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August 13, 2014

To: Mary Jo White, Chair
Elizabeth M. Murphy, Secretary
Charles Kwon, Office of Chief Counsel,
Division of Corporation Finance
Securities and Exchange Commission
100 F Street, NE, Washington, DC 20549-1090
CC: rule-comments@sec.gov
CC: Edward J. Markey, United States Senator (**the Senate leader of the group of "nein"**)
CC: Jeff Merkley, United States Senator
CC: Tom Harkin, United States Senator
CC: Mazie K. Hirono, United States Senator
CC: Barbara Boxer, United States Senator
CC: Carl Levin, United States Senator
CC: Elizabeth Warren, United States Senator
CC: Christopher Murphy, United States Senator
CC: Al Franken, United States Senator

From: Jason Coombs, Co-Founder and CEO
Public Startup Company, Inc.
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Re: File No. S7-11-13, http://www.gpo.gov/fdsys/pkg/FR-2014-01-23/pdf/2013-30508.pdf
JOBS Act legislation URL http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf

The letter submitted by the nine Senators CC'ed above, dated August 1, 2014, is profoundly disappointing.

See http://www.sec.gov/comments/s7-11-13/s71113-123.pdf

As a member of the "exorbitant class of people" which these "nein" Senators insist on excluding from the unregistered securities initial public offering or secondary public offering markets, and on behalf of all other "exorbitant class" members, I wish to point out that these Senators are engaging in disgusting, completely un-American class warfare, and they are urging the SEC to perpetuate a system of class warfare, abuse and corruption, rather than proposing a remedy to these systemic problems in our economic system.

The group of nine Senators who urged the SEC to withdraw its proposed preemption of state regulation have failed to provide any reasonable basis for their assertions that such withdrawal is necessary or that it is even helpful to state securities regulators' efforts to detect and punish fraudulent offers and sales of securities. The Senators wrote "Blue Sky laws are also a means to punish those persons who defraud individuals on a small scale." However, the Senators appear to entirely fail to understand the dramatic difference between state securities law and federal securities law which makes full federal preemption a practical necessity in order for the SEC to implement JOBS Act Rules for Title IV Regulation A+ sales.

As the Senators point out correctly, in many states merely selling unregistered securities in private sales can technically be a crime under Blue Sky laws, ***EVEN WHEN THERE IS NO GENERAL SOLICITATION OR GENERAL ADVERTISING THEREOF***. The Senators point to one recent case in particular in Kansas, in which a convicted sex offender named Charles Ray Matthews was sentenced to prison for two counts of selling unregistered securities and one count of securities fraud. Based on a prior criminal indictment from 2013 it appears the securities fraud was only detected after Matthews was arrested and his computers were searched, presumably by federal computer forensic examiners. Matthews was reportedly charged with 14 felony counts for violations of Kansas securities laws, and could have been sentenced to 172 months prison in addition to the 150-month prison sentence imposed for his unrelated federal child pornography offenses. There is no reason to believe Kansas Blue Sky Law helped detect, nor to punish, Matthews' securities fraud.

See http://thebellevilletelescope.com/articles/2013/06/19/man-faces-federal-pornography-charges
and http://thebellevilletelescope.com/articles/2014/01/15/securities-commission-files-complaint-against-belleville-man
and http://thebellevilletelescope.com/articles/2014/04/09/man-agrees-prison-terms-securities-fraud-child-pornography

In a case where there is clear securities fraud, the anti-fraud statutes are totally adequate for both detection and punishment of offenses. If the state of Kansas did not have a prohibition against selling unregistered securities, it would still have been able to charge and convict Matthews for the felony crime of selling fraudulent securities after obtaining proof of the offense from the federal computer forensic examinations. When the Senators claim that Kansas must be able to continue to criminalize offers or sales of unregistered securities in Kansas in order to be able to punish fraud, the Senators are factually and objectively mistaken.

Even if the Senators presume that Matthews would have conducted a Regulation A+ Offering, rather than completely ignoring securities regulations as appears to be the facts of this case, and therefore Matthews would not have been subject to Kansas criminal statutes prohibiting sales of his unregistered securities, it is perfectly clear that upon learning that the sales were fraudulent the state of Kansas would still have brought charges for fraud and obtained precisely the same sentence upon Matthews' plea agreement and conviction. This case also brings up another very important point that the Senators have completely ignored. It appears that Charles Ray Matthews was already listed in a sex offender registry at the time of the securities fraud. If the victims who bought the fraudulent securities from Matthews had bothered to search for public records of past wrongdoing, perhaps they would not have purchased the securities. This offense does not appear to be a disqualifying event based on SEC's proposed Bad Actor Rule for Regulation A+ and Rule 506(c) but it seems the Kansas Securities Commission would not consider this to be a disqualifying prior bad act, either.

See http://www.homefacts.com/offender-detail/LA1629242/Charles-Raymond-Mathews-Iii.html

In the other case cited by the Senators there was no accusation of criminal fraud, but rather the case appears to have involved deceptive and defective offering documents and misleading, inappropriate sales tactics. To protect the investors who were deceived and bought the unregistered securities, the state securities regulator alleged that a registered broker-dealer in Santa Monica, California had failed to properly supervise its agent.

See http://www.sec.state.ma.us/sct/archived/sctnpc/consentorder.pdf
and **http://www.sec.state.ma.us/sct/archived/sct3entities/3entities_complaint.pdf**

The Senators, in their letter to the Commission, have failed to properly explain the true legal basis of the successful recovery of the $3.9 million from the California broker-dealer. This is not a minor mistake by these Senators. In their letter to the Commission the Senators alleged that the $3.9 million recovered was “from a corporation that was selling 'unregistered highly risky securities' to senior citizens in 2008.” But as explained in the consent order cited (see above, and footnote #11 in the Senators' letter to the Commission) the corporation that agreed to reimburse the $3.9 million was in fact the registered broker-dealer located in Santa Monica, California and not in fact the company that had sold the questionable unregistered securities!

In fact, the consent order plainly stipulates, in its Findings of Fact, that the request submitted by the selling agent to the registered broker-dealer with whom he was affiliated was rejected by the broker-dealer. Despite rejecting the agent's request for authorization to enter into a selling agreement with the issuer of the highly risky and questionable unregistered securities, the state securities regulator asserted that the broker-dealer was liable for their agent's actions because they failed to properly supervise and because seven of the people who were deceived by the agent were the broker-dealer's customers. The customers obviously did not know the difference between a transaction that was approved by the broker-dealer and a transaction that had been rejected but which the broker-dealer's selling agent brokered and sold anyway, without permission, himself.

From the point of view of seven of the buyers of the EDFC securities they thought they were purchasing the securities through the registered broker-dealer located in Santa Monica, California. The legal theory offered by the state securities regulator, that the broker-dealer was liable for all of the sales because it should have better supervised their agent in Massachusetts, was not litigated nor adjudicated in this case. Regardless, it is perfectly clear that the Senators have erred in a very serious way by levying a false accusation that the broker-dealer who agreed to reimburse the $3.9 million was the corporation that had sold the securities. The Senators owe the broker-dealer a written, public apology, and a full explanation of their mistake to the SEC.

I would like the Senators to explain to me, and to the rest of the "exorbitant class of people" of which I am personally a member by financial status, exactly why they are claiming that either the state of Kansas or the state of Massachusetts would be incapable of regulating, why they would be incapable of bringing civil and/or criminal cases in court or through administrative proceedings in their respective jurisdictions, in order to achieve ***precisely*** the same outcomes as in ***any*** case of securities fraud or deceptive or abusive sales of unregistered securities particularly the two cases cited in the Senators' letter to the SEC.

I agree that sales of unregistered securities through broker-dealer intermediaries **ARE VERY COMPLEX AND PROBLEMATIC TO REGULATE.** As mentioned in the Senators' letter, footnote #8, H.R. 1070 was amended in 2011 to remove "the exemption from State level review that was previously provided to an issuer using a broker-dealer to distribute" securities. However, the Senators appear to be making precisely the same mistake that the SEC may have made in formulating the proposed blanket, wholesale preemption of state securities regulation: it appears to be a mistake to read the words "exemption from State level review that was previously provided to an issuer using a broker-dealer to distribute" as though the words "using a broker-dealer to distribute" are not a meaningful part of the legislative reasoning and debate as the proposed amendment to H.R. 1070 was accepted in 2011. Neither the Senators nor the SEC can ignore the fact that the debate, and the amendment cited, were specifically related to the use of a broker-dealer as an intermediary in an unregistered securities offering. The Senators themselves articulate the correct reasoning and interpretation, when, in their letter to the SEC, they assert "Congress knows how to preempt the state Blue Sky laws when it wants to, as it chose to do in Title III of the JOBS Act." As the Senators are aware, Title III authorizes the use of an intermediary "funding portal" as an alternative to a broker-dealer when unregistered securities are offered and sold, with conditions imposed to restrain the funding portal from doing things that only registered broker-dealers should be doing – namely, handling customer funds and distributing securities. The fact that the 2011 amendment to H.R. 1070 would have likewise imposed this same restraint on the use of broker-dealer intermediaries should not be a surprise to anyone. What is a shock and disturbing is the manner in which the "Lynch" mob from the House of Representatives and the group of "nein" Senators (those nine Senators who have resorted to false accusations and inappropriate misreading of the obvious and plain language meaning of an important historic record such as floor debate in H.R. 1070 in order to justify saying "no" to the reasonable and necessary preemption of state securities regulations for issuers who qualify their Regulation A+ offerings with the SEC) are ignoring the needs of small businesses and startups – not just the majority of employers in the United States but the overwhelming super-majority.

According to the Small Business Administration's latest statistics, small businesses are a full 99.7% of the employers in this country. That is **99.7 percent** of all employer firms! Let me say it again: almost 100% of employers in the country are small businesses according to the Small Business Administration. The "Lynch" mob from the House of Representatives, and the group of "nein" Senators, are, astonishingly, disturbingly, attempting to preserve 80-year-old unconstitutional barriers to capital formation for 99.7% of our nation's new job creators and existing employers. How can the "Lynch" mob and the group of "nein" justify this?

See **http://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf**

It is just incomprehensible to see these members of Congress playing politics and spewing evidence that they do not even understand the very important technical issues about which they are spreading fear and propagating their peculiar uninformed brand of misinformation or veiled threats of retaliation against the SEC if it does not withdraw its proposed state preemption language for the Title IV Regulation A+ Rule. The "Lynch" mob and the group of "nein" should try harder to become adequately informed on the issues and **needs of the 99.7%** on whose behalf the SEC is finally appearing to act after 80 years of utter failure.

According to the SBA, small businesses (the ones who will primarily benefit from the preemption of state review in qualifying Regulation A+ offerings) represent not only **99.7% of employer firms in our nation** but they also represent **98% of all firms exporting goods** and **33% of all exports by value** in our entire GDP. For a "Lynch" mob and group of "nein" to target the firms responsible for 98% of all exports of goods begs the question: "have these members of Congress been bribed by foreign governments or companies?"

Few comment letters have been submitted about Title IV of the JOBS Act compared to the other proposed Rules such as Title II and Title III. The SEC, and the misbehaving or uninformed members of Congress like the group of "nein" CC'ed above, should not mistake this relative lack of involvement by members of the general public, issuers or stakeholders in the securities industry, as a sign that nobody cares what happens with this Title IV Rulemaking. It is perfectly clear that this Rule, more than any of the others, carries with it the power to completely disrupt and rewrite the standards of practice in every part of the capital formation ecosystem in our country. Title II preempts the stupid, irrational and unjustifiable criminal statutes of states like Kansas where people are still being threatened with prison merely for speaking publicly about the offer and sale of unregistered securities, but decriminalizing public speech and sales of unregistered securities to Accredited investors doesn't really change anything – everyone knows that Accredited investors routinely ignored these stupid, irrational state laws and purchased whatever securities they wished to purchase, since they were unlikely ever to be prosecuted for doing so even if the issuer from whom they purchased the securities would be prosecuted. Accredited investors knew that state securities regulators would always choose not to prosecute the wealthy buyers for participating in illegal unregistered securities offerings. Now thanks to Title II preemption nobody, not the issuer nor their Accredited buyer, ever needs to worry about the SEC or a state regulator taking any enforcement action, provided that the new Rule 506(c) is obeyed.

Title III preempts state regulators on the condition that the "funding portal" complies with complex rules for use of the "Crowdfunding Exemption" – whatever those Rules end up being in the Final Rule form. As the SEC has proposed the Rule for use of "funding portals" in Title III, the issuers will be the ones who issue securities after receiving funds and identities of the investors who purchased securities through the chosen portal. The preemption of state regulation under Title III is contingent upon the issuer complying with limits on general solicitation and general advertising materials – importantly, as proposed by the SEC, issuers will not be permitted to provide their own contact information but instead will be required to refer potential investors to the funding portal for all information about their Title III unregistered securities offering.

If the "Lynch" mob in the House of Representatives and the group of "nein" in the Senate would just take a moment to comprehend the truth of the nature and purpose of the preemption that is most reasonable for Title IV in light of how the proposed preemption for Title III and the current preemption for Title II function then surely any thinking, rational, reasonable member of these nay-saying groups will be able to understand that the SEC should be finalizing a Title IV Rule that preempts state regulation on the condition that issuers **do their own sales and marketing** of unregistered securities that are first properly qualified with the SEC. As long as Title IV securities are advertized and marketed by the issuers themselves, and not through any broker-dealer intermediary, then issuers can and will strictly control what is communicated to investors. The SEC could, trivially, require a legend attached to all such investor communications that asks anyone who sees the legend to please voluntarily submit a copy of the information electronically to the Commission via its website, Apps or other information systems such as its future CAT supercomputer now being developed.

There are obviously more ways to get this right than to get it wrong. If the SEC gets this wrong it will harm 99.7% of the employer firms in our country. Given what is at stake here, I am astonished that the SEC has not received thousands of comment letters about its Title IV Rulemaking. Presumably, if the SEC does get this wrong, if the SEC caves in to uninformed misguided nay-sayers who cannot understand the difference between protecting the freedoms that are the basis of our economic prosperity and "protecting" money by stopping it from flowing freely in legitimate non-fraudulent commerce, then after-the-fact the SEC will end up receiving the thousands of letters that people would have written if they had been aware of what is now transpiring in this complicated and difficult Rulemaking process. If, on the other hand, the SEC gets all this right and stands up for the rights and the needs of the 99.7% of employers who would make use of this new Regulation A+ Rule if it does preempt state regulators at the qualification stage, then the SEC will be able to see the profound positive impact of its wisdom and good work by virtue of a sea change in behavior and capital formation norms in both startups and growing companies that employ people in high-quality careers. In my opinion if the SEC preempts state regulators in Regulation A+ then Rule 506(c) will remain the norm for hedge funds to raise capital while the $500B per year that is raised by employers will shift to Reg A+.

Based on the plain language and legislative history of the JOBS Act, Section 401(b) clearly encompasses two distinct scenarios in which state preemption is required: resales through a national securities exchange and direct sales “to a qualified purchaser” – clearly only the former (resales) should involve a broker-dealer.

The group of “nein” Senators should think carefully about these two scenarios, and would do well to review the following classic story on origin of Blue Sky Laws. This was published in 1911; now it's public domain:

See **https://web.archive.org/web/20110721043230/http://www.ksc.ks.gov/edu/bluesky.html**

How Kansas Drove Out A Set Of Thieves

By Will Payne
As it appeared in The Saturday Evening Post
December 2, 1911
Volume 184, Number 23
The Curtis Publishing Company, Philadelphia, PA

Not less than a hundred million dollars, in the opinion of those most competent to judge, is stolen from the people in this country every year by the sale of fake and wildcat "securities." The Post-Office Department puts the sum rather higher. Virtually every one of the swindling concerns that prey upon ignorance and credulity to this staggering extent is "duly incorporated" and possesses a charter under the great seal of some sovereign state, qualifying it to go out and rob as many suckers as it can find.

Though nearly every state and territory, with the greatest good nature in the world, will incorporate any sort of rank swindle that comes along, only one state, so far as I know, seriously attempts to protect its citizens from these stock-peddling pirates.

In every state, of course, a purchaser of fake stock may sue for the recovery of his money – which is about as satisfactory as the privilege of suing a pickpocket for the recovery of your watch. There are also general statutes against obtaining money under false pretenses; but nine times out of ten the fake stock scheme is framed up with sufficient ingenuity to make conviction extremely doubtful, and almost always the victim simply pockets his loss. Generally speaking, it's as safe as taking candy from unprotected infants.

With the exception that I am about to describe, the Post-Office Department is the only effectual barrier between credulous people with money to lose and harpies with wildcat stocks to sell. If the fraud involves use of mails, and a complaint is made to the Post-Office Department, prosecution will follow – and most of the prosecutions end in conviction; but, unless the fraud does involve use of the mails, the Department has no power to intervene; and in any event it cannot intervene until the swindling operation is actually under way – which almost always means not until a great many people have lost their money.

A state official recently remarked: "Of course ninety-nine per cent of the mining companies that go round peddling stock are either rank frauds or mere wildcat prospects in which the investor is pretty certain to lose his money. Every intelligent person knows that; but if people are

foolish enough to buy such stuff I don't see how you are going to keep them from doing it."

That is the prevailing view. It is, of course, exactly equivalent to saying: "Why, if a merchant is silly enough to take a counterfeit bill let him stand the loss. Why should we try to protect him by passing laws to prevent counterfeiting?" If a bank teller doesn't know any better than to pay a forged check why should the state try to save him from the consequences of his own blundering?"

In Kansas they have taken an entirely different view of this fake stock swindle. They have not only done something about it, but have virtually stopped it so far as the limited power of any single state can accomplish that end.

The credit for this Kansas innovation belongs mainly to J.N. Dolley, state bank commissioner. Mr. Dolley stands, I should judge, rather better than six feet and possesses an adequate chest development. His shoulders are as big with his coat off – and it is rather apt to be off in business hours – as with it on. He has a chin. No person with any skill in reading physiognomy would pick him out as a promising subject with whom to stir up gratuitous trouble.

"Why, I had been in the banking business here in Kansas a good many years before I became bank commissioner," he explained when I asked him about the genesis of the Blue Sky Law. "Every now and then I would hear of one of these swindles – that somebody had lost his money through buying stock in a fake mine, or in a Central America plantation that was nine parts imagination, or in some wonderful investment company that was going to pay forty per cent dividends. Sometimes I knew the man or woman who had been swindled. Of course I thought it was an outrage, but I don't know as it occurred to me then that there was any way to stop it.

"After I was appointed bank commissioner I heard more reports and complaints of fake stock swindles than ever. The banks hear of such cases because usually the victim draws money out of a bank to buy his wildcat mining shares or his stock in a lunar oil company, or whatever it may be. Kansas has been prosperous of late years, you know; the people have accumulated money. If you go back fifteen years you will see that all the state banks in Kansas then held less than fourteen million dollars of the people's deposits. Now they hold ninety millions and the national banks of the state sixty millions. That's fat picking.

"So reports of these stock swindles drifted to me. I received complaints and inquiries direct from people who had been swindled, wanting me to look up the company and see if they couldn't get their money back – after they had parted with the money! An old farmer I used to know came up to Topeka to see me. He'd sold his Kansas farm and had the money in the bank. A couple of smooth gentlemen came along and persuaded him to invest the money in developing a magnificent tract in New Mexico that was just about to be irrigated. He invested; and, after waiting patiently a good many months for the promised returns, he came up to see

me. I advised him to invest some more money in a railroad ticket and go down and look at his land personally. He did go down there. He got off at the railroad station that was to be their shipping point and walked half a day through the sagebrush, and then climbed some bare, mountainous hills until his wind gave out. The land he'd invested in was still higher up. The only way to irrigate it would be from the moon. That was only one instance out of a good many. There was no law to reach the sharks – except, of course, that a man might sue them or prosecute them for getting money under false pretenses; but a man couldn't do either until after he had lost his money. So far as the law went there seemed nothing to do by way of protecting him, from losing his money; but I made up my mind I'd do something."

I may mention here that doing something in this connection was no part of the official duty of the state bank commissioner. So far as law and custom went his duties consisted in supervising the state banks. There are – or were at the date of the last annual report – eight hundred and sixty-two of them scattered throughout the state, holding a hundred and twenty-five million dollars of assets. To supervise them under the law is a fairly full-sized man's job. I may also mention that Kansas does not specially encourage her bank commissioner to go outside of his official duties for the purpose of discovering extra burdens to assume, for she pays him only the very modest salary of twenty-five hundred dollars a year. Mr. Dolley did not touch upon these phases of the situation. Evidently, however, there is a well-defined theory at Topeka that, as regards banking, the grand duty of the state government is to protect depositors rather than merely to make things pleasant for bankers; and the systematic raids by stock-sharks upon the state's fat bank deposits might be considered a matter in which the state bank department could properly interest itself.

"I started an investigation, as best I could, into this fake and wildcat stock-selling," Mr. Dolley continued, "by inquiries from this office and through the bank examiners who visit every town in the state. I concluded that there must be at least five hundred agents in Kansas selling wildcat stocks. A large majority of them seemed to make that their regular business. Some of them had been at it for years. I believe they were getting anywhere from three to five million dollars a year out of the people of this state; and I am certain that at least ninety-five per cent of all the money put in those stocks was irretrievably lost.

"These fellows had become experts at the business. They had a regular system. They watched real-estate transfers; and if a man sold his farm they were right after him. They kept an eye on probate courts; and if anybody that might prove an easy mark inherited money they were on the spot with some gilt-edge investment yielding anywhere from twenty to a hundred per cent per year. They were always on the lookout for farmers with ready money in the bank; but about their best hold was life insurance, especially fraternal life insurance and the smaller policies – one, two, three, or five thousand dollars."

A great many men carry such insurance in some lodge or mutual

association – farmers, workmen, small tradesmen, and so on. The life-insurance money is enough to tide over the crisis in the family's affairs that is caused by the breadwinner's death; it gives the widow ready cash to meet debts, pay expenses, and support herself and the children for a while. As a rule, the widow has no business experience, has never earned a living, and is more or less bewildered and terrified by the prospect ahead of her; but just about the time the life-insurance money is paid over – and these fellows are so well up in the game they can calculate it to a day – Mr. Agent drops in.

"'You have two thousand dollars,' he says. 'The bank will pay you three per cent interest, or sixty dollars a year. Of course that will do you no good. You will have to live on the principal and in a couple of years it will be gone; but here is a perfectly safe investment that will pay you thirty-five per cent a year. That will give you a sure yearly income of seven hundred dollars. You and the children can live on that quite comfortably!' And in scores and scores of cases he got the money. Do you think the state ought to stand for that?" Mr. Dolley inquired.

The bank commissioner himself didn't think so. On his own initiative he began investigating such stock-peddling concerns as he could hear of. A year ago last April he sent to every newspaper in the state a circular letter as follows:

To the Editor: As you perhaps know, I have established a department in the bank commissioner's office to protect the people of Kansas from fakers with worthless stock to sell. I give you below a small item concerning the matter, which I hope you may be able to use in your paper. I have no funds for advertising purposes; and the only way I can get this information before the people is through the generosity of the Kansas press. Thanking you for whatever you may do, I am----

The small item read:

To the people of Kansas
Topeka, April 9, 1910

The State Banking Department has established a bureau for the purpose of giving information as to thefinancial standing of companies whose stock is offered for sale to the people of Kansas. If you are offered any stock and want information as to the financial standing of the company offering the same, before investing, please write to this department and I will furnish it.

J.N. Dolley, State Bank Commissioner.

The newspapers very generally printed this item. Many of them supplemented it with advice and warning of their own. Inquiries regarding stock-selling concerns poured into the commissioner's office and the fake stock industry in Kansas thereby suffered some check; but the commissioner had no legal authority whatever to require a statement of any kind from a concern that was selling stock in the state, and no power to stop the sale of the stock, however rotten it might be.

As fast as he got names and addresses of stock-selling concerns he wrote

to them, asking for a detailed statement of financial condition, property owned, plan of operation, and so on; concluding by saying that, unless a satisfactory statement were forthcoming within a reasonable time, he should feel obliged to advise all inquirers not, under any circumstances, to buy the concern's stock.

Many companies replied and furnished statements; but they could make the statement in any form they pleased – touching very lightly or entirely ignoring such points as they did not care to have the commissioner scrutinize. Others failed to reply and there was no way of compelling them to do so. In addition to inquiries of the companies themselves, the commissioner wrote to banks, commercial agencies and other sources that seemed likely to be in possession of useful information; but he still stood, so to speak, on a level footing with the fake stock-seller. The law gave him no advantage. If he could persuade a citizen not to buy a worthless stock, well and good. If an eloquent agent could persuade the citizen to buy it the commissioner was helpless.

In his report for 1910 Commissioner Dolley called attention to the wildcat stock industry and urged the passage of a law to stop it.

The legislature took up the subject as its last session and in March passed the Blue Sky Law – so nicknamed because it is designed to prevent the swindling of people through sales of "securities" that are based mostly upon atmosphere.

State and national banks, trust companies, real-estate mortgage companies, building and loan association and corporations not organized for profit are exempt from this law – as there are other statutes governing them.

Every other corporation or company, whether organized in Kansas or elsewhere, that sells or negotiates for the sale of any stocks, bonds or other securities of any kind – except Government, state or municipal bonds – is brought within the scope of the act. Before offering any stock, bond, or security for sale in Kansas it must file with the bank commissioner a statement in complete detail, in the form prescribed by him, giving an itemized exhibit of its financial condition, assets, liabilities, description of property owned, the plan upon which it proposes to do business, a copy of its charter, by-laws, and all contracts that it proposes to make with its contributors – "and such other information regarding its affairs as said bank commissioner may require" – all to be verified by the oath of a responsible officer of the company.

"And if said bank commissioner shall deem it advisable he shall make or have made a detailed examination of such company's affairs, which examination shall be at the expense of the company." And all such companies shall be subject to examination by the bank commissioner or his deputies at any time the bank commissioner may deem it advisable, in the same manner as now provided in the case of state banks." The company must, moreover, make a detailed statement of its condition to the bank

examiner twice a year after being admitted to do business in the state, or oftener if he requires it.

Having before him all the information he requires, and having decided that the company is legitimate, solvent and operating upon a plan that is fair and equitable to all classes of security-holders, the commissioner shall then decide where its operations "in his judgement promise a fair return on the stocks, bonds and other securities by it offered for sale." If his judgment is favorable he then issues to the company a revocable license to sell its securities in Kansas.

The company may then appoint one or more agents to sell its stock or bonds; but the agent also must procure a license from the bank examiner, "subject to revocation at any time by the bank commissioner for cause appearing to him sufficient."

Section XII provides that: "Any person who shall knowingly subscribe to or make or cause to be made any false statement or false entry in any book of such company, or make or publish any false statement of the financial condition of such company or the stocks, bonds or other securities by it offered for sale, shall be deemed guilty of felony; and upon conviction thereof shall be fined not less than two hundred dollars nor more than ten thousand dollars, and shall be imprisoned for not less than one year nor more than ten years in the state penitentiary."

Section XIII says that any agent who attempts to sell the stocks, bonds or other securities of a company that has not complied with the act, or any agent who attempts to sell stock or bonds without having received a license from the bank examiner, shall be fined not more than five hundred dollars or imprisoned in the county jail not more than ninety days, or both.

The Blue Sky Act, in short, is a real law with real teeth in it. As soon as the act was passed, Commissioner Dolley instructed his bank examiners, who are continually traveling about the state, to keep a lookout everywhere for "investment agents." He also requested the eight hundred-and-odd state banks of Kansas to report any stock-peddling operations of which they might learn. "If you hear of anybody offering any stock for sale," he wrote, "find out whether he has a state license. If he hasn't wire me and I will send an officer after him on the first train."

Usually banks do hear of any stock-peddling operations that are going on in their localities, for the cash to pay for the stock comes out of a bank in one way or another. Naturally no banker likes to see money drawn out of his institution and put into a wildcat investment where neither he nor anybody else thereabout will ever see it again. Consequently the banks form an excellent detective force for the enforcement of the law; and the passage of the act was immediately followed by a great clearing out of wildcat concerns and their stock-peddling agents.

The law, it will be noticed, is very broad, so that perfectly legitimate

enterprises fall within its scope. It would include, for example, the offering of stock in a manufacturing concern that was entirely solvent and reputable. The legitimate concern has only to comply with the act – file its detailed statement with the bank commissioner, show who its directors are, and so on – to receive a license.

The law went into effect March 15, 1911; and some idea of the extent of the fraud at which it was aimed may be gathered from the fact that within six months the bank commissioner received more than five hundred applications to sell stocks or bonds in Kansas – and out of about five hundred and fifty applications he approved just forty-four! No doubt the most outrageous schemes simply withdrew from the state without any attempt to get a license; so that the five-hundred-and-odd that did apply and were rejected represent, so to speak, the upper crust or the more plausible of the Blue Sky fraternity.

Bearing that probability in mind, the rejected applications on file in the commissioner's office are really amazing. They show, more graphically than anything else I know of, with what sublime assurance ingenious gentlemen go out after the money of suckers in exchange for stock engravings; in fact, the astonishing tolerance of the law toward this form of fraud has elevated it into a sort of respectability. It has become a kind of vested interest. Apparently some of the people engaged in it think they have an inalienable constitutional right to sell worthless "securities"; and they resent any interference with their operations as an act of tyranny and oppression.

For example, soon after the law was passed two well-dressed, prosperous-looking gentlemen, who made their headquarters at Topeka, waited in person upon the bank commissioner. They were surprised and rather indignant because an application to sell stock in which they were interested had been peremptorily rejected. They thought the commissioner must be mistaken as to the sort of gentlemen he was dealing with; they had good clothes, jewelry and money in the bank; were well acquainted with various substantial and more or less leading citizens; could furnish references. When they had stated their case the following colloquy occurred:
"How long have you been selling stocks round here?"

"Seven years."

"You must have sold stocks in that time to a good many people."

"Oh, yes; a great many."

"Good!" I'll give you two dollars a head for all the people you will bring to my desk who ever bought stock of any kind from you and got back as much as five per cent of their money."

Whereupon the prosperous agents faded away.

Coming back to the applications, a majority, it is hardly necessary to

say, are from mining concerns. Undoubtedly people will fall more readily for a fake or wildcat mining stock than for any other variety. Nothing but bitter experience, it seems, will convince them that any mine, anywhere on earth, which is in such a state of development that large dividends are assured doesn't need to go about peddling its stock at a discount, any more than a man with a pocketful of five-dollar goldpieces needs to stand on a street corner beseeching passers-by to purchase them at four dollars apiece.

Next in number, perhaps, come oil companies – and there is a remarkable assortment of irrigation schemes, plantations in Mexico, Central and South America, transportation enterprises and what not; in fact, the undertakings described in these applications dot the Western Hemisphere from the Equator to the Arctic circle. In running them to earth, Commissioner Dolley has written to every state in the Union, to the State Department at Washington and to foreign Governments. In some cases the accumulated documents make a pile an inch thick.

For example, here is the case of a corporation with a high-sounding title, duly incorporated under the laws of a sovereign state, as a copy of its charter, adorned with the state's great seal, duly attests. Headquarters of the concern for stock-selling purposes, however, are at Chicago, a thousand miles from the place of incorporation. A beautifully typewritten letter from the president, on fine linen paper, sets forth that the company is engaged in developing and marketing a tract of one hundred and twenty-five thousand acres of fruit land in Central America specially adapted to banana culture. It has a contract on the land from the Central American Government, under which it receives title direct from the Government on payment of two dollars and a half an acre; but similar land, with a little additional improvement, sells readily at twenty dollars an acre. The company is offering five hundred thousand dollars of its treasury stock. With the proceeds it will take title to the land and make judicious improvements. The land may then be sold at twenty dollars an acre or it may be held and cultivated, in which case handsome profits are certain. Any purchaser of the company's stock may turn in his shares and receive a clear title to an equivalent amount of land at the original price of two dollars and a half an acre, plus cost of improvements made by the company; or he may keep the stock as an investment and participate in the company's profits.

Attached to the letter are certified copies of the charter and by-laws; a handsomely engraved stock certificate on bond paper that looks quite like a Government bond; reports as to the character of the land. There are also references and a quite imposing list of directors.

All this looks very plausible. One trouble with it is, it looks too plausible. Why should gentlemen who can buy land for two dollars and a half an acre and very soon sell it for twenty dollars be coming out to Kansas in order to raise the necessary capital in one-hundred-dollar and two-hundred-dollar lots, incidentally paying a large commission to stock-peddling agents? The commissioner begins to investigate. He doesn't get anything in particular "on" the men at the head of the

concern. The land is undoubtedly there, and from the best information obtainable it seems to be very good land, quite suitable for fruit culture and capable, under proper management, of returning good profits. The commissioner continues to investigate, however, and discovers that the Central American Government had repudiated the entire contract upon which the scheme is based. At best, the purchaser of stock would be buying a dubious lawsuit or an equally dubious diplomatic negotiation. He writes "No" upon the application in large, firm letters.

Here is an application from a corporation that proposes to build a railroad through a section of the United States that is now without transportation facilities, but that promises to develop an enormous traffic. My notes, I find, are a bit blurred, so I cannot tell how many ciphers there are in the capitalization; but a few ciphers more or less are immaterial. This, of course, is frankly a "prospect." The corporation doesn't pretend it has any railroad now. So the first question is as to the character of the men behind the undertaking. The commissioner begins inquiring; and it presently appears that one man, though he doesn't figure so prominently on the letterheads as some others, is really the guiding spirit.

Now, fortunately, any man engaged in this stock-vending industry must leave some sort of trail. He can't say: "My name is Smith and I just alighted from the moon." If he is a man of standing, as he claims to be, he must have come from somewhere, and at that somewhere he must have left a record and have told people where he came from before that. So the commissioner patiently followed up the arch-promoter's trail and discovered that, within nine months of the time he launched this imposing transportation project, he had jumped a sixty-dollar board-bill. A little farther back he appeared as the defaulting borrower of small sums. Derogatory letters from the trail showered in upon the commissioner. A country banker in a state far from Kansas, whose experience with the promoter was some four years olds, wrote feelingly: "All the common honesty in his composition could be put in the hull of a mustard seed."

This personal trail is one of the chief reliances in running down fake stock schemes. Other standard sources of information are the commercial agencies and the banks; but it is a fact that a great number of banks are scandalously good-natured in lending countenance to stock-selling projects which every banker must know are disreputable. It looks as though the average banker cannot find it in his heart to think ill of a man who deposits money with him. He may not, and probably will not, actually indorse the scheme; but often he will write a letter saying that Mr. So-and-So has done business with the bank for such and such a length of time, has always met his obligations promptly and the bank's relations with him have been highly satisfactory – or something of that sort, which the average sucker will regard as tantamount to a bank indorsement of the stock project.

It is another melancholy fact that a great number of men who are considered respectable and responsible in the communities where they

live will lend their names to wildcat stock schemes. All sorts of mining and other concerns, every one of whose promoters ought to be in jail, come before credulous investors with boards of directors containing names that are considered quite respectable.

How these respectable dummies reconcile their consciences I cannot imagine. It is not, of course, that the schemes which they indorse and tout for are outright swindles. In nearly all cases, no doubt, where the roster contains respectable names, the scheme has some tangible foundation. In some cases, probably, it would be a fair gamble for a man able and willing to take the risk. The question is: "Would you advise a widow whose fortune consists of two thousand dollars of life insurance money to put it into this stock?" Almost every stock-selling campaign by advertisement of the employment of agents draws in more or less money of that kind; and no man who indorses it can escape the moral responsibility.

That question is what Kansas asked herself in passing the Blue Sky Law. Commissioner Dolley's inquiries had shown that millions of dollars were drawn from people of little business experience and limited intelligence, who didn't at all understand that they were going into a gamble but accepted the lying assurances of the agents and the prospectuses that they were certain of getting back their money and of receiving large returns upon it. Out of the five-hundred-and-odd rejected applications on file in the commissioner's office there isn't one that an intelligent and honest man would recommend as a secure investment for persons of small means. Except for the bar interposed by the Blue Sky Law, it is safe to say all of those concerns would now be selling stock in Kansas to persons who thought they were getting a secure investment.

In his annual report for 1910 Commissioner Dolley characterized these stock-peddlers as "fakers – and I wish to say, in a great majority of cases, common thieves." In view of all the circumstances – especially of the helpless class upon which they prey – this characterization seems none too strong; but other states, through cheerfully chartering all manner of wildcat concerns, interpose no effectual bar between them and credulous citizens.

In 1905 Wisconsin passed an act providing that an association or corporation "doing business as a so-called investment company, for the licensing, control and management of which there is no law now in force in this state," and which shall solicit payments to be made to itself, either in a lump sum or on the installment plan, issuing therefor so-called bonds, shares, coupons or other evidences of obligation or agreement, shall be under the control and supervision of the state bank commissioner, must make annual reports to him, and must deposit one hundred thousand dollars with the state as a guaranty fund.

This law, however, is vague and has not been held to apply to wildcat mining, irrigation, plantation and like concerns that offer stock for sale in Wisconsin. Strictly speaking, they are not "investment

companies," but mining companies, land companies, and so on. In a few cases wildcat companies that purported to be organized primarily for the investment of money in mortgages and so on, have been called to account; but the law affords no protection to the people of Wisconsin against fake stocks in general.

The Kansas law is effective as far as the power of the state can go. It can and does protect the people against wildcat stocks when offered by agents or by advertisements within the state. There has been a wholesale exodus of fake stock agents since the law went into effect – many of them undoubtedly resuming operations in states that preserve an open door for robbery of this kind.

The Kansas law, however, cannot touch advertisements printed outside the state. The wildcat mine or fake oil concern may still offer its wares to Kansas suckers through the advertising pages of newspapers published beyond the state border. Probably that cannot be stopped until every state takes as intelligent and vigorous action against this form of swindling as Kansas has taken.

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Times have clearly changed. Markets have changed. The Blue Sky Laws must change, too, or get out of the way. It appears impossible for state securities regulators to coordinate a nationwide consistent set of rules and regulations, and clearly states such as Kansas are not going to agree to stop sending people to prison for the "crime" of speaking publicly about unregistered securities offerings despite the fact that such laws have never been constitutionally-valid except when there is clear law enforcement probable cause and findings of actual fraud. If state Blue Sky Laws were limited in all states to acts of fraud and to reasonable prohibitions on telling lies and falsely-advertising unregistered securities using deceptions, then perhaps there would be a reasonable basis to ask the SEC to defer to state regulators and their new "coordinated review" scheme. But in fact the states cannot even agree as to whether unregistered securities represent prima facie evidence of criminal fraud! If some states continue to view unregistered securities offerings as probable cause for law enforcement to serve search warrants and seize computers and business records and compel testimony and freeze assets and appoint receivers to liquidate issuers of unregistered securities then how can there possibly be a JOBS Act? This goes straight to the heart of the political debate: does Congress have the power to pass laws regulating interstate commerce, as the U.S. Constitution asserts clearly, or does it not? If it does, then clearly in this instance Congress has passed a law instructing the SEC to enact a Rule that preempts state regulatory review of Regulation A+ Offerings, and empowers issuers to offer and sell Regulation A+ securities nationwide without fear of persecution by states such as Kansas or Massachusetts, while leaving intact the rest of state securities regulation in particular all of the various state anti-fraud statutes which obviously remain effective and are not impacted in any way at all by the prospect of federal preemption in the qualification process for Regulation A+ Offerings. Probable cause to conduct a state law enforcement investigation will simply need to come from something other than a regulator seeing a public advertisement or a startup pitch event or a video of somebody speaking publicly to a public gathering offering securities. It is my understanding that most securities enforcement actions are commenced in response to a complaint by a person to whom the suspect securities are sold. A single complaint from any investor is sufficient to create probable cause for state regulators to investigate unregistered securities offerings. If regulators wanted to be creative about ensuring that they would always have probable cause to investigate and to litigate, perhaps the regulators should buy shares in every unregistered securities offering that receives SEC qualification!

Ironically, the SEC has found it necessary to take enforcement action against the state of Kansas recently:

See http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542629913