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Marc I. Steinberg

*Southern Methodist University Dedman School of Law*

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# Enhanced “Blue Sky” Enforcement: A Path to Help Solve Our Public School Funding Dilemma

Marc I. Steinberg\*

I very much appreciate being invited to author the lead contribution to this commemorative issue of the *Washburn Law Journal*. This outstanding journal is celebrating fifty years of superb scholarship with a key focus of this issue on the 100th anniversary of the Kansas “blue sky” statute,<sup>1</sup> the first meaningful state securities statute enacted in our country’s history.<sup>2</sup> Indeed,

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\* Radford Professor of Law and Senior Associate Dean for Research, SMU Dedman School of Law. A.B., University of Michigan; J.D., University of California, Los Angeles; LL.M., Yale University. In February 2006, I had the honor of being the Foulston Siefkin Lecturer at Washburn University School of Law. I had a wonderful experience and thank the school, the administration, and its students.

I thank Gregory Ivy, Associate Law Librarian, at the SMU Law School for his research assistance on this project. I also thank my wife, Laurie Steinberg, for her superb insights. My wife, our three children—Alexandra (Alex), Avram (Avi), and Phillip (Bear)—and I have attended public schools. We are strong advocates of the public school system in our country.

This Essay is dedicated to my wonderful sister, Nancy Burman. She has taught in the Columbus, Ohio, public schools for approximately twenty-five years. She has worked long and productive hours for the good of her students for far too little compensation and appreciation. She has raised three lovely daughters, all of whom are products of public schools, who now are all successful professionals, mothers, and wives. And now she has seven grandchildren. Kudos to my terrific big sister, Nancy—I am fortunate to be your little brother, and I Love You.

1. 1911 Kan. Sess. Laws 210. The term “blue sky” may be derived from the saying at the time the laws were created that promoters of fraudulent schemes would even “sell building lots in the blue sky in fee simple.” Thomas Mulvey, *Blue Sky Law*, 36 CANADIAN L. TIMES 37, 37 (1916). As more fully stated by Mulvey:

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

*Id.*

2. See Louis Loss, Joel Seligman & Troy Paredes, *SECURITIES REGULATION* 53–54 (4th ed. 2006). The 1911 Kansas statute embraced merit regulation and had enforcement capability. *Id.* There is commentary regarding the Kansas blue sky statute at or around the time of its passage. See, e.g., *Kansas’s “Blue Sky” Law*, N.Y. TIMES, Oct. 13, 1911, at 10; *Expect to Improve “Blue Sky” Law*, N.Y. TIMES, Nov. 23, 1912, at 8; *State to Guard Investors*, N.Y. TIMES, Feb. 23, 1913, at 24; Harry F. Kohr, *The Blue Sky Law*, TECHNICAL WORLD MAGAZINE, Mar. 1912, at 36; Will Payne, *How Kansas Drove Out a Set of Thieves*, SATURDAY EVENING POST, Dec. 2, 1911, at 3. The Topeka newspaper, then called the *Topeka Daily Capital*, also reported the Act’s passage. See, e.g., *Dolley’s “Blue Sky” Bill Is Ready to Be Signed*, TOPEKA DAILY CAPITAL, Mar. 8, 1911, at 4; *Blue Sky Law Enough to Scare Them Out*, TOPEKA DAILY CAPITAL, Mar. 24, 1911, at 4; *Protection Is Blue Sky*, TOPEKA DAILY CAPITAL, Mar. 26, 1911, at 17; *“Blue Sky Law” Is Explained by Dolley*, TOPEKA DAILY CAPITAL, Mar. 28, 1911, at 4; *Collier’s Commends Dolley’s Blue Sky Law*, TOPEKA DAILY CAPITAL, Apr. 6, 1911, at 4; *Other States Ask About Blue Sky Bill*, TOPEKA DAILY CAPITAL, Apr. 9, 1911, at 18; *They Want to Know About Blue Sky Law*, TOPEKA DAILY CAPITAL, Apr. 29, 1911, at 4. Blue sky laws were constitutionally upheld in *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917) (holding that Ohio’s version of the blue sky law did not violate the Fourteenth Amendment).

the Kansas statute justifiably may be viewed as the first significant consumer protection legislation in United States history.

Much has been written on state securities laws.<sup>3</sup> This scholarship has focused on the origins of the blue sky statutes, their proclaimed attributes, and their asserted deficiencies.<sup>4</sup> Undoubtedly, the past few decades have witnessed a deluge of criticism levied on blue sky regulation.<sup>5</sup> These statutes and their enforcement have been taken to task for their purportedly excessive regulatory zeal and impairment of capital formation.<sup>6</sup>

State securities regulators and the laws they enforce are thus favorite targets for those favoring deregulation of our capital markets.<sup>7</sup> State statutory and enforcement practices are criticized for their ineptness, rigidity, and failure to modernize to current-day market conditions.<sup>8</sup> In this respect, state securities regulators and the statutes they administer have much in common with public school teachers—both suffer indignation by critics who claim they should do better with the same or fewer resources.<sup>9</sup>

3. See, e.g., JOSEPH C. LONG, 12-12A BLUE SKY LAW § L (2010); Louis Loss, COMMENTARY ON THE UNIFORM SECURITIES ACT (1976); Louis Loss & Edward M. Cowett, BLUE SKY LAW (1958).

My scholarship has addressed blue sky law on several occasions. See, e.g., MARC I. STEINBERG & RALPH C. FERRARA, SECURITIES PRACTICE: FEDERAL & STATE ENFORCEMENT, §§ 13:01-13:30 (2d ed. 2001 & Supp. 2011) [hereinafter STEINBERG & FERRARA]; MARC I. STEINBERG, SECURITIES REGULATION 15-16, 99-104, 194-207, 543-66, 851-52 (revised 5th ed. 2009) [hereinafter STEINBERG, SECURITIES REGULATION]; MARC I. STEINBERG, SECURITIES REGULATION: LIABILITIES & REMEDIES §§ 5.03[1], 9.06 (2010); Marc I. Steinberg & Chris Claassen, *Attorney Liability Under the State Securities Laws: Landscapes and Minefields*, 3 BERKELEY BUS. L.J. 3 (2005); Marc I. Steinberg, *The Emergence of State Securities Laws: Partly Sunny Skies for Investors*, 62 U. CIN. L. REV. 395 (1993); Marc I. Steinberg, *The Ramifications of Recent U.S. Supreme Court Decisions on Federal and State Securities Regulation*, 70 NOTRE DAME L. REV. 489 (1995).

4. See generally, Rutherford B. Campbell, Jr., *Blue Sky Laws and the Recent Congressional Preemption Failure*, 22 J. CORP. L. 175 (1997); Johnathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347 (1991); Hugh H. Makens, *Who Speaks for the Investor? An Evaluation of the Assault on Merit Regulation*, 13 U. BALT. L. REV. 435 (1984); Richard B. Tyler, *More About Blue Sky*, 39 WASH. & LEE L. REV. 899 (1982).

5. See, e.g., Ad hoc Subcomm. on Merit Regulation of the State Regulation of Sec. Comm., *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785 (1986) [hereinafter *Subcommittee on Merit Regulation*]; Campbell, *supra* note 4, at 179; Rutherford B. Campbell, Jr., *The Insidious Remnants of State Rules Respecting Capital Formation*, 78 WASH. U. L.Q. 407 (2000); Rutherford B. Campbell, Jr., *An Open Attack on the Nonsense of Blue Sky Regulation*, 10 J. CORP. L. 553 (1985) [hereinafter Campbell, *Open Attack*]; James S. Mofsky & Robert D. Tollison, *Demerit in Merit Regulation*, 60 MARQ. L. REV. 367 (1977); Mark A. Sargent, *State Disclosure Regulation and the Allocation of Regulatory Responsibilities*, 46 MD. L. REV. 1027 (1987).

6. See *supra* note 5. For example, regarding the shortcomings of merit regulation, Professor Campbell has stated that “millions of dollars are spent each year on a system of [state] regulation that provides no significant protection to investors and retards capital formation.” Campbell, *Open Attack*, *supra* note 5, at 579.

7. See Campbell, *Open Attack*, *supra* note 5; Mofsky & Tollison, *supra* note 5, at 369 (opining that state “regulators are more often concerned with benefits than they are with costs [and that] [t]he cost side of the measurement is sometimes not even addressed as an issue”).

8. See Subcommittee on Merit Regulation, *supra* note 5, at 847 (asserting that “merit regulation is not, indeed cannot be, without costs, and the reality of those costs must be acknowledged”); Campbell, *Open Attack*, *supra* note 5, at 553 (asserting that state securities laws “are ineffective, philosophically unsound, and unnecessarily expensive, and they should be substantially eliminated”); Mofsky & Tollison, *supra* note 5, at 369.

9. See, e.g., Michael Cooper & Katharine Q. Seelye, *Wisconsin Leads Way as Workers Fight State Cuts*, N.Y. TIMES, Feb. 19, 2011, at A1; Robert M. Costrell, *Oh, to Be a Teacher in Wisconsin*, WALL ST. J., Feb. 25, 2011, at A15; Monica Davey & Steven Greenhouse, *Big Budget Cuts Add Up to Rage in Wisconsin*, N.Y. TIMES, Feb. 17, 2011, at A1; Trip Gabriel, *Teachers Wonder, Why the Heapings of Scorn?*, N.Y. TIMES, Mar. 3, 2011, at A1; Kris Maher & Douglas Belkin, *Union Fight Heats Up*, WALL ST. J., Feb. 18, 2011, at A1; *supra* notes 5-8.

We are well aware of the current siege against public school teachers. Faced with budget shortfalls, state legislatures are seeking to rein in perceived teacher entitlements.<sup>10</sup> Some of the populace have jumped on this bandwagon, asserting that teachers have "soft" jobs, excessively long vacations, and disproportionately large paychecks.<sup>11</sup> Layoffs and benefit reductions are common fare, with tongue-lashing accompaniments.<sup>12</sup> With the financial challenges that many states face, this situation appears here to stay.

This predicament is, to say the least, unfortunate. In addition to core values and feelings (such as love, commitment, integrity, empathy, and patriotism), education is among the most important assets that parents and society can provide for a child. We are in a country rich in resources and people. During the past 100 years, we have spent hundreds of billions of dollars and suffered the loss of hundreds of thousands of our young men and women in our continual efforts to promote democracy and fight terror in the world. Today, our nation's armed forces are in Afghanistan and Iraq, among other countries, pursuing this mission. In this respect, a treasure of our country is our children. We must provide them with every reasonable opportunity to succeed. Having deficient schools with dissatisfied teachers is not a viable route to achieve this objective.

Many of us can remember a teacher or two or three who made a real difference in our perception of self. For me, who had a speech impediment growing up, that teacher was a third grade science teacher, Mr. Lucchi. He was the first person outside of my family who convinced me that I am, at least to some degree, intelligent and perceptive. Perhaps I would have acquired the self-confidence I have today through the love and support of my mother, father, and sister, Nancy, without this reinforcement. But for many children in our country, it is the teachers who are on the front lines and who are critical to children's quests for success.

A country that spends billions abroad but fails to educate its young people capably is flirting with tumult. Something positive must be done to alleviate the funding catastrophe our public schools face. Recognizing that appropriate funding is lacking and that large tax increases are not a palatable approach, an alternative path must be found. I propose that this path is before us and rekindles our endearment to an old ally—the state blue sky laws. Many states today authorize the imposition of monetary fines based on civil and criminal violations of their state securities laws.<sup>13</sup> My proposal is for

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10. See John Fund, *What's at Stake in Wisconsin's Budget Battle*, WALL ST. J., Feb. 19, 2011, at A13; R.M. Schneiderman & Andrew Romano, *Showdown: Forget Wisconsin's Meltdown. How Ohio's Budget Battle Could Decide Who Wins the White House in 2012*, NEWSWEEK, March 7, 2011, at 14.

11. See Gabriel, *supra* note 9, at A1 ("The jabs Erin Parker has heard about her job have stunned her. Oh you pathetic teachers, read the online comments and placards of counterdemonstrators. You are glorified baby sitters who leave work at 3 p.m. You deserve minimum wage.").

12. See *supra* notes 9–11.

13. See, e.g., TEX. REV. CIV. STAT. ANN. art. 581-23-1 (West 2010); *Cox v. Garvin*, 607 S.E.2d 549 (Ga. 2005); LONG, *supra* note 3, at § 8.01.

states to create the authority to fine if none exists and for those states that have such provisions to revisit them and determine whether they should be expanded.

With the staffing by the states of enforcement personnel, including accountants, attorneys, analysts, and investigators, who are proficient and sufficient in number, an increase in the quantity and size of meritorious enforcement actions is likely. An ensuing consequence is that the amount of monetary penalties and fines that violators pay should significantly increase. These dollars, under my proposal, should be earmarked solely for public school education, including teacher hiring, retention, salaries, and benefits. In this manner, valuable additional funding can be procured for our public schools.

Whether these amounts paid in fines and penalties would be sufficient in some states to make a significant difference in the level of funding for public schools is questionable. Nonetheless, with respect to those states that experience widespread investor fraud, the amounts that foreseeably can be generated are significant. These states include Arizona, California, Colorado, Florida, Illinois, Maryland, Massachusetts, Michigan, Missouri, Nevada, New Jersey, New York, Ohio, Pennsylvania, Tennessee, Texas, and Utah.<sup>14</sup>

This framework readily can be expanded to encompass other state regulatory violations. Monetary fines imposed by the states on violators for engaging in consumer and tax fraud serve as examples. Although these funds can be directed to serve other state purposes, earmarking these funds for public education should ameliorate the current funding dilemma.

This proposal, looking to the blue sky laws and state securities regulators to help solve a public crisis, flows nicely with the traditional role played by these actors. Enacted to combat widespread investor fraud, the Kansas blue sky law, and others that followed, sought to protect residents within their respective states.<sup>15</sup> Through the years, the blue sky laws have been vigorously enforced by some state regulators and have provided meaningful relief to aggrieved investors.<sup>16</sup> In many states, regulators can procure significant civil enforcement remedies, including cease and desist orders, injunctions, disgorgement of ill-gotten profits, appointment of a receiver, and monetary

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14. See generally Jay T. Brandi, *Securities Practitioners and Blue Sky Laws: A Survey of Comments and a Ranking of States by Stringency of Regulation*, 10 J. CORP. L. 689 (1985); Paul G. Mahoney, *The Origins of the Blue Sky Laws: A Test of Competing Hypotheses*, 46 J.L. & ECON. 229 (2003). Texas, my home state, under the leadership of Securities Commissioner Denise Voigt Crawford and her proficient staff of the Texas State Securities Board, is well-known as an active jurisdiction with respect to securities enforcement. Crawford, who served on two different occasions as President of the North American Securities Administrators Association ("NASAA"), has recently retired.

15. See Loss & Cowett, *supra* note 3, at 1-10; Macey & Miller, *supra* note 4, at 350-70; *supra* notes 1-2.

16. See LONG, *supra* note 3, at §§ 7:01-9:08; STEINBERG & FERRARA, *supra* note 3, at §§ 13:7-13:27; Michael J. Missel, Stephen G. Topetzer & Marc R. Bryant, *Dealing with State Securities Regulators*, 28 REV. SEC. & COMM. REG. 203 (1995).

penalties.<sup>17</sup> Criminal enforcement, likewise, is vigorous in a number of states where convictions may be procured for certain violations, such as registration violations, based on strict liability.<sup>18</sup> Treating state securities law violations as public welfare offenses premised on strict liability principles, thereby giving prosecuting authorities vast discretion whether to institute a criminal case, enhances compliance with state law mandates.<sup>19</sup>

Similarly, investors frequently enjoy significant protections under the blue sky laws. Registration violations are premised on strict liability;<sup>20</sup> a number of states have longer statute of limitations than the one-year period provided under federal law.<sup>21</sup> The making of a material misstatement<sup>22</sup> by a seller<sup>23</sup> in the offer or sale of securities is actionable unless such seller establishes that he exercised reasonable care.<sup>24</sup> And, unlike federal law,<sup>25</sup> aider and abettor liability against secondary actors is expressly provided for by many states' blue sky statutes.<sup>26</sup>

17. See *Cox*, 607 S.E.2d 549; *Sec'y of State v. Tretiak*, 22 P.3d 1134 (Nev. 2001); *Oklahoma ex. rel. Day v. Sw. Mineral Energy Corp.*, 617 P.2d 1334 (Okla. 1980); *Kirk v. Texas*, 611 S.W.2d 148 (Tex. App. 1981); Uniform Securities Act (USA) § 408 (1956); LONG, *supra* note 3, at §§ 9:04–9:07; Joseph C. Long, *A Guide to the Investigative and Enforcement Provisions of the Uniform Securities Act*, 37 WASH. & LEE L. REV. 739, 740–63 (1980); STEINBERG & FERRARA, *supra* note 3, at §§ 13:18–13:20.

18. See, e.g., *Arizona v. Gunnison*, 618 P.2d 609 (Ariz. Ct. App. 1979); *Cox*, 607 S.E.2d 549; *Idaho v. Montgomery*, 17 P.3d 292 (Idaho 2001); *Tennessee v. Casper*, 297 S.W.3d 676 (Tenn. 2009); *Wisconsin v. Temby*, 322 N.W.2d 522 (Wis. Ct. App. 1982). See generally Mark A. Sargent, *A Blue Sky State of Mind: The Meaning of "Willfully" in Blue Sky Criminal Cases*, 20 SEC. REG. L.J. 96 (1992).

19. See STEINBERG & FERRARA, *supra* note 3, at § 13:22.

20. See USA § 410(a)(1); *Giordano v. Auditore*, 244 N.E.2d 555 (Mass. 1969); *Cola v. Terzano*, 322 A.2d 195 (N.J. Sup. Ct. 1974).

21. Compare Securities Act of 1933 § 13, 15 U.S.C. § 77(m) (2006) (setting forth a one-year statute of limitations for Securities Act registration violation), with TEX. REV. CIV. STAT. ANN. art. 581-33(H)(1) (West 2010) (setting forth three-year statute of limitations for registration violation).

22. Generally, information is material if reasonable investors would consider such information important in their investment or voting decisions. See *Malone v. Brincat*, 722 A.2d 5 (Del. 1998); cf. *Basic Inc. v. Levinson*, 485 U.S. 223 (1988).

23. Generally, states have adopted different definitions of seller. The majority view appears to adopt the U.S. Supreme Court's standard set forth in *Pinter v. Dahl*, 486 U.S. 622, 644–45 (1988) (defining a seller under § 12(1) of the Securities Act to encompass the vendor, the vendor's agent, one who solicits the purchase for personal financial gain, and one who solicits the purchase to benefit the vendor). Some state courts have chosen to adopt *Pinter*. See, e.g., *Meyers v. Lott*, 993 P.2d 609 (Idaho 2000); *Wilson v. Misko*, 508 N.W.2d 238 (Neb. 1993); *Shavin v. Virginia*, 437 S.E.2d 411 (Va. 1993). Nonetheless, a number of states have declined to adopt *Pinter*. See, e.g., *Mays v. Ridenhour*, 811 P.2d 1220 (Kan. 1991); *Hoffer v. Washington*, 776 P.2d 963 (Wash. 1989). See also Matthew J. Morrison, *Participant Liability Under Blue Sky Rescission Statutes: The Diminishing Importance of the Definition of a Statutory Seller*, 33 SEC. REG. L.J. 102 (2005); Steinberg & Claassen, *supra* note 3, at 11–13.

24. See USA § 410(a)(2). Factors that may be considered in determining whether the reasonable care defense is met include:

(1) [t]he relationship of the parties, (2) [t]heir respective knowledge of information about the security in the transaction, (3) [t]heir relative sophistication and access to such information, (4) [t]heir respective expectations of benefit from the transaction, [and] (5) [w]hether the untruth or omission was in a document prepared for use in the purchase or sale of a security . . .

TEX. REV. CIV. STAT. ANN. art. 581-33 cmt. to § 33.

25. See *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 191 (1994) (holding no private aiding and abetting liability may be imposed under § 10(b) of the Securities Exchange Act); *Stonridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 166–67 (2008) (holding that no primary liability may be levied against a secondary actor when purchasers of subject securities did not rely on the secondary actor's conduct or statements).

26. See, e.g., USA § 410(c) (providing for aider and abettor liability exposure on the following people: "every partner, officer, or director of such a person, every person occupying a similar status or performing similar functions, every employee of such a person who materially aids [the sale], and every broker-dealer or

Indeed, exasperated by plaintiffs flocking to state courts to bring their class actions after the enactment of the Private Securities Litigation Reform Act of 1995,<sup>27</sup> Congress three years later passed the Securities Litigation Uniform Standards Act ("SLUSA"),<sup>28</sup> which preempts, with certain exceptions,<sup>29</sup> state class actions involving nationally traded companies.<sup>30</sup> SLUSA signifies that generally, with the exception of derivative actions and breach of fiduciary suits in merger and acquisition transactions,<sup>31</sup> class actions involving companies listed on the national stock exchanges, such as the New York Stock Exchange and the NASDAQ Global Market, can be instituted only in federal court alleging federal claims.<sup>32</sup> SLUSA thus significantly enhances the ability of publicly held companies to fend off perceived strike suit litigation.<sup>33</sup> On the other hand, it precludes ordinary investors, who do not have the resources to bring an individual action, from their state remedies in meritorious

agent who materially aids in [the sale]"). See, e.g., *Taylor v. Perdition Minerals Grp., Ltd.*, 766 P.2d 805 (Kan. 1988); *Michelson v. Voison*, 658 N.W.2d 188 (Mich. Ct. App. 2003); *Sterling Trust Co. v. Adderley*, 168 S.W.3d 835 (Tex. 2005); *Hines v. Data Line Sys., Inc.*, 787 P.2d 8 (Wash. 1990).

27. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.). For discussion of the Private Securities Litigation Reform Act ("PSLRA"), see Symposium, *The Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 975 (1996).

28. Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C.).

29. Key SLUSA exceptions are that derivative actions and suits based on breach of fiduciary duty in merger and acquisition transactions are not preempted. Moreover, SLUSA does not affect the bringing of individual actions under state law. Also, the state securities regulators are not preempted under SLUSA from bringing enforcement actions based on violation of state law. See Steinberg, *SECURITIES REGULATION*, *supra* note 3, at 544-45; Lisa L. Casey, *Shutting the Doors to State Court: The Securities Litigation Uniform Standards Act of 1998*, 27 SEC. REG. L.J. 141 (1999); Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1 (1998).

30. Nationally traded companies include, for example, those companies whose common stock is listed on the New York Stock Exchange, the American Stock Exchange, and the NASDAQ Global Market. Securities Act of 1933 § 18(b)(1)(A) (codified as amended at 15 U.S.C. § 77r(b)(1)(A) (2006)).

31. See *supra* note 29.

32. Class actions under SLUSA are defined more broadly than under Rule 23 of the Federal Rules of Civil Procedure, generally to encompass a lawsuit in which damages are sought on behalf of more than fifty people involving common questions of law or fact. Securities Litigation Uniform Standards Act § 101, Pub. L. No. 105-353, 112 Stat. 3227 (amending 15 U.S.C. § 77p(f)(2)(B), § 78bb(f)(5)(B)).

33. Generally, strike suit litigation is sufficiently meritorious to fend off a motion to dismiss but is not a case in which the plaintiff has a realistic possibility of success if the matter were to be litigated at trial. The U.S. Supreme Court has taken a dim view of strike suit litigation. See, e.g., *Stoneridge Inv. Partners L.L.C. v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 163-64 (2008); *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 191 (1994); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739-48 (1975). For example, in a case decided more than thirty-five years ago, the U.S. Supreme Court took a critical view of securities litigation:

The potential for possible abuse of the liberal discovery provisions of the Federal Rules of Civil Procedure may . . . exist in this type of case to a greater extent than they do in other litigation. The prospect of extensive deposition of the defendant's officers and associates and the concomitant opportunity for extensive discovery of business documents, is a common occurrence in this and similar types of litigation. To the extent that this process eventually produces relevant evidence which is useful in determining the merits of the claims asserted by the parties, it bears the imprimatur of those Rules and of the many cases liberally interpreting them. But to the extent that it permits a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the process will reveal relevant evidence, it is a social cost rather than a benefit.

*Blue Chip Stamps*, 421 U.S. at 741 (holding that standing in private § 10(b) actions is limited to purchasers or sellers of subject securities).

actions.<sup>34</sup> Whether Congress appropriately weighed these competing considerations, particularly in light of the financial debacles that have occurred in the past decade,<sup>35</sup> is subject to debate.<sup>36</sup>

Thus, preemption of the blue sky laws is a route that Congress has undertaken with some vigor. For example, due to the states' perceived unduly harsh and inconsistent treatment of nationally traded companies registering their securities,<sup>37</sup> government oversight of such registration today is now solely within the purview of the federal securities laws.<sup>38</sup> As another example, with respect to private offerings under Rule 506 of Regulation D,<sup>39</sup> a number of states were viewed by their critics as imposing unduly rigorous conditions for perfecting the exemption on the state level, thereby needlessly impeding capital formation.<sup>40</sup> By preempting from registration state regulation of offerings that meet the Rule 506 exemption,<sup>41</sup> Congress agreed with this position in its enactment of the National Securities Markets Improvement Act of 1996.<sup>42</sup>

Shortly after engaging in this quest of preemption and removal of perceived regulatory impediments to capital raising, our country has witnessed massive financial debacles during the past decade that threaten the integrity of the U.S. capital markets.<sup>43</sup> Congress responded by enacting corporate governance legislation in 2002 (the Sarbanes-Oxley Act)<sup>44</sup> and in 2010 (the

34. See Casey, *supra* note 29, at 146–47; Painter, *supra* note 29, at 71–75.

35. These include Enron, WorldCom, Tyco, Global Crossings, Adelphia, Madoff, and Stanford.

36. See generally KURT EICHENWALD, CONSPIRACY OF FOOLS (2005); JAMES B. STEWART, DEN OF THIEVES (1991); Colloquium, *Ethics in Corporate Representation*, 74 FORDHAM L. REV. 947 (2005).

37. See Campbell, *Open Attack*, *supra* note 5, at 557–67.

38. See Securities Act of 1933 § 18(b)(1) (codified as amended 15 U.S.C. § 77r(b)(1)). Although enacted pursuant to the National Securities Markets Improvement Act of 1996 ("NSMIA"), this national market exemption to securities listed or to be listed on a national securities exchange was the practice prior to the passage of that Act. See Robert G. Bagnell & Kimble Cannon, *The National Securities Markets Improvement Act of 1996: Summary and Discussion*, 25 SEC. REG. L.J. 3, 6 n.13 (1997) (citing [1996 Transfer Binder] Blue Sky L. Rep. (CCH) ¶ 6401 at 2501, 2514.) Note, however, that if the offering documents are materially misleading, the respective states retain their enforcement authority.

39. 17 C.F.R. § 230.506. Rule 506 was adopted in Securities Act Release No. 6389 (1982).

40. See Mark A. Sargent, *The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform*, 68 WASH. U. L.Q. 225 (1990).

41. Securities Act of 1933 § 18(b)(4)(D) (codified as amended at 15 U.S.C. § 77r(b)(4)(D)); see Bagnell & Cannon, *supra* note 38, at 89. Court decisions have interpreted preemption of the Rule 506 exemption. See, e.g., *Brown v. Earthboard Sports USA, Inc.*, 481 F.3d 901 (6th Cir. 2007); *Temple v. Gorman*, 201 F. Supp. 2d 1238 (S.D. Fla. 2002); *Buist v. Time Domain Corp.*, 926 So.2d 290 (Ala. 2005); *Risdall v. Brown-Wilbert, Inc.*, 753 N.W.2d 723 (Minn. 2008).

42. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.).

43. See, e.g., CHRISTOPHER DODD, COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, THE RESTORING AMERICAN FINANCIAL STABILITY ACT OF 2010, S. REP. NO. 111-176, at 35 (2010) (stating that the Act contains "provisions that respond to significant aspects of the financial crisis caused by poor securitization practices (Subtitle D); erroneous credit ratings (Subtitle C); ineffective SEC regulation . . . ; and executive compensation practices that promoted excessive risk-taking (Subtitle E)"); PAUL SARBANES, COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, PUBLIC COMPANY ACCOUNTING REFORM AND INVESTOR PROTECTION ACT OF 2002, S. REP. NO. 107-205, at 2 (2002) (stating that "[t]he purpose of the [Sarbanes-Oxley Act] is to address the systematic and structural weaknesses affecting our capital markets which were revealed by repeated failures of audit effectiveness and corporate financial and broker-dealer responsibility in recent months and years").

44. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 15 U.S.C.). See generally JAMES HAMILTON & TED TRAUTMANN, SARBANES-OXLEY



Dodd-Frank Act).<sup>45</sup> Provisions in these Acts federalize norms of corporate governance that traditionally have been within the purview of the states.<sup>46</sup>

Whether these Acts will serve their objectives of enhancing corporate governance and compliance with the law remains to be seen. But what is clear is that the U.S. Securities and Exchange Commission (“SEC”) cannot reliably be depended on to detect and enforce violations of the law, particularly massive financial frauds, on a uniform basis. The Madoff and Stanford scandals are simply the best known, of course, for good reason in light of the huge investor losses suffered.<sup>47</sup>

Although a premier regulatory agency, the SEC simply does not have the wherewithal in resources or personnel to accomplish this arduous objective.<sup>48</sup> Although Congress expanded the SEC’s tasks in the Dodd-Frank Act in 2010,<sup>49</sup> it thus far has refused to authorize the necessary appropriations for the Commission to have any realistic possibility of success in this endeavor.<sup>50</sup> Nonetheless, missing the existence of massive financial frauds in its enforcement practice long has been a characteristic of the SEC. One may remember the Equity Funding debacle more than thirty years ago when the SEC ignored tips relating to financial fraud.<sup>51</sup> Only after the fraud’s public revelation

ACT OF 2002: LAW AND EXPLANATION (2002); Marc I. Steinberg, UNDERSTANDING SECURITIES LAW 158–73 (5th ed. 2009).

45. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1375 (codified as amended in scattered sections of 12 U.S.C.).

46. Under the Sarbanes-Oxley Act, examples include: the requirement that members of the audit committee be independent directors; the SEC’s power to procure a court order precluding a violator of the securities laws, who engaged in fraud and who is deemed unfit, from serving as an officer or director of a publicly held company; and the general prohibition of publicly held companies extending loans to its directors and executive officers. Under the Dodd-Frank Act, examples include requiring advisory shareholder votes on executive compensation and golden parachutes, as well as requiring that the compensation committee be comprised entirely of independent directors. See generally CCH Attorney-Editor Staff, *Dodd-Frank Wall Street Reform and Consumer Protection Act* (2010); [SEC Commissioner] *Casey Criticizes Increasing Federalization of Corporate Governance*, FED. SEC. L. REP. (CCH) No. 2463, at 15 (Feb. 2, 2011).

47. See, e.g., DIANA B. HENRIQUES, *THE WIZARD OF LIES* (2011); Lewis D. Lowenfels & Alan R. Bromberg, *How Did Madoff ‘Pull It Off?’*, 43 SEC. REG. & L. REP. (BNA) at 550 (Mar. 14, 2011); Kara Scannell, *The Madoff Fraud: SEC Botched Inquiries into Madoff Scheme—Inspector General Cites Inexperienced Staff and Delays*; “*A Failure That We Continue to Regret*”, WALL ST. J., Sept. 3, 2009, at C3; Glenn R. Simpson, Dionne Searcey, & Kara Scannell, *The Stanford Affair: Madoff Case Led SEC to Intensify Stanford Probe*, WALL ST. J., Feb. 19, 2009, at A14; Eric Torbenson, *Director of Fort Worth SEC Office Is Leaving*, DALLAS MORNING NEWS, Mar. 10, 2011, at D03 (pointing to the SEC’s “failure to act on information that might have halted Stanford’s sales practices sooner”).

48. See David Ratner, *The SEC at Sixty: A Reply to Professor Macey*, 16 CARDOZO L. REV. 1765, 1779 (1995) (opining that “[t]he SEC is one important reason why the securities industry is in so much better shape than other financial service industries, and why U.S. securities markets are the best securities markets in the world”). Of course, the recent scandals and the SEC’s failure to detect these frauds have sullied to some degree the Commission’s superb reputation. See *supra* note 47.

49. See David S. Hilzenrath, *SEC Chair Schapiro: Budget Freeze Hurts Ability to Regulate Financial Markets*, WASH. POST, Feb. 5, 2011, at A10 (stating that under Dodd-Frank, “the SEC has expanded responsibilities for regulating hedge fund advisers, credit rating agencies and derivatives, [and] is also tasked with translating the law into many new rules”).

50. See Jessica Holzer, *SEC Watchdog in a Plea for Cash*, WALL ST. J., Feb. 11, 2011, at C6; *SEC Will Have to Furlough Staff with House Republican Cuts*, [SEC Chairman] *Schapiro Says*, 43 SEC. REG. & L. REP. (BNA) at 527 (Mar. 14, 2011); [SEC Commissioner] *Walter Says Congress Setting SEC on Path to Failure Through Tight Purse*, 43 SEC. REG. & L. REP. (BNA) at 476 (Mar. 7, 2011).

51. See *Dirks v. SEC*, 463 U.S. 646, 650 (1983), *rev’g*, 681 F.2d 824 (D.C. Cir. 1982). The SEC’s lack of impressive investigative acumen is set forth by the D.C. Circuit as follows:

became known significantly through analyst Raymond Dirks' diligence did the SEC awake. And then it rewarded Dirks by bringing an insider trading enforcement action against him<sup>52</sup>—indeed, remarkable.

That is why the states in their enforcement of the blue sky laws are important to market integrity and investor protection. The SEC needs help. The states are well equipped to render assistance. Although not a cure-all, vigorous state enforcement will provide a welcome boost to these laudable objectives. Enhanced blue sky enforcement in the face of continual investor fraud that inflicts billions of dollars of loss to state residents,<sup>53</sup> many of whom are elderly,<sup>54</sup> is a mandated prescription in these times. Now is the time for the state legislatures to be proactive and provide the necessary tools and resources for their blue sky personnel to protect their residents.

Implementation of this strategy should redound to the benefit of the states—not only investors—children as well. By creating an "Education Fund" whereby penalties and fines levied on blue sky violators will be placed into this fund, the public school funding crisis will be alleviated, hopefully to a significant degree. Our children deserve a good public education. Implementing this proposal will help to achieve this endeavor.<sup>55</sup> The only

The SEC had a history of failing to act promptly in the Equity Funding case. In 1971, the SEC was approached by William Mercado, an Equity Funding employee, with reports of questionable accounting practices at Equity Funding. The SEC performed a cursory investigation and took no further action. When [former Equity Funding insider] Ronald Secrist decided to discuss his suspicions about false insurance with someone, he did not go to the SEC because he had heard that the SEC had repeated information it received from employees to Equity Funding's president.

On March 7, 1973, however, before meeting with Dirks, Secrist told his whole story to people at the New York State Insurance Commissioner's Office. They in turn relayed the information to the California Insurance Department, which had jurisdiction over Equity Funding. On March 9, 1973, an official of the California Department had a conference with one of the staff attorneys in the SEC's Los Angeles office at which he repeated Secrist's charges as relayed by the New York authorities. The California official stated that he thought his department might want to do a full inspection of Equity Funding, and he asked for help from the SEC. The SEC staff attorney stated that similar allegations had been made about Equity Funding before by disgruntled employees. He recommended "delaying any type of inspection of the Equity Funding operations until next year when more personnel are available." The attorney's memorandum to his superior describing this conversation was apparently not written until March 16, and it was not read until after the SEC's interviews with Dirks had begun.

*Dirks*, 681 F.2d at 832 n.6 (internal citations omitted).

52. *Dirks*, 463 U.S. 646 (1983). The U.S. Supreme Court held that Dirks did not engage in illegal tipping under § 10(b) of the Securities Exchange Act. *Id.* For discussion on insider trading, see MARC I. STEINBERG & WILLIAM K.S. WANG, *INSIDER TRADING* (3d ed. 2010).

53. It has been estimated that "securities fraud alone costs investors \$40 billion per year." NASAA, *NASAA Year in Review 2006: Advancing a Legacy of Investor Protection* at 4, <http://www.nasaa.org/content/Files/2006YIR.pdf> (last visited June 25, 2011); see also Tim Beyers, *The Next Penny Stock Scam*, THE MOTLEY FOOL (Apr. 28, 2010), <http://www.fool.com/investing/general/2010/04/28/the-next-penny-stock-scam.aspx>; SEC, *Internet Fraud* (Feb. 1, 2011), [www.sec.gov/consumer/cyberfr.htm](http://www.sec.gov/consumer/cyberfr.htm); NASAA, *NASAA Fraud Center*, [http://www.nasaa.org/Investor\\_Education/NASAA\\_Fraud\\_Center](http://www.nasaa.org/Investor_Education/NASAA_Fraud_Center) (last visited June 25, 2011); Eric Holder, U.S. Att'y Gen., Dep't of Justice, *Announcement of Results of Operation Broken Trust* (Dec. 6, 2010) (transcript available at <http://www.justice.gov/iso/opa/ag/speeches/2010/ag-speech-101206.html>).

54. Victims of elder financial abuse suffer annual loss "estimated to be at least \$2.6 billion." MetLife, *Broken Trust: Elders, Family and Finances: A Study on Elder Financial Abuse Prevention*, at 7 (Mar. 2009) <http://www.metlife.com/assets/cao/mmi/publication/studies/mmi-study-broken-trust-elders-family-finances.pdf>; see AARP, *Elder Fraud Leader's Guide* (2010); Investor Protection Trust, *IPT Elder Investor Fraud Survey*, <http://www.investorprotection.org/learn/research/?fa=eiffesurvey> (last visited June 25, 2011).

55. In this regard, the "Fair Funds" provision enacted pursuant to the Sarbanes-Oxley Act provides a comparison. Sarbanes-Oxley Act of 2002 § 308(a), Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in

unresolved question is the magnitude of the funds generated. We do not know whether the monetary amounts placed into the Education Fund will make a critical difference.<sup>56</sup> Given our current plight, it is a venture worthy of implementation.

It is fitting that this proposal is developed here in the *Washburn Law Journal*. After all, Topeka is the home of *Brown v. Board of Education*.<sup>57</sup> That decision, of course, opened avenues of opportunity for all American children. We must not sit idly by engaging in barbs against teachers to justify cutbacks in our public schools. We must be proactive to uncover needed sources of revenue. After all, children are America's greatest asset. We must do whatever we practically can to successfully educate our children in our public schools. It is time for the "blue sky" laws to be invoked for another admirable endeavor—to bring "blue sky" to our public classrooms and schools.

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scattered sections of 15 U.S.C.). Under the Act's "Fair Funds" provision, monetary penalties levied in SEC enforcement actions may be directed to a fund to help compensate aggrieved investors. *See* Official Committee of Unsecured Creditors of WorldCom, Inc. v. SEC, 467 F.3d 73, 83–84 (2d Cir. 2006) (pursuant to the Fair Funds provision, affirming SEC's plan to distribute \$750 million to WorldCom investors); *see also* Verity Winship, *Fair Funds and the SEC's Compensation of Injured Investors*, 60 FLA. L. REV. 1103 (2008).

56. As discussed earlier in this Essay, funds derived from penalties and fines levied upon violators of other state statutes, such as those focused on consumer and tax fraud, also may be directed to that state's education fund.

57. 347 U.S. 483 (1954). Today the school that was one of four schools represented in that lawsuit is still standing as a national historic site in Topeka, Kansas, the home city of Washburn University School of Law. Nat'l Parks Serv., *Brown v. Bd. of Education National Historic Site*, <http://www.nps.gov/brvb/> (last visited June 25, 2011).