Understanding the Blue Sky Laws

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What are Blue Sky Laws?

The term "blue sky laws" refers to an umbrella grouping of laws within United States code that is meant to protect the average investor from overly speculative investments that either do not have any intrinsic value or contain such a gross imbalance between risk and reward so as to be considered an ethical fraud even if the fraud cannot be defined as a technical one.

Why Did Investors Need Blue Sky Laws?

Before the age of the Internet, investors had no way to keep up with the minute to minute activity of any stock or security that they were invested in. The only way that an investor would be able to monitor a speculative stock that had to be traded on a short term basis was through a broker. Brokers within the elite financial institutions who were actually on the trading floor of the stock exchange were the only people who knew the immediate value of a stock at any given time. If an investor wanted to find out the immediate value of his or her stock, he or she would have to call the broker directly and hope the broker picked up the phone. If the broker was not available or did not answer, the investor would simply have to wait on the end of day stock ticker in the next day's newspaper.

Because brokers held such inordinate power, blue sky laws were enacted in order to keep them from speculating too much with money from investors that was literally kept blind to them on a minute to minute basis.

The Difference Between Federal Regulations and Blue Sky Laws

Blue sky laws are by definition state laws. Although there are federal regulations concerning the behavior of stockbrokers, none of these laws are known as blue sky laws. Because each state has the power to enact its own blue sky laws, they will vary from state to state. In some cases, stockbrokers will have to obtain a license in that state as well as a federal permission in order to trade stocks professionally on behalf of an investor.

State Blue Sky Laws in Federal Cases

Although blue sky laws are state laws, they have been cited by the Supreme Court as justification for a decision.

The Origin of the Blue Sky Laws

Joseph Norman Dolley, the banking commissioner of the state of Kansas in 1911, lobbied for the first blue sky law to be implemented in the state that year. Mr. Dolley is also generally given credit for inventing the term "blue sky law." Mr. Dolley first initiated the efforts which led to blue sky laws by attempting to legislatively curtail the efforts of "blue sky merchants" in Kansas, or merchants who seemed to sell fraudulent securities which were backed up by nothing but the blue sky.

Many historians make the mistake of attributing the invention of the term to the first Supreme Court Justice to cite a blue sky law in a decision for a case. Justice Joseph McKenna first used the term judicially in his written opinion in the Hall v. Geiger-Jones Co., 242 U.S. 539 (1917) case, which brought up the issue of constitutionality of the blue sky laws that had recently been enacted. In the opinion, Justice McKenna explained what brought about the name of the law, saying of the investments covered by the laws, "speculative schemes which have no more basis than so many feet of 'blue sky'." However, even in this opinion, Justice McKenna seems to imply that the term was given to him by an earlier, unnamed source, which was likely Mr. Dolley, although the justice did not name the source in his opinion. The Oxford dictionary details the first use of the term as circa 1906.

The term caught on with the general public when the New York Times began reporting on the many laws that states were passing in response to the legislative victory of Mr. Dooley in Kansas. They referred to all of these laws as "blue sky laws," and the name stuck in other media publications as well.

The initiative was quickly picked up by other states and by 1933, 47 of the 48 states in the United States at the time had initiated some form of blue sky law. The single holdout was the state of Nevada.

A Short History of Blue Sky Laws

Today, most of the blue sky laws on the books are modeled after a federal prerogative, the Uniform Securities Act, which was initiated in 1956. Between 1956 and 1996, there was a great deal of duplication between federal statues involving the trading of stocks and the blue sky laws that were being enacted by the 50 states at that time. However, with the introduction of the National Securities Markets Improvement Act of 1996 by the Securities and Exchange Commission (SEC), much of the duplication was largely preempted.

With many of the blue sky laws now preempted, the jurisdictional arguments as to the registration of securities covered by blue sky laws and the way that advisors and brokers were to be regulated began. For the most part, the federal government took over the regulation of much of the business that the blue sky laws of each state had taken care of previously. Much of the regulation of stock advisors and brokers was now under the jurisdiction of the federal government as well. However, there were some regulatory matters that were left completely up to the states including fraud litigation.

Some state law securities fraud claims were, however, also preempted by the Securities Litigation Uniform Standards Act. Specifically, litigation that was effectively or technically a class action lawsuit was now under the complete jurisdiction of the federal government.

The Attempt to Federalize All Blue Sky Laws

In 1996, the federal government initiated its last large effort to date to attempt to preempt and standardize all state blue sky laws with the National Securities Market Improvement Act of 1996 (NSMIA). NSMIA was brought into being officially in October of 1996 and was enacted specifically in response to the failure of the states to create a uniform regulatory structure for offerings of securities with federal implications. With the passage of the Act, Section 18 of the Securities Act of 1933 was amended, creating a class of securities that was not subject to any jurisdiction from the states at all. These securities were known as "covered securities" and included any security that was either listed or approved for listing on the three major stock indices: the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX) and the Nasdaq (National Market). This new class of covered securities also included any security from the same issuers of listed securities which were equal to or senior in rank above any listed security. Shares of mutual funds, securities that were already exempt under Section 3(a) of NSMIA and securities that were being sold to as yet unidentified "qualified" purchasers were also made exempt from state scrutiny. Securities that were exempt under Section 3(a) included commercial paper, securities from banks as well as securities from municipalities.

Securities that were in compliance with Rule 506 of Regulation D were also made exempt, as mentioned before. However, in any case in which the state has a legitimate reason to suspect out and out fraud, they retain the right under NSMIA to investigate as well as prosecute without being preempted by federal law.

Only the securities were made completely exempt from state scrutiny under NSMIA. Brokerages as well as agents are still compelled to submit to the authority of the state regulatory bodies as well as the federal overseers when conducting business on behalf of another investor.

The Basic Provisions of All State Blue Sky Laws

As stated before, although blue sky laws vary from state to state having been individually implemented by each governing body, there are some similarities between all blue sky laws that are expressly identified as such.

All blue sky laws require a securities offer and sales of securities to be registered with the state. Also, brokerage firms as well as stockbrokers must register with the state. All state blue sky laws are administered by the appropriate state regulatory agency. In order for a private investor to have a legitimate claim of securities fraud against a stockbroker, an advisor or a market maker, the private cause of action must be noted within the blue sky law.

Registration of Securities Transactions in Compliance with Blue Sky Law

Today, most of the regulations that deal with securities fraud are federal in nature and overseen directly by the SEC and the various SROs of the federal government. However, the states have plenty of power to bring cases against brokerages as well as securities advisors who are suspected of dealing with fraudulent securities, although there has been much federal regulation in recent years to limit this power.

In order to sell a security in a state, a registration must be created first so that the transaction will be fully covered. If the brokerage firm, the transaction itself and the stockbroker who is personally conducting the transaction is not registered, the state may have cause to bring an action of fraud against the transaction or those involved in it. There are few exemptions to this rule in most states; however, there are a few ways to circumvent this basic type of registration.

Brokerages and individual securities advisors are expected to go over the individual rules and regulations of each state before conducting any transaction in that state on behalf of another investor.

Securities That are Exempt from Blue Sky Laws

As mentioned before, there are some types of securities that are kept exempt from the registration requirements of blue sky laws in states. For one, many of the 40 states who currently enact federally based state blue sky laws still maintain the autonomy to exempt from state securities registration requirements any Regulation D private offering. However, even if there is a state exemption for registration, the offering must still be in compliance with SEC Rules 501-503 or the federal government may still have a course for action based in fraud against the brokerage or the stockbroker who is conducting the trade on behalf of another investor.

Although many states do not require registration for certain transactions such as Regulation D private offerings, this does not mean that they are exempt from any scrutiny from the state whatsoever. In place of a mandatory regulation, many types of transactions that are otherwise exempt still require filings with the state. States may also put additional conditions on any exemption. Most reputable stockbrokers and brokerage agencies will consult with a dedicated Blue Sky attorney before attempting any transaction in a state with which they have no experience.

State Blue Sky Laws as Relates to Stockbrokers, Agents and Dealers

Since the states retained most of their rights when it came to regulating stockbrokers, agents and dealers, the blue sky laws that have been individually enacted within each state are still valid. This means that brokers, dealers and agents have to be especially careful when conducting trades on behalf of an investor to determine what state has jurisdiction and if he or she is following the state regulations.

Many states, in response to lobbying efforts from brokers and agents who were completely confused by the plethora of overlapping rules and regulations that they faced, actually permit filings of registration to be conducted through the National Association of Securities Dealer's Central Registory Depository System (CRD). Most states have also federalized their requirements for the testing of brokers, agents and dealers by accepting the results of tests that are administered by the NASD.

However, there are a few states such as Vermont, Maryland, Ohio, Florida, Louisiana and Colorado who do not adhere to the requirement of brokers, agents and dealers of securities in those states to take and pass the NASD Series 63 test. Also, other states such as Michigan, California and Hawaii do not allow any initial dealer or broker registrations to be made through the CRD or Internet CRD standards. These states mentioned, along with a few others, actually require more of brokers and agents including a copy of business financials that have been properly audited and certified.

Because of the many conflicting state and federal laws and regulations, brokers who transfer firms can lose out on a lot of business. The entire process can take up to a few weeks, during which time that broker will not be able to trade on behalf of his client base. However, the TAT system was created in 1984 to counter these delays as the speed of transactions began to increase exponentially. Under the TAT system, as long as a broker does not have any disciplinary actions set against him, he or she is given three full weeks (21 days) to complete the registration process for a new state. However, only 20 states have enacted this TAT standard, with the rest requiring a full physical transfer.

New York: No Private Right of Action?

Perhaps the most striking example of the range of trading environments that state blue sky laws can set is New York, in which a private right of action is completely out of the question as relates to fraud. Put another way, an individual has no right to sue a broker, an agent or a dealer for any type of fraudulent action. This action can only be taken by the attorney general in the state. The only recourse that the individual investor has in the state of New York as relates to any alleged fraudulent actions of a dealer or a broker is to bring action under common law. An individual may also take a legal action against a dealer, an agent or a broker for breach of fiduciary duty. This type of blue sky law gives a great deal of protection to the stockbrokers in the state of New York, and each set of blue sky laws seems to reflect the balance of power that the securities industry has with the general public that is looking to that industry to invest its money and protect its assets.

The Overall Effect of Blue Sky Laws

In theory, the federal laws and regulatory bodies combined with the blue sky laws of each state make the brokerage industry easily the most regulated industry on the planet Earth. However, in practice, many critics say that the federalization of many blue sky laws under the umbrella of the federal government has allowed large financial institutions and powerful brokers and agents to get away with behavior that would normally not be tolerated on the smaller scale of a state regulatory body. Critics of federalization of the blue sky law initiatives also state that the federal government has been overrun with cases of fraudulent behavior by many agents and agencies and they simply do not have the manpower to prosecute all of the cases.

Opponents of the federalization of blue sky laws point to the covered securities that the federal government has deemed untouchable by the states. They claim that a great deal of the fraud that has gone unprosecuted has come from these protected securities, including the alleged fraudulent actions of many of the large banks during the 2008 housing and banking crises which threatened to unnerve the entire economy of the United States and with it, the world economy. Proponents of state blue sky laws also point to the unwillingness of the federal government to prosecute heads of large financial institutions that many people considered to have been perpetrators of fraud during those crises. They claim that those individuals might have been brought to a greater justice if they had been under the scrutiny of state blue sky laws, which had, for the most part, been rendered impotent in the face of the federal crisis.

However, the confusion that the securities industry faces by having to adhere to 50 different sets of regulations as well as federal regulations has the ability to slow down commerce to a grinding halt, say proponents of the federalization of blue sky laws. They claim that as the federal government takes over the reins of the regulation of fraud, the amount of legal transactions that are able to take place far outweigh the fraudulent behavior that may slip through the cracks because the federal government does not have enough manpower to prosecute all of the fraud that takes place within agencies around the entire United States.

Proponents of the federalization of blue sky laws also argue that the states have actually been given a great deal of leeway when it comes to deciding whether they will adhere strictly to federal standards or implement their own standards as in the case of New York, California and Texas for the testing and the vetting of agents and brokerages within the state.

Overall, blue sky laws continue to be usurped by and large by the federal government, which seems quite intent on creating a single standard for brokers, agents and dealers around the country when doing business on behalf of the average investor.

The debate will undoubtedly continue and serve as a lightning rod for states' rights versus the power of the federal government to impose its will against the wishes of the leadership of the state. It will also no doubt create a great deal of confusion for new dealers, agents and brokers who are looking to do business in the new digital age of unregulated cross markets. Who is to say which state or country has jurisdiction over transactions that occur over a digital platform with no home state or country? As legislators clamor for control over these new markets, agents, brokers and dealers of securities will have to find ways to continue to do business in an ever thickening web of laws and regulations.