

**Securities Law Committee  
Of the Business Law Section  
Washington State Bar Association**

March 22, 2010

The Honorable Christopher Dodd, Chairman  
Senate Committee on Banking, Housing, and Urban Affairs

**Re: Section 926 of the “Restoring American Financial Stability Act of 2010”**

Dear Senator Dodd:

This letter represents the views of the Business Law Section of the Washington State Bar Association (“WSBA”), which counts approximately 1,000 business lawyers as members, and its Securities Law Committee (“Committee”). The Business Law Section’s members represent small, medium and large businesses throughout the state of Washington, and the Committee’s members are composed of lawyers who practice in the field of corporate law and securities regulation. This letter was approved by an overwhelming majority of both the governing committee of the Business Law Section and the Committee. The Board of Governors of the WSBA has not taken a position, and individual members of the WSBA and their associated firms or companies may not necessarily concur with the views expressed in this letter.

**Summary**

Our Committee opposes the adoption of Section 926 of the “Restoring American Financial Stability Act of 2010” (the “Bill”), as introduced in the Senate on March 15, 2010. We believe that Section 926 would operate as a practical matter to eviscerate the existing federal preemption of state securities laws with respect to private offerings of securities made pursuant to SEC Rule 506. Current law strikes the proper balance between reducing the costs of capital formation for smaller business while giving state securities regulators full authority to protect investors from fraudulent securities offerings.

As residents of Washington State we are justifiably proud of the strength of our local high-tech and other businesses, both large and small, created and nurtured in significant part by the very sort of private financings that are now the target of Section 926’s no-doubt well intentioned but, we believe, severely misguided provisions. These businesses are our clients which we advise every day, and we are jealous for their continued viability. This Committee believes that a practical evisceration (*de facto* repeal) --- whole or partial --- of the existing federal preemption of state registration requirements for private offerings of securities under SEC Rule 506 would

significantly set back the financing of legitimate business, and would represent a return to the balkanized, confusing and costly system of private small business financing that prevailed in the days before that Section's enactment. It is our belief that the adoption of Section 926 would be a *significant* impediment to the efforts of small companies --- and even larger ones --- to raise the capital that will allow them to grow and create jobs, and so we strongly recommend its removal from the bill.

### **The Context and Basis for Federal Preemption**

#### **What Section 18(b)(4)(D) Says.**

Congress added Section 18(b)(4)(D) to the Securities Act of 1933, as amended (the "Securities Act") --- the content, purpose and history of which are briefly described below --- through passage of the National Securities Markets Improvement Act of 1996 ("NSMIA").

Section 18(b)(4)(D) is fairly simple: it provides that no state may require registration or qualification, or limit or impose conditions upon the use of an issuer's offering documents, or directly or indirectly prohibit, limit, or impose conditions, based on the merits of such offering or issuer, upon any security offered and sold in a transaction "that is exempt from registration under this title pursuant to \* \* \* [Securities and Exchange Commission ("SEC")] rules or regulations issued under section 4(2) [of the Securities Act --- the "private offering" exemption of SEC Rule 506], except that this subparagraph does not prohibit a State from imposing notice filing requirements that are substantially similar to those required by rule or regulation under section 4(2) that are in effect on September 1, 1996."

In the words of the statute (as added by NSMIA), such Rule 506 securities are "covered securities."

#### **The Historical Setting of Section 18(b)(4)(D): Competing Federal/State Philosophies of Securities Regulation.**

From its adoption in 1933 until 1996, the Securities Act expressly provided that its provisions were not intended to preempt state securities laws. These state laws, first enacted beginning with Kansas in 1911 and known as "Blue Sky" laws, typically provide for the registration of securities offerings, just as the Securities Act does-- with one very important, fundamental difference.

Many of the state Blue Sky laws then and now provide for what is called "merit regulation." This means that in order for a business to sell its shares to the public in such a state, it must not only meet the *Federal* standard for registration --- full and fair disclosure of all material information --- but it must convince that *state's* securities regulator that the offering is "fair, just and equitable."

In 1933, the result of this "battle of the philosophies," *i.e.*, the Federal standard of "full disclosure," originally championed by Louis Brandeis in his 1914 book "Other People's Money," and that of "merit review," advocated by then-Professor William O. Douglas of Yale, was a

system of concurrent Federal-State regulation that carried with it the inherent risk that any given securities offering could find itself subject to a crazy-quilt of varying requirements imposed by different jurisdictions.

### **The Nature of Securities Registration and the Section 4(2) "Private Placement" Exemption.**

Since its adoption in 1933, the Securities Act has required that businesses ("issuers") wishing to raise funds by selling securities through use of the mails and instrumentalities of interstate commerce must first file a registration statement with the (now) Securities and Exchange Commission.

Such registrations are, especially for new companies and/or first-time registrants, expensive, time consuming and intended to be exhaustive insofar as all material information concerning the company, its management, its history, its plans and its financial statements are concerned. Compliance with this process is simply beyond the means of virtually all small and new businesses.

For good reasons, Congress provided a number of exemptions from the Securities Act's registration requirements, one of them being --- in what is now Section 4(2) of that Act --- for "transactions by an issuer not involving any public offering."

Faced with the task of determining exactly what those nine words mean, our U.S. Supreme Court held that the exemption is for offers and sales of securities to persons "who are shown to be able to fend for themselves." SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953). Following that opinion, the lower federal courts issued numerous decisions, not always in harmony, as to what the Section 4(2) exemption requires.

Finally, in 1974, the SEC, pursuant to its statutory rulemaking power, created a "safe harbor" in the form of Rule 146, which attempted to clarify the Section 4(2) exemption. Among other things, it required the preparation of extensive written disclosure, forbade advertisement of the offering and mandated that the offering could be made only to persons possessing (either personally or with their professional advisers) financial sophistication such that they could understand the risks and merits of the investment.

After eight years of experience with Rule 146, the SEC replaced it in 1982 with Rule 506, which retained much of the substance of the prior rule but created a class of persons defined as "accredited investors" who, if they meet certain objective standards of wealth, are conclusively *presumed* to be able to "fend for themselves." Rule 506 offerings have become the standard by which companies raise money privately from investors.

Prior to 1989, the Commission required the filing of Form D as a condition to the Rule 506 exemption: Form D was and is a relatively simple, "census"-like form by which issuers disclose the existence of their Rule 506 offering, a brief description of the offering's nature, amount and terms, the identity and addresses of management and any brokers, dealers or finders assisting in

the offering, the proposed application of the proceeds of the offering, and the identity of the U.S. jurisdictions in which the offering had been made. In 1989 the SEC amended its rules so as to no longer *require* the filing of a Form D as a condition to claiming the Rule 506 exemption, although the failure to so file may still result in sanctions.

This is where the law of Section 4(2) and “private placements” stood in 1996, when NSMIA was adopted. That statute’s inclusion of what is now Section 18(b)(4)(D) of the Securities Act was the result of a real problem, one of particular significance to smaller businesses.

### **The Impetus Behind Section 18(b)(4)(D).**

From the outset of Federal securities regulation, companies seeking to raise financing under the private placement exemption had not only to be concerned about complying with all the Federal exemption’s requirements, but also had to meet whatever requirements were imposed by each and every state in which the offering was to be made. Naturally, in circumstances where each state regulator was free to impose whatever criteria he or she felt appropriate for a given offering, the cost in both time and money could increase dramatically, as well as the uncertainty of planning.

It was a simple fact of life for many companies that, while the cost of full compliance with the *Federal* requirements for private offerings was generally, both in terms of time and money, predictable and reasonable, such was by no means always the case with *Blue Sky* requirements -- - despite certain Blue Sky regulators’ voluntary attempts at simplicity and uniformity. Further, the legal costs of complying with a particular state’s securities laws could be disproportionately high compared to the amount of capital the company hoped to raise from investors in that state, especially if only one or two state residents invested. There is simply no question that Federal preemption has succeeded in reducing the legal costs of raising capital, despite paying filing fees to each state where an offering is conducted (\$300 in Washington State).

Many members of our Committee have personal knowledge of numerous instances where issuers were met with regulatory demands at the state level which had nothing to do with the honesty of disclosure and everything to do with the particular regulator’s desire to re-write the business plans or models in the manner most pleasing to the regulator, subjectively deciding which companies’ offerings have “merit” --- and it was with just such problems in mind that Section 18(b)(4)(D) was enacted as a part of NSMIA.

But it is not our intention to argue for “legislation by anecdote.”

While Congress has recently heard testimony citing several examples of fraudulent securities offerings --- purportedly made, according to their promoters, pursuant to SEC Rule 506 --- and been told that such frauds might never have taken place had the states been allowed to require filings of the issuers and subject them to the scrutiny of registration, the simple reality is that the statute specifically permits states to require filing notices of offerings. The problem is that fraudsters do not file notices of their offerings, just as they typically do not prepare disclosure

documents disclosing their intentions or the falsity of their offerings. They simply don't file anything anywhere --- its saves them time, money and scrutiny.

The result? The companies which endure the time delays and substantial costs of pre-filing and vetting of their offerings are the honest ones.

If Congress retains the existing Federal policy that *private* offerings made solely to those who can fend for themselves should be exempt from the rigors, delays and costs that attend registered offerings made to the *public*, then the Committee believes that Section 18(b)(4)(D) should remain in the Securities Act as written. With the ever increasing inter-state communications and access to information, it is rare that private offerings are made to potential investors in just one state. To return to a system where each state can impose its own merit review of a placement could dramatically increase the time and costs of raising capital. Why, *especially in severe economic times like the present*, should we *now* return to a system that can guarantee only one thing for certain --- an increase in the costs and uncertainties of raising capital and, even *more* significantly, an increase which becomes proportionally harder the *smaller* the business in need of the financing?

### **The Problems with Section 926**

We initially took interest in this matter because the total repeal of Section 18(b)(4)(D) was included in a discussion draft of possible Senate legislative action circulated in November of 2009. We were aware that such proposal was only put forth for the purposes of public discussion, and that no bill previously considered or passed by this Congress has contained such a repeal provision --- including H.R. 4173, the "Wall Street Reform and Consumer Protection Act" passed by the House of Representatives on December 11, 2009 and now on referral to the Senate Committee on Banking, Housing and Urban Affairs.

We understand and appreciate that, as now introduced in the Senate, the Bill effectively leaves the repeal --- total or partial --- of Section 18(b)(4)(D) to the discretion of the Securities and Exchange Commission ("SEC), which Section 926 does by granting the SEC the authority to "designate, by rule, a class of securities that it deems not to be covered securities because the offering of such securities is not of sufficient size or scope," and then allows the individual states to impose their own, unique requirements on any such "non-covered" offerings.

In the event that the SEC chooses to exercise the discretion which Section 926 would grant, it is a certainty, given the Section's criteria *limiting* such discretion, that at least *small* business, if not bigger business as well, will be directly and adversely affected by a return to the pre-NSMIA system of having *one* set of Federal standards for private financings of business and 53 others belonging to the states, the District of Columbia, Puerto Rico and Guam.

If that were not bad enough, Section 926 then goes on to provide that the SEC must review any filings made in connection with those private offerings that *remain* "covered," and, if the Commission fails to do so, any security that was sold in that offering "shall no longer be a

covered security [unless] \* \* \* a State securities commissioner (or equivalent State officer) has determined that there has been a good faith and reasonable attempt by the issuer to comply with all applicable terms, conditions, and requirements of the filing; and (II) upon review of the filing, the State securities commissioner (or equivalent State officer) determines that any failure to comply with the applicable filing terms, conditions, and requirements are insignificant to the offering as a whole.”

The unfortunately ambiguous text leaves wide open the question as to whether any business could *ever* safely use the proceeds of its Rule 506 offering without escrowing the funds and nervously waiting an additional 120 days to see if the SEC does --- or does not --- “review” whatever filing it is that Section 926 is referring to --- *and, as explained above, no SEC filing is presently required as a condition to the validity of a Rule 506 offering.* And if the SEC, *for whatever reason*, fails to complete any such review within the 120 days, then the issuer’s claim of exemption will be destroyed, and the issuer thereby subjected to potential criminal, administrative and private civil liabilities through no fault of its own --- unless a State securities commissioner (or equivalent State officer), who has neither any *duty* nor, *perhaps more importantly*, any *incentive* whatsoever in the matter --- affirmatively determines that there has been a “good faith” and “reasonable” attempt by the issuer to comply with all applicable terms, conditions, and requirements of the *SEC* filing, and that any failure to comply with the applicable terms, conditions, and requirements of that *Federal* agency are “insignificant to the offering as a whole.”

An express invitation for a return to the days of crazy-quilt regulation of private securities financings could not have been better written. Assuming the SEC takes up Section 926’s offer of the power to exclude certain businesses from the benefits of “covered security” status --- the smaller, more “local” ones, whose offerings are “not of sufficient size or scope”--- then private securities financing of small business will be dependent *first* upon a Federal agency acting in a timely manner and *then*, if *that* fails, upon the *voluntary* action of a *state* regulator, who is told to interpret the *Federal* agency’s requirements --- but to do so according to that state regulator’s *subjective* views, with nothing but downside for that regulator if he/she gives that issuer the benefit of *any* doubt.

### **The Prevention of Fraud.**

We would like to make one final point.

In the words of a former Commissioner of the Securities and Exchange Commission, Sumner Pike, “Well, we *are* against fraud, *aren’t* we?”

Despite the implication that might be taken from certain public statements made by proponents of the repeal or modification of Section 18(b)(4)(D), the preemption of state registration requirements for offerings under SEC Rule 506 was not intended to and, we respectfully submit, *does not*, impair the states’ ability to prevent frauds upon their residents. As stated in the final report of the Conference Committee on that legislation:

The Managers have preserved the authority of the states to protect investors through application of state antifraud laws. This preservation of authority is intended to permit state securities regulators to continue to exercise their police power to prevent fraud and broker-dealer sales practice abuses, such as churning accounts or misleading customers. It does not preserve the authority of state securities regulators to regulate the securities registration and offering process through commenting on and/or imposing requirements on the contents of prospectuses or other offering documents, whether prior to their use in a state or after such use.

We believe that much of the concern shown by the opponents of Section 18(b)(4)(D) can be directly traced to a fear – not unjustifiable -- arising from the earliest reported case regarding Section 18(b)(4)(D), which held that all a defendant had to do to avoid all liabilities under state laws was to *claim* that its offering was pursuant to SEC Rule 506. Temple v. Gorman, 201 F. Supp. 2d 1238 (S.D. Fla. 2002).

Ignoring the plain wording of the statute -- that Federal preemption of state securities registration provisions is available only if the offering “*is exempt*” from Federal registration pursuant to SEC Rule 506 -- Temple and another Federal district court simply ignored the plain wording of the statute as well as decades of precedent holding that one who asserts an exemption under the Federal securities laws bears the burden of proving each and every element of that exemption. See SEC v. Ralston Purina Co., above.

To date, subsequent decisions, including those of both the state and Federal appellate courts, have almost uniformly rejected the holding in Temple. As discussed at length in a very recent law review article, Chadwick, "Proving Preemption by Proving Exemption: The Quandary of the National Securities Markets Improvement Act," 43 U. Rich. L. Rev. 764 (2009), the tide has clearly and strongly turned against those early decisions:

Passing arguments can be made to support the preemption of state law for all Rule 506 offerings, but it is nearly impossible to combat the unambiguous language of the statute. Recent case law has sharply criticized *Temple's* minority approach, and it is unlikely that future courts will endorse an interpretation that permits issuers to evade state liability by hiding behind Rule 506.

In short, we respectfully submit that those who claim that Section 18(b)(4)(D) is somehow an open loophole through which fraud may easily crawl are wholly mistaken. The plain language of the statute, as well as its legislative history, make it clear that the preemption created by that subsection is *only* available to those who *comply* with the securities registration exemption of SEC Rule 506, and only with respect to the *registration requirements* of state securities laws --- *not their anti-fraud provisions*, with respect to which the State securities regulators retain their formidable arsenals of remedies --- e.g., summary cease and desist orders, civil injunctive proceedings, orders of rescission/restitution, fines, suspension or revocation of licenses, and criminal prosecutions, for example --- not to mention the private rights of action that State

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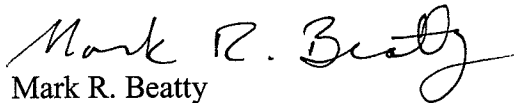
securities laws typically afford injured investors and which provide for rescission or damages, costs of court, statutory interest (a very healthy *eight percent (8%) per annum* in Washington State) and reasonable attorneys' fees.

### **Conclusion**

As a Committee, we firmly believe that Section 926 lacks any appreciation or understanding of the critical importance to smaller business of private placement financing, and of the mechanics by which such financing necessarily takes place. With community banks' ability to make loans to smaller businesses crippled from the recent collapse of the credit and real estate markets, a private securities offering may be the *only* remaining tool for many smaller businesses to raise the capital needed to fuel their survival, much less the growth and job creation on which our country's economy has so long depended. The adoption of Section 926, which will *undeniably* increase the uncertainties, delays, costs and restrictions already facing smaller businesses in their search for capital, cannot possibly be in the public's best interest. We strongly recommend that it be removed from the Bill in its entirety.

Thank you for your consideration in this matter.

Respectfully,



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