976) *with* 1978 Draft, *supra* note 7, § 605(b) *and* MINN. STAT. ANN. § 80B.02(1), (3)-(7) (West Supp. 1978).

142. 1978 Draft, *supra* note 7, § 1905.

The Reporter has indicated that this formulation recognizes the essential distinction between *power* in the international law sense and *policy.*[143] Among the activities that the Code expressly places beyond the SEC's reach is the regulation (except antifraud) of distributions initiated within the United States but occurring outside,[144] although international law would probably support jurisdiction in these instances.[145] As a matter of federal-state relations, the Code limits extraterritorial application of the state laws to that of the federal law, with one exception: Section 1904(d)[146] permits a state to extend its securities registration provisions to offers made from that state into a foreign country.[147]

E. Residual State Power

Section 1904(i)[148] is designed to avoid any inference that, even though express preemption is carefully circumscribed, the Code occupies the field of securities regulation more expansively than is specifically described,[149] or that application of state law in a manner consistent with the Code's federal-state relations provisions would stand "as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[150] The language is generally that of section 18 of the Securities Act.[151] Thus, the Code does not interfere with the states' antifraud, investigatory, enforcement, and civil liability provisions, or the registration of securities distributions (except to the extent of enforcing coordination[152]) other than those registrations defined as blue chip.[153] Nor does the Code affect the states' exemption schemes, or the blue sky regulation of broker-

143. TD-3, *supra* note 6, § 1604, Comment (1)(c), at 164 (1974).

144. 1978 Draft, *supra* note 7, § 1905(b)(1).

145. *See* Wandschneider v. Industrial Incomes, Inc. [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,422 (S.D.N.Y. March 22, 1972).

146. Section 1904(d) of the 1978 Draft provides: "[*Preemption with respect to extraterritorial transactions.*] Section 1905(a) to (c) inclusive (except section 1905(b)(1)) is exclusive and plenary so that State law applies extraterritorially only to the extent that this Code applies."

147. This is the effect of the parenthetical "except" clause in § 1904(d).

148. Section 1904(i) of the 1978 Draft provides:

> [*Residual state power.*] (1) Nothing in this Code affects the applicaton of State law to any security, transaction, or person except as provided in sections 917(a) and (b), 1904(a) to (d) inclusive, and 1906.
>
> (2) Nothing in this Code diminishes any fiduciary duty owed by any person under State law except as provided in section 917(a) and (b).

149. *See* Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947). *See also* City of Burbank v. Lockheed Air Terminal, Inc., 411 U.S. 624, 633 (1973).

150. Hines v. Davidowitz, 312 U.S. 52, 67 (1940).

151. *See* text accompanying note 26 *supra.*

152. 1978 Draft, *supra* note 7, § 1904(a).

153. *Id.* § 1904(b).

dealers, investment advisers, and their employees. Furthermore, the Code leaves the states free to investigate in order to determine whether jurisdiction exists over a particular person, security, or transaction.[154]

Sections 917(a) and (b), referred to in the residual state power clause, relate to payment for brokerage and research services ("paying up" for research). Taken virtually verbatim from Exchange Act section 28(e)(1),[155] these sections permit a fiduciary to cause an account to pay a broker or dealer a larger sales commission than another broker-dealer might have charged, so long as the fiduciary reasonably believes[156] that the commission was reasonable in relation to the value of the services provided, without having breached a fiduciary duty under state or federal law. The paying up provision is exclusive and plenary unless otherwise expressly provided by contract, and supersedes state common law or any other state or federal law in effect when the 1975 Act amendments were enacted.[157] Section 1904(i)(2), confirming that state fiduciary law is unaffected by the Code, except for sections 917(a) and (b), is included out of an abundance of caution.[158]

The last item referenced here, section 1906, governs the Code's relation to state and federal revenue laws. It codifies both Exchange Act section 28(d) relating to securities transfer taxes[159] and the Securities Investors Protection Act of 1970[160] provisions on Securities Investors Protection Corporation (SIPC) tax implications. Section 28(d) (Code section 1906(a)), which was part of the Securities Acts Amendments of 1975, prohibits the imposition of state taxes on securities or transfer of securities merely because the facilities of a clearing agency are physically located in the taxing state.[161] The SIPC provisions (Code section 1906(b)) prescribe certain tax treat-

154. Also unaffected by the Code are the states' general corporation laws (unless a tender offer statute of the type preempted by § 1904(c) is located there) and their banking, insurance, and public utility laws. The Code preserves, in § 1904(f), the Public Utility Holding Company Act's deference to state regulatory authorities. *See* note 29 *supra.*

155. 15 U.S.C. § 78bb(e)(1) (1976).

156. In accordance with the Code's uniform style, the § 28(e)(1) language "determines in good faith" was changed to "reasonably believes" with no intended change in meaning.

157. 1978 Draft §§ 917(a) and (b), like their predecessor § 28(e)(1), may be overridden by a state or federal law enacted after June 4, 1975.

158. *See, e.g.*, 1978 Draft, *supra* note 7, §§ 1411-1412 (which make unlawful certain conflicts of interest on the part of persons affiliated with an investment company).

159. 15 U.S.C. § 78bb(d) (1976).

160. 15 U.S.C. § 78aaa-111 (1976).

161. This provision preserves state authority with respect to transactions traditionally within the state's taxing jurisdiction, but prohibits tax levies based solely on the geographic location of a clearing facility. Such taxes would seriously inhibit the development of a national market system. *See* S. REP. No. 75, 94th Cong., 1st Sess. 60 (1975).

ments applicable to SIPC and its members.[162]

What remains, of course, is the possibility of an unanticipated conflict between the Code and the blue sky laws.[163] To the extent a state law were "so inconsistent" with the Code that it frustrated Congress' purposes and objectives, the law would be preempted under the supremacy clause.[164] The areas in which such a conflict could occur, however, after years of dual regulation, and as modified with great precision in sections 1904(a)-(d) of the Code, must be few indeed.

F. Other Federal-State Relations Provisions

Less important than those already mentioned are various federal-state relations provisions in section 1904 and other sections scattered throughout the Code. Section 1904(e),[165] for example, assures the states access to copies of SEC filings in order that state administrators may be informed[166] and levy filing fees.[167] Section 1904(g) requires that the SEC admit an interested state agency, official, or political subdivision as a party in any proceeding before it under the investment companies or utility holding companies parts of the Code, and section 1904(h)[168] is a general exhortation to the SEC to cooperate with the states in order to maximize investor protection, expressing a mood intended to pervade the Code.[169]

162. 15 U.S.C. § 78kkk(f) (1976).

163. The Code avoids the controversy as to whether *statutory* "conflict" language, as in § 28(a) of the Exchange Act, implies anything more than is meant in the supremacy clause. *See* Great Western United Corp. v. Kidwell, 577 F.2d 1256, 1274-81 (5th Cir. 1978).

164. *See* Jones v. Rath Packing Co., 430 U.S. 519, 525-26 (1977).

165. Section 1904(e) of the 1978 Draft provides: "[*Copies of filings.*] Nothing in section 1904 prevents a State securities commission from requiring (and charging fees for) the filing of a copy of any filing under this Code. See also section 2003(d)(4)."

166. There is no suggestion here, however, of an *expansion* of the present state filing requirements. In particular, states should not infer that they may regulate indirectly, through additional filings and use of their antifraud powers, transactions the Code places within the exclusive purview of the federal law.

167. The financial effect on the states of the Code's federal-state relations provisions is difficult to predict and may vary somewhat from state to state. The major sources of revenue for most state securities commissions, however, are fees for the registration of investment company shares (which are generally higher than those charged other issuers) and for the licensing of broker-dealers, investment advisers, and their agents. None of these regulatory activities is affected by the Code.

168. Section 1904(h) of the 1978 Draft provides:

[*Cooperation with State securities commissions.*] The Commission shall cooperate with the State securities commissions, insofar as the Commission considers it practicable to do so, with a view to maximizing the protection of investors at Federal and State levels, and toward that end may exchange information with respect to investigations; but no action of the Commission is invalidated solely by section 1904(h). See also section 2004(b)(3)(E).

169. *See* TD-3, *supra* note 6, § 1603, Comment, at 156-57 (1974). Section 1904(h) of the

Other minor provisions of the Code have a limited preemptive effect,[170] preserve state law,[171] and encourage federal-state cooperation.[172]

G. *Local Distribution Exemption*[173]

In at least one important respect the Code defers to the states and places greater reliance on their regulation: It establishes a new, broader federal exemption to replace that currently provided by Securities Act section 3(a)(11)[174] and Rule 147 thereunder.[175] This the Reporter calls "the opposite side of the coin" to the preemptive provisions of section 1904.[176]

1978 Draft also provides the SEC express authority to share with the states information derived from its investigations. There have been infrequent instances when SEC staff members have questioned their authority to share this information under present law. *See also* 1978 Draft, *supra* note 7, § 2004(b)(1).

170. 1978 Draft, *supra* note 7, § 1203(i)(6) (state recordation requirements in connection with SIPC borrowings); *id.* § 1206(d)(6) (state laws affecting voidance of transfers by SIPC trustees); *id.* § 1305(c) (state interpretations of trust indenture provisions); *id.* § 1313(b) (state laws affecting the preservation of liens upon the institution of a trustee action under an indenture); *id.* §§ 1724(e)(2)(A)(ii), (4)(A) (state law determinations of the validity of indemnification and insurance for liability under the Code); *id.* § 1805(i) (inconsistent state accounting requirements); *id.* § 1806(j)(3) (limitations on the ability of state authorities to furnish their trustee bank examinations to the SEC); *id.* § 2008 (state privileges and immunities provisions).

171. *Id.* § 1009(c) (providing that a violation of the Code's lost, counterfeit, or stolen securities section does not affect a state law "bona fide purchaser"); *id.* § 1722(e) (preserving all non-Code actions and remedies except as otherwise provided).

172. *Id.* § 605(a)(5) (SEC to maximize usefulness to state agencies of insider-filing data); *id.* § 920(e) (SEC consultation with state authorities on broker-dealer registration materials); *id.* §§ 1511(d)(3), 1513(a)(1) (SEC coordination with state utility commissions); *id.* § 1803(e) (SEC cooperation with state banking authorities); *id.* § 1804(a)(4) (SEC rules may permit filing of state documents in lieu of federal requirements); *id.* § 2003(d)(4) (SEC rules may require copies of any federal filing to be sent to states); *id.* § 2004(b)(1), (3)(E) (SEC disclosure of information to state officials); *id.* § 2004(e) (SEC disclosure of indenture materials to state officials).

173. The local distribution exemption (now Code § 514) has already received attention in the first volume of this Symposium. *See* Cheek, *Exemptions Under the Proposed Federal Securities Code*, 30 VAND. L. REV. 355, 378-84 (1977). But because this section is an integral part of the federal-state relations scheme of the Code, and has been changed significantly since Mr. Cheek wrote his excellent Article, it is discussed again here.

174. 15 U.S.C. § 77c(a)(11) (1976).

175. Securities Act Rule 147, Securities Act Release No. 5450 (Jan. 7, 1974) [hereinafter referred to as Rule 147], *reprinted in* [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,617. There are, of course, other exemptions established in the Code that have the effect of deferring federal jurisdiction in favor of the states, such as the "small offering" exemption of § 512(e), the "limited offering" exclusion from the definition of "distribution" in § 242(b), the exemption for certain secondary distributions in § 512(d), and the exemption for certain intrastate investment companies in § 1424(a)(2). But the local distribution exemption represents a deliberate effort to limit federal authority and enhance the states' responsibility with respect to securities transactions that are essentially local in character.

176. ALI FED. SEC. CODE § 513, Comment (2), at 31-32 (Tent. Draft No. 4, 1975)

Section 3(a)(11) of the Securities Act presumably was intended to exempt from federal control distributions having few multi-state implications.[177] The exemption has been interpreted so narrowly by the courts[178] and the SEC,[179] however, that it now has become perilous and of minimal utility.[180] In order to claim the exemption, an issuer not only must be incorporated and have its principal office in the same state in which it proposes to make the offering, but also, if Rule 147 comfort is to be had, must be doing an overwhelming part of its business in that state.[181] Further, if a single unit of the distribution is even *offered* to a nonresident[182] of that state, the exemption is lost for the entire distribution and the issuer may face enormous civil liability.[183]

In light of its fragility, the Reporter gave serious consideration to eliminating the intrastate exemption entirely.[184] The alternative ultimately selected was to create a successor exemption that defines a local transaction as to which state regulation could be relied upon, but with fewer risky technicalities, and with some limited SEC authority to loosen or tighten the exemption as appropriate. The result was section 514,[185] which establishes a partially automatic

[hereinafter cited as TD-4].

177. "Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory." 15 U.S.C. § 77c(a)(11) (1976).

178. *See* SEC v. Van Horn, 371 F.2d 188 (7th Cir. 1966); Hillsborough Inv. Corp. v. SEC, 276 F.2d 665 (1st Cir. 1960); Stadia Oil & Uranium Co. v. Wheelis, 251 F.2d 269, 274-75 (10th Cir. 1957); Shaw v. United States, 131 F.2d 476, 480 (9th Cir. 1942); Belhumeur v. Dawson, 229 F. Supp. 78, 85 (D. Mont. 1964); SEC v. Truckee Showboat, Inc., 157 F. Supp. 824 (S.D. Cal. 1957).

179. *See, e.g.,* SEC Securities Act Release No. 4434 (Dec. 6, 1961), *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶ 2270; SEC Securities Act Release No. 3825 (Aug. 12, 1957), *reprinted in* FED. SEC. L. REP. (CCH) ¶ 76,539, at 80,127.

180. *See* Cummings, *The Intrastate Exemption and the Shallow Harbor of Rule 147,* 69 NW. U.L. REV. 167, 170-84 (1974); Gadsby, *The Securities and Exchange Commission and the Financing of Small Businesses,* 14 BUS. LAW. 144, 145-48 (1958); Hicks, *Intrastate Offerings Under Rule 147,* 72 MICH. L. REV. 463, 489-99 (1974); Sosin, *The Intrastate Exemption: Public Offerings and the Issue Concept,* 16 W. RES. L. REV. 110, 121 (1964).

181. "Doing business" in a state, according to Rule 147(c)(2), requires that the state be the locus of at least 80 percent of the issuer's consolidated gross revenues, consolidated assets, and the use of the net proceeds. Although the Rule is merely a "safe harbor," few practitioners will chance to use § 3(a)(11) without satisfying virtually all of the Rule's requirements.

182. A "resident" for purposes of the Rule is an individual who, at the time of the offer or sale, has his principal residence in the state. Rule 147(d)(2). Before enactment of the Rule, the term was construed to mean "domiciled" in the conflict-of-laws sense. *See* SEC Securities Act Release No. 4434, at 3 (Dec. 6, 1961), *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶ 2270, at 2609.

183. 15 U.S.C. § 77l(1) (1976).

184. TD-4, *supra* note 176, § 513, Comment (3), at 31-32.

185. Section 514 of the 1978 Draft provides:

exemption from the Code's offering statement filing requirements,[186] as well as its offers and sales restrictions,[187] if the distribution has a strong nexus with a particular locale. There is no doubt that this exemption will prove considerably more usable than the present intrastate exemption.

Section 514(a) defines a local distribution as one that (a) results in sales substantially restricted to residents of, or persons with their primary employment in, a single state (or an "area" that may include several states and/or a contiguous foreign country, if the SEC by rule so prescribes), and (b) the issuer does, or proposes to do, business primarily in that state (or area). The term "substantially restricted" is defined to permit, even without an SEC area rule, sales resulting in up to five percent of the buyers holding of record up to twenty percent of the securities *outside* the particular state.[188]

[*Local distributions.*] (a) [*Definition.*] A "local distribution" is one that (1) results in sales substantially restricted to persons who are residents of or have their primary employment in a single State, or an area in contiguous States (or a State and a contiguous foreign country) as that area is defined by rule or order on consideration of its population and economic characteristics, and (2) involves securities of an issuer that does business or proposes to do business primarily in that State or area, regardless of where it is organized. Section 514(a)(1) is not satisfied unless at least 95 percent of all the buyers holding of record at least 80 percent of the securities distributed are persons there described.

(b) [*Secondary distributors.*] Section 514(a) extends to a local distribution by a secondary distributor, whether or not he is a resident of the State or area in question; but, if he acquired any securities of the same class in a limited offering (not otherwise exempted) during the one-year or three-year period (as the case may be) specified in section 242(b), section 514(a) applies only to securities of the class in excess of those he so acquired.

(c) [*Exemption.*] Sections 502 to 504 inclusive do not apply with respect to a local distribution except when the security is issued by an investment company.

(d) [*Resales.*] (1) Section 242(b)(4) to (6) inclusive applies for purposes of section 514, but as if section 242(b)(4)(A) referred to resellers within whatever period up to one year is specified by rule.

(2) An original seller or a reseller who in good faith accepts from his buyer a written undertaking that is reasonably designed to avoid an illegal distribution and complies with any rule adopted under this section is not considered to be a participant in any such distribution.

(3) When an owner of securities that were the subject of a local distribution within whatever period is specified by rule under section 514 owned other securities of the same class at the time that he acquired those securities, or later acquired other securities of the same class that were not the subject of a local distribution within the specified period, and he sells securities of the class, it is considered for purposes of this Code, regardless of which certificates or papers he delivers, that he is selling the other securities if he retains for the specified period at least as many of his securities of the class as were the subject of the local distribution.

186. 1978 Draft, *supra* note 7, § 502.

187. *Id.* §§ 503-504.

188. This latitude is designed not only to ameliorate the harsh effects of an inadvertent slip under the present exemption, but also to permit sales to a small number of persons (perhaps employees, relatives, or a primary supplier) *known* to be nonresidents.

Offers that do not result in sales are disregarded. And unlike Rule 147, there is no requirement either that the issuer be organized in the state, or that it already be doing business there.[189]

The Commission will likely limit some of the exemption's terms.[190] "Resident," for instance, while partially defined in the Code,[191] might be further construed by rule (consistent with the Code's definition) for purposes of this section. "Primary employment," the alternative to residence, and "does [or proposes to do] business primarily" also invite SEC elaboration. The Commission should be expected to have a decent regard for the English language in defining these terms,[192] however, remembering the purpose of the new exemption and that in addition to state regulation of the offering, the Code's antifraud proscriptions, civil and criminal liability, and other *in terrorem* provisions remain available to protect local distribution buyers.

An "area" rule is left entirely to the Commission's discretion. Without it, of course, the boundaries of a local distribution are those of a single state, although expanded slightly by the statute's definition of "substantially restricted." But because use of the present intrastate exemption is especially difficult in an urban area that spills over into an adjacent state, and because in any event state borders have little to do with the locale of discrete securities markets, section 514(a)(1) invites the SEC to formulate a rule (or order, in the case of a particular distribution) considering population and economic characteristics, that would establish areas in which the exemption could be utilized.[193]

189. *See generally,* Alberg & Lybecker, *New SEC Rules 146 and 147: The Nonpublic and Intrastate Offering Exemptions from Registration for the Sale of Securities,* 74 COLUM. L. REV. 622, 650-51 (1974).

190. *See* 1978 Draft, *supra* note 7, § 1804(a)(1) (the SEC's general rulemaking authority).

191. *Id.* § 299.44. The Code's definition of a natural person-resident is circular—resident means a person resident in a specified place—but it *does* expressly preclude a narrow "domicile" interpretation. *See* note 182 *supra.*

192. "Primary" and "primarily" are commonly defined as "essentially," "mostly," "chiefly," and "first or highest in rank of importance." *See, e.g.,* RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 1142 (1966). It might reasonably be assumed, therefore, that an 80 percent test, or the like, would not be proper. Indeed, something less than 50 percent (of income, assets, time, or whatever) could well be primary in the circumstances. *But see* Rule 147(c)(2) (interpreting the current statutory phrase "doing business" unadorned by *any* adjective or adverb).

193. In addition to the split-cities (Kansas City, St. Louis, Detroit-Windsor) and financial centers (counties of New York-New Jersey-Connecticut), the Commission might ultimately consider making an "area" of two or more contiguous states. Early drafts of the exemption included, as a factor to be considered, the effectiveness of state regulation in the area of a local distribution. Although this criterion was later deleted (for all sorts of reasons, including the problem of who would make the decision and how), the SEC's regard for the

Secondary distributors may use the local distribution exemption, whether or not residents of the particular state or area, but only to the extent the securities were not acquired in a limited offering[194] during the prior three years (one year if the issuer is a one-year registrant).[195] Resales are dealt with in a fashion similar to that provided for limited offerings,[196] but the SEC is permitted to designate a period of time, up to a maximum of one year, within which the resale restrictions apply.[197]

V. CONCLUSION

The Ninety-Sixth Congress has begun what may prove to be a lengthy process of hearings and deliberations on the American Law Institute's Federal Securities Code. This monumental codification project, already ten years in the works, was undertaken with the greatest degree of care and scholarship by persons whose expertise in the field is unsurpassed[198] and deserves considerable deference in the legislative process.

The Code's approach to federal-state relations in securities regulation involves a sparing use of the Constitution's supremacy clause to "harmonize" the new federal law with a system of state regulation now sixty-eight years old. State securities regulation in its modern form began in the early years of this century as a response to a perceived need to provide protection to investors beyond that afforded under the general criminal statutes. The blue sky laws, then and now, include authority for the administrator to ex-

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quality of investor protection provided by a state might well play a part in determining the geographic expansiveness of its "area" rules. Even beyond such rules, however, the Commission could use its authority under § 303 to fashion an exemption for distributions, perhaps limited in size (but larger than the § 512(e) small offering), that are to be made entirely within a group of states in which the standard of blue sky review is considered adequate.

194. *See* 1978 Draft, *supra* note 7, § 242(b).

195. *Id.* § 514(b). As a practical matter, however, a secondary distributor may well choose the highly abbreviated "secondary distribution" procedure provided by § 510 if the issuer is a one-year registrant, rather than restrict the distribution to a state or area under § 514.

196. The SEC may require written buyers' undertakings, legended transfer restrictions, and stop-transfer notices. *See id.* § 242(b)(4)-(6).

197. *Id.* § 514(d). *See* Cheek, *supra* note 173, at 383-84.

198. In addition to Professor Louis Loss of the Harvard Law School, the Code's Reporter, groups of consultants and advisers consisting of preeminent securities lawyers, judges, academicians, and SEC personnel met three or four times a year to review preliminary drafts of the Code. Other experts were brought into the drafting and deliberations as needed. The American Law Institute, itself an organization of outstanding attorneys from throughout the country, devoted a full day at each of its annual meetings to consideration of the Tentative Drafts as they were prepared. And the American Bar Association's Committee on Federal Regulation of Securities, having met at least annually for two or three days with the Reporter, offered guidance and many specific suggestions that are presently reflected in the Code.

amine the merits of a proposed securities offering and to deny registration if the offering fails to comply with substantive standards established by the administrator.

None of the federal securities laws adopted between 1933 and 1940 was intended to displace state securities regulation. Contrarily, all of those statutes expressly preserved the regulatory jurisdiction of the states. It is reasonable to conclude, in fact, that Congress would not have been satisfied in 1933 with a law reflecting merely a full disclosure philosophy if the states were not already applying substantive standards to the review of securities offerings.

Over the course of forty-five years of dual regulation, federal-state relations have been generally cooperative and increasingly coordinated. The SEC and the state administrators have worked together to limit duplication, standardize procedures, and defer to one another when appropriate. In the area of tender offer regulation, however, a federal circuit court has held that the state takeover laws, which are not actually blue sky statutes at all, conflict with and are thus preempted by federal securities law.

The Federal Securities Code makes several significant changes in the relationship between state and federal securities regulation. The states are required to apply a registration procedure substantially coordinated with the Code's procedure for distributions, which must include acceptance of SEC forms and simultaneous state and federal effectiveness. States may continue to impose "substantive" or "fair, just and equitable" standards in their review of securities offerings, but may not, without the SEC's acquiescence, require disclosures additional to those in the federal disclosure document unless they are appropriate in light of the application of a substantive standard.

The Code gives the SEC exclusive jurisdiction for the oversight of certain distributions by so-called "blue chip" issuers—those that qualify under a list of criteria relating to the financial stability of the issuer, availability of public information about the issuer, and the nature of the market for its stock. The Code also eliminates a practical and perhaps constitutional problem involving state regulation of takeovers by preempting such laws, except as applied to a tender offer for the securities of a company that is not a "registrant" under the Code or one that has its principal place of business and more than fifty percent of its shareholders holding more than fifty percent of its shares resident in the same state.

Preemption, however, is only half the story. The Code enlarges the responsibility of the states in the area of local distributions by replacing the present federal intrastate exemption with one that is both broader and considerably less risky. The new exemption permits up to five percent of all buyers holding up to twenty percent of the securities to be nonresidents of the state in which the local distribution is made, and does not require that the issuer be organized or already doing business in the state. The "merit review" authority of state regulators in the registration of securities offerings is expressly recognized and preserved in the Code. Moreover, a broad residual state powers clause leaves unaffected the states' authority to regulate broker-dealers and investment advisers, investigate and prosecute violations of state statutes, and enforce the antifraud provisions of the blue sky laws.[199]

Rather than ignoring the matter, on the one hand, or mounting an all-out attack on state securities regulation, on the other, the Code's careful treatment of federal-state relations tends to strengthen the current system of dual regulation by allocating exclusive authority to the states or the federal government in certain areas, and by promoting coordination in other areas in which joint regulation serves the interests of the public. Enactment of the Code will not only be a giant step forward in federal jurisprudence, but will also establish a framework for the use of regulatory resources—state and federal—to the best advantage of the Nation's investors.

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199. A few of the regulatory activities reserved to the states by this section of the Code's Proposed Official Draft were the subject of extensive discussions during the preparation of early drafts. Tentative Draft No. 3, the first draft to cover federal-state relations, proposed to preempt, in the area covered by Part V of the Code (distributions), "trading transactions" (non-issuer, broker-dealer trades) and certain of the Code's exempted securities and transactions. Tentative Draft No. 3 also proposed exclusive federal authority with respect to virtually all of the Code's post-registration provisions (proxy solicitations, annual reports, insider disclosure filings, ownership information filings, as well as tender offers), broker-dealer and investment adviser registration forms, and trust indenture provisions. Each of these provisions was ultimately deleted, either because the state regulation in the area was determined not unduly duplicative of federal regulation, or because effective steps have been taken to reduce such duplication.