University of Richmond Law Review

Volume 43 | Issue 2 Article 7

1-1-2009

Proving Preemption by Proving Exemption: The Quandary of the National Securities Market Improvement Act

Jeffrey D. Chadwick
University of Richmond School of Law

COMMENT

PROVING PREEMPTION BY PROVING EXEMPTION: THE QUANDARY OF THE NATIONAL SECURITIES MARKET IMPROVEMENT ACT

I. INTRODUCTION

If the securities laws were etched on the stone tablets at Mt. Sinai, the first commandment would likely read: thou shall not defraud the investor. Above all, the goal of regulating the securities field is to protect investors from trickery, deceit, and fraudulent schemes.[1] The states and the federal government have approached this task differently, and the interaction between dueling regulations has created a complex set of rules that many find difficult to navigate.[2] There are obvious drawbacks to both the under-regulation and the over-regulation of the securities market, and achieving the proper balance has perplexed lawmakers for decades.[3] For instance, under-regulation can threaten the very core of the market by permitting con artists to evade liability by manipulating the field and deceiving investors.[4] Over-

1. *See* Kenneth I. Denos, *Blue and Gray Skies: The National Securities Markets Improvement Act of 1996 Makes the Case for Uniformity in State Securities Law*, 1997 UTAH L. REV. 101, 104 (1997); Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement*, 11 CONN. INS. L.J. 107, 112 (2004) [hereinafter *Dynamic Federalism*]; *see also* Rutherford B. Campbell, Jr., *Blue Sky Laws and the Recent Congressional Preemption Failure*, 22 J. CORP. L. 175, 176 (1997) (describing securities law as a response to perceived bargaining failures).

2. *See* Renee M. Jones, *Does Federalism Matter? Its Perplexing Role in the Corporate Governance Debate*, 41 WAKE FOREST L. REV. 879, 890 (2006) [hereinafter *Does Federalism Matter?*].

3. *See generally Does Federalism Matter?*, *supra* note 2 (discussing the competing interests of investors, state governments, and federal law).

4. *See* Denos, *supra* note 1, at 103–04 (describing how regulation of the securities

regulation, on the other hand, stunts capital formation by forcing issuers to register their securities with both the federal government and state authorities.[5]

The tug of war between under- and over-regulation prompted Congress to enact the National Securities Market Improvement Act ("NSMIA"), which sought to balance investor protection with the need to streamline the securities registration process.[6] The basic tool is preemption, as the NSMIA prohibits states from regulating or requiring the registration of federally "covered" securities, including those securities exempt from federal registration.[7] Though the NSMIA was supposed to revolutionize the securities registration process,[8] the NSMIA's effectiveness has been limited to exempt private offerings[9] made under Rule 506 of Regulation D.[10] One issue that has been bubbling in lower courts is whether the NSMIA preempts state law whenever a securities offering is made *pursuant to* Rule 506, but does not *actually comply* with the Rule's substantive requirements.[11] In other words, must a defendant "prove preemption by proving exemption"?[12] The remainder of this comment explores decisions that have confronted this issue and the significance of the preemption-by-exemption debate. Part II examines the development of the security field's dual regulatory system and the mechanics of proving NSMIA preemption. Part III surveys the state and federal decisions addressing the preemption-by-exemption issue. Part IV analyzes the merits of the majority and minority arguments and frames the debate against the continued role of federalism in securities regulation reform. Part V concludes.

---

field increased drastically after the stock market crash of 1929); *see also* Brown v. Earthboard Sports USA, Inc., 481 F.3d 901, 911 (6th Cir. 2007) (illustrating the need to deter securities violators from evading state registration requirements).

5. *See Denos*, supra note 1, at 106 (explaining that issuers "not only had to comply with increasingly labyrinthine federal requirements, but also faced fifty similarly worded statutes interpreted by state courts and regulators who viewed their duty to investors from a completely different perspective").

6. *See* H.R. REP. NO. 104-622, at 16–17 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3878–79.

7. *See* 15 U.S.C. § 77r(a) (2006).

8. *See* Campbell, *supra* note 1, at 203.

9. *See* Douglas J. Dorsch, *The National Securities Market Improvement Act: How Improved Is the Securities Market?*, 36 DUQ. L. REV. 365, 386 (1998).

10. *See* 17 C.F.R. § 230.506 (2008).

11. *See, e.g.*, Grubka v. WebAccess Int'l, Inc., 445 F. Supp. 2d 1259, 1269 (D. Colo. 2006).

12. *See id.*

II. DEVELOPMENT OF THE SECURITIES LAWS AND NSMIA PREEMPTION

A. *Development of the Dual Regulatory System*

The states adopted the first measures to protect investors, with Kansas enacting the first blue sky statute in 1911.[13] Even though every state except Nevada had an investor protection statute before Congress intervened, early state legislation was largely unsuccessful.[14] The states' failure led to widespread securities fraud and was a major catalyst for the stock market crash of 1929.[15] Amidst the Great Depression, President Franklin Roosevelt recognized the need for federal regulation and implored Congress to enact the Securities Act of 1933 (the "Securities Act")[16] and the Securities Exchange Act of 1934 (the "Exchange Act").[17] The Securities Act regulated the sale of securities to the general public in the primary market, and the Exchange Act created the Securities and Exchange Commission (the "SEC") to regulate the resale or exchange of securities in the secondary market.[18] With a necessary degree of overlap, the two Acts aimed to eradicate fraud in the marketplace "by requiring proper registration of securities and full disclosure of all 'material information' to investors."[19]

While the federal government could have preempted the entire field of state securities regulation,[20] it merely supplemented existing state law and created a dual system of regulatory enforce-

13. *See Dynamic Federalism*, *supra* note 1, at 111.

14. *Id.* at 111–12.

15. *See* Denos, *supra* note 1, at 104.

16. Securities Act of 1933, ch. 38, sec. 1, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§ 77a–77aa (2006)).

17. Securities Exchange Act of 1934, ch. 404, sec. 1, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a–78nn (1994)); *see also* Denos, *supra* note 1, at 104 (describing the heightened speculation that proceeded the stock market crash and gave the 1932 Congress the political wherewithal to begin regulating the securities field); Dorsch, *supra* note 9, at 367 (explaining Roosevelt's New Deal legislation).

18. *See* Michael W. Ott, *Delaware Strikes Back:* Newcastle Partners *and the Fight for State Corporate Autonomy*, 82 IND. L.J. 159, 164–65 (2007).

19. Dorsch, *supra* note 9, at 367.

20. Congress arguably has the power to preempt the entire field of interstate securities regulation under the Commerce Clause, U.S. CONST. art. I, § 8, cl. 3, which gives Congress the authority to "regulate Commerce . . . among the several States." *Id.* For a good explanation of the logistics of implementing a completely federal scheme, see Dorsch, *supra* note 9, at 393.

ment.[21] The division of power was fueled by competing philosophies: the federal government believed the best way to protect investors was by eliciting full disclosure of investment opportunities, and the states believed a stronger system would permit state authorities to review the merits of securities before they could be sold in their jurisdiction.[22] Though theoretically opposed, the two philosophies were designed to work together to avoid the pitfalls that precipitated the 1929 crash.[23]

As the dual regulatory system evolved, the cry for uniformity became louder and louder.[24] The basic problem was that different states had different laws,[25] and even if the states had the same laws, they would be interpreted differently.[26] Because the steep transaction costs of federal and multi-state compliance stymied many small issuers, capital formation was stunted.[27] While

21. *See* Ott, *supra* note 18, at 164.

22. *See* Denos, *supra* note 1, at 110–11 (stating that the federal system was premised on the "notion that the availability of information would allow the market to evaluate investments, but would not . . . try to keep investors from making bad bargains," while the states acted like "'local cops on the beat'" to patrol the "worthiness of securities issued in their locale" (citing Douglas M. Branson & Karl Shumpei Okamoto, *The Supreme Court's Literalism and the Definition of "Security" in State Courts*, 50 WASH. & LEE. L. REV. 1043, 1045–48 (1993))); *see also* Campbell, *supra* note 1, at 177 (describing the disclosure versus merit review distinction between federal and state regulatory regimes as one of procedure versus substance); Dorsch, *supra* note 9, at 368 (pointing out that the "SEC does not regulate the price of securities," but "merely ensures that investors are provided with adequate information when purchasing securities by subjecting issuers to a detailed registration and disclosure regime.").

23. *See* LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 57–59 (3d ed. 1989); *see also* Denos, *supra* note 1, at 111 (describing the interaction between federal and state securities regulations); *Does Federalism Matter?*, *supra* note 2, at 889 (acknowledging conventional wisdom that states exercise local enforcement duties and the SEC handles setting national policy objectives).

24. *See* LOSS & SELIGMAN, *supra* note 23, at 43 ("It would be difficult to think of any area of the law where uniformity is so essential."); *see also* H.R. REP. NO. 104-864, at 39 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3920, 3920 (chronicling the systemic problems with the dual regulatory system).

25. *See* Denos, *supra* note 1, at 125 (describing state securities laws as "a balkanized array of statutes with little resemblance to each other" that "were extremely imposing for multistate issuers").

26. *See id.* at 126 (explaining that interpretation of verbatim provisions of the Uniform Securities Act varied as much as the judges and regulators attempting to interpret them).

27. *See Does Federalism Matter?*, *supra* note 2, at 889–90 (explaining how the lack of uniformity caused corporations to complain "that the system was duplicative and wasteful because it required companies to contend with the costs and inconvenience of complying with federal securities laws as well [as] the laws of every state in which their securities traded"). Apple Computer's initial public offering is a good example of how varied state regulation can stunt capital growth. *See* Denos, *supra* note 1, at 112. In 1980, twenty states refused to approve the offering because it was "too risky," despite being underwrit-

$50,000 transaction costs were a drop in the bucket for mega-corporations, smaller companies were often deterred from raising startup or investment capital.[28] Congress, the states, and the SEC attempted to quell these concerns through mechanisms such as the Uniform Securities Act,[29] the Uniform Limited Offering Exemption,[30] and the Small Corporate Offering Registration,[31] but each attempt failed to fix the systemic ills of the dual regulatory system.[32]

Discouraged by the omnipresent failure to unify state and federal law,[33] Congress decided to alleviate some of the tension by preempting state regulatory authority, thereby permitting certain

---

ten by Morgan Stanley and achieving a very high appraisal. *See id.* As we know now, the offering was very lucrative for investors.

28. *See* Dorsch, *supra* note 9, at 392 ("Compliance costs of $100,000 are more easily swallowed by an issuer of $7,000,000 of securities than by an issuer of only $250,000.").

29. The Uniform Securities Act, which was designed to unify state law and coordinate the interpretation of it with the federal system, was approved by the National Conference of Commissioners on Uniform State Laws in 1956. UNIF. SEC. ACT (amended 1988), 7C U.L.A. 215 prefatory note (2006). The Act, adopted by forty-one states, embraced the traditional state philosophy of merit review. *See generally* Denos, *supra* note 1, at 125–26 (discussing various provisions of the Uniform Securities Act and its subsequent failure to bring uniformity to the state of securities regulation).

30. The Uniform Limited Offering Exemption ("ULOE") is largely a derivation of a Securities Act provision which exempted private securities offerings from federal registration requirements. *See* 15 U.S.C. § 77d(2) (2006) (exempting transactions "not involving any public offering"); Denos, *supra* note 1, at 126. The ULOE is significant to the NSMIA because it prompted the SEC to develop Regulation D, which is a series of rules providing safe harbors for issuers seeking exemption under section 4(2) of the Securities Act. *See* Regulation D, 17 C.F.R. §§ 230.501–508 (2008). For more detailed discussion of Regulation D, see *infra* Part II.B. For a discussion of the ULOE's failures to achieve uniformity, see generally Campbell, *supra* note 1, at 188–89.

31. The Small Corporate Offering Registration ("SCOR") was designed by the SEC and several states to alleviate the difficulties of multistate compliance to produce a single form for offerings under Regulation A or Rule 504 of Regulation D. *See* Denos, *supra* note 1, at 129. For an example of a manual used to help companies complete the registration process, see N. AM. SEC. ADMIN. ASS'N, N. AM. SEC. ADMIN. ASS'N SMALL COMPANY OFFERING REGISTRATION MANUAL (1999), *available at* http://www.nasaa.org/industry___Regulatory_Resources/Corporation_Finance/564.cfm. (follow "Issuer's Manual for Form U-7" hyperlink") (last visited Dec. 11, 2008). Though the adoption of SCOR did not repair the systemic ills of the dual regulatory system, it was significantly more successful in helping small issuers than the Uniform Securities Act or the ULOE. *See* Denos, *supra* note 1, at 130.

32. *See generally* Denos, *supra* note 1, at 124–30 (examining the botched attempts at unifying the securities field).

33. In his testimony before the Senate Committee on Banking, Housing, and Urban Affairs, SEC Chairman Arthur Levitt admitted that "[t]he current system of dual federal-state regulation is not the system that Congress—or the Commission—would create today if we were designing a new system." *See* S. REP. NO 104-293, at 2 (1996), *available at* 1996 WL 367191.

securities offerings to comply with just one set of rules.[34] The touchstone pieces of federal preemption legislation were the Private Securities Litigation Reform Act of 1995 ("PSLRA"),[35] the NSMIA,[36] and the Securities Litigation Uniform Standards Act of 1998 ("SLUSA").[37] Commentators generally view the NSMIA as the most detrimental piece of federal regulation to the dual regulatory system.[38] It was enacted, after all, with the express purpose of "eliminat[ing] the costs and burdens of duplicative and unnecessary regulation by, as a general rule, designating the Federal government as the exclusive regulator of national offerings of securities."[39] Similar to Roosevelt's New Deal legislation, Congress did not preempt the entire securities field, but balanced the need to reduce compliance costs with the established goal of investor protection.[40] Principally, states retained the authority to investigate and prosecute securities fraud within their jurisdiction, to require the notice filing of any document filed with SEC, and to require the payment of filing or registration fees in effect before NSMIA enactment.[41]

---

34. *See Does Federalism Matter?*, *supra* note 2, at 894 (explaining that the preemption legislation "overturned a seventy-year tradition of federal deference to state authority in the securities arena"); *Dynamic Federalism*, *supra* note 1, at 113–14 (describing a series of federal attacks on state regulatory power in the securities field); *see also* Campbell, *supra* note 1, at 196 (describing the essence of preemption as the notion that "states no longer have the authority to enact rules requiring the registration or merit qualification of certain securities or with respect to certain transactions").

35. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.). The PSLRA dramatically changed securities fraud claims by raising pleading standards and enacting lead plaintiff provisions for securities class actions. *See id*; *see also Dynamic Federalism*, *supra* note 1, at 113 n.27.

36. Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified as amended in scattered sections of 15 U.S.C.).

37. Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified as amended in scattered sections of 15 U.S.C.). The SLUSA preempts class action suits for securities fraud based on state law when the securities at issue are a "covered security." *See Dynamic Federalism*, *supra* note 1, at 113–14 & n.29.

38. *See* Manning Gilbert Warren III, *Reflections on Dual Regulation of Securities: A Case for Reallocation of Regulatory Responsibilities*, 78 WASH. U. L.Q. 497, 499 (2000) ("[In passing the NSMIA, Congress] inflicted a severe, if not fatal, wound on the dual system of securities regulation that had protected investors and their marketplace since the end of the Great Depression.").

39. H.R. REP. NO. 104-622, at 16 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3878.

40. *See id.* at 17, *reprinted in* 1996 U.S.C.C.A.N. at 3879; *see also* Denos, *supra* note 1, at 131 (stating that NSMIA advocates believed the legislation "would simultaneously lower the cost of raising money and increase investor protection").

41. 15 U.S.C. § 77r(c) (2006). The preservation of state authority corresponds with the NSMIA's stated intent to permit state governments "to regulate small, regional, or intrastate securities offerings, and to bring actions pursuant to State laws and regulations pro-

Detractors of federal preemption legislation may have valid gripes about the NSMIA's effectiveness,[42] but Congress's decision to "rethink the system of dual Federal and State securities regulation" was a step in the right direction.[43] The simple fact is that federal preemption is a viable alternative to the patchwork quilt of multi-state regulation.[44]

B. *The Mechanics of NSMIA Preemption*

The foregoing illustrates the reactive nature of securities regulation. Investors suffer from an under-regulated field, and the law reacts with a spattering of state and federal regulation. In turn, investors suffer from an over-regulated field, and the law reacts by attempting to unify a dual system, ultimately choosing one regulatory level over the other.[45] The following explores one of the latest links in the reactive chain, the NSMIA preemption of state law for covered securities.

At its core, the NSMIA prohibits states from regulating federally covered securities.[46] Covered securities include transactions

---

hibiting fraud and deceit, including broker-dealer sales practices abuses." *See* H.R. REP. NO. 104-622, at 16 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3878.

42. The many arguments for securities reform go well beyond the scope of this comment. For general views regarding the failure of the NSMIA and recommended changes to securities regulation, *see generally* Campbell, *supra* note 1; Dorsch, *supra* note 9; Lanny A. Schwartz, *Suggestions for Procedural Reform in Securities Market Regulation*, 1 BROOK. J. CORP. FIN. & COM. L. 409 (2007); Warren, *supra* note 38.

43. *See* H.R. REP. NO. 104-622, at 16 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3878.

44. For a particularly scathing critique of blue sky regulations, see J. Sinclair Armstrong, *The Blue Sky Laws*, 44 VA. L. REV. 713, 714 (1958). The former SEC commissioner chastises blue sky laws for their "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." *Id.* at 714–15.

45. *See generally Does Federalism Matter?*, *supra* note 2 (discussing the tug of war between investors, state governments, and federal law).

46. In pertinent part, Title 15, section 77r(a) of the United States Code states:

> Except as otherwise provided in this section, no law, rule, regulation, or order, or other administrative action of any State or any political subdivision thereof—
>
> (1) requiring, or with respect to, registration or qualification of securities, or registration or qualification of securities transactions, shall directly or indirectly apply to a security that—
>
> (A) is a covered security; or
>
> (B) will be a covered security upon completion of the transaction;
>
> (2) shall directly or indirectly prohibit, limit, or impose any conditions upon the use of—

that are exempt from federal registration under the Securities Act.[47] If a security is exempt, then the issuer is not required to register its offering with the SEC prior to a security being offered or sold.[48] There are a number of transactions exempted from the registration requirement, the most pertinent of which are "transactions by an issuer not involving any public offering."[49] To provide a sense of clarity to the private offering exemption, the SEC adopted Regulation D, which provides a safe harbor for issuers complying with the Regulation's substantive requirements.[50] Regulation D includes private offerings made pursuant to Rule 506, which have experienced the most tangible change since the enactment of the NSMIA's preemption scheme.[51]

A brief explanation of the interaction between Rule 506 offerings and NSMIA preemption is helpful in framing the preemption-by-exemption debate. In the typical situation, an issuer will invoke Rule 506 when he is selling securities to a private individual or investment company and does not want to register the sale

> (A) with respect to a covered security described in subsection (b) of this section, any offering document that is prepared by or on behalf of the issuer; or
> (B) any proxy statement, report to shareholders, or other disclosure document relating to a covered security or the issuer thereof that is required to be and is filed with the Commission or any national securities organization registered under section 78o-3 of this title, except that this subparagraph does not apply to the laws, rules, regulations, or orders, or other administrative actions of the State of incorporation of the issuer; or
> (3) shall directly or indirectly prohibit, limit, or impose conditions, based on the merits of such offering or issuer, upon the offer or sale of any security described in paragraph (1).

15 U.S.C. § 77r(a) (2006).

47. *Id.* § 77r(b); *see also* Campbell, *supra* note 1, at 196–99 (explaining the Act's definition of covered securities). Securities are also covered if they are listed on a national exchange, are issued by an investment company registered under the Investment Company Act of 1940, or are sold to a qualified purchaser. 15 U.S.C. § 77r(b).

48. *See* 15 U.S.C. § 77r. For an example of state registration requirements, see GA. CODE ANN. § 10-5-5(a) (West 2000) ("It shall be unlawful for any person to offer or to sell any securities to any person in this state unless: (1) They are subject to an effective registration statement under this chapter; (2) The security or transaction is exempt under Code Section 10-5-8 or Code Section 10-5-9, respectively; or (3) The security is a federally covered security.").

49. *See, e.g.*, 15 U.S.C. § 77d. Though there are multiple exemptions available to various types of issuers and transactions, this comment will only explore exemption under Rule 506 of Regulation D.

50. *See* 17 C.F.R. §§ 230.501–.508 (2008).

51. *See* Campbell, *supra* note 1, at 205; *see also* Dorsch, *supra* note 9, at 386 (asserting that with regard to 506 offerings, the NSMIA has finally "created a situation which actually benefits the issuer").

formally with the SEC.[52] Though there is no limitation on the total offering price,[53] in order to be exempt from registration, an issuer must meet three principal conditions.[54] First, the private offering must satisfy the general conditions of Rules 501 and 502, which define the levels of purchaser sophistication, limit the combination of multiple offerings which would evade Regulation D requirements, and prohibit general solicitation.[55] Second, while there is no limit on the amount of accredited investors that may participate in the offer, there can be no more than thirty-five purchasers.[56] Third, each purchaser, or non-accredited investor, must possess sufficient "knowledge and experience in financial and business matters" to evaluate capably the merits and risks of the investment.[57] While Regulation D specifically accounts for an honest failure to comply with an insignificant condition of the exemption,[58] prudent investors file a Form D with the SEC, notifying the Commission of the impending or completed sale of unregistered securities.[59] Should an issuer fail to meet the requirements of Rule 506, the securities are not exempt from registration with the SEC, and the purchaser of the securities may bring an action for the sale of unregistered securities to rescind the transaction and recover the consideration paid.[60]

When an issuer makes a private offering pursuant to Rule 506 of Regulation D and complies with all of the Rule's substantive requirements, the offering will be exempt from registration with the SEC.[61] Under the NSMIA's preemption scheme, the exempt private offering will be considered a covered security and neither the transaction nor the issuer will be subject to state regulation or liability.[62] But what happens when an issuer fails to meet a mandatory requirement of Rule 506, and the securities offering is not actually exempt from federal registration? Is the federal gov-

52. *See* 17 C.F.R. § 230.506. The Rule 506 exemption is an issuer-only exemption. *Id.*

53. *See id.*; *see also* Dorsch, *supra* note 9, at 385 (delineating the requirements of a Rule 506 offering).

54. *See* 17 C.F.R. § 230.506.

55. *See* 17 C.F.R. §§ 230.501–.502.

56. *See id.* § 230.506. An "accredited investor" is defined by Rule 501. *Id.* § 230.501(a).

57. *Id.* § 230.506b(2)(ii).

58. *See id.* § 230.508.

59. *See id.* § 230.503.

60. *See* 15 U.S.C. § 77l (2006).

61. *See* 17 C.F.R. § 230.506.

62. *See* 15 U.S.C. §§ 77(d)(2), 77r(b)(4)(D) (2006).

ernment still the exclusive regulator of all private offerings purporting to comply with Rule 506? Or are the states permitted to enforce their blue sky laws against violators who claim Rule 506 compliance, but do not actually meet the Rule's substantive requirements? In other words, when an issuer finds himself a state law defendant for the sale of unregistered securities, must he "prove preemption . . . by proving exemption"?[63] The answer, it turns out, is an important one. Not only is the statute of limitations much shorter under the NSMIA than under the blue sky laws of most states,[64] engaging in the preemption-by-exemption debate may affect the role of federalism in future securities reform efforts.

III. PREEMPTION-BY-EXEMPTION JURISPRUDENCE

The issue of whether the NSMIA preempts state blue sky law when an unregistered security was offered pursuant to, but did not actually qualify for, a federal exemption first reached the courts in 2002,[65] six years after the NSMIA was enacted.[66] Since then, state and federal decisions have carved out clear majority and minority positions. The majority view, first articulated in *Buist v. Time Domain Corporation*, only preempts state law when the unregistered security offering actually complies with the federal exemption requirements of Rule 506 of Regulation D.[67] The minority view, stated first by *Temple v. Gorman*, preempts state law whenever the unregistered security is offered pursuant to a federal exemption, regardless of whether the offering meets the exemption's substantive requirements.[68] The following case survey illustrates that recent decisions, including one from the Sixth Circuit,[69] have trended towards the majority position, relying on both statutory and policy-based arguments.

63. *See* Grubka v. WebAccess Int'l, Inc., 445 F. Supp. 2d 1259, 1269 (D. Colo. 2006) (framing the preemption-by-exemption issue).

64. *Compare* 15 U.S.C. § 77m, *with* OKLA. STAT. ANN. tit. 12, § 95 (West 2000 & Cum. Supp. 2008).

65. *See* Temple v. Gorman, 201 F. Supp. 2d 1238 (S.D. Fla. 2002).

66. Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.).

67. 926 So. 2d 290, 297–98 (Ala. 2005).

68. *See Temple*, 201 F. Supp. 2d at 1244.

69. *See* Brown v. Earthboard Sports USA, Inc., 481 F.3d 901 (6th Cir. 2007).

A. Temple v. Gorman

Although several cases referenced the preemption-by-exemption dilemma prior to 2002,[70] *Temple* was the first published decision to examine the matter with any finality.[71] *Temple* concerned the private sale of eight million shares of eCampus.com stock.[72] The purchasers of the eCampus securities sued the sellers to rescind the sale, alleging that the securities were not properly registered with the SEC or the state of Florida.[73] The sellers, who filed a Form D with the SEC, argued that Florida's blue sky law was preempted because the securities were sold pursuant to Rule 506 of Regulation D.[74] The investors claimed that the offering was not exempt from federal registration because it failed to comply with Rule 506's substantive requirements.[75] Because the securities were not exempt from federal registration, the investors contended, they were not covered securities and Florida law was not preempted.[76]

In a case of first impression, the *Temple* court relied on the Congressional purpose of the NSMIA "to . . . eliminate the costs and burdens of duplicative and unnecessary regulation by, as a general rule, designating the Federal government as the exclusive regulator of national offerings of securities."[77] Without analyzing the statute itself, the court summarily found the eCampus stock a federally "covered security" because it was sold *pursuant*

70. *See, e.g.*, Zuri-Invest AG v. Natwest Fin. Inc., 177 F. Supp. 2d 189, 197 (S.D.N.Y. 2001) (stating that the NSMIA does not automatically preempt state securities fraud claims); Myers v. Merrill Lynch & Co., No. C-98-3532, 1999 WL 696082, at *9 (N.D. Cal. Aug. 23, 1999) (finding that plaintiff's claims for discriminatory bid practices were preempted by the NSMIA pursuant to SEC Regulation M).

71. *See Temple*, 201 F. Supp. 2d at 1244.

72. *Id.* at 1239.

73. *Id.* at 1240. The typical federal cause of action is brought under Section 12(a)(1) of the Securities Act for the sale of unregistered securities. *See* 15 U.S.C. § 771 (2006).

74. *Temple*, 201 F. Supp. 2d at 1240. The defendants comtended that the federal claim was time-barred by the Securities Act's one-year statute of limitations and that the state claim was preempted by the NSMIA. *Id.*; *see also* 15 U.S.C. § 77m (2006). The court heard, and ultimately agreed with, these arguments on defendants' motion to dismiss. *Temple*, 201 F. Supp. 2d at 1244.

75. *Temple*, 201 F. Supp. 2d at 1243. Specifically, the plaintiffs maintained that "the presence of unaccredited investors triggered certain information and auditing requirements, with which the private placement did not comply." *Id.* at 1240.

76. *Id.* at 1243.

77. *Id.* (quoting H.R. REP. NO. 104-622, at 16 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3878). Surprisingly, the court seemed to focus more on congressional intent than the statute itself. *Id.* at 1244.

to Rule 506 of Regulation D.[78] The court explained, "[r]egardless of whether the private placement actually complied with the substantive requirements of Regulation D or Rule 506, the securities sold to Plaintiffs are federal 'covered securities' because they were sold pursuant to those rules."[79] As a result, the *Temple* rule preempts state blue sky law whenever the offering is made pursuant to Rule 506, regardless of actual compliance.[80]

B. Lillard v. Stockton

After *Temple*, the Northern District of Oklahoma addressed the preemption-by-exemption problem in *Lillard v. Stockton*.[81] *Lillard* presented a securities fraud case where hedge fund investors sued administrators of the fund for breach of fiduciary duty, securities fraud, negligence, and the sale of unregistered securities.[82] The cause of action for the sale of unregistered securities included federal and state claims, both of which came to the court on the defendants' motion to dismiss.[83] The defendants cited *Temple*, arguing that the federal claim was time-barred and the state claim, which benefited from a longer limitations period, was preempted by the NSMIA.[84] Like *Temple*, the *Lillard* court referenced the NSMIA's congressional intent to reduce the burdens of a duplicative regulatory system by appointing the federal government as the sole regulator of national securities offerings.[85] The court granted the defendants' motion to dismiss the plaintiff's claim for the sale of unregistered securities under Oklahoma law, holding that because the securities were offered pursuant to Rule 506, the NSMIA preempted the application of Oklahoma law.[86] Though implicitly approving *Temple*, the court noted that the NSMIA preemption argument, which was raised in the de-

78. *Id.* at 1243.
79. *Id.* at 1244.
80. *Id.*
81. 267 F. Supp. 2d 1081 (N.D. Okla. 2003).
82. *Id.* at 1090–91.
83. *Id.* at 1114; *see also* 15 U.S.C. § 77l (2006); OKLA. STAT. ANN. tit. 71, §§ 301, 408(a)(1) (2002) (repealed 2004).
84. *Lillard*, 267 F. Supp. 2d at 1114.
85. *See id.* at 1115.
86. *Id.* at 1116.

fendants' reply brief, was never countered by the plaintiffs in their brief or at oral argument.[87]

C. Buist v. Time Domain Corp.

After two federal decisions found preemption regardless of Regulation D compliance, the Supreme Court of Alabama rejected the *Temple* approach in *Buist v. Time Domain Corp.*[88] There, Buist purchased Time Domain stock and debt securities directly from the corporation in a private offering.[89] A few months later, Buist discovered that new investors were taking control of Time Domain and under the reorganization, each Time Domain shareholder would receive one share of the new class of stock for every sixty-nine shares of existing Time Domain stock.[90] Buist objected to the reorganization and demanded payment plus interest on his debt securities.[91] His demands were rejected and Buist sued Time Domain under a number of legal theories, such as minority shareholder oppression, bad faith, and violation of the Alabama Securities Act ("ASA") for the sale of unregistered securities.[92] Time Domain filed a motion for partial summary judgment based on NSMIA preemption.[93] Time Domain argued that the securities were "covered securities" because they were sold pursuant to Rule 506 of Regulation D and, as a result, federal law preempted any ASA violation.[94] Buist argued that the securities were not covered because Time Domain failed to prove that the private offering actually complied with the substantive requirements of Rule

87. *Id.*

88. 926 So. 2d 290, 297–98 (Ala. 2005). Prior to *Buist*, the Western District of Kentucky referenced *Temple* in an unpublished decision. *See* Myers v. OTR Media, Inc., 2005 WL 2100996, at *5 n.2 (W.D. Ky. Aug. 30, 2005). Although the *Myers* court specifically mentioned that its holding relieved the court from expressing an opinion on *Temple* and *Lillard*, *see id.*, the court denied a motion for summary judgment because there were questions of fact concerning the offeror's compliance with Rule 506. *See id.* at *5. The court's decision to punt the *Temple* issue is questionable, then, because the court acknowledged that the issuer's compliance with Rule 506 was a material issue of genuine fact, which precluded summary judgment. *See id. Temple*, of course, held that compliance with Rule 506 was immaterial. *See* Temple v. Gorman, 201 F. Supp. 2d 1238, 1244 (S.D. Fla. 2002).

89. *Buist*, 926 So. 2d at 292.

90. *Id.* The stock exchange scheme is referred to as a "reverse split." *Id.*

91. *Id.*

92. *Id.*

93. *Id.*

94. *Id.* Time Domain buttressed its motion for partial summary judgment with evidence of two Form Ds filed with the Alabama Securities Commission and the Commission's findings that both filings met its requirements. *Id.*

506.[95] The trial court granted Time Domain's partial summary judgment motion and Buist appealed.[96]

The Supreme Court of Alabama first noted that federal preemption was an affirmative defense with the burden of proof on the defendant.[97] After outlining the interaction between the ASA and the NSMIA,[98] the court examined the parties' competing arguments.[99] Relying on *Temple* and *Lillard,* Time Domain contended that exemption was a separate analysis from preemption.[100] In other words, a defendant with the burden of proving federal preemption is not required to prove that the challenged securities sale was actually exempt from federal registration, but only that the sale was offered pursuant to Rule 506 of Regulation D.[101] Buist argued that because exemption and preemption were functionally equivalent, the only way to prove preemption was to prove that a securities sale met the requirements of Regulation D.[102] The court agreed with Buist, holding that "a failure to comply with a requirement of Rule 506 'voids' the exemption, thereby eliminating the possibility of preemption."[103] Though acknowledging *Temple* and *Lillard* as persuasive authority, the court rejected their line of reasoning as "*ipse dixit* without any accompanying analysis."[104] Specifically, the court emphasized *Temple*'s lack of caselaw or supporting authority and *Lillard*'s bare re-

95. *Id.* at 292–93.

96. *Id.* at 293.

97. *Id.* The court emphasized that summary judgment may only be granted where there is no issue of material fact regarding an affirmative defense. *Id.* (citing Wal-Mart Stores, Inc. v. Smitherman, 743 So. 2d 442, 445 (Ala. 1999)).

98. *Id.* at 294. The ASA generally requires securities sales to be registered with the state unless they are exempted by the Alabama Securities Commission or preempted by federal law. *See id.* Time Domain was relying on federal preemption, which follows the statutory scheme outlined *supra* part II.B.

99. *Buist*, 926 So. 2d at 295–96.

100. *Id.* at 296 (presenting the defendant's argument that "preemption entails a much lower burden than proving exemption").

101. *Id.*

102. *Id.* at 295–96.

103. *Id.* at 296. In addition to rejecting *Temple*'s logic, the court based its holding on *In re* Cherokee Energy Co., Order No. CD-2003-02, (Ala. Sec. Comm'n Feb. 4, 2003), http://www.asc.state.al.us/Orders/2003/CD-2003-0002.pdf, a case decided by the Alabama Securities Commission. *Buist*, 926 So. 2d at 296. In *Cherokee Energy*, the Commission found that a dealer violated Rule 502, which prohibited general solicitation, by selling unregistered securities to Alabama residents. *Cherokee Energy*, at 4; *see Buist*, 926 So. 2d at 296. The Commission ordered the dealer to stop selling the securities because the sales failed to comply with Regulation D, voiding the federal exemption and "covered securities" status provided for in the NSMIA. *Cherokee Energy*, at 4–5; *see Buist*, 926 So. 2d at 296.

104. *Buist*, 926 So. 2d at 297.

liance on *Temple*.[105] Because Time Domain's Form Ds were not sufficient to prove compliance with Rule 506, the burden of federal preemption never shifted to Buist to demonstrate an issue of material fact.[106] Therefore, the court reversed Time Domain's motion for partial summary judgment and remanded for further proceedings.[107]

D. AFA Private Equity Fund v. Miresco Investment Services

In 2005, the Eastern District of Michigan decided *AFA Private Equity Fund v. Miresco Investment Services*.[108] The plaintiffs brought a cause of action under Michigan's Uniform Securities Act for the sale of unregistered securities, which the defendant argued should be dismissed due to NSMIA preemption.[109] Though some authorities cite *Miresco* as tacit approval of *Buist*,[110] the court's approach is not that simple. Just as the Supreme Court of Alabama did in *Buist*, the court denied the defendant's motion for partial summary judgment because the defendant failed to meet its burden of proving federal exemption.[111] What remains unclear, however, is whether the court required actual Regulation D exemption to prove NSMIA preemption. In its abbreviated analysis, the court failed to mention any specifics of the securities offering or whether the defendant had filed Form

105. *Id.* It is somewhat ironic that the *Buist* Court derided *Temple* for its lack of authority. After all, *Buist* itself only rested on the shaky pillars of an Alabama Securities Commission decision that was entitled to no deference whatsoever. *See id.* at 296.

106. *Id.* at 298. Earlier, the court noted that the Alabama Securities Commission did not review the Form Ds, which constituted notice filing, for substantive compliance with federal exemption procedures. *Id.* at 295.

107. *Id.* at 298. *Buist* also contained concurring and dissenting opinions. Justice Lyons concurred, but only to emphasize that Time Domain showed a future promise to comply with Rule 506. *Id.* (Lyons, J., concurring). If Time Domain had shown more, the burden would have shifted to Buist to demonstrate a genuine issue of material fact. *Id.* A dissent by Justice Harwood also failed to offer any insight into the preemption-by-exemption debate. *See id.* at 298–303 (Harwood, J., dissenting). Instead of contradicting the main premise of the majority's rationale, Harwood focused on Buist's failed procedure to preserve the preemption argument and the specifics of Rule 506 compliance. *See id.* at 298–302.

108. No. 02-74650, 2005 WL 2417116 (E.D. Mich. Sept. 30, 2005).

109. *Id.* at *4, *9.

110. *See* Brown v. Earthboard Sports USA, Inc., 481 F.3d 901, 910 (6th Cir. 2007).

111. *See Miresco*, 2005 WL at *9 (stating that it was the defendant's burden to "establish that the exemption applies and that all conditions of the exemption have been satisfied"); *see also Buist*, 926 So. 2d at 298 (stating that the defendant failed to meet its burden of "showing that there was no genuine issue of material fact as to its exemption under Rule 506").

Ds with federal or Michigan authorities.[112] Perhaps more telling is the opinion's failure to cite *Temple*, *Lillard*, or *Buist*.[113] The questions surrounding *Miresco*'s analysis, and the fact that it was an unpublished opinion,[114] outweigh most of its precedential authority in the preemption-by-exemption debate.

E. Pinnacle Communications International, Inc. v. American Family Mortgage Corp.

Unlike prior NSMIA preemption cases, *Pinnacle Communications International, Inc. v. American Family Mortgage Corp.* did not stem from the classic scenario of soured investors suing to invalidate the sale of unregistered securities.[115] Pinnacle, an Internet shopping company, sold securities to American Family in a private offering negotiated between the parties.[116] When American Family defaulted on its payment, Pinnacle sued for breach of contract.[117] American Family counterclaimed for the sale of unregistered securities under federal and Minnesota law.[118] On cross-motions for summary judgment, the Minnesota District Court denied summary judgment on the federal claim because there were material issues of fact regarding Pinnacle's compliance with the substantive requirements of Regulation D.[119] Despite its uncertainty over whether Pinnacle was actually exempt from federal registration under Regulation D, the court held that the NSMIA preempted American Family's state law claim because Pinnacle "purported to sell its stock under the Rule 506 exemption."[120] In strong language, the court explained, "[w]hen an offering purports to be exempt under federal Regulation D,

112. *See Miresco*, 2005 WL at *1–3.

113. *See id.* at *9.

114. *Id.* at *1.

115. *See* 417 F. Supp. 2d 1073 (D. Minn. 2006).

116. *See id.* at 1076–77. During negotiations and in the Subscription Agreement, American Family's president represented that his company was an "accredited investor" within the meaning of Regulation D. *Id.* at 1077. Further, Pinnacle filed a Form D with the SEC claiming an exemption from federal registration. *Id.* at 1079.

117. *Id.*

118. *Id.* at 1079–80.

119. *Id.* at 1086–87. In particular, the court found issues with whether Pinnacle sold to unaccredited investors without the proper documentation and disclosure required by Rules 505 and 506. *Id.* at 1086. The court also rejected Pinnacle's argument for a Rule 508 residual exemption. *Id.* at 1086–87.

120. *Id.* at 1087.

any allegation of improper registration is covered exclusively by federal law."[121] Though it adopted the *Temple-Lillard* line of reasoning, the *Pinnacle* court did not invoke the congressional intent behind NSMIA or discuss any issues of statutory interpretation.[122] Rather, it merely outlined the NSMIA preemption scheme and cited *Temple* and *Lillard* without further analysis.[123]

F. Hamby v. Clearwater Consulting Concepts

Until *Hamby v. Clearwater Consulting Concepts*, the decisions in the preemption-by-exemption debate formed a predictable dichotomy between federal and state courts.[124] Of the four published decisions, three federal opinions held that the NSMIA preempted state blue sky law whenever a securities offering was made pursuant to Regulation D, regardless of whether the offering was actually exempt from federal registration.[125] The one state court to address the issue held the opposite, that the NSMIA only preempted state blue sky law when the securities offering complied with Regulation D and was actually exempt from federal registration.[126] Unsurprisingly, the federal courts favored preemption while the state court favored preservation of state authority. In *Hamby*, however, the Eastern District of Arkansas explicitly rejected *Temple* and its progeny,[127] concluding that "the only way to assert federal preemption is to first show that an exemption from federal registration actually applies."[128]

In *Hamby*, an Arkansas investor purchased $256,000 in unregistered securities from Clearwater Consulting Concepts, a limited liability partnership organized in the U.S. Virgin Islands.[129] The promised tax benefits from the investment never

121. *Id.*

122. *Id.*

123. *Id.*

124. *See* 428 F. Supp. 2d 915 (E.D. Ark. 2006).

125. *See Pinnacle,* 417 F. Supp. 2d at 1087; Lillard v. Stockton, 267 F. Supp. 2d 1081, 1116 (N.D. Okla. 2003); Temple v. Gorman, 201 F. Supp. 2d 1238, 1244 (S.D. Fla. 2002).

126. *See* Buist v. Time Domain Corp., 926 So. 2d 290, 296–98 (Ala. 2005). *Miresco* has been viewed by some to adopt the *Buist* line of reasoning, but the court's analysis is more appropriately characterized as dicta. *See* AFA Private Equity Fund v. Miresco Inv. Serv., No. 02-74650, 2005 WL 2417116 (E.D. Mich. Sept. 30, 2005); *see also* discussion *supra* Part III.D.

127. *See Hamby,* 428 F. Supp. 2d at 921 n.2.

128. *See id.* at 921.

129. *Id.* at 916–17.

materialized and Hamby sued Clearwater for the sale of unregistered securities in violation of Arkansas law.[130] Clearwater raised the affirmative defense of NSMIA preemption, and argued that "the sale of the security to Hamby was a covered security because it was offered as such, regardless of whether the defendants actually complied with Rule 506 of Regulation D or not."[131] Citing *Temple*, Clearwater relied on language in its partnership agreement which stated that any securities sale was made pursuant to an exemption from federal registration.[132] Because Congress did not entirely preempt the field of securities regulation, the court explained, the NSMIA only preempted state law attempting to regulate a covered security.[133] In a footnote to the opinion, the court declined to follow *Temple*, harping on its complete lack of supporting authority.[134] Without supporting affidavits or deposition testimony, Clearwater was unable to meet its burden of proving Regulation D exemption, and the court denied its motion for summary judgment.[135]

G. Grubka v. WebAccess International, Inc.

After the *Hamby* Court became the first federal court to align itself with *Buist*,[136] the Colorado District Court continued the trend in *Grubka v. WebAccess International, Inc.*[137] The case arose when the Grubkas' $38,411 investment in WebAccess soured, prompting a suit for securities fraud and malfeasance based on the sale of unregistered securities under federal and Colorado law.[138] WebAccess argued that the NMSIA preempted

---

130. *Id.* at 917. Hamby also brought causes of action for breach of contract and unjust enrichment. *Id.*

131. *Id.* at 920. Before reaching Clearwater's preemption argument, the court disposed of a threshold procedural issue. *Id.* at 919. Clearwater failed to file a Form D with the SEC, but the court found that "filing a Form D [was] not a condition to obtaining an exemption under Rules 504–506." *Id.* at 920.

132. *Id.* at 919–20.

133. *Id.* at 920–21 (citing 15 U.S.C. § 77r(a)(1) (2006); Dudek v. Prudential Sec., Inc., 295 F.3d 875, 879 (8th Cir. 2002)).

134. *Id.* at 921 n.2 ("Contrary to *Temple*, most commentators have stated the obvious: a security has to actually be a 'covered security' before federal preemption applies.") (citing Hugh H. Makens, *Blue Sky Practice—Part I: Doing it Right*, SL075 ALI-ABA COURSE OF STUDY 549, 554 (Mar. 16, 2006)).

135. *Id.* at 921, 923.

136. *See id.* at 921 n.2.

137. 445 F. Supp. 2d 1259, 1269–70 (D. Colo. 2006).

138. *Id.* at 1261, 1263.

the Colorado blue sky claim because the unregistered securities were offered pursuant to Rule 506 of Regulation D.[139] The Grubkas contended that WebAcess was required to "prove preemption of the state law claim by proving exemption under the NSMIA."[140] The court agreed with the Grubkas, asserting that the *Temple* Court erred by reading the "pursuant to" language into the statute.[141] The *Grubka* Court buttressed its statutory reading with the need to avoid the "unsavory proposition" of permitting defendants to "eviscerate" the investor protections of state blue sky laws by simply "declaiming . . . compliance with Regulation D."[142] Outside of *Temple*'s appeal to Congressional intent,[143] *Grubka* represents the first of several forays into the policy behind the preemption-by-exemption debate.[144]

H. In re Blue Flame Energy Corp.

In re Blue Flame Energy Corp. was an appeal brought by the Ohio Department of Commerce, Division of Securities (the "Division").[145] The Division contended that the trial court erroneously ruled that the NSMIA prevented the Division from enforcing Ohio's blue sky laws against issuers who claimed a Rule 506 exemption, but did not meet the Rule's substantive requirements.[146] Because Blue Flame's private offering was not exempt from federal registration, the Division argued that the offering was not a federally covered security and the NSMIA did not preempt Ohio's blue sky laws.[147]

---

139. *Id.* at 1269.

140. *Id.* As expected, WebAccess relied on *Temple*, *see* Moving Defendants' Motion to Dismiss Plaintiffs' First Amended Complaint and Brief in Support 23–24, Grubka v. WebAccess Int'l, Inc., No. 05-cv-02483-LTB (D. Colo. Mar. 31, 2006), while the Grubkas cited *Buist* for authority. *See Grubka*, 445 F. Supp. 2d at 1269.

141. *Id.* at 1270 ("If Congress had intended that an offeror's representation of exemption should suffice it could have said so, but did not.").

142. *Id.*

143. *See* Temple v. Gorman, 210 F. Supp. 2d 1238, 1243 (S.D. Fla. 2002) (citing H.R. REP. NO. 104-622, at 16 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3878).

144. For a more detailed analysis, see *infra* Part IV.A–B.

145. 871 N.E.2d 1227, 1234 (Ohio Ct. App. 2006).

146. *See id.* at 1235–36. Specifically, the Division alleged that Blue Flame, an oil and gas exploration company, violated Regulation D's prohibition against general solicitation. *Id.* at 1235 (citing 17 C.F.R. § 230.502(c) (2008)).

147. *Id.* at 1241 (arguing that the NSMIA "only prohibits state law from regulating securities that *actually are* 'covered securities'").

Unlike previous decisions construing the preemption-by-exemption issue, the Ohio Court of Appeals engaged in a detailed analysis. The court began by outlining its method of review.[148] Though "[t]he ultimate touchstone of any preemption analysis is congressional intent," such intent can be "explicitly stated in a statute's language or implicitly contained in the structure and purpose" of the legislation.[149] Further, if the preemption provision in a statute is ambiguous, "a court has a duty to accept the reading that disfavors preemption, particularly in areas of traditional state regulation."[150] In other words, a federal statute can expressly preempt state regulation, but it should be clearly asserted on the face of the statute. Applying this analytical scheme to the NSMIA, the court found the statute unambiguous.[151] A private offering was only a covered security, and thus capable of preempting state law, "if it '*is exempt* from registration. . . .'"[152] Like *Hamby*, the court rejected *Temple* on two grounds.[153] First, the NSMIA's preemption language is unambiguous, and *Temple* crafted an alternative reading by consulting the statute's legislative history.[154] Second, the *Temple* reading permits issuers to avoid liability under state law by merely averring compliance with Regulation D.[155] Because the NSMIA only preempted state blue sky law when the challenged securities were actually exempt under Rule 506, and Blue Flame violated Regulation D by engaging in general advertising, the Ohio Court of Appeals reversed and remanded the trial court's decision.[156]

I. Brown v. Earthboard Sports USA, Inc.

Prior to *Brown v. Earthboard Sports USA, Inc.*, only state courts and federal district courts had ruled on the preemption-by-exemption question.[157] The Sixth Circuit's decision holding "that

148. *See id.* at 1241–42.

149. *Id.* at 1242.

150. *Id.* (citing Bates v. Dow Agrosciences, L.L.C., 544 U.S. 431, 449 (2005)).

151. *Id.* at 1243.

152. *Id.* (quoting 15 U.S.C. § 77r(b)(4) (2006)).

153. *Id.* at 1244 ("We find *Temple* and its progeny unpersuasive.").

154. *Id.* ("[I]ntent is irrelevant if the statute is unambiguous."); *see also* Grubka v. WebAccess Int'l, Inc., 445 F. Supp. 2d 1259, 1270 (D. Colo. 2006).

155. *See In re Blue Flame*, 871 N.E.2d at 1244; *see also Grubka*, 445 F. Supp. 2d at 1270.

156. *See In re Blue Flame*, 871 N.E.2d at 1244, 1250.

157. *See* 481 F.3d 901, 909–10 (6th Cir. 2007).

offerings must actually qualify for a valid federal securities registration exemption in order to enjoy NSMIA preemption," was certainly a major victory for *Buist* and its progeny.[158] As a survey of decisions subsequent to *Brown* illustrates, it remains to be seen whether state or federal courts will ever revive the *Temple* line of reasoning.[159]

In *Brown*, the plaintiff, Brown, was induced to invest $600,000 in Earthboard Sports when his financial advisor, Vaughn, told him Vans Shoe Company was prepared to acquire Earthboard Sports and offer a two-for-one stock exchange.[160] The falsified transaction never closed and the scheme was revealed to be fraudulent.[161] Brown sued Vaughn and Earthboard, but the District Court held that the Kentucky blue sky law was preempted by the NSMIA because the challenged securities were offered pursuant to Rule 506 of Regulation D.[162] On appeal, Brown argued the securities were not exempt from federal registration and the NSMIA could not preempt state law unless the offering was actually exempt under Rule 506.[163]

The court acknowledged the preemption-by-exemption split and recognized that it was the first federal appeals court to rule on the issue.[164] The court rejected the holding in *Temple*, basing its argument on the NSMIA's plain statutory language and the policy justification for requiring actual compliance.[165] Although legislative history may be helpful in cases of ambiguity, the court emphasized that Congress could have, but did not, completely preempt the field of state blue sky regulation.[166] Further, preempting state law whenever offerings add boilerplate language purporting to qualify for federal exemption would eviscerate the investor protections of state registration.[167] In the end,

158. *See id.* at 910.
159. *See infra* Part III.J–L.
160. *Brown*, 481 F.3d at 905–07.
161. *Id.* at 908.
162. *Id.*
163. *Id.* at 909.
164. *Id.* at 909–10.
165. *Id.* at 911–12.
166. *See id.*
167. *See id.* at 911.

the Sixth Circuit agreed with *Buist*, becoming the highest court to rule on the issue.[168]

J. Apollo Capital Fund v. Roth Capital Partners

The California Court of Appeals took the next foray into the preemption-by-exemption debate in December 2007.[169] In *Apollo Capital Fund v. Roth Capital Partners*, a group of investors sued an Internet company for securities fraud and failure to register under federal and state law.[170] Roth Capital argued that the NSMIA preempted Apollo's state claim "regardless of whether the private placement actually complied with . . . Regulation D . . . ."[171] Apollo contended that an offering was not a covered security unless it met the substantive requirements of Regulation D.[172] The trial court found preemption, but the appellate court reversed, choosing to align itself with the line of authorities "which have 'stated the obvious: a security has to actually be a 'covered security' before federal preemption applies.'"[173] Although the court offered little independent analysis, it referenced the well-reasoned criticism of *Temple* in recent decisions and placed particular emphasis on *Brown*'s federal appellate authority.[174] Because Roth Capital's compliance with Regulation D presented material factual issues, the appellate court concluded that the trial court erred in sustaining Roth Capital's demurrer.[175]

K. Consolidated Management Group, L.L.C. v. Department of Corps.

In *Consolidated Management Group, L.L.C. v. Department of Corps.*, a Kansas limited liability company formed and sold inter-

---

168. *Id.* at 922.

169. *See* Apollo Capital Fund v. Roth Capital Partners, 70 Cal. Rptr. 3d 199 (Cal. Ct. App. 2007).

170. *Id.* at 205.

171. *Id.* at 219. Roth Capital relied on *Temple* and the fact that they filed a Form D with the SEC. *Id.* (quoting Temple v. Gorman, 201 F. Supp. 2d 1238, 1244 (S.D. Fla. 2002)).

172. *Id.*

173. *Id.* (quoting Hamby v. Clearwater Consulting Concepts, 428 F. Supp. 2d 915, 921 n.2 (E.D. Ark. 2006)).

174. *Id.* at 219–220.

175. *Id.* at 220.

ests in several general partnerships.[176] The company did not register the securities offerings with the state of California, but did file Form D notices of private placements with the SEC pursuant to Rule 506.[177] When the offerings failed to meet the substantive requirements of Rule 506, the California Department of Corporations issued Consolidated a desist and refrain order.[178] Consolidated challenged the order on the grounds of federal preemption, arguing that "any purported offer of securities pursuant to Rule 506 of Regulation D is sufficient to establish preemption, whether or not the offer is implemented in accordance with the requirements of that rule."[179]

The court extensively detailed Consolidated's position, which largely tracked the reasoning in *Temple*.[180] The court then outlined the majority and minority positions in the preemption-by-exemption debate, ultimately holding that a security must actually comply with Rule 506 in order for state registration requirements to be preempted.[181] The court based its decision on two rationales. First, the plain language of the statute "defines a 'covered security' as one that is exempt from registration . . . ."[182] Because state law is only preempted by a covered security, an offering must be exempt from registration for the NSMIA preemption provision to apply.[183] Second, if state registration requirements were preempted by any private placement offered pursuant to Rule 506, the law would effectively provide a blueprint for unscrupulous issuers wishing to avoid state registration.[184] The plain language of the statute, combined with the policy of fraud prevention, led the court to align itself with *Brown* and other courts rejecting *Temple*.

---

176. *See* 75 Cal. Rptr. 3d 795, 800 (Cal. Ct. App. 2008).

177. *See id.*

178. *Id.*

179. *Id.* at 802.

180. *See id.* at 802–03.

181. *See id.* at 803–04.

182. *Id.* at 803 (quoting *In re* Blue Flame Energy Corp., 871 N.E.2d 1227, 1244 (Ohio Ct. App. 2008)) (emphasis omitted).

183. *See id* (quoting Brown v. Earthboard Sports USA, Inc., 481 F.3d 901, 910 (6th Cir. 2007)).

184. *See id.* at 803–04 (quoting *Brown*, 481 F.3d at 911).

L. Risdall v. Brown-Wilbert, Inc.

Like Minnesota's federal district court,[185] the Minnesota Court of Appeals concluded that a private securities offering did not actually have to comply with Regulation D for the NSMIA to preempt state registration law.[186] The *Risdall* action stemmed from the sale of unregistered securities to the Risdall family.[187] The trial court rejected Brown-Wilbert's preemption argument and granted summary judgment to the Risdalls on their Minnesota claim.[188] The appellate court reversed, holding that a private securities offering purporting to be exempt under Regulation D should be governed exclusively by federal law and any claim under state law should be preempted.[189] Because federal courts were more qualified than state courts to review issues of federal law, the court reasoned, federal courts should be the only judges of the availability of a Regulation D exemption.[190]

Brown-Wilbert's victory was short-lived, however. In July 2008, the Supreme Court of Minnesota granted the Risdalls' appeal to determine "whether federal law preempts state registration requirements with respect to securities that purport to be, but are not in fact, federal covered securities."[191] Like the Sixth Circuit in *Brown*, the Supreme Court of Minnesota emphasized the importance of Congressional intent when considering whether a federal law preempted a state statute.[192] The best evidence of Congressional intent, the court noted, was the express language of the federal statute at issue.[193] The court found that "[t]he court of appeals disregarded the plain language of 15 U.S.C. § 77r and Rule 506 . . . ."[194] Specifically, the preemption provision of section 77r only applies to "a security that . . . *is* a covered security."[195]

---

185. *See* Pinnacle Commc'ns Int'l, Inc. v. Am. Family Mortgage Corp., 417 F. Supp. 2d 1073, 1087 (D. Minn. 2006).

186. *See* Risdall v. Brown-Wilbert, Inc., 733 N.W.2d 827, 832 (Minn. Ct. App. 2007).

187. *Id.* at 829.

188. *Id.* at 830.

189. *Id.* at 832. Though the court found the challenged securities offering in compliance with Regulation D, the court based its decision on the *Temple-Lillard-Pinnacle* line of reasoning, not the lower court's flawed Rule 506 analysis. *Id.* at 832–33.

190. *Id.* at 832.

191. Risdall v. Brown-Wilbert, Inc., 753 N.W.2d 723, 727 (Minn. 2008).

192. *Id.* at 728 (citing Cal. Fed. Sav. & Loan Ass'n v. Guerra, 479 U.S. 272, 280 (1987)).

193. *Id.* (citing Dahl v. Charles Schwab & Co., 545 N.W.2d 918, 922 (Minn. 1996)).

194. *Id.* at 729.

195. *Id.* (quoting 15 U.S.C. § 77r(a)(1)(A) (2006)) (emphasis added). The court also cited

Noting that the majority of courts weighing in on the preemption-by-exemption debate have found that actual compliance is necessary for preemption, the court found "that federal law does not preempt state registration requirements with respect to securities that purport to be, but are not in fact, federal covered securities."[196]

IV. THE MERITS AND SIGNIFICANCE OF THE EXEMPTION-BY-PREEMPTION ISSUE

As the preceding survey demonstrates, recent case law has strongly supported the majority proposition that a defendant must prove NSMIA preemption by establishing a Rule 506 exemption. Commentators[197] and the Sixth Circuit[198] have struck serious blows to the minority, and opinions supporting *Temple*'s initial declaration have diminished in regularity. *Lillard*, for example, summarily adopted the *Temple* approach shortly after the *Temple* decision;[199] *Pinnacle* contained little independent analy-

---

to section 77r(b)(4)(D) for the proposition that a security is only a covered security when it is exempt from registration, and to Rule 506 for the qualification that a private offering will only be exempt if the offering satisfies all the terms and conditions of the rule. *Id.* (citing 15 U.S.C. § 77r(b)(4)(D); 17 C.F.R. § 230.506 (2008)).

196. *Id.* at 729–31. Interestingly, the Supreme Court of Minnesota criticized the *Temple* court's reliance on the House of Representatives Commerce Committee Report accompanying the NSMIA. *See id.* at 730 (citing Temple v. Gorman, 201 F. Supp. 2d 1238, 1243 (S.D. Fla. 2002)). In *Temple*, the Southern District of Florida relied on the Report language "offered or sold pursuant to a Commission rule or regulation" to justify its decision that securities offered pursuant to, but not actually qualifying, for federal exemption would nonetheless be treated as federal covered securities. Temple, v. Gorman 201 F. Supp. 2d. 1238, 1243–44 (S.D. Fla. 2002) (citing H.R. REP. NO. 104-622, at 32 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3894–95. The Supreme Court of Minnesota, however, construed the language "pursuant to" in accordance with its Black's Law Dictionary definition of "[i]n compliance with." *Risdall*, 753 N.W.2d at 730 n.6 (citing BLACK'S LAW DICTIONARY 1272 (8th ed. 2004)). As such, the Report "actually suggests that compliance with the private offering exemption is required for federal law to preempt Minnesota's registration requirements." *Id.*

197. *See, e.g.*, 1 THOMAS LEE HAZEN, THE LAWS OF SECURITIES REGULATION § 4.24[4] (5th ed. 2005) (rejecting the *Temple* opinion as contrary to plain statutory language); *see also* 1 STUART R. COHN, SECURITIES COUNSELING FOR SMALL AND EMERGING COMPANIES § 6:24.50 (Cum. Supp. 2007) (setting up the preemption-by-exemption debate and siding with *Buist*); Makens, *supra* note 134, at 554.

198. *See* Brown v. Earthboard Sports USA, Inc., 481 F.3d 901, 910 (6th Cir. 2007).

199. *See* Lillard v. Stockton, 267 F. Supp. 2d 1081, 1116 (N.D. Okla. 2003). *Lillard*'s precedential value is further hampered by a decision from *Lillard*'s sister district in *Odor v. Rose*, No. CIV-07-554-R, 2008 WL 2557607 (W.D. Okla. June 20, 2008). While the court's decision in *Odor* failed to add any substantive gloss on the preemption-by-exemption debate, it did recognize that a defendant asserting preemption has the burden of proving its offering complied with SEC rules and regulations, and was thus a covered

sis;[200] and the *Risdall* decision was swiftly overturned by the Supreme Court of Minnesota.[201] While the question discussed in these cases is an admittedly narrow issue, it is an important one. Since 2002, several courts have addressed the issue for the first time, and more issuers are beginning to use Rule 506 offerings to avoid state registration.[202] Posing the merits of each position against the greater role of federalism in the securities field, therefore, is not only a worthy task, but an essential one.

A. *The Merits of the Majority Position*

The majority position—that an offering must actually comply with Rule 506 to preempt state law—rests on the twin pillars of statutory interpretation and public policy.[203] The strongest argument is based on a plain reading of the NSMIA, which states that "[a] security is a covered security with respect to a transaction that *is exempt* from registration . . . ."[204] While the statute also notes that securities can be covered "*pursuant to* . . . Commission rules or regulations,"[205] the SEC has consistently declined to define all securities as covered, opting instead for an exclusive set of preconditions for federal exemption.[206] If the statute is plain, the argument continues, legislative history is irrelevant.[207] After all, states are only prohibited from regulating a

security for purposes of the NSMIA. *See id.* at *2. Considering the Western District of Oklahoma's tacit disapproval of *Lillard*, coupled with *Lillard*'s own precedential limits, it is questionable whether the Northern District of Oklahoma would reach the same conclusion if it were again confronted with facts similar to those in *Lillard*.

200. *See* Pinnacle Commc'ns Int'l, Inc. v. Am. Family Mortgage Corp., 417 F. Supp. 2d 1073, 1087 (D. Minn. 2006).

201. *See Risdall*, 753 N.W.2d at 730–31, 734.

202. *See* COHN, *supra* note 197, at § 6.24:50.

203. Although *Buist* was the first court to reject *Temple* and thereby articulate what became to be the majority view, *see* Buist v. Time Domain Corp., 926 So. 2d 290, 297–98 (Ala. 2005), *Grubka* was arguably the first decision to outline the rationale behind that decision. *See* Grubka v. WebAccess Int'l, Inc., 445 F. Supp. 2d 1259, 1270 (D. Colo. 2006).

204. 15 U.S.C. § 77r(b)(4) (2006) (emphasis added).

205. *Id.* § 77r(b)(4)(D) (emphasis added).

206. *See* Brown v. Earthboard Sports USA, Inc., 481 F.3d 901, 911–12 (6th Cir. 2007) ("[I]t is dispositive to our inquiry that Congress chose not to include broadly preemptive language when it enacted NSMIA. . . . [F]ar from defining 'covered securities' in a manner that generally incorporates all securities, the SEC has promulgated specific requirements that must be met in order for a security to be 'covered.'").

207. *See* Violette v. P.A. Days, Inc., 427 F.3d 1015, 1017 (6th Cir. 2005) ("To avoid a law's plain meaning in the absence of ambiguity would trench upon the legislative powers vested in Congress by . . . the Constitution.") (quoting Dep't of Housing and Urban Dev. v. Rucker, 535 U.S. 125, 134–35 (2002)).

covered security, and a security is not covered unless it *is exempt* from federal registration with the SEC.[208]

The statutory argument dovetails nicely with the policy rationale behind requiring actual compliance with Rule 506. The basic thrust of the majority's policy argument is a natural extension of the central commandment of securities regulation: to protect investors from fraudulent tactics.[209] If issuers were able to avoid state regulation by simply offering their securities under Rule 506 and claiming compliance, then a critical layer of protection would be eliminated and the risk of investor fraud would be substantially heightened.[210] The fear of an under-regulated securities field is supported by the state of the market preceding the 1929 crash[211] and recent examples of scofflaws manipulating securities laws and defrauding investors.[212]

B. *The Merits of the Minority Position*

The minority position—that an offering only needs to be offered pursuant to Rule 506 to preempt state law—is supported by the sweeping language of the NSMIA's legislative history, the policy of avoiding duplicative securities regulation, and the basic argument that federal courts are better equipped to interpret and enforce federal law. *Temple* epitomized the minority's heavy reliance on legislative intent.[213] The intent to designate the federal

---

208. *See* 15 U.S.C. § 77r.

209. *See supra* Part II.A.

210. *See, e.g.*, *Brown*, 481 F.3d at 911 ("In such a [*Temple*] world, state registration requirements could be avoided merely by adding spurious boilerplate language to subscription agreements suggesting that the offerings were 'covered,' or by filing bogus documents with the SEC."); Grubka v. WebAccess Int'l, Inc., 445 F. Supp. 2d 1259, 1270 (D. Colo. 2006) ("[T]hat a defendant could avoid liability under state law simply by declaiming its alleged compliance with Regulation D is an unsavory proposition and would eviscerate the statute."); COHN, *supra* note 197, at § 6:24.50 ("Unless courts require at a minimum a bona fide effort to comply with Rule 506, the mere assertion of a form would control, and sham Rule 506 offerings would be exempt from state registration or exemption laws."); 12 JOSEPH C. LONG, BLUE SKY LAW § 3:81 n.7 (2008) ("If all that was required for preemption was a bald-face statement that the offering was made under Rule 506, then any con artist could avoid state registration by telling the investor that the offering was a private placement under Rule 506.").

211. *See supra* notes 14–15 and accompanying text.

212. *See, e.g.*, *Brown*, 481 F.3d. at 905–09 (describing how a corporate investor and a financial advisor defrauded a wealthy investor out of a substantial amount of money by fabricating a merger).

213. *See* Temple v. Gorman, 201 F. Supp. 2d 1238, 1243 (S.D. Fla. 2002) ("'The purpose of Congress is the ultimate touchstone in every preemption case.'") (quoting Fla. E. Coast

government as the sole regulator of national securities offerings, the *Temple* Court explained, was effectively an intent to preempt state blue sky law for any offering purporting to qualify for exemption under Rule 506.[214] Because the NSMIA was designed to overhaul and unify the dual regulatory system through federal preemption,[215] strictly interpreting the statute to permit state evaluation of federal exemption and registration requirements would be directly contradictory to the congressional purpose.[216] Viewed in the context of the NSMIA's sister statutes, the PSLRA and the SLUSA, the Congressional attack on state authority cannot be denied.[217]

The minority's second argument flows directly from its first. The rationale behind injecting the federal government with a broad grant of preemption was the perceived need to avoid the duplicity of the current registration process.[218] In a case predating the preemption-by-exemption debate, the Second Circuit aptly described the purpose of the NSMIA:

> The primary purpose of NSMIA was to preempt State "Blue Sky" laws which required issuers to register many securities with state authorities prior to marketing in the state. By 1996, Congress recognized the redundancy and inefficiencies inherent in such a system and passed NSMIA to preclude states from requiring issuers to register or qualify certain securities with state authorities.[219]

The minority argues that the need to promote capital formation outweighs the exaggerated threat of heightened investor fraud.[220] States not only retain the authority to prosecute fraud within their jurisdiction,[221] but there are available federal remedies un-

---

Ry. Co. v. City of W. Palm Beach, 266 F.3d 1324, 1329 (11th Cir. 2001)).

214. *See id.* (citing H.R. REP. NO. 104-622, at 16 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3878).

215. *See* Campbell, *supra* note 1, at 203 ("Judged by the rhetoric of its legislative history, the [NSMIA] was intended to be revolutionary regarding the dual control by the federal government and states over the sale of securities and the capital formation process.").

216. *See* Opening Brief of Appellants at 22, Consolidated Management Group, L.L.C. v. California Dep't of Corps., 75 Cal. Rptr. 3d 795 (Ct. App. 2008) (No. 05-1256) [hereinafter Opening Brief of Appellant].

217. *See supra* notes 33–37 and accompanying text.

218. *See* H.R. REP. NO. 104-622, at 16 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3878.

219. Lander v. Hartford Life & Annuity Ins. Co., 251 F.3d 101, 108 (2d Cir. 2001).

220. *See* Final Brief of Defendant-Appellee at 20, Brown v. Earthboard Sports USA, Inc., 481 F.3d 901 (6th Cir. 2007) (No 05-6317) [hereinafter Final Brief of Defendant-Appellee].

221. *See* 15 U.S.C. § 77r(c) (2006); *see also* Houston v. Seward & Kissel, L.L.P., No.

der section 12(a)(1) of the Securities Act.[222] To hold that states may evaluate an issuer's compliance with federal registration requirements contradicts the entire purpose of the NSMIA to avoid dual levels of capital compliance.[223] Likewise, there is a slippery slope involved. Jurisdictions are bound to interpret Regulation D differently, producing an amalgam of conflicting regulatory obstacles for issuers to overcome.[224] To permit such state-to-state inconsistency would only invite the very regulatory encumbrances that Congress tried to remedy when it enacted the NSMIA.

The minority also argues that federal courts are more qualified to interpret federal law.[225] While this premise can be seriously questioned,[226] "[t]he magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally traded securities cannot be overstated."[227] In essence, then, this third rationale builds from the basic policy arguments that broad federal preemption is the best way to ensure a uniform system of securities regulation. Because the federal interest in—and the societal need for—capital growth is so strong, the goals of the NSMIA should not be so easily discarded.

C. *The Future Role of Federalism in Securities Regulation*

Although *Brown* may have turned *Temple* into an endangered species, the process of debating the preemption-by-exemption issue is probably more important than the end result. Most nota-

---

07cv6305, 2008 WL 818745, at *4–5 (S.D.N.Y. Mar. 27, 2008) (finding that the NSMIA does not preempt Oregon's securities fraud statutes).

222. *See* 15 U.S.C. § 77l (2006); *see also* Final Brief of Defendant-Appellee, *supra* note 220, at 22 (stating that the exclusive cause of action "to assert a claim that a private offering issued pursuant to § 4(2) was, in actuality, a public offering that should have been registered under § 5 . . . is under § 12(a)(1) for the sale of unregistered securities").

223. *See* Opening Brief of Appellant, *supra* note 216, at 26 ("[R]equiring issuers to prove compliance with federal exemptions to the satisfaction of *state* regulators flies in the face of Congress's clear intent to reduce duplicative regulatory burdens on securities offerings and thereby facilitate access to capital markets.").

224. *See id.*

225. *See* Risdall v. Brown-Wilbert, Inc., 733 N.W.2d 827, 832 (Minn. Ct. App. 2007) ("Because federal courts are uniquely qualified to address issues of federal law, such as the availability of a Regulation D exemption, we conclude that the better view is that an offering purporting to be exempt under Regulation D is governed exclusively by federal law, and any claim under state law relating to the offering is therefore preempted.").

226. *See generally* Anthony J. Bellia Jr., *State Courts and the Interpretation of Federal Statutes*, 59 VAND. L. REV. 1501 (2006) (discussing the importance of state courts in the interpretation of federal statutes).

227. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 547 U.S. 71, 78 (2006).

bly, the judicial dialogue highlights the diminishing role of states in the face of inevitable securities reform. The passage of the PSLRA, the NSMIA, the SLUSA, and even Sarbanes-Oxley lends credence to the notion that lawmakers are content to replace the dual regulatory system through the gradual federalization of the securities field.[228] While states retain a necessary degree of intrastate prosecutorial authority,[229] the allocation of regulatory power will need to be revisited regardless of whether the *Temple* doctrine flourishes. If *Temple* survives—a highly suspect proposition considering the NSMIA's plain statutory language—more federal circuits will be forced to address the split. If *Brown* becomes the unanimous view, as most believe it should, courts will begin to interpret the many provisions of Regulation D uniquely, producing a "balkanized array" of legal doctrines which will perplex issuers and demand reconciliation.[230]

While it is generally undisputed that the securities field is in need of *some* reform, the substance of that reform takes many shapes. Most acknowledge that Congress, under the Commerce Clause, could preempt the entire field of securities regulation,[231] but few are willing to go to such extremes.[232] Rather, many view the inherent struggle between states and the federal government positively, as the dual vestiges of regulatory power work in concert to fill gaps and enhance the capital market.[233] Like total preemption, however, there is also basic disagreement over the scope of state authority within the dual system.[234] For now, it is sufficient that Congress, with the NSMIA, has foreshadowed the "creeping federalization" of the securities market.[235] The courts and the policymakers will revisit securities reform in the near fu-

228. *See* A. Brooke Overby, *Our New Commercial Law Federalism*, 76 TEMP. L. REV. 297, 321 (2003) (describing the federal government's increased occupation of commercial law authority as "the phenomenon of creeping federalization").

229. The investigation of Wall Street analyst conflicts conducted by Elliot Spitzer under the Martin Act, which eventually led to a large global settlement, is a great example of how the states can use their prosecutorial authority to ferret out securities fraud and deceit. *See Dynamic Federalism*, *supra* note 1, at 118–19.

230. *See* Denos, *supra* note 1, at 125 (describing state blue sky laws as a "balkanized array of statutes").

231. *See* Overby, *supra* note 228, at 321 (noting Congress's expansive power under the Commerce Clause).

232. *But see* Dorsch, *supra* note 9, at 393. Dorsch lays out a detailed plan of total preemption, an event which he believes the NSMIA has already foreshadowed. *See id.*

233. *See* Warren, *supra* note 38, at 497.

234. *Compare id.* at 497–98, *with* Dorsch, *supra* note 9, at 387–93.

235. *See* Overby, *supra* note 228, at 321.

ture, and the judicial dialogue permeating the preemption-by-exemption debate will be an essential tool in the development of an effective securities regime.

V. CONCLUSION

Seeking to grease the wheels of capital formation without abandoning the historical commitment to investor protection,[236] the NSMIA reversed seventy years of thinking by attempting to replace the dual regulatory system with a broad grant of federal preemption.[237] Despite this grandiose vision, application of the NSMIA's preemptive scheme has been severely limited by the statutory definition of a covered security as "a transaction that *is exempt* from registration . . . ."[238] 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,[239] and it is unlikely that future courts will endorse an interpretation that permits issuers to evade state liability by hiding behind Rule 506.[240] Nevertheless, the issue of whether a defendant must prove preemption by proving exemption remains a viable one, if only for the impact the discussion can have on impending securities reform. In all likelihood, the NSMIA has failed to accomplish what it set out to do: designate the federal government as the sole regulator of national securities offerings.[241] The resolution, and more importantly, the discussion of the preemption-by-exemption debate, contains valuable lessons as lawmakers contemplate how to allocate state and federal power to achieve the noble balance of investor protection and capitalistic growth.

Jeffrey D. Chadwick

---

236. *See supra* notes 39–40 and accompanying text.

237. *See Does Federalism Matter?*, *supra* note 2, at 894.

238. 15 U.S.C. § 77r(b)(4) (2006) (emphasis added).

239. *See, e.g.*, Brown v. Earthboard Sports USA, Inc., 481 F.3d 901, 911–12 (6th Cir. 2007).

240. *See id.* at 911.

241. *See* H.R. REP. NO. 104-622, at 16 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3878.

***