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Arizona Corporation Commission v. Media Products, Inc.: Clarification of Competing Federal and State Securities Regulation

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ARIZONA CORPORATION COMMISSION v. MEDIA PRODUCTS, INC.: CLARIFICATION OF COMPETING FEDERAL AND STATE SECURITIES REGULATION

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The rationale [for a state's substantial interest in out of state sales] is that a state has an interest in seeing that its territory is not used as a base of operations to conduct illegal sales in other states.[1]

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[1] 12 J. LONG, BLUE SKY LAW 3.04[3][a] (rev. ed. 1989) (citations omitted).

I. INTRODUCTION

It was simply a matter of time, budget constraints, and a necessary battle of wills between regulatory determination and the participants in the capital markets. While the regulatory methods of the Securities Exchange Commission (SEC)[2] and those of the fifty states have enjoyed peaceful coexistence for over fifty years, that uneventful coexistence has largely resulted from ambiguities in the regulatory process at the national and state levels and the fine line between the supremacy clause[3] and the commerce clause.[4] All fifty states, the District of Columbia, and Puerto Rico have some form of securities regulation[5] or blue sky laws.[6] It was inevitable that the question of the jurisdiction of the states in their regulation of the sales of securities would eventually be litigated with the two provisions of the U.S. Constitution as the weapons of the respective parties. While the more recent reforms by the SEC have sprung from

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[2] The Securities Exchange Commission (SEC) is the Congressionally-created federal agency given the charge of implementing and enforcing the federal securities laws. Created under the Securities Exchange Act of 1934, 15 U.S.C. § 78(a) et seq. (1989), the SEC regulates initial offerings of securities to the public and the secondary market. This article focuses on the SEC regulation of initial offerings.

[3] The supremacy clause comes into play when there is a conflict between state and federal regulation, and is used to void a state statute when "compliance with both federal and state regulations is a physical impossibility . . . ." Florida Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132, 142-43 (1963), or where the state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress . . . ." Hines v. Davidowitz, 312 U.S. 52, 67 (1941). The supremacy clause provides:

> This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the Supreme Law of the Land; and the Judges in every state shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary not withstanding.

U.S. CONST. art. VI, cl. 2.

[4] U.S. CONST. art. I, § 8, cl. 3, provides: "The Congress shall have Power . . . To regulate Commerce . . . among the several States . . . ." The Supreme Court has recognized that the commerce clause:

> reflected a central concern of the Framers that was an immediate reason for calling the Constitutional Convention: the conviction that in order to succeed, the new Union would have to avoid the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation.

Hughes v. Oklahoma, 441 U.S. 322, 325-26 (1979).

[5] *See infra* note 8 and accompanying text.

[6] "Blue sky laws" refers to state laws regulating the sale and registration of securities. The term was coined in Hall v. Geiger-Jones Co., 242 U.S. 539 (1917). The Court described certain fraudulent securities offerings as "speculative schemes which have no more basis than so many feet of 'blue sky'." *Id.* at 550.

state and federal cooperation,[7] there still remains a form of territorialism,[8] whether or not it is justified or supportable[9] on the part of the state regulators to control which securities are registered,[10] sold in,[11] sold from,[12] or sold by companies located in[13] their particular states. While most regulators at both the state and federal levels espouse an attitude and philosophy of cooperation, the fact is that, because of conflicts in authority and unresolved constitutional issues, most nationwide offerings are becoming more difficult to execute and are burdened by so many bureaucratic loopholes that the role of the United States as a capital market in the international sense may be greatly impaired.[14] The purpose of this Article is to explain the coexistence of federal and state securities regulation, define the resolved constitutional issues, and discuss those that remain unresolved. Finally, the Article proposes a peaceful coexistence for the dual regulators such that the regulatory system is not an impediment to the United States being a significant player in the international capital markets.

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[7] Regulation D, 17 C.F.R. §§ 230.501-506 (1982), is the most recent evidence of the flexibility demonstrated by the SEC and Congress in working to establish more uniformity and simplicity in raising capital, particularly for smaller businesses. Regulation D is the result of the Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980) (codified at 15 U.S.C. § 77s(c)(3)(c) (West 1989)), which was passed in response to demands for uniformity and simplicity in the registration and sale of securities at the state and federal levels, and the Omnibus Small Business Capital Formation Act of 1980 (codified at 15 U.S.C. § 77s(a) to (c) (1989)), which granted the SEC the authority "to cooperate with any association composed of duly constituted representatives of State governments whose primary assignment is the regulation of securities business within those states 'for' the development of a uniform exemption from registration for small issuers which can be agreed upon among several States or between the States and the Federal Government." 15 U.S.C. § 77(c)(3)(1)(c) (West 1989). Twenty states now recognize Regulation D exemptions as state exemptions. 12 J. LONG, *supra* note 1, Appendix E.

[8] The federal statutes make it clear that state laws can exist. *See infra* notes 15-16. This mutual coexistence has been reaffirmed with each amendment and as late as 1980 with the passage of the Small Business Investment Incentive Act with the following language: "Nothing in this Act . . . shall be construed as authorizing preemption of State law." 15 U.S.C. § 77s(c)(3)(C) (1989).

The territorialism results when the states adopt standards different from federal standards; for example, on the Regulation D offerings. The following twenty-five jurisdictions have exemptions which are compatible with both Rule 505 and 506 offerings: Alaska, ALASKA ADMIN. CODE tit. 3, § 08.501 (May 1984), 1 Blue Sky L. Rep. (CCH) Para. 8,448A; Arizona, ARIZ. REV. STAT. ANN. § 44-1844 (1987), 1 Blue Sky L. Rep. (CCH) Para. 9,536; Colorado, COLO. REV. STAT. § 11-51-113.2(o) (1987), 1 Blue Sky L. Rep. (CCH) Para. 13,113; Connecticut, CONN. GEN. STAT. ANN. § 36-500-22(b)(9)(A), (B) (West 1987), 1 Blue Sky L. Rep. (CCH) Para. 14,422; Delaware, DEL. CODE ANN. tit. 18 § 5108, Rule 9(b)(9)(II) (1984), 1A Blue Sky L. Rep. (CCH) Para. 15,419B; Georgia, GA. CODE ANN. § 10-5-9, Rule 590-4-5-.01 (1989), 1A Blue Sky L. Rep. (CCH) Para. 18,441; Idaho, IDAHO CODE § 30-1435, Rule 27 (1983), 1A Blue Sky L. Rep. (CCH) Para. 21,426; Kansas, KAN. STAT. ANN. § 17-1262(o) (1985), KAN. ADMIN. REGS. § 81-5-6 (1984), 1A Blue Sky L. Rep. (CCH) Paras. 26,114 & 26.405E; Louisiana, LA. REV. STAT. ANN. § 51:709 (West 1987), 1A Blue Sky L. Rep. (CCH) Para. 28,511; Maryland, MD. BUS. REG. CODE ANN. § 11-602, Rule .15 (1985), 1A Blue Sky L. Rep. (CCH) Para. 30,441; Massachusetts, MASS. GEN. LAWS ANN. Ch 110A, § 402(b)(a)(c)), 1A Blue Sky L. Rep.

(CCH) Para. 31,472; Michigan, MICH. COMP. LAWS ANN. § 451.803.7 (West 1989), 1A Blue Sky L. Rep. (CCH) Para. 32,483A; Missouri, MO. ANN. STAT. §§ 409.402, 30-54.210 (Vernon 1985), 2 Blue Sky L. Rep. (CCH) Para. 35,520A; Montana, MONT. CODE ANN. §§ 30-10-105(1) to (21), Rule 6.10.120 (1984), 2 Blue Sky L. Rep. (CCH) Paras. 36,105, 36,460; Nebraska, NEB. REV. STAT. § 8-1111 (1982), 2 Blue Sky L. Rep. (CCH) Para. 37,415; New Jersey, N.J. STAT. ANN. § 49:3-60(b) (West 1989) (as to offerings other than real estate syndications), 2 Blue Sky L. Rep. (CCH) Para. 40,125; New York, N.Y. GEN. BUS. LAW § 359-ff (McKinney 1982) (as to offerings other than real estate syndications), 2 Blue Sky L. Rep. (CCH) Para. 42,132; Oklahoma, OKLA. STAT. ANN. tit. 71, §§ 401, 406 (West 1982), 2 Blue Sky L. Rep. (CCH) Paras. 46,151, 46,414; Oregon, OR. REV. STAT. § 59.025, Rule 815-36-500 (1987), 2 Blue Sky L. Rep. (CCH) Para. 47,634; South Carolina, S.C. CODE ANN. § 113-21 (Law Co-op 1987), 3 Blue Sky L. Rep. (CCH) Para. 51,521; Tennessee, TENN. CODE ANN. § 48-2-103, Rule 0780-4-2-.04 (1988), 3 Blue Sky L. Rep. (CCH) Para. 54,414; Vermont, VT. STAT. ANN. tit. 9, §§ 4203, 4204 (1984), 3 Blue Sky L. Rep. (CCH) Paras. 58,104, 58,404; Virginia, VA. CODE ANN. § 13.1-514(b)(14), Rule 503 (1989), 3 Blue Sky L. Rep. (CCH) Paras. 60,114, 60,439; Utah, UTAH CODE ANN. § 61-1-14 (1989), 3 Blue Sky L. Rep. (CCH) Para. 57,413; West Virginia, W. VA. CODE §§ 32-3-305, 15.06 (1988), 3 Blue Sky L. Rep. (CCH) Para. 63,496.

Kansas and Tennessee follow NASAA and limit their exemptions to Rule 505. Colorado and New York regulate only intrastate offerings (where as Regulation D exemptions apply only if the offering is interstate). Oregon and Alaska register by coordination — federal approval or exemption is compliance with their requirements.

The following states have exemptions based on the number of purchasers, but the exemptions do not parallel Regulation D; hence, special structure would be necessary in these states: Florida, FLA. STAT. ANN. § 517.061(11)(a)(1), Rules 3E-500.05 to .07 (West 1988), IA Blue Sky L. Rep. (CCH) Paras. 17,106, 17,445-47; Illinois, ILL. ANN. STAT. ch. 121-5, § 137.4G (Smith-Hurd 1989), 1A Blue Sky L. Rep. (CCH) Para. 22,123; Iowa, IOWA CODE ANN. § 502.203(9)(a) (West 1989), 1A Blue Sky L. Rep. (CCH) Para. 25,113; Minnesota, MINN. STAT. ANN. § 80A.15 sub. 2(h) (West 1989), Reg. 2875.0180, 1A Blue Sky L. Rep. (CCH) Paras. 33,115, 33,408; Mississippi, MISS. CODE ANN. § 75-71-203(9), (10) (1988), 2 Blue Sky L. Rep. (CCH) Para. 34,146; Nevada (25 purchasers), NEV. REV. STAT. § 90,530(11)(a) (1985), 2 Blue Sky L. Rep. (CCH) Para. 38,179; Pennsylvania (25 purchasers), PA. STAT. ANN. tit. 70, § 1-203(d) (Purdon 1989), 2 Blue Sky L. Rep. (CCH) Para. 48,113; South Dakota (25 purchasers for domestic corporations, 5 for other issuers), S.D. CODIFIED LAWS ANN. § 47-31A-402 (1989), 3 Blue Sky L. Rep. (CCH) Paras. 52,224, 52,227, 52,835.

States with only Rule 506 exemptions are: Alabama, ALA. CODE § 830-X-6-.11 (1975), 1 Blue Sky L. Rep. (CCH) Para. 7471; Arkansas, ARK. STAT. ANN. § 67,1248(b)(14) (1980), 1 Blue Sky L. Rep. (CCH) Para. 10,114; Interpretative Opinion, Blue Sky L. Rep. (CCH) Para. 10,661; California, CAL. CORP. CODE § 25,102(f) (West 1989), 1 Blue Sky L. Rep. (CCH) Para. 11,133; Rules 260.102.12 to 14), 1 Blue Sky L. Rep. (CCH) Para. 11,780A-C; Indiana, IND. CODE ANN. § 23-2-1(b)(10) (Burns 1982), 1A Blue Sky L. Rep. (CCH) Para. 24,102; Kentucky, KY. REV. STAT. ANN. § 808 (Baldwin 1988), 1A Blue Sky L. Rep. (CCH) Para. 27,415; Maine, ME. REV. STAT. ANN. tit. 32, §§ 874-A(c), 10502 (1988), 1A Blue Sky L. Rep. (CCH) Para. 29,124; North Carolina, N.C. GEN. STAT. § 78A-17, Rule 1206 (1985), 2 Blue Sky L. Rep. (CCH) Para. 43,416; Ohio, OHIO REV. CODE ANN. § 1707.03 (Baldwin 1989), 2 Blue Sky L. Rep. (CCH) Para. 45,103; Texas, TEX. BUS. & COM. CODE ANN. § 8-401 (Vernon 1989), Rule 109.4(11), 3 Blue Sky L. Rep. (CCH) Para. 55,554; Washington, WASH. REV. CODE ANN. §§ 21.20.640, 460-44A-501 to 503, 506 (1989), 3 Blue Sky L. Rep. (CCH) Paras. 61,752 to 754, 757, 761; Wisconsin, WIS. STAT. ANN. § 551.23(10) (West 1988), 3 Blue Sky L. Rep. (CCH) Para. 64,113.

The other states (Hawaii, Wyoming, North Dakota, New Hampshire, New Mexico, and Rhode Island) have peculiar exemption requirements.

Ten jurisdictions (Alaska, Colorado, Delaware, D.C., Indiana, New York, New Jersey, Oklahoma, Oregon, and Washington) recognize Rule 504 exemptions.

[9] The regulators at the state level cite protection of local investors and their interest in seeing that their particular territories are not used as bases of operation to conduct illegal sales in other states, resulting in their state acquiring a reputation as a center for illegal or questionable securities activity. 12 J. LONG, *supra* note 1.

[10] "States have traditionally regulated intrastate securities transactions, and this court has upheld the authority of States to enact 'blue sky' laws against Commerce Clause challenges on several occasions." Edgar v. MITE Corp., 457 U.S. 624, 641 (1982) (citations and footnote omitted). The Court's rationale for upholding blue sky laws was that they only regulated transactions occurring within the regulating states.

[11] "The provisions of the law . . . apply to dispositions of securities *within* the State . . . ." Hall v. Geiger-Jones Co., 242 U.S. 539, 557 (1917) (citing Ohio blue sky laws).

[12] "[W]hile information of [securities] issued in other States and foreign countries is required to be filed . . . , they are only affected by the requirement of a license of one who deals in them *within* the State." *Id.*

[13] One of the focuses of this article is the authority of state regulators to regulate offerings not sold in the state but made by companies doing business in the state. See Arizona Corp. Comm'n v. Media Products, Inc., 763 P.2d 527 (1988); *supra* notes 11, 14, and accompanying text.

[14] In the appellant's brief for *Media Products*, the appellant notes that control by one state of a securities offering could result in a complete prohibition of sales (a complete ban on interstate commerce). *See* Appellant's Brief at 24-25, Media Products (No. CA-CIV. 9655).

II. SEC AND STATE SECURITIES REGULATION: QUASI-PEACEFUL COEXISTENCE

A. Congressional Allowance of, and Limitations on Blue Sky Laws

It is clear that Congress intended that blue sky laws coexist with the federal securities laws. In both the Securities Act of 1933[15] and the Securities Exchange Act of 1934[16] there are clear statements that permit state regulation and provide that the federal laws are not preempted.[17] When there is a direct conflict between state and federal regulation, a preemption analysis becomes necessary. There will be a judicial finding of preemption when: (1) compliance with both state and federal laws is a "physical impossibility;"[18] (2) federal regulation in the field is so pervasive that state regulation is "an obstacle to the accomplishment and execution of the full purposes and objectives of Congress;"[19] or (3) the

[15] 15 U.S.C. § 77r (West 1989) or Section 18 of the Securities Act of 1933 provides: "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."

[16] 15 U.S.C. § 78 bb(a)(1989) or Section 28(a) of the Securities Exchange Act of 1934 provides: "Nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder."

[17] The legislative history does not offer much insight into why the provision was included except that the original House version prohibited interstate sales into any state where such sales would not have complied with that state's blue sky laws. H.R. REP. NO. 85, 73rd Cong., 1st Sess. § 18, at 25 (1933). The hearings indicate the provision was one of assurance to the states that their laws were not being supplanted but supplemented. *Federal Securities Act Hearings on H.R.* 4314 *Before the Comm. on Interstate and Foreign Commerce,* 73rd Cong., 1st Sess. 117 (statement of Ollie M. Butler). The Senate deleted the House version and inserted section 18, *supra* note 15, which has remained up to the present.

[18] *See* Florida Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132, 142-43 (1963). In the case of federal securities laws versus state securities laws, many argue there can be no problem of physical impossibility since the federal standard is either less than or the same as state standards and the state requirements are in addition to, not in contradiction of, federal standards. However, if an offeror wants a Regulation D exemption, one of the requirements is that purchasers have access to information (financial and otherwise) from the offeror. Unless the offeror is registered in the state of principal operations, such information cannot be given to the purchasers without risking a violation. The effect of state law here is to override the federal exemption. *See infra* note 85 and accompanying text.

[19] Hines v. Davidowitz, 312 U.S. 52, 67 (1941). *See also* Ray v. Atlantic Richfield Co., 435 U.S. 151, 158 (1978) and Jones v. Rath Packing Co., 430 U.S. 519, 525-26 (1977). Again, this form of preemption is not a problem if the purposes of the federal securities laws are perceived to be investor protection since all states have the same or higher standards. If the purpose is changed, i.e., to assure uniformity and ease of registration, then state regulation would be an obstacle. Presently, state registration only adds more investor information and is consistent with congressional intent in regulating securities. However, with Regulation D's authorization there is some showing by Congress of an interest in easing the business burden in obtaining authorization for registration.

state legislation and regulation challenged so burdens interstate commerce (without a legitimate local interest or in excess of that local interest) that the state blue sky regulations violate the federal domain of interstate commerce.[20] So long as states establish a regulatory scheme within these three judicially confining constraints, the federal and state regulators and processes can peacefully coexist. To understand when that peaceful coexistence can occur, it is critical to understand the nature of the state regulatory schemes.

B. Methods of State Regulation: Registration by Disclosure or Merit Review

State regulatory schemes face constitutional challenges when their regulations are either more stringent than the federal regulatory schemes or represent a state's attempt to take jurisdiction beyond that which is necessary for protection of state interests. The regulation at the federal level is regulation by disclosure and, in spite of issues of financial soundness and a myriad of other problems that may exist with an offering, the SEC will not prevent such an offering from being sold so long as there is full disclosure.[21] However, state regulation varies from a standard of SEC full disclosure review as a prerequisite for approval to a full scope merit review process. With the first standard, there will be no conflict with federal regulations. However, conflicts arise where the states undertake to do more than the federal standards.

C. The True Areas of Conflict: Regulation of Specifics

The potential for conflict between state and federal securities regulation is best illustrated by an example. Suppose that in a merit review state a proposed offering has a problem with excessive dilution.[22] Under that

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[20] Pike v. Bruce Church, Inc., 397 U.S. 137 (1970). The fact that Congress has specifically permitted state regulation hampers many commerce arguments. However, as will be noted later, there are times when the scope, and not the form, of state registration can violate the commerce clause.

[21] *See In re* Universal Camera Corp., 19 S.E.C. 648 (1945), in which the SEC noted:

> In contrast to some of the State officials and commissions, operating under state "Blue-Sky" laws that authorize them to pass upon the merits of securities registered with them, it is not this Commission's function under the Securities Act to approve or disapprove securities and the statute specifically makes it unlawful to represent that the Commission has passed upon the merits of any security, or given approval to it.

Id. at 656 (footnotes omitted).

[22] Excessive dilution exists when the promoters (principals) in the stock offering are able to purchase stock at a substantial discount. Excessive dilution generally is found when the price reduction for insiders is greater than 33 1/3%. *See, e.g.*, S. WING & H. BLUMENTHAL, SECURITIES LAW § 9.10[3] (1973).

state's merit review process, the regulators could halt the offering,[23] require that the promoters' shares be held in escrow for a period of time,[24] or require a change in the terms of the offering.[25] In the event the offering is halted or voluntarily withdrawn, the conflict between the state and federal regulations becomes clear. The offering has federal approval for national sale since the SEC standard of full disclosure does not require that the issue of excessive dilution be pursued so long as the extent of that dilution is fully disclosed in the registration materials and shareholder prospectus. Yet, without state approval, or with a structured state approval, the offering becomes fragmented and an administrative nightmare if a sufficient number of merit states vary the terms of the offering or even withhold approval.

There are several other forms of specific regulation that could stop registration in a state in spite of SEC approval. These include provisions regulating cheap stock,[26] promoter investment,[27] offering price,[28] options and warrants,[29] excessive commissions or underwriting and selling expenses,[30] insufficient earnings,[31] inequitable voting rights,[32] the offeror's capital structure,[33] and whether, generally, the offering is fair, just, and equitable.[34] Given these specifics and variations in the application of standards, an offeror has little assurance of a national market for its securities and, in many cases, could find its offering fragmented or in various forms[35] throughout the country. It is also at this point that the

[23] For example, Arizona provides that a registration may be denied if it "would be unfair or inequitable to the purchasers." ARIZ. REV. STAT. ANN. § 44-1921(3) (1989).

[24] Again, in Arizona, the regulators can require that shares be placed in escrow or that funds from the sale of speculative securities be impounded. *See* ARIZ. REV. STATE ANN. §§ 44-1876 and 44-1878 (1989).

[25] The change could come by the issuer's voluntary amendment (*see, e.g.*, ARIZ. REV. STAT. ANN. § 44-1897 (1984)) or the escrow requirements noted *infra* note 26.

[26] Cheap stock is a term used to refer to securities issued (sold or otherwise) within the two years immediately preceding the public offering at a price less than the offering price proposed in the registration materials. Cheap stock results in excessive dilution and the accompanying control of the corporation by the promoters who, financially, do not have as much at risk as the other shareholders of the corporation. Hueni, *Application of Merit Requirements in State Securities Regulation*, 15 WAYNE L. REV. 1417, 1423-28, n. 23 (1968).

[27] In the case of issuers who have no significant record of operations or earnings, state securities regulators will typically require the promoters to hold an investment which equals at least ten percent of the total equity offering. The idea is to ensure that the promoter is at risk and will, theoretically, use more effort and care in operating the business and expending funds. *Id.* at 1421-23.

[28] Regulators attempt to set offering prices on new issues so that consumers are protected from overvalued issuances. The regulation has been called arbitrary since basing the price on price-earnings is based on future earnings and setting a "reasonable price" may cause the issuer to pull out of a particular state if the stock can command a better price elsewhere. For example, the Texas statute provides as follows:

> *Price if no established market or reliable earnings record.* In offerings where there is no established market price for either the securities of the issuer or similar securities of other issuers or the issuer is in the

> development phase and does not have a record of earnings, primary consideration will be given to the proposed offering price established by the underwriters if there is a firm commitment by the underwriters and the proposed underwriters have the financial ability to perform their commitment in light of their net capital positions. If, in the judgment of the commissioner, doubt is raised as to the fair, just and equitable nature of the offering based on known facts, the principle underwriter may be asked to present to the commissioner an analysis supporting the determination of such principal underwriter to market the securities at the proposed offering price including the factors applied, such as potential earnings, the ability and experience of management, the contributions of promoters to the business, and the voting and preferential rights of the proposed issue of securities, and any other factors relied upon the underwriter. The commissioner, upon receipt of the analysis, will make a determination as to whether such a price is fair, just and equitable in light of the factors on which such analysis was based and other factors when the commissioner may deem appropriate.

TEX. ADMIN. CODE tit. 7, § 113.3(4) (1979).

[29] Options and warrants are rights to purchase a company's shares. They are generally held by officers and directors as a means of compensation and thus can cause dilution of outside shareholders' interests in the firm. Furthermore, the options tend to be exercised at a time when the firm's earnings are high and hence not in need of the capital. From an efficiency perspective then the options are also a concern. Regulators' concern about options and warrants centers on dilution and the reasonableness of them with respect to employee and management incentives. Another concern is the issuance of options and warrants to underwriters. *See* North American Securities Administrators Association statement of policy, NASAA Reports (CCH) para. 2801.

[30] These fees are usually regulated by the standard of "reasonable amount" or as a maximum percentage limitation and are designed to prevent excessive dilution. The impact of this form of merit regulation is significant since riskier offerings will necessarily require higher fees by underwriters and result in an elimination by market factors as opposed to the merit of the offering. *See* Empirical Research Project, *Blue Sky Laws and State Takeover Statutes: New Importance for an Old Battleground,* 7 J. CORP. L. 689, 712 (1982).

[31] This concern arises primarily in debt offerings where the regulators' concerns are the ability of the firm to service the debt. In some cases, state regulators escrow promoters' stock until earnings reach an acceptable level. *See* A.L.I., FED. SEC. CODE tit. 1 § 506.

[32] The idea behind this form of merit regulation is that those who do the contributing are those who should control. *See, e.g.,* TEX. ADMIN. CODE tit. 7, § 113.3(6) (1979), which provides:

> *Voting Rights.* In offerings of non-voting shares or shares with disproportionate voting rights, which offerings normally are not fair, just, and equitable, the commissioner may consider whether or not the disparity in voting rights is a temporary condition and whether or not the deprived shareholder receives an offsetting benefit (e.g., dividend preference or preference in liquidation) to compensate for such disparity.

[33] Excessive debt is often used as a standard for reviewing the general health of the firm. *See, e.g.,* ARIZ. REV. STAT. ANN. § 44-1921(4) (Supp. 1988).

[34] This generic standard could refer to the offering's price; *see* TEX. ADMIN. CODE tit. 7, § 113.3(2) (1981), or used generically as the standard for review; *see* CAL. CORP. CODE § 25140 (Deering's Supp. 1989).

[35] For example, the offering could be escrowed in some states and subject to no restrictions in other states. An issuer could find itself with large blocks of stock tied up in various jurisdictions.

jurisdictional issue becomes critical, for if states have powers that extend beyond state borders, then approval in all states becomes a necessity. For example, if a state can regulate an offering simply because of closings occurring in the state, the effect of the state's non-approval is the veto of a national offering. Hence it is the issue of jurisdiction which controls the degree of impediment states hold in their reviews. Given the inconsistencies in regulations and their application, the question of the scope of authority of the regulators or how far the regulatory arm of the state can extend in controlling securities offerings is one that has been answered in certain respects but remains unclear in those cases in which the offeror has minimal contact with the state, particularly in the execution of an offering. Several basic questions arise in these minimum contact cases with respect to a state's authority:

(1) Can state regulators preclude sales of securities within that state?
(2) Can state regulators preclude sales of securities from operations conducted within that state?
(3) Can state regulators preclude all sales on the basis of the offeror's activities within that state?

These three questions represent the areas of supremacy and commerce clause conflict between state and federal securities regulations and are separately discussed in the following sections.

III. THE CROSSOVERS: STEPPING ON THE TOES OF THE SUPREMACY AND COMMERCE CLAUSES

A. The Limitation of Sales Within a State Under the Authority of State Blue Sky Laws: Scenarios One and Two

As noted in the preceding section, states have been given full federal authority to develop schemes for regulation of securities, and the only constraints against such regulation would be the generic commerce clause restriction that the statute not "discriminate against interstate commerce."[36] It is clear from the Uniform Securities Act that the question of a state's jurisdiction is left to the states, with the states resorting to common law principles for resolution of issues relating to their jurisdiction.[37] Thus, the states have only certain constraints when dealing with

[36] CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 87 (1987).

[37] The Uniform Securities Act relies on the language "in this state" but for all its detail does not resolve the issue of scope of jurisdiction for the state. Section 414 provides:

Section 414. [Scope of the Act and Service of Process]

[Sellers]

(a) Sections 101, 210(a), 301, 405, and 410 apply to persons who sell or offer to sell when (1) an offer to sell is made in this state, or (2) an offer to buy is made and accepted in this state.

sales of securities to state residents. One such constraint is the commerce clause prohibition on discriminatory regulation designed to help in-state firms while impeding foreign firms' abilities to sell securities in the state.[38] For example, if a merit review process applied to foreign corporations, but domestic corporations were subject only to a disclosure type of review, the state would be discriminating against out-of-state firms even if the state could show the need to obtain more information on firms not subject to in-state records requirements.[39]

Discriminatory regulation would also occur if blue sky laws were inapplicable to domestic corporations but applicable to out-of-state corporations, since the result would be to provide domestic corporations with an unfair advantage over foreign corporations in the state's capital mar-

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[Buyers]

(b) Sections 101, 210(a), and 405 apply to persons who buy or offer to buy when (1) an offer to buy is made in this state, or (2) an offer to sell is made and accepted in this state.

[Offer in this State]

(c) For the purpose of this section, an offer to sell or to buy is made in this state, whether or not either party is then present in this state, when the offer (1) originates from this state or (2) is directed by the offeror to this state and received at the place to which it is directed (or at any post office in this state in the case of a mailed offer).

[Acceptance in this State]

(d) For the purpose of this section, an offer to buy or sell is accepted in this state when acceptance (1) is communicated to the offeror in this state and (2) has not previously been communicated to the offeror, orally or in writing, outside this state; and acceptance is communicated to the offeror in this state, whether or not either party is then present in this state, when the offeree directs it to the offeror in this state reasonably believing the offeror to be in this state and it is received at the place to which it is directed (or at any post office in this state in the case of a mailed acceptance).

[Publications, Radio and Television]

(e) An offer to sell or to buy is not made in this state when (1) the publisher circulates or there is circulated on his behalf in this state any bona fide newspaper or other publication of general, regular, and paid circulation which is not published in this state, or which is published in this state but has had more than two-thirds of its circulation outside this state during the past twelve months, or (2) a radio or television program originating outside this state is received in this state.

UNIF. SEC. ACT § 414(a)-(e), 7B UNIF. L. ANN. 673.

[38] *See, e.g.*, CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 87 (1987): ("The principal objects of dormant Commerce Clause scrutiny are statutes that discriminate against interstate commerce.").

[39] *See* Pike v. Bruce Church Inc., 397 U.S. 137 (1970) in which a state regulation requiring in-state packing of cantaloupes discriminated against firms with an out-of-state packing facility by, in effect, requiring them to have two business facilities while Arizona firms needed only one. Arizona's claimed need to prevent deceptive packing was not sufficiently related to the requirement of an in-state facility and, therefore, did not justify the burden on interstate commerce.

kets.[40] The fascinating perspective of merit review is that it appears to discriminate in opposite fashion; that is, it discriminates against operations within the state in that it places greater hurdles on domestic offerors than on foreign offerors. Foreign offerors have the choice of simply not offering in the state, while domestic firms appear to be jurisdictionally bound to comply with state law and approval for sales. In addition to the commerce clause prohibition against discrimination, there is the additional component of the clause that invalidates those statutes which adversely affect interstate commerce.[41] The process of determining whether a statute imposes an impermissible burden on interstate commerce is one of balancing the interests of the state with the extent of the burden imposed by the regulation. The general rule for evaluating the state regulation was set forth by the Supreme Court in *Pike v. Bruce Church, Inc.*:[42]

> Where the statute regulates evenhandedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits. If a legitimate local purpose is found, then the question becomes one of degree.[43]

As early as 1917, the Supreme Court recognized the interest of the states in the regulation of securities sales as one of protection of the public.[44] The problems of inconvenience from different state regulations

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[40] *See, e.g.*, Lewis v. BT Inv. Managers, Inc., 447 U.S. 27 (1980), in which a Florida statute prohibiting out-of-state banks, trusts, and bank holding companies from owning businesses within the state which provide investment advisory services was held unconstitutional under the commerce clause; and Philadelphia v. New Jersey, 437 U.S. 617 (1978), in which a New Jersey statute that prohibited the importation of solid or liquid waste which originated or was collected outside the territorial limits of the state was held to be unconstitutional under the commerce clause.

[41] CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987).

[42] 397 U.S. 137 (1970).

[43] *Id.* at 142 (citation omitted).

[44] *See* Hall v. Geiger-Jones Co., 242 U.S. 539 (1917), in which the Court stated in determining the validity of an Ohio Statute which required securities dealers to obtain a license:

> It will be observed, therefore, that the law is a regulation of business, constraints conduct only to that end, the purpose being to protect the public against the imposition of unsubstantial schemes and the securities based upon them. Whatever prohibition there is, is a means to the same purpose, made necessary, it may be supposed, by the persistence of evil and its insidious forms and the experience of the inadequacy of penalties or other repressive measures. 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." Even if the descriptions be regarded as rhetorical, the existence of evil is indicated, and a belief of its detriment; and we shall not pause to do more than state that the prevention of deception is within the competency of government and that the appreciation of the consequences of it is not open for our review.

Id. at 550-51.

were not sufficient for a finding that such regulations were an unconstitutional burden under the commerce clause.[45] It is clear that today's standards for state securities registration are more detailed and stringent than those few that existed at the time the federal securities statutes were adopted and the state protection afforded.[46] However, it is also clear that in spite of fierce opposition, merit regulation has survived most commerce clause challenges.[47] For example, state regulators have constitutional authority to require a seller to obtain a license before selling securities in the state,[48] halt the sale of securities in a state for the offering's failure to meet state standards,[49] and prosecute those who violate state securities laws.[50] In short, state regulators have the power to

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[45] Again, in Hall v. Geiger-Jones Co., the court stated: "Inconvenience may be caused and supervision and surveillance, but this must yield to the public welfare; . . ." *Id.* at 552.

[46] At the time the Secruities Act was enacted, Kansas had its own statute because of its vulnerability:

> The State of Kansas, most wonderfully prolific and rich in farming products, has a large population of agriculturists not versed in ordinary business methods. This State was the hunting ground of promoters of fraudulent enterprises; in fact their frauds became so barefaced that it was stated that they would sell building lots in the blue sky in fee simple. Metonymically they became known as blue sky merchants, and the legislation intended to prevent their frauds was called Blue Sky Law.

Mulvey, *Blue Sky Law* 36 CAN. L. TIMES 37 (1916).

[47] *See* L. LOSS & E. COWETT, BLUE SKY LAW 3-10 (1958).

[48] *See* Hall v. Geiger-Jones Co., 242 U.S. 539 (1917), *supra* notes 6, 11, 12, 49, 50. *See also* Caldwell v. Sioux Falls Stock Yards Co., 242 U.S. 559 (1917); Merrick v. N. W. Halsey & Co., 242 U.S. 568 (1917).

[49] In Edgar v. MITE Corp., 457 U.S. 624 (1982), the court noted:

> States have traditionally regulated intrastate securities transactions, and this Court has upheld the authority of States to enact "blue-sky" laws against Commerce Clause challenges on several occasions (citations omitted). The Court's rationale for upholding blue-sky laws was that they only regulated transactions occurring within the regulating States. "The provisions of the law . . . apply to dispositions of securities *within* the State and while information of those issued in other States and foreign countries is required to be filed . . . , they are only affected by the requirement of a license of one who deals with them *within* the State . . . Such regulations affect interstate commerce in [securities] only incidentally." *Hall* v. *Geiger-Jones Co.*, (citations omitted). Congress has also recognized the validity of such laws governing intrastate securities transactions in 28(a) of the Securities Exchange Act, 15 U.S.C. 78 bb(a), a provision "designed to save state blue-sky laws from pre-emption. *Leroy* v. *Great Western United Corp.*, 443 U.S. 173, 182 n.13 (1979).

Id. at 641.

[50] For early cases, *see* Hall v. Geiger-Jones Co., 242 U.S. 539 (1917); Caldwell v. Sioux Falls Stock Yards Co., 242 U.S. 559 (1917); Merrick v. N. W. Halsey & Co., 242 U.S. 568 (1917). For later cases *see, e.g.*, Underhill Assoc. Inc. v. Bradshaw, 674 F.2d 293 (4th Cir. 1982); Lintz v. Carey Manor Ltd., 613 F. Supp. 543 (W.D. Va. 1985); Oil Resources, Inc. v. Florida, 583 F. Supp. 1027 (S.D. Fla. 1984); Enntex Oil & Gas Co. vs. State, 560 S.W.2d 494 (Tex. Civ. App. 1977); *Cf.* Mon-Shore Mgmt., Inc. v. Family Media, Inc., 584 F. Supp. 186 (S.D. N.Y. 1984).

prevent, enjoin, and prosecute any "in-state" illegal securities activities.[51] While these local regulatory activities generally are presumptively permitted, the wisdom of such a piecemeal approach in a national capital market governed by a significantly detailed federal regulatory scheme is questionable.[52] The varying regulation of securities brokers and dealers is no different than the various licensing requirements throughout the states for other professions. However, such licensing is ostensibly for a lifetime, while a securities offering is executed quickly and is critically timed according to market conditions. The impact of the various forms of state securities registration can create confusion in initial sales if approval is piecemeal. Some investors can participate in the initial gains often made in the market place during the rapid sales and resales made immediately upon public notice and availability,[53] while investors in those states in which approval for sale of the offering was not obtained can only hope to participate in secondary sales.[54]

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[51] The scope of the authority to regulate "from" the state is discussed in detail in section III B of this article, which deals with sales "from" the state as opposed to "in" the state. *See infra* notes 63-67 and accompanying text. For authority on "in-state", see North Star Int'l v. Arizona Corp. Comm'n, 720 F.2d 578 (9th Cir. 1983).

[52] *See, e.g.*, Karmel, *Blue-Sky Merit Regulation: Benefit to Investors or Burden on Commerce?* 53 BROOKLYN L. REV. 105 (1987), in which the author notes:

> State merit regulation is a burden on interstate commerce and stands as an obstacle to the achievement of the SEC's statutory goals of facilitating capital formation and the establishment of a national market system (NMS). Further, the basic philosophical conflict between federal and state regulation will become increasingly troublesome as the SEC grapples with the problems of regulating the market for corporate control of large public companies and participating in the regulation of international capital markets.

Id. at 107 (footnote omitted).

[53] According to the finance literature, many offerings experience a period after initial sales when an initial purchaser could resell for gain in the secondary market before the leveling off effect occurs. However, those who are not primary purchasers lose the time frame needed for that initial gain. *See* Chen, Roll, & Ross, *Economic Forces and the Stock Market,* 59 J. BUS. 383 (July 1986).

[54] One question that arises from this effect is which investors merit review is trying to protect. From the observed market phenomenon it appears the effect of prohibition of sales in a state is to require that state's investors to wait and see the general market reaction before investing in the securities. Again, this pause causes those investors to lose out on the initial returns to be made if the stock gains momentum immediately upon its public offering.

Although regulating "in-state" transactions seems to be a relatively simple concept, the nature of the capital market and its universality can result in the following scenarios:

1) Sales of securities by domestic (state A) corporations to state A residents
2) Sales of securities by foreign corporations to state A residents
3) Sales of securities by a domestic corporation from state A to those outside state A
4) Sales of securities by a foreign corporation from state A to non-residents
5) Sales of securities by a foreign corporation to A residents but occurring in state B
6) Sales of securities by a foreign corporation to non-residents but the transaction occurs in state A
7) Sales of securities by a domestic corporation only outside the state and only to non-residents.

The justification for all of these scenarios is that state A has an interest in regulating transactions in the state in order to uphold the state's reputation. There is a further interest in protecting the state's citizens regardless of where they happen to consummate sales.[55] As one moves down the above list, the scope of state regulation expands, the conflict with federal approval increases, and the state regulation becomes a more significant burden on the offeror's national approach to raising capital. Scenarios one and two are clear constitutional exercises of state regulatory authority, but the remaining scenarios are the focus of *Arizona Corporation Commission v. Media Products, Inc.*,[56] and the center of discussions on the role of state regulators.

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[55] There is some support for this notion of "extraterritorial" protection in the field of international law, for the U.S. Government has jurisdiction over its citizens (foreign and natural) anywhere in the world. Such a discussion is beyond the scope of this article, but *see, e.g.*, ITT v. Vencap Ltd., 519 F.2d 1001 (2d Cir. 1975); RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 30(1)(a) (1965); Thomas, *Extraterritorial Application of the United States Securities Laws: The Need for a Balanced Policy*, 7 J. CORP. L. 189 (1982).

[56] 763 P.2d 527 (Ariz. Ct. App. 1988).

B. Scenario Three: The Regulation of Sales "from" the State

The Uniform Securities Act,[57] which has been adopted in 39 states,[58] is applicable to sales without regard to a seller's citizenship or residence.[59] Some states' versions of the Act have made the state blue sky laws applicable to sales "in and from" the state.[60] Other states require registration for "sale in this state,"[61] and judicial construction has been liberal in determining the scope of jurisdiction under the general phrase.[62] The concern in regulating sales not made to state residents but made "from" the state is that the state gains a reputation as a launching pad for boilerroom operations that perpetrate frauds on the rest of the nation.[63] Courts have been supportive of the regulators' use of the police power in this manner. It could be argued that such state regulation is necessary where the offeror somehow slipped between the federal and state jurisdictional coverage in registration.[64]

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[57] The Uniform Securities Act is a product of the work of NAASA (North American Association of Securities Administrators), securities lawyers and legal scholars with Louis Loss being a principal in the undertaking. See 7B UNIF. L. ANN. 510 (1985).

[58] The thirty-nine states or territories which have adopted or substantially adopted the Uniform Securities Act include:

Alabama	Kentucky	North Carolina
Alaska	Maryland	Oklahoma
Arkansas	Massachusetts	Oregon
Colorado	Michigan	Pennsylvania
Connecticut	Minnesota	Puerto Rico
Delaware	Mississippi	South Carolina
District of Columbia	Missouri	Tennessee
Guam	Montana	Utah
Hawaii	Nebraska	Virginia
Idaho	Nevada	Washington
Indiana	New Hampshire	West Virginia
Iowa	New Jersey	Wisconsin
Kansas	New Mexico	Wyoming

1 Blue Sky L. Rep. (CCH) para. 5500 (1989).

[59] The drafters of the Uniform Securities Act consciously rejected citizenship or residence within a particular state as the policy base for the application for the Act. Instead, they elected a territorial base, requiring that a transaction have some physical nexus with a state. 12 J. LONG, *supra* note 1, at § 3.02 [3]-[7].

[60] *See, e.g.*, ARIZ. REV. STAT. ANN. § 44-1841 (1987) which provides: "It is unlawful to sell or offer for sale *within or from* this state any securities unless such securities have been registered." (emphasis added)

[61] *See, e.g.*, ILL. ANN. STAT. ch. 121 1/2 Para. 137.5, § 5 (Smith-Hurd 1989); CAL. CORP. CODE § 25008(a) (West 1977) which provides in pertinent part:

> (a) An offer or sale of a security is made in this state when an offer to sell is made in this state, or an offer to buy is accepted in this state, or (if both the seller and the purchaser are domiciled in this state) the security is delivered to the purchaser in this state. An offer to buy or a purchase of a security is made in this state when an offer to buy is made in this state, or an offer to sell is accepted in this state, or (if both the seller and the purchaser are domiciled in this state) the security is delivered to the purchaser in this state.

[62] *See* Lintz v. Carey Manor Ltd., 613 F.Supp. 543 (W.D. Va. 1985).

[63] *See supra* note 1 and accompanying text.

[64] The federal laws were passed in 1933 in spite of the fact that every state

C. Scenario Four: *Arizona Corporation Commission v. Media Products* and the Length of the Regulatory Arm

The more tenuous jurisdictional issues of scenarios four through seven create a field ripe for harvest at the hands of a commerce clause or preemption challenge. Mixed metaphors aside, it has become clear that the scope of state regulation has been expanding.[65] The scenario in *Arizona Corporation Commission v. Media Products, Inc.*[66] combines several of the elements given in the remaining scenarios. Media Products, a Delaware corporation with principal offices located in Arizona, hired a Spokane, Washington underwriter to sell its unseasoned public stock offering of 1,300,000 shares. The initial public offering (IPO) was registered with the SEC and in California, Colorado, Connecticut, Georgia, Idaho, Illinois, Minnesota, Montana, New Jersey, New York, Oregon, Pennsylvania, and Washington. Media Products had applied for Arizona registration but later withdrew its application[67] and informed the Securities Division of the Arizona Corporation Commission that it would proceed with the offering in the other states. The Commission maintained that going forward with the offering without Arizona approval would be a violation of Arizona securities laws, and filed suit to enjoin the public offering and assess civil penalties.

Arizona's statute permitted jurisdiction in sales "from" the state.[68] The Commission took the position that Media Products was subject to Arizona jurisdiction, noting that:

(a) Media Products' principal place of business and base of operations was in Arizona; (b) Media Products' officers and directors resided in Arizona; (c) stock certificates were prepared and issued in Arizona; (d) Board meetings took place in Arizona; (e) Notice address on the offering was in Arizona; and (f) closing for the offering occurred in Arizona.[69]

The amici brief noted that having a principal place of business in a state did not subject the offeror to that state's blue sky laws.[70] However, the court correctly noted that Arizona had not adopted the Uniform Securities Act and found the sales had occurred "from" the state.

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except Nevada had blue-sky laws, for the more clever of the issuers were able to develop interstate schemes and escape any form of regulation. *See e.g.*, Gadsby, *Historical Development of the SEC - The Government View*, 28 GEO. WASH. L. REV. 6 (1959); M. PARRISH, SECURITIES REGULATION AND THE NEW DEAL (1970).

[65] For example, when the Supreme Court handed down CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987), a case in which a state corporate takeover law was held not to be preempted simply because of a Williams Act filing, many state securities regulators viewed the case as a victory for state jurisdictional powers not only in the area of takeovers. *CTS Corp.*, in essence, expanded state jurisdictional power, in contrast to previous limits on such power (Edgar v. MITE Corp., 457 U.S. 624 (1982).

[66] 763 P.2d 527 (Ariz. Ct. App. 1988).

[67] The securities division of the Arizona Corporation Commission issued a deficiency letter on the proposed offering noting problems with the offering, and Media Products withdrew its application shortly thereafter.

[68] ARIZ. REV. STAT. ANN. § 44-1841 (1987).

[69] 763 P.2d at 529.

[70] The *Amici* brief, quoted in 12 J. LONG, *supra* note 1, at § 3.02[3], provides: "mere maintenance of a principal place of business or any place of business within the state is not sufficient to trigger the local version of the Uniform Act."

This initial finding of the court was largely irrelevant given its decision that Arizona's statute violated the commerce clause. The court noted that the state has no legitimate interest in protecting non-residents:

> Under the facts of this case, Arizona had no duty to the purchasers whose home states had already determined that the offerings met their own state's standards and had registered the offerings in those states and with the Securities and Exchange Commission. To hold otherwise would allow the Commission to have an effective veto over offerings and sales approved by the Securities and Exchange Commission and securities officials from other states, even though no purchases were made by Arizona residents.[71]

In response to the Commission's concern about Arizona's reputation, the court found a prohibition of sales to be overly broad given the clear delineation of the corporation's origins in the prospectus.[72] The dissenting opinion in the case noted that Media Products was an "Arizona enterprise," and cited the long-recognized state interest in preventing its territory from being used as a base of operations for unregulated transactions as sufficient to justify the burden on interstate commerce.[73] Some have questioned the court's interpretation of "from," but the constitutional analysis appears to be sound.[74]

D. *Scenario Five: Sales to Residents Outside the State*

States have an interest in protecting their citizens regardless of where those citizens happen to be.[75] No serious challenges have been brought under this scenario,[76] and this jurisdictional aspect also appears to afford those citizens the private right of suit based on their local laws in spite of the non-resident transaction.[77]

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[71] 763 P.2d at 533.

[72] "The prospectus and supplement placed prospective purchasers on notice that Media Products was a Delaware corporation, that the offerings and sales were not approved by the Arizona Corporation Commission . . . ." *Id.* at 533-34.

[73] Judge Corcoran noted that Tennessee, Oklahoma, Texas, and Utah gained ill repute for serving as host states for questionable securities activity. *Id.* at 534 (Corcoran, J., dissenting).

[74] *See* 12 J. LONG, *supra* note 1, at § 3.02.

[75] *See, e.g.*, CAL. CORP. CODE § 25008 (West 1989).

[76] *See, e.g.*, Western Air Lines Inc. v. Sobieski, 191 Cal. App. 2d 399, 12 Cal. Rptr. 719 (1961). However, this assumes some delivery or closing in the state. The jurisdictional issue is quite different if the citizens consummate the deal outside the state altogether. *See* Cal. Corp. Comm'n Interpretative Op. No. 70/168, 2 Cal. Corp. Comm'n Official Op. (Dec. 31, 1970). *Accord* Cal. Corp. Comm'n Interpretative Op. No. 73/270, 5 Cal. Corp. Comm'n Official Op. (March 5, 1973).

[77] *See* Lintz v. Carey Manor, Ltd., 613 F. Supp. 1027 (S.D. Fla. 1984); *But see* Gaillard v. Field, 381 F.2d 25 (10th Cir. 1967) (involving an issue of whether a plaintiff could recover under California securities law when Oklahoma holds oil and gas interests which do not constitute securities), *cert. denied*, 389 U.S. 1044 (1968).

E. Scenario Six: Sales by Foreign Corporations to Non-Residents with Use of a State

The boiler room operation theory which applies in this situation brings this analysis very close to scenario four but removes the questionable aspect of "from" and has the offeror use the state for solicitation, close of escrow, or some other part of the transaction. Without any further activity, the language of the Uniform Securities Act would not afford jurisdiction, but constitutionally the cases appear very similar to those in which residents are outside the state. If some portion of the transaction returns to the state, then regulation would be within commerce clause standards.

F. Scenario Seven: Sales by Domestic Corporations Outside the State and Only to Non-Residents

This scenario differs from *Media Products* in that the offering will be handled entirely outside the state. Two states have determined there is no blue sky jurisdiction unless the domestic corporation answers telephone inquiries regarding the securities which would put the transaction into the sales-"from"-a-state category.[78]

IV. WHO IS REALLY IN CHARGE? IS THERE A NEED FOR DUPLICITOUS STATE REGULATION?

While Congress, and to a large extent, the courts have attempted to delineate the differences between state and federal regulations and the insignificant burden of state regulation, the fact is the state rules remain obstacles to a uniform and national capital market. For example, even the Regulation D exemptions[79] are subject to some state regulation and may require, pursuant to scenario seven, full registration if the home office wants to be able to answer questions about the offering directly (as is required under Regulation D).[80] In some states, an offeror may have to escrow its stock in order to obtain registration. These two abilities alone give state regulators veto power over transactions intended to be national in scope. Additionally, it is possible that the denial or withdrawal of registration in one state may influence the market's reaction particularly in the case of an initial public offering.

[78] *See* Cal. Corp. Comm'n Interpretative Op. No. 81/10C, 11 Cal. Corp. Comm'n Official Op. (Nov. 12, 1981) (calls from outside the state to general partner from potential investors made it an offer "from" the state); Op. Utah Att'y Gen., [1954-1961 Transfer Binder] Blue Sky L. Rep. (CCH) Para. 70,245 (Oct. 8, 1954) (local office could not give corporation's home office number in response to securities offerings inquiries).

[79] Regulation D — Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933, 17 C.F.R. §§ 230.504-506 (1982).

[80] *See* 17 C.F.R. § 230.502(b)(2)(v) (1988), which requires that all purchasers be allowed to ask questions about the offering and have them answered.

A. Financial Impact

Apart from the legal arguments related to the commerce and supremacy clauses, there are the financial market arguments against varying and piecemeal regulation. First, proponents of merit review assume that regulators are able to uncover or obtain additional information, akin to the level of inside information, that the market would not already have.[81] Further, even assuming the regulators had such information, the assumption inherent in merit review is that those who perpetrate frauds always go to the time, trouble, and effort of registering their offerings.[82] The state regulatory schemes for securities have been permitted to exist to the point of control within, without, and through the states and there is a resultant loss of the market forces as evaluators of business and its potential. Merit review at the state level is a substitution of state regulators' judgment for that of the capital market, or in some cases, a change by state regulators in the offering structure in order for the offeror to obtain approval. State blue sky laws were originally permitted to preclude the problem of firms avoiding SEC registration on the grounds of intrastate activity under the commerce clause protection. Presently those blue sky laws have grown to the point of a national veto based on the public interest argument for the regulation. Blue sky laws represent a web of complexities for an initial public offering having immeasurable effects running from a lack of offerings, to ill-timed offerings, to interference with the natural selection of the market. In the long run, it is the financial and economic arguments that prove stronger than federal preemption or supremacy. While the legal debate enlarges, the capital market fragments and foreign markets grow.

B. Avoiding Duplicity and Enjoying Uniformity: Exemptions, Clearing Houses, and Long Arms

The implementation of several procedures could avoid the unnecessary conflicts and overlap resulting from this dual system. First, there is the need for uniform application of Regulation D with state recognition of those federal exemptions. Such a step would not only avoid the potential conflicts noted earlier in trying to meet federal requirements without invoking all the state registration requirements, but could also remove some of the cost barriers that still remain for smaller offerings. Second,

[81] It often appears that merit analysis was developed in a vacuum apart from the research in finance, particularly that work which relates to the efficient market hypothesis. When merit review precludes an offering, the review is, in effect, attempting to control risk in the market place and assumes that regulators have information the market did not already have. *See* Morton, *On Estimating the Expected Return on the Market,* 8 J. FIN. ECON. 323 (Dec. 1980).

[82] Again, the finance literature is directly to the contrary: it costs too much just to register securities at a national level and the possibility for long-term survival is completely lost. These two factors serve as a greater hindrance to fraudulent offerings than the registration review. Darby & Karni, *Free Competition and the Optimal Amount of Fraud,* 16 J. LAW & ECON. 16 (1973).

state administrators of registration programs, particularly for those states with some form of merit review, should develop a central clearing or processing office for national registrations. In that office, experienced regulators would review the offering for all the criteria used by the various states in reviewing the merits of an offering. That clearing office would then issue a report with recommendations. The offeror would have the same opportunity to provide additional information and respond to concerns that would be available in working with state regulators. State regulators would fund, manage, and set policy and review guidelines for the central processing unit. The benefits are that the states retain the opportunity to review offerings for something more than full disclosure but offerors are not subject to duplicity in the merit review process. At present, state regulators have certain procedures in place that would facilitate such a central clearing house. A uniform application is used and the application requires offerors to list the other states where approval for sale has been obtained or is pending, so that exchange of information with other regulators is possible.

The details regarding state acceptance of central clearance could be established, but state autonomy on additional securities regulation could be retained while the lack of uniformity impeding international capital market strategies would be eliminated. Resolving the jurisdictional scope of the states is difficult. If the idea is to have some state regulation, it would be more consistent to regulate on a central basis with a shopping list of merit issues that would permit the central clearance. In such a system, the jurisdictional issues become irrelevant since all sales in states desiring more control than mere disclosure would be assured of adequate review. The issue of jurisdiction would become irrelevant with the creation of the equivalent of a national credit bureau for securities. The jurisdictional issues would still arise between merit and non-merit states, but the conflicts between merit states would be resolved with a hopefully uniform and central review of proposed offerings.

The system is not without flaws. State autonomy, particularly with its political genesis is difficult to eliminate and the system almost requires states to behave uniformly. However, the capital market is no longer a U.S. market and territorialism could be costly. The point of a uniform or centralized system is not to deprive investors of protection or regulators of the opportunity to screen offerings, but rather to ensure consistency in reviews and to institute a system of expectations. The presence of a uniform system at least delineates the issues for those entering the capital markets and eliminates the surprises and inconsistencies that result from state-to-state review by ever-changing staffs and regulators.

As the United States moves into a decade which has begun with the elimination of the European common market and the elimination of the Berlin wall and Lenin's vision of Russia, it is not difficult to conclude that trade barriers are nearly nonexistent. Capital barriers have necessarily followed suit and businesses are operating in a unified financial market and a global market-place that knows no country-to-country barrier or boundary. This new global business methodology mandates streamlined operations and regulations in a company's domestic head-

quarters for effective international competition. A firm that cannot rely on its own regulators to act quickly and consistently will be required to operate with a time disadvantage in the international markets.

Presently, regulators and businesses are faced with a tradeoff between the ability to compete effectively in a world-wide market and the need for individual and state-by-state review of offerings. The trade-off is not, fortunately, an either/or proposition. Rather, the compromise of a centralized review process may offer a resolution that satisfies the political issue of investment protection, but allows the expedited and consistent review needed for effective participation in the international capital markets.