ORAL ARGUMENT NOT YET SCHEDULED
Nos. 15-1149, 15-1150

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 15-1149

Monica J. Lindeen, Montana State Auditor, ex officio Montana Commissioner of Securities and Insurance,
Petitioner,

v.

United States Securities and Exchange Commission,
Respondent.

Consolidated with No. 15-1150

William F. Galvin, Secretary of the Commonwealth of Massachusetts,
Petitioner,

v.

United States Securities and Exchange Commission,
Respondent.

Petitions for Review of Final Rule of the
United States Securities and Exchange Commission

OPENING BRIEF OF PETITIONERS MONICA J. LINDEEN and WILLIAM F. GALVIN

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CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

(A) Parties and *Amici*

Petitioners

William F. Galvin, Secretary of the Commonwealth of Massachusetts

Monica J. Lindeen, Montana State Auditor, ex officio Montana Commissioner of Securities and Insurance

Respondent

United States Securities and Exchange Commission

Amici

National Small Business United, d/b/a/ National Small Business Association

North American Securities Administrators Association

(B) Rulings Under Review

These petitions challenge the Securities and Exchange Commission's final rule, *Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A)*, 80 Fed. Reg. 21,806 (Apr. 20, 2015) (to be codified at 17 C.F.R. parts 200, 230, 232, 239, 240, 249, & 260).

(C) Related Cases

The cases under review have never previously been before this Court. Counsel is aware of no related cases currently pending in any other court.

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GLOSSARY

APA	Administrative Procedure Act
GAO	U.S. Government Accountability Office
JOBS Act	Jumpstart Our Business Startups Act
NASAA	North American Securities Administrators Association
NSMIA	National Securities Markets Improvement Act of 1996
SEC	U.S. Securities and Exchange Commission

INTRODUCTION

Petitioners William F. Galvin and Monica J. Lindeen, the chief securities regulators for Massachusetts and Montana, challenge the lawfulness of a new rule promulgated by the United States Securities and Exchange Commission – commonly referred to as "Regulation A-Plus" – that puts vulnerable investors at unacceptable risk. For certain Regulation A offerings up to $50 million in size, which are exempt from federal protection, the rule leaves investors exposed to the risk of fraud by broadly preempting state securities registration and qualification requirements. The states, which have reviewed securities offerings far longer than the federal government, are now barred from performing this essential role, even for offerings that are substantially sold in local-area markets.

That is not what Congress intended, and it is not what the law provides. The Commission's authority to preempt state securities law by rule is limited to securities offered and sold to "qualified purchasers" – a term that plainly refers to limited groups of investors with sufficient wealth, income, and sophistication to protect themselves in the absence of state registration and qualification requirements. By defining "qualified purchaser" to mean "any person" to whom these securities are offered or sold, the Commission disregarded the plain meaning

of that term, the larger statutory framework, usage of the term in other federal securities laws and regulations, and extensive legislative history. The Commission further failed to provide a reasoned explanation for why it promulgated a definition of "qualified purchaser" that lacks any qualifications on purchasers, or why it rejected its earlier proposal equating the term with "accredited investors." Finally, the Commission failed to conduct the cost-benefit analysis required under applicable law and did not disclose a reasoned basis for its conclusion that investors will be adequately protected under the new rule. For these reasons, this Court should vacate the rule and enjoin the Commission from enforcing it.

STATEMENT OF JURISDICTION

This case is before the Court on petitions to review a final rule of the Securities and Exchange Commission. This Court has jurisdiction pursuant to Rule 15(a) of the Federal Rules of Appellate Procedure; Section 9 of the Securities Act of 1933, 15 U.S.C. § 77i; and Section 706 of the Administrative Procedure Act ("APA"), 5 U.S.C. §§ 701 *et seq.*

STATUTES AND REGULATIONS

The text of relevant statutes and regulations is set forth in the Addendum, which is separately bound to this brief.

STATEMENT OF ISSUES

The Commission's rule defines "qualified purchaser" to mean "any person to whom securities are offered or sold" pursuant to a Tier 2 offering under Regulation A. The issues are:

1. Under the first step in the analysis under *Chevron, U.S.A., Inc. v. NRDC*, 467 U.S. 837 (1984), whether the Commission's rule is unlawful because it conflicts with the plain language of Title IV of the JOBS Act and Section 18(b)(3) of the Securities Act and the express intent of Congress, disregards how "qualified purchaser" and related terms are used in other federal securities laws and regulations, violates fundamental canons of statutory construction, exceeds the scope of preemptive authority delegated to the Commission, and undermines the public interest and the protection of investors.

2. Under *Chevron* step two, whether the Commission's rule is unlawful because it is not based on a permissible construction of the Securities Act or supported by a reasoned explanation.

3. Whether the Commission violated the APA and Section 2(b) of the Securities Act by failing to adequately consider the protection of investors and the public interest.

STATEMENT OF THE CASE

This case concerns a final Commission rule that was published in the Federal Register on April 20, 2015. 80 Fed. Reg. 21,806. Petitioners filed their petitions for review in this Court on May 22, 2015: *Lindeen v. SEC*, No. 15-1149, and *Galvin v. SEC*, No. 15-1150. This Court consolidated the two cases on May 27, 2015. On June 5, 2015, Petitioner Lindeen asked the Commission to stay the rule pending final resolution of these petitions. The Commission denied Lindeen's request on June 16, 2015. The rule became effective on June 29, 2015.

The final rule amends the Commission's Regulation A, which since 1936 has exempted certain small-dollar securities offerings from the federal registration requirements of Section 5 of the Securities Act. The Commission's new rule, through a definition of "qualified purchaser" that imposes no qualification based on a purchaser's wealth, income, or sophistication, preempts state securities registration and qualification requirements for certain Regulation A offerings up to $50 million in size.

A copy of the final rule is reprinted in the Addendum to this brief.

STATEMENT OF FACTS

A. State Securities Regulation.

The states have engaged in securities regulation far longer than the federal government. A Massachusetts law passed in 1852, for example, required railroad companies chartered in the Commonwealth to file certificates "stating that all of the stock named in the charter has been subscribed for by responsible parties, and that twenty [percent] of the par value of each and every share of the stock thereof has been actually paid into the treasury of the company." Brandon F. White & Andrew J. Palid, *The Rise of the Massachusetts Uniform Securities Act*, 94 Mass. L. Rev. 117, 118 (2013) (quoting 1852 Mass. Acts 303); *see generally* Stuart Banner, *Anglo-American Securities Regulation: Cultural and Political Roots, 1690-1860* (2002). Comprehensive regulation of securities began with the Kansas "Blue Sky" Laws of 1911. Most states passed their own securities laws shortly after, including Montana in 1913 and Massachusetts in 1921. Act of Mar. 13, 1913, ch. 85, § 9, 1913 Mont. Laws 367, 370-71; Mass St. 1921, ch. 199, §§ 1-16.

These statutes were referred to as "blue sky" laws because they were intended to protect investors from "speculative schemes which have no more basis than so many feet of 'blue sky.'" *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550

(1917). The statutes typically required securities and securities salespersons to be registered with the state, and allowed states to prohibit the sale of securities that were not "fair, just, or equitable." *See, e.g.,* 1933 Mont. Laws, ch. 47, § 4, at 76. Such substantive review of securities offerings by regulators is called "qualification" or "merit" review.

Following the enactment of the federal securities laws, legislators sought to make state and federal securities regulation more uniform. In 1956, the Conference of Commissioners on Uniform State Laws approved the Uniform Securities Act. More than 40 states have adopted versions of this model legislation, including Montana in 1961 and Massachusetts in 1972. *See* Securities Act of Montana, Mont. Code Ann. §§ 30-10-101 *et seq.*; Massachusetts Uniform Securities Act, Mass. Gen. Laws ch. 110A.

B. The Securities Act and Regulation A.

Following the stock market crash of 1929, Congress created a federal regulatory structure to supplement existing state law and establish a dual system of regulatory enforcement.

Congress enacted the Securities Act of 1933 ("Securities Act"), 15 U.S.C. §§ 77a-77aa, to regulate the sale of securities to the general public in the primary

market. It enacted the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §§ 78a-78nn, which created the Commission to regulate the resale or exchange of securities in the secondary market.

Unless a specific exemption applies, Section 5 of the Securities Act requires companies that are making an offering of securities to the general public to file a registration statement, including a prospectus, with the Commission. Section 3(b) of the Securities Act delegated authority to the Commission to exempt certain small-dollar securities offerings from those federal registration requirements, provided that the offerings do not exceed $5 million and the Commission finds that federal registration "is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering." 15 U.S.C. § 77c(b)(1).

Regulation A, first promulgated in 1936, is an exercise of the Commission's authority under Section 3(b). SEC Release No. 33-632 (Jan. 21, 1936). Until it was amended in 2015, Regulation A allowed issuers to make public offerings of securities up to specified amounts, provided that the issuers (i) filed an offering statement with the Commission that included an offering circular and financial statements, and (ii) provided the offering circular to investors. Regulation A's

initial annual offering limit of $100,000 was raised to $300,000 in 1945, $500,000 in 1970, $1.5 million in 1978, and $5 million in 1992. Until the Commission promulgated the rule at issue in this case, Regulation A offerings were generally subject to state review.

C. The National Securities Markets Improvement Act.

In 1996, Congress enacted the National Securities Markets Improvement Act of 1996 ("NSMIA"), Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.). As summarized in the accompanying House Report, the purpose of NSMIA was "to modernize and rationalize certain important aspects of the regulatory scheme governing our capital markets, including the respective responsibilities of Federal and State governmental authorities over the securities markets." The Act sought to "eliminate the costs and burdens of duplicative and unnecessary regulation" by generally "designating the Federal government as the exclusive regulator of national offerings of securities" while allowing states to "retain authority to regulate small, regional, or intrastate securities offerings." H.R. Rep. No. 104-622, at 16 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3878.

To that end, NSMIA prohibited states from requiring the registration or qualification of "covered securities." 15 U.S.C. § 77r(a). As amended by NSMIA, Section 18(b) of the Securities Act lists several classes of "covered securities":

- securities listed on the New York Stock Exchange, American Stock Exchange, or Nasdaq National Market System;
- securities issued by an investment company registered under the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.*;
- most exempt securities listed in Section 3(a) of the Securities Act, 15 U.S.C. § 77c(a);
- securities issued in exempt transactions under Section 4(1) or (3) of the Securities Act, 15 U.S.C. § 77d(a)(1), (3), where the issuer files reports under the Exchange Act;
- securities issued in exempt transactions under Section 4(4) of the Securities Act, 15 U.S.C. § 77d(a)(4);
- securities issued in certain private offerings made to "accredited investors" under Rule 506 of Regulation D, 17 C.F.R. § 230.506; and
- securities offered or sold "to qualified purchasers, as defined by the Commission by rule."

15 U.S.C. § 77r(b).[1] With respect to this last category – the only non-self-executing category of "covered securities" – NSMIA provided that "the

[1] The Commission summarized these categories in its 2001 Proposing Release on the definition of "qualified purchaser." *See Defining the Term "Qualified*

Commission may define the term 'qualified purchaser' differently with respect to different categories of securities, consistent with the public interest and the protection of investors." *Id.* § 77r(b)(3).

The Committee Report on the Senate bill explained that the purpose of these provisions was to codify at the federal level existing state exemptions, including those based on the "level of wealth and sophistication" of certain investors:

> The securities registration structure in the United States is one of dual Federal and state regulation. In fact, state registration of securities predates the Securities Act of 1933. Most states presently exempt from state review certain securities offerings that are registered with the SEC and do not require state regulatory oversight. In particular, states have exempted from their "blue sky" regulation securities traded on the New York Stock Exchange, the American Stock Exchange and the National Market System of Nasdaq. The bill codifies these exemptions and gives the SEC authority to expand the exemption for securities traded on exchanges that have "substantially similar" listing standards. This flexibility reflects the Committee's desire to include in the preemption future securities exchanges or trading systems provided their listing standards are comparable to those of the exchanges and Nasdaq's National Market System.
>
> The bill also codifies another exemption existing in most states – the preemption from state "blue sky" registration for offers and sales to qualified purchasers. Based on their level of wealth and sophistication, investors who come within the definition of "qualified

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Purchaser" Under the Securities Act of 1933, 66 Fed. Reg. 66,839, 66,840 (proposed Dec. 27, 2001).

> purchasers" do not require the protections of registration. The bill creates a uniform standard among the states for the "qualified purchaser" exemption.
>
> For both the "blue chip" stock and "qualified purchaser" registrations, the legislation does not create a new category of exempt offerings. Instead, S. 1815 makes uniform existing preemptions by adopting a single standard.

S. Rep. 104-293, at 14-15 (1996).

The House Committee Report similarly emphasized the need for "a uniform national rule for qualified purchasers, which should greatly facilitate the ability of issuers to use it." H.R. Rep. No. 104-622, at 31 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3893. "In all cases," the report stated, "the Committee intends that the Commission's definition be rooted in the belief that 'qualified' purchasers are sophisticated investors, capable of protecting themselves in a manner that renders regulation by State authorities unnecessary." *Id.*, *reprinted in* 1996 U.S.C.C.A.N. at 3894. The Committee further offered "guidance" that in defining "qualified purchaser" for this purpose under the Securities Act, the Commission should "consider a definition of qualified purchaser not more restrictive than that provided in Title II of this legislation under Section 3(c) of the Investment Company Act." *Id.* at 31-32, *reprinted in* 1996 U.S.C.C.A.N. at 3894. As enacted, that definition of "qualified purchaser" set forth high asset requirements for

Investment Company Act exemptions. *See* 15 U.S.C. 80a–2(a)(51) (defining "qualified purchaser" to include persons and family companies with at least $5 million in investments, companies that own and invest at least $25 million in investments, and trusts with trustees or settlors who are qualified purchasers under this definition).

D. The Commission's Proposed Definition of "Qualified Purchaser" Under NSMIA.

In 2001, the Commission proposed to define "qualified purchaser" under Section 18(b), as modified by NSMIA. Its proposed rule, which was never finalized, defined "qualified purchaser" for purposes of the Securities Act to mean an "accredited investor" as defined in Rule 501(a) of Regulation D, 17 C.F.R. § 230.501(a). *See Defining the Term "Qualified Purchaser" Under the Securities Act of 1933*, 66 Fed. Reg. 66,839 (proposed Dec. 27, 2001) (the "2001 Proposing Release"). Rule 501(a) defines "accredited investor" for purposes of the federal registration exemption under Rule 506 of Regulation D, 17 C.F.R. § 230.506. Under Rule 501(a), "accredited investors" include only investors distinguished by their high level of wealth, income, and sophistication: institutional investors and employee benefit plans where sophisticated fiduciaries make investment decisions; charitable organizations, business entities, and trusts with more than $5 million in

assets; natural persons whose current and likely future annual income exceeds $200,000 (or whose joint income with a spouse exceeds $300,000); and natural persons whose individual net worth (not including a primary residence) exceeds $1 million. *See* 17 C.F.R. § 230.501(a). For offerings made through general solicitation under Rule 506(c), issuers must take "reasonable steps" to verify that purchasers are in fact "accredited investors." *Id.* at § 230.506(c)(2)(ii).

In explaining in 2001 why the same definition should be used for "qualified purchaser," the Commission observed that it had developed its approach on "accredited investors" following the Supreme Court's holding that the application of a different federal registration exemption for non-public offerings (Section 4(a)(2) of the Securities Act) "depended on whether the offerees were able to fend for themselves and had access to the same kind of information that would be disclosed in registration." 66 Fed. Reg. at 66,840 (discussing *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953)). The same logic applied to Section 18(b), the Commission found: "NSMIA's legislative history indicates that qualified purchasers for purposes of the Securities Act preemption of state regulation should include investors that, by virtue of their financial sophistication and ability to fend for themselves, do not require the protections of registration under the state

securities laws." *Id.* at 66,841. Unifying the same definition – i.e., for both "qualified purchasers" under Section 18 and "accredited investors" under Section 4 – was appropriate not only because it would "simplif[y] the regulatory structure for issuers and . . . facilitate the capital formation process," but also because "the regulatory and legislative history of both terms are based upon similar notions of the financial sophistication of investors." *Id.* at 66,840.

E. The JOBS Act.

In 2012, Congress passed the Jumpstart Our Business Startups Act (the "JOBS Act"), Pub. L. No. 112-106, 126 Stat. 306. Title IV, Section 401 of the JOBS Act amended Section 3(b) of the Securities Act by designating existing Section 3(b) (which exempts certain securities offerings of up to $5 million from federal registration requirements and provides authority for Regulation A) as Section 3(b)(1); and by creating a new Section 3(b)(2), which increased the annual offering limit for securities issued pursuant to this federal registration exemption from $5 million to $50 million.

Section 401 did not, by itself, exempt offerings made under Section 3(b)(2) from state registration and qualification requirements. However, Section 401 added to the Securities Act Section 18(b)(4)(D), which provides that certain

securities exempt from federal registration requirements under the new Section 3(b)(2) are also "covered securities" exempt from state registration and qualification requirements under Section 18(b). To qualify as "covered securities" for this purpose, the securities must be either

> (i) offered or sold on a national securities exchange, or
>
> (ii) offered or sold to a qualified purchaser, as defined by the Commission pursuant to [Section 18(b)(3)] with respect to that purchase or sale.

15 U.S.C. § 77r(b)(4)(D). The second condition – central to this case – refers to the category of "covered securities" under NSMIA, which, at the time the JOBS Act was passed, the Commission had not executed due to its decision to drop the definition of "qualified purchaser" it proposed in 2001.

Title IV of the JOBS Act adopted the text of H.R. 1070, the Small Company Capital Formation Act of 2011, which the House of Representatives passed on November 2, 2011. The version of the bill initially approved by the House Committee on Financial Services included language that included as "covered securities" not only securities offered or sold on a national securities exchange or to "qualified purchasers," but also securities "offered or sold through a broker or dealer." *See* H.R. Rep. No. 112-206, 2 (2011). Members of the committee

expressed concern about this provision, stating, "Regulation A securities are sometimes high-risk offerings that may be susceptible to fraud, making the protections provided by state review essential." *Id.* at 13 (minority views). When the bill was brought to the floor for a final vote, a bipartisan compromise eliminated the exemption for securities "offered or sold through a broker or dealer." A sponsor explained that Congress did not intend to broadly preempt small securities offerings from state regulation, since "Regulation A securities can be high-risk offerings that may also be susceptible to fraud, making protections provided by the State regulators an essential [feature]." 157 Cong. Rec. H7231 (daily ed. Nov. 2, 2011) (statement of Rep. Gary Peters).

F. The Commission's Proposed Rule Amending Regulation A.

In January 2014, the Commission proposed a new rule to amend Regulation A for the purpose of implementing Title IV of the JOBS Act. *See Proposed Rule Amendments for Small and Additional Issues Exempted Under Section 3(b) of the Securities Act*, 79 Fed. Reg. 3925 (proposed Jan. 23, 2014).

In the preamble to its proposed rule, the Commission noted the suggestion of some commenters in the pre-proposal stage that "the cost of state securities law compliance" was "an obstacle to the use of existing Regulation A," and it cited a

GAO report (called for under Section 402 of the JOBS Act) that indicated that state securities laws were one among many factors that "may have contributed to the lack of use of Regulation A." *See* 79 Fed. Reg. at 3967-68. The Commission also observed that the North American Securities Administrators Association (NASAA) had proposed "a coordinated review process for Regulation A offerings, which, if implemented, could potentially reduce the state law disclosure and compliance obligations of Regulation A issuers." *Id.* at 3968.

On the issue of state-law preemption, the Commission stated that "[s]ome commenters suggested that the Commission preempt state securities laws by permitting Section 3(b)(2) securities to be listed and traded on a national securities exchange, others suggested preemption by means of a 'qualified purchaser' definition, while others still suggested some combination of both approaches." *Id.* However, because securities listed or traded on a national securities exchange are already exempt from state registration and qualification requirements under Section 18 of the Securities Act, *see* 15 U.S.C. § 77r(b)(1), the Commission recognized that action on its part was not required to effect such preemption. *See* 79 Fed. Reg. at 3968.

As for preemption for "qualified purchasers," the Commission reviewed several suggested definitions of that term, including "[a]ny purchaser in a Regulation A offering"; "[a]ny purchaser meeting a specified net worth standard, set at or lower than the current 'accredited investor' definition in Rule 501 of Regulation D"; "[a]ny definition meeting a net worth or income test based on thresholds below accredited investor thresholds combined with an investment cap"; and "[a]ny purchaser who purchased through a registered broker-dealer." *Id.* at 3969. The Commission stated that it was "concerned that the costs associated with state securities law compliance may deter issuers from using Regulation A, even if the increased cap on offering size and other proposals intended to make Regulation A more workable are implemented." *Id.* It expressed its belief that "Regulation A, as we proposed to amend it, would provide substantial protections to purchasers," including disclosure requirements in Regulation A offering statements, limitations on eligible issuers, and "bad actor" disqualification provisions. *Id.* The Commission then proposed that "qualified purchasers" be defined as follows:

> (i) All offerees; and
>
> (ii) All purchasers in a Tier 2 offering.

Id. "Tier 2" refers to the second of two tiers of Regulation A offerings proposed by the Commission: Tier 1 for offerings of up to $5 million and Tier 2 for offerings of up to $50 million, each in a 12-month period. *Id.* at 3927. Tier 2 offerings would be subject to more extensive disclosure and reporting requirements, including audited financial statements.

Under this definition of "qualified purchasers," the proposed rule would have preempted state registration and qualification requirements with respect to (i) anyone who received a Regulation A offering (either Tier 1 or Tier 2) and (ii) anyone who purchased securities in a Tier 2 offering. States would have retained only their authority to require the filing of any document filed with the Commission and the payment of filing fees, and to investigate and bring enforcement actions after the fact regarding fraudulent securities transactions and unlawful conduct by broker-dealers in such offerings. The Commission did not explain how its proposed definition of "qualified purchaser" conformed to the text and legislative intent underlying Sections 18(b)(3) and 18(b)(4)(D) of the Securities Act.

The Commission proposed a limitation on the amount of securities that investors could purchase in a Tier 2 offering "to no more than 10% of the greater

of their annual income and their net worth." *Id.* at 3938. This limitation would be "calculated for individual purchasers as provided in the accredited investor definition under Rule 501 of Regulation D," but, unlike with Rule 506(c), issuers under Regulation A would have no obligation to verify an investor's representation of compliance with this investment limitation. *See id.*

G. The Commission's Adopting Release.

After receiving extensive comments on its proposed rule, the Commission approved its final rule amending Regulation A on March 25, 2015, and published the amendments the following month. *See Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A)*, 80 Fed. Reg. 21,806 (Apr. 20, 2015) (to be codified at 17 C.F.R. parts 200, 230, 232, 239, 240, 249, & 260) ("Adopting Release"); *see also id.* at 21,857-58 (summarizing comments). While the final rule modified some aspects of the earlier proposal, it continued to preempt state-law registration and qualification requirements based on a definition of "qualified purchaser" unlimited by any qualifying factors such as wealth, income, or sophistication. *See id.* at 21,858 ("[W]e are adopting the "qualified purchaser" definition in Regulation A, substantially as proposed."). The Commission also eliminated a lower-cost disclosure format for Form 1-A filings,

called "Model A," *see id.* at 21,828-29; and weakened safeguards for solicitations of interest, called "testing the waters" materials, by allowing issuers to use them before the offering statement is filed, *see id.* at 21,842.

In the final rule the Commission changed its two-tier structure for Regulation A by increasing the annual offering limitation for Tier 1 offerings from $5 million to $20 million. 80 Fed. Reg. at 21,813. It maintained the $50 million limitation for Tier 2 offerings, although it noted that it may consider increasing that limitation in future years. *Id.* The Commission then defined "qualified purchaser" as follows:

> For purposes of Section 18(b)(3) of the Securities Act [15 U.S.C. § 77r(b)(3)], a "qualified purchaser" means any person to whom securities are offered or sold pursuant to a Tier 2 offering of this Regulation A.

80 Fed. Reg. at 21,899 (to be codified at 17 C.F.R. § 230.256). Thus, the final definition of "qualified purchaser" does not include offerees in Tier 1 offerings, and states "retain oversight over how these offerings are conducted." *Id.* at 21,858. By contrast, state law securities requirements are preempted with respect to all Tier 2 offerings – offerings in any amount up to $50 million – as well as to all Tier 2 purchases.

The Commission also maintained its proposed limitation on the amount of securities that investors can purchase in a Tier 2 offering. *See id.* at 21,815-18. This limitation provides that purchasers in a Tier 2 offering may invest no more than 10 percent of the greater of their annual income or their net worth. *Id.* at 21,815, 21,895-96 (to be codified at 17 C.F.R. § 230.251(d)(2)(C)). The Commission clarified in its final rule that this investment limitation does not apply to purchasers who qualify as "accredited investors" under Rule 501 of Regulation D, because "investors that qualify as accredited under our rules satisfy certain criteria that suggest they are capable of protecting themselves in transactions that are exempt from registration under the Securities Act." *Id.* at 21,816. As for other, non-accredited investors, the Commission continued to allow issuers under Regulation A to rely on representations of compliance with this limitation made by the investors themselves. *Id.* at 21,815. It was unnecessary and overly burdensome, in the Commission's view, to require issuers "to take reasonable steps to verify . . . investors' compliance with the investment limitation"; doing so might "dissuad[e] issuers from selling to non-accredited investors in Tier 2 offerings by increasing compliance uncertainties and obligations." *Id.* at 21,817.

In defending its decision to broadly preempt state securities law as to Tier 2 offerings, the Commission stated that Securities Act Section 18(b)(3) (the NSMIA provision that established a non-self-executing category of preemption for securities offered or sold to "qualified purchasers") and Section 18(b)(4)(D) (the JOBS Act provision that allowed for state preemption for "qualified purchasers" in transactions exempt from federal registration under Section 3(b)(2)) had to be "read in conjunction" with each other. *See* 80 Fed. Reg. at 21,859. It reasoned that preemption afforded under Section 18(b)(4)(D) would "necessarily encompass[]" the other statutory requirements for conducting an exempt offering under Section 3(b)(2) (such as the filing of annual audited financial statements and "bad actor" disqualification), and "the particular characteristics of transactions exempt from registration pursuant to Section 3(b)(2)" (such as the "specified investment limitations" discussed above) would apply. *Id.* The Commission also noted that Section 18(b)(3) "contemplates that the term 'qualified purchaser' can be defined 'differently with respect to different categories of securities.'" *Id.* at 21,859-60. For these reasons, it rejected the argument of some commenters that "a 'qualified purchaser' definition adopted by the Commission must at a minimum be based on

attributes of the purchaser, such as a person's wealth, income, or sophistication." *Id.* at 21,859.

The Commission acknowledged that its earlier proposed definition – the 2001 Proposing Release – "noted that certain aspects of NSMIA's legislative history suggest that a qualified purchaser definition should include investors that are sophisticated and capable of protecting themselves" and, accordingly, sought to equate "qualified purchaser" with the existing definition of "accredited investor." *Id.* That earlier definition of "qualified purchaser," the Commission stated, did not conflict with its new rule because "the definition being adopted today serves a different purpose because it applies only in Regulation A offerings." *Id.* at 21,859-60.

The Commission provided a brief analysis of the costs and benefits to investor protection of "blue sky" preemption for Tier 2 offerings. It first identified the perceived costs of preemption, including the loss of a second layer of regulatory review; elimination of state merit-based reviews; the loss of the "localized knowledge and resources" state regulators provide in facilitating compliance and detecting fraud, particularly among "small, localized issuers"; and possible investor perceptions of increased risk of fraud resulting in a demand of

higher returns. *Id.* at 21,886. The Commission offered a one-paragraph response to these concerns, asserting that the states' remaining regulatory authority and the new rule provisions "could mitigate [the] potential impacts" of state preemption. *Id.* at 21,887. The Commission did not explain how these provisions related to or ameliorated the identified investor protection concerns. *See id*. And while the Commission provided an economic analysis of commenters' proposed coordinated review process, it did not analyze the costs and benefits to investor protection of that proposal. *See id*. at 21,887-88.

SUMMARY OF ARGUMENT

The Commission's rule preempting state securities laws through a definition of "qualified purchaser" that means "any person to whom securities are offered or sold pursuant to a Tier 2 offering of this Regulation A" is contrary to law and should be struck down under *Chevron* step one. Congress clearly intended the scope of preemption under Section 18(b)(3) of the Securities Act and Title IV of the JOBS Act to be limited to persons who do not require the protections of state registration and qualification requirements because of their wealth, income, and sophistication. The term "qualified purchaser" in those provisions plainly requires a meaningful limitation on potential purchasers, and Congress and the Commission

have elsewhere uniformly used the term to mean a limited group of investors with the wherewithal and experience to assume greater risk. The Commission's new rule conflicts with the statutory framework underlying both provisions, renders the "qualified purchaser" requirement surplusage, and undermines Section 18(b)(3)'s requirement that any definition of the term be "consistent with the public interest and the protection of investors."

In addition, because the Commission's rule is neither based on a permissible construction of the Securities Act nor supported by reasoned decisionmaking, it fails *Chevron* step two. In defending its position, the Commission argued that Section 18(b)(3) allows "qualified purchaser" to be defined differently with respect to different categories of securities. That authority, however, does not allow the Commission to issue a definition that is completely unqualified as to who may purchase the securities. Moreover, the fact that other parts of the rule currently allow investors to lose only up to 10 percent of their net worth (provided that the investors voluntarily comply with this limitation, since issuers need not verify compliance themselves) does not ameliorate the problems with the Commission's decision to impose no limitation whatsoever based on investors' wealth, income, or sophistication. Tellingly, the Commission fails to explain why it rejected the

definition of "qualified purchaser" that it first proposed in 2001 – a definition that equated the term with "accredited investor" under Regulation D and acknowledged that "similar notions of financial sophistication" underlie both terms.

Finally, the rule should be vacated as arbitrary and capricious because the Commission failed to adequately analyze the rule's effects on investor protection and the public interest. The Commission failed to give due consideration to investor protection in its cost-benefit analysis of state-law preemption for Tier 2 offerings under Regulation A and other aspects of the rule. It acknowledged that preemption in this area will result in the loss of state regulators' superior knowledge of local issuers and other benefits of state-based reviews, but it provided no evidence or rationale for its claim that other provisions of the rule and states' retained regulatory authority "could mitigate" these impacts.

STANDING

Petitioner Galvin is the chief securities regulator for Massachusetts. The Office of the Secretary of the Commonwealth administers and enforces the Massachusetts Uniform Securities Act, Mass. Gen. Laws ch. 110A, though the Massachusetts Securities Division. Petitioner Lindeen, as the Montana State Auditor, is ex officio Commissioner of Securities for the State of Montana and

enforces the Securities Act of Montana, the primary purpose of which is to "protect the investor, persons engaged in securities transactions, and the public interest." Mont. Code Ann. §§ 30-10-102(1). Petitioners have authority under their respective state laws to conduct merit-based review of Regulation A filings to protect investors in their states. The Commission's rule preempts that authority.

STANDARD OF REVIEW

Under the APA, a reviewing court must strike down regulations that are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law"; "in excess of statutory jurisdiction, authority, or limitations, or short of statutory right"; or issued "without observance of procedure required by law." 5 U.S.C. § 706(2)(A), (C), (D).

This Court reviews the Commission's rule under the two-step analytical framework of *Chevron, U.S.A., Inc. v. NRDC*, 467 U.S. 837 (1984). At step one, the Court examines the statute *de novo*, *see Int'l Union, United Mine Workers v. Mine Safety & Health Admin.*, 626 F.3d 84, 90 (D.C. Cir. 2010), and "employ[s] traditional tools of statutory construction," including an examination of the statute's text, purpose, structure and legislative history, to determine whether Congress unambiguously expressed its intent on "the precise question at issue,"

Chevron, 467 U.S. at 843 & n.9. If Congress has done so, "that is the end of the matter" because "the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." *Meredith v. Fed. Mine Safety & Health Review Comm'n*, 177 F.3d 1042, 1053 (D.C. Cir. 1999) (citation omitted); *see also Chevron*, 467 U.S. at 843 n.9 (Congress's "intention is the law and must be given effect").

Only if Congress's intent is unclear does the Court proceed to *Chevron* step two, which asks "whether the agency's answer is based on a permissible construction of the statute." *Id.* at 843. Although this review is normally deferential, the Court's function is "neither rote nor meaningless." *Natural Res. Def. Council v. Daley*, 209 F.3d 747, 752 (D.C. Cir. 2000). This Court defers to an agency's interpretation only if it is "reasonable and consistent with the statutory scheme and legislative history," *City of Cleveland v. U.S. Nuclear Regulatory Comm'n*, 68 F.3d 1361, 1367 (D.C. Cir. 1995), and it does not "diverge[] from any realistic meaning of the statute," *Massachusetts v. U.S. Dep't of Transp.*, 93 F.3d 890, 893 (D.C. Cir. 1996).

In this case, the standard APA analysis is bolstered by the general presumption against federal preemption of state law, particularly in areas

traditionally regulated by the states. *See Medtronic, Inc. v. Lohr*, 518 U.S. 470, 486 (1996) (stating that courts "start with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress") (internal quotations and citations omitted). To overcome this presumption, the party asserting preemption must demonstrate that "the clear and manifest purpose of Congress" supports it. *N.Y. State Conference of Blue Cross & Blue Shield Plans v. Travelers Ins. Co.*, 514 U.S. 645, 655 (1995) (citation omitted). As a result, even in cases where "the text of a pre-emption clause is susceptible of more than one plausible reading, courts ordinarily 'accept the reading that disfavors pre-emption.'" *CTS Corp. v. Waldburger*, 134 S. Ct. 2175, 2188-89 (2014) (citation omitted); *see also Pliva, Inc. v. Mensing*, 131 S. Ct. 2567, 2575 n.3 (2011) (stating that courts "do not defer to an agency's ultimate conclusion about whether state law should be pre-empted") (citing *Wyeth v. Levine*, 555 U.S. 555, 576 (2009)).

Finally, the Court must "conduct[] a 'searching and careful' inquiry, in order to assure that the Commission has 'examine[d] the relevant data and articulate[d] … a rational connection between the facts found and the choice made.'" *Ass'n of Oil Pipe Lines v. FERC*, 83 F.3d 1424, 1431 (D.C. Cir. 1996) (quoting *Citizens to*

Preserve Overton Park, Inc. v. Volpe, 401 U.S. 402, 416 (1971), and *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983)). In particular, a rule is arbitrary and capricious if the agency fails to "consider factors 'it must consider under its organic statute.'" *Public Citizen v. Fed. Motor Carrier Safety Admin.*, 374 F.3d 1209, 1216 (D.C. Cir. 2004). Under Section 2(b) of the Securities Act, when the Commission engages in rulemaking it must consider "the protection of investors" among other factors in determining whether its action "is necessary or appropriate in the public interest." 15 U.S.C. § 77b(b). The Commission must also consider comments submitted on the costs and benefits of the rule and "respond in a reasoned manner to those that raise significant problems." *Covad Communs. Co. v. FCC*, 450 F.3d 528, 550 (D.C. Cir. 2006) (citation omitted).

ARGUMENT

I. THE COMMISSION'S DEFINITION OF "QUALIFIED PURCHASER" CONFLICTS WITH THE UNAMBIGUOUSLY EXPRESSED INTENT OF CONGRESS.

Because Congress has spoken to the precise issue presented here, this case should be resolved at *Chevron* step one.

A. The Meaning of the Statutory Language Is Plain.

1. "Qualified" means limited, restricted, and possessing necessary qualifications.

"The starting point for [the] interpretation of a statute is always its language," *Community for Creative Non-Violence v. Reid*, 490 U.S. 730, 739 (1989) (citation omitted), and "courts must presume that a legislature says in a statute what it means and means in a statute what it says there," *Conn. Nat'l Bank v. Germain*, 503 U.S. 249, 253-54 (1992).

Here, the meaning of the statutory language is straightforward. The use of the term "qualified" to modify "purchaser" means that the set of applicable purchasers must be limited based on one or more qualifications applicable to them. The commonly understood meaning of "qualified" is "limited, restricted, or modified" or "having the appropriate qualifications for an office, a position, or a task." The American Heritage College Dictionary 1117 (3d ed. 2000); *see also* Webster's II New Riverside University Dictionary 961 (1984) ("having met the requirements for a specific position or task"); Black's Law Dictionary 1254 (7th ed. 1999) ("possessing the necessary qualifications" or "limited; restricted").

This is precisely how the term "qualified" has been used in other legal contexts: *i.e.*, limiting the scope of a category or group based on particular

requirements or criteria. *See, e.g.*, *Olmstead v. L.C. ex rel. Zimring*, 527 U.S. 581, 602 (1999) (stating that "qualified individuals" under Americans with Disability Act are persons with disabilities who meet "the essential eligibility requirements" for habitation in community-based program); *Planned Parenthood of Indiana, Inc. v. Comm'r of Indiana State Dep't Health*, 699 F.3d 962, 978 (7th Cir. 2012) (referring to dictionary definition of "qualified" as "[p]ossessing the necessary qualifications" and holding that "qualified" in context of Medicaid services "unambiguously relates to a provider's fitness to perform the medical services the patient requires") (citations omitted); Fed. R. Evid. 702 (allowing for testimony of "[a] witness who is qualified as an expert by knowledge, skill, experience, training, or education"). Indeed, as discussed in Section I.C, *infra*, when the term "qualified" has been used to modify "purchaser" or "investor" in the context of other federal securities laws and regulations, the effect has always been to restrict the set of potential investors to those with sufficient wealth, income, and sophistication to assume greater financial risk.

It is inconsistent with the plain meaning of "qualified" for the Commission to now define "qualified purchaser" to mean "any person" who makes a particular purchase.

2. The Commission's unqualified definition of "qualified purchaser" violates the term's plain meaning.

In its Adopting Release, the Commission acknowledged commenters' objections that its proposed definition of "qualified purchaser" violated the plain meaning of Section 18(b)(3) because "[t]he qualifications of the purchaser are key, not the nature of the issuer or the offering." *See* 80 Fed. Reg. at 21,857. While the Commission did not directly respond to this criticism, it proceeded to defend its statutory interpretation on two general grounds.

First, the Commission argued that Section 18(b)(3) "does not prescribe specific criteria that the Commission must consider in determining, or the manner in which it must determine, a purchaser to be 'qualified.'" *See id.* at 21,859. That is only partly true, since Section 18(b)(3) specifically requires that any definition of "qualified purchaser" by the Commission be consistent with "the public interest and the protection of investors." 15 U.S.C. § 77r(b)(3); *see generally* Section I.A.3, *infra*. More generally, the modifier "qualified" imposes a clear and meaningful requirement with which the Commission must comply. No additional definition or list of criteria is needed to understand what this term means. *See* *Perrin v. United States*, 444 U.S. 37, 42 (1979) ("A fundamental canon of statutory construction is that, unless otherwise defined, words will be interpreted as taking

their ordinary, contemporary, common meaning.") (citation omitted); *American Fed'n of Gov't Employees, AFL-CIO v. Glickman*, 215 F.3d 7, 10 (D.C. Cir. 2000) ("[T]he lack of a statutory definition does not render a term ambiguous.") (citation omitted).

Second, the Commission emphasized its authority under Section 18(b)(3) to issue different definitions of "qualified purchaser" based on "different categories of securities" at issue. 15 U.S.C. § 77r(b)(3). It stated: "This means that, rather than considering the characteristics of the purchaser *in isolation*, the Commission may adopt a qualified purchaser definition that is *also* tailored to reflect the characteristics of the particular type of issuer or transaction." 80 Fed. Reg. at 21,859 (emphasis added). As qualified by the words in italics, this statement is accurate: the Commission may issue definitions of "qualified purchaser" that are "also tailored" to reflect particular categories of securities. That does not mean that the Commission may issue definitions that impose no qualification on purchasers of those securities. Whatever general discretion the Commission may have to define "qualified purchaser" in different ways, that discretion does not carry with it the prerogative to disregard Congress's requirement that the scope of any such definition actually be limited to those that are "qualified."

In its recent order denying Auditor Lindeen's request for a stay, the Commission argued that its definition "is consistent with the plain meaning of 'qualified' because that term, in the context of Section 18(b)(3), refers to the Commission's ability to determine, by rule, that the attributes of a category of securities are consistent 'with the public interest and the protection of investors,' and are therefore sufficient to justify status as a 'covered security.'" *See* SEC Release No. 9808 at 5-6 (June 16, 2015) (Certified Record Index Doc No. ("CRI") 156) ("Order Denying Stay"). But that argument is circular and distorts the statutory language. The term "qualified" in Section 18(b)(3) modifies "purchaser"; it does not "refer to" or otherwise provide authorization for the Commission to designate particular categories of securities as subject to preemption absent a simultaneous definition of "qualified purchaser" that limits such preemption's scope. Furthermore, the clause "consistent with the public interest and the protection of investors" does not enable the Commission to determine which "attributes of a category of securities" serve to justify status as a "covered security." To the contrary, that clause modifies how the Commission must define the term "qualified purchaser" in order for any such preemption to take effect. *See* Section I.A.3, *infra*.

The Commission's position also contradicts the plain language of the JOBS Act, as set forth in Section 18(b)(4)(D) of the Securities Act. That subsection provides that certain securities exempt from federal registration requirements under Section 3(b)(2) – *i.e.*, those offered or sold under the newly expanded Regulation A – may also be "covered securities" exempt from state registration and qualification requirements under Section 18(b) if they are:

> (i) offered or sold on a national securities exchange, or
>
> (ii) offered or sold to a qualified purchaser, as defined by the Commission pursuant to [Section 18(b)(3)] with respect to that purchase or sale.

15 U.S.C. § 77r(b)(4)(D). In denying Auditor Lindeen's stay request, the Commission argued that this language shows Congress's intent to "bring some Regulation A securities into the category of 'covered securities.'" Order Denying Stay at 7. But that is true only to the extent allowed by Section 18(b)(4)(D). In the first part of that provision, Congress itself designated a particular category of securities (those offered or sold on a national exchange) as "covered securities." In the second part, Congress allowed for additional preemption only with respect to securities for which the Commission has defined "qualified purchaser . . . with respect to that purchase or sale." This statutory structure clearly prohibits the

Commission from designating whatever additional categories of Regulation A securities it likes as "covered securities" under Section 18(b), absent a limiting definition of "qualified purchaser." That is what the Commission did here by "defining" "qualified purchaser" to mean everyone to whom Tier 2 Regulation A securities are offered or sold.

3. Any definition of "qualified purchaser" must also promote investor protection and the public interest.

Section 18(b)(3) also requires that any definition of the term "qualified purchaser" by the Commission be consistent with "the public interest and the protection of investors." 15 U.S.C. § 77r(b)(3). This requirement reinforces Congress's intent that any definition must limit the set of potential purchasers to those who do not require the protections of state registration and qualification requirements due to their level of wealth, income, and sophistication. It is not consistent with the statute for the Commission to promulgate a definition of "qualified purchaser" that provides no protection for vulnerable purchasers.

The Commission attempts to elide this requirement in its Adopting Release by pointing to Section 3(b)(2) of the Securities Act (added by the JOBS Act) which, with respect to the exemption of federal registration requirements under Regulation A, imposes certain requirements and allows the Commission to impose

additional "terms, conditions, or requirements as the Commission may determine necessary in the public interest and for the protection of investors." 15 U.S.C. § 77c(b)(2)(G). This provision, the Commission argues, allows it to consider "not only the mandatory features of Section 3(b)(2), but also many of the discretionary features contained in our final rules" – *i.e.*, the entirety of its amendments to Regulation A – in determining whether, for purposes of state preemption, its definition of "qualified purchaser" to mean all purchasers of Tier 2 securities is consistent with the public interest and investor protection. *See* 80 Fed. Reg. at 21,859-60; *see also* Order Denying Stay at 6. That reasoning is flawed.

First, Section 18(b)(3), which Section 18(b)(4)(D) incorporates by reference, requires that any definition of "qualified purchaser" *itself* be "consistent with the public interest and the protection of investors." 15 U.S.C. § 77r(b)(3). This requirement specifically controls the Commission's authority to determine new areas of state preemption and may not be disregarded by pointing to other statutory "features" that apply more generally. *See RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065, 2071 (2012) (holding that where "a general authorization and a more limited, specific authorization exist side-by-side," the "terms of the specific authorization must be complied with").

Second, the additional "features" referenced by the Commission do not promote investor protection in the manner required by Section 18(b)(3). The Commission places greatest emphasis on "the requirement that purchasers in Tier 2 offerings be limited to accredited investors *or* persons otherwise subject to specified investment limitations." *See* 80 Fed. Reg. at 21,859 (emphasis added). It is important to recognize what this limitation does not do. In promulgating its new rule on Regulation A, the Commission could have defined "qualified purchaser" to mean an "accredited investor" as defined in Rule 501(a) of Regulation D, 17 C.F.R. § 230.501(a). Indeed, that is how the Commission proposed defining "qualified investor" generally in its 2001 Proposing Release. *See* Section II.C, *infra*. Instead, the Commission now chose to define "qualified purchaser" to mean all purchasers of Tier 2 securities under Regulation A, and then provided elsewhere that Tier 2 purchasers must be *either* accredited investors *or* limit their investment to a maximum of 10 percent of their annual income or net worth. *See* 80 Fed. Reg. at 21,895-96 (to be codified at 17 C.F.R. § 230.251(d)(2)(C)). Furthermore, in contrast to the requirement under Regulation D that issuers making general solicitation offerings under Rule 506(c) must take "reasonable steps" to verify that purchasers are "accredited investors," *see* 17 C.F.R. § 230.506(c)(2)(ii), the

Commission refused to require issuers under Regulation A "to take reasonable steps to verify . . . investors' compliance with the investment limitation" – since doing so might "dissuad[e] issuers from selling to non-accredited investors in Tier 2 offerings by increasing compliance uncertainties and obligations," *see* 80 Fed. Reg. at 21,817.

As a result, non-accredited investors – *i.e.*, people who do *not* satisfy criteria indicating that "they are capable of protecting themselves in transactions that are exempt from registration under the Securities Act," *see* 80 Fed. Reg. at 21,816 – may now lose up to 10 percent of their net worth in Regulation A offerings. They may lose even more if they do not accurately report their wealth. This potential for significant loss by non-sophisticated investors does not promote "the protection of investors," and it is not what Congress had in mind when it allowed the Commission authority to establish limited state preemption based on a definition of "qualified purchasers."

4. The Commission's "definitional authority" does not allow it to disregard the statute's plain meaning.

The Commission's primary argument on plain meaning now appears to be that it does not have to follow it. In its order denying Auditor Lindeen's request for a stay, the Commission argued that the plain meaning of "qualified purchaser"

is irrelevant because Congress authorized the Commission to define the term "qualified purchaser" under the Securities Act. *See* Order Denying Stay at 5; *see also id.* at 5-6 (claiming broad "definitional authority"). The Commission is mistaken.

The fact that statutory language may be ambiguous or subject to agency definition "in some abstract sense" does not matter under *Chevron* step one. *See Cal. Indep. Sys. Operator Corp. v. FERC*, 372 F.3d 395, 400 (D.C. Cir. 2004). Instead, what matters is whether Congress has spoken to "the precise question at issue." *Chevron*, 467 U.S. at 842; *see also Brown v. Gardner*, 513 U.S. 115, 118 (1994) ("Ambiguity is a creature not of definitional possibilities but of statutory context.") (citation omitted).

Accordingly, even where an agency has authority to define a term in some respect, it may not promulgate a definition that wholly contradicts the term's plain meaning. *See, e.g.*, *MCI Telecomm. Corp. v. AT&T Co.*, 512 U.S. 218, 225-29 (1994) (rejecting agency's definition of "modify" because "an agency's interpretation of a statute is not entitled to deference when it goes beyond the meaning that the statute can bear"); *Sw. Airlines Co. v. Transp. Sec. Admin.*, 554 F.3d 1065, 1069-70 (D.C. Cir. 2009) (holding that agency's interpretation of

"screening passengers" to include non-passengers violates term's "widely understood meaning"); *NRDC v. EPA*, 489 F.3d 1250, 1257-60 (D.C. Cir. 2007) (holding that EPA's definition of "commercial or industrial waste" conflicts with "plain statutory language" and "halts our review at *Chevron*'s step 1"). As Justice Scalia put it, "It does not matter whether the word 'yellow' is ambiguous when the agency has interpreted it to mean 'purple.'" *United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 1836, 1846 n.1 (2012) (Scalia, J., concurring).

Here, Congress authorized the Commission to define by rule "qualified purchaser" for the purpose of identifying a "covered security with respect to the offer or sale of the security to qualified purchasers" that would be subject to state preemption under Section 18(b)(3) of the Securities Act. 15 U.S.C. § 77r(b)(3). It further allowed the Commission to define that term "differently with respect to different categories of securities, consistent with the public interest and the protection of investors." *Id.* Congress did not authorize the Commission to define "qualified purchaser" in a way that would impose no qualification on purchasers of particular securities. This action – effectively circumventing the "qualified purchaser" requirement altogether by designating a category of securities for which

all purchases are subject to preemption – is the equivalent of defining "yellow" to mean "purple." Accordingly, it fails at *Chevron* step one.

B. The Commission's Definition Renders the "Qualified Purchaser" Requirement Surplusage and Conflicts with the Broader Statutory Framework.

The plain meaning of the statutory language is reinforced by two well-established canons of statutory construction.

First, "[i]t is 'a cardinal principle of statutory construction' that 'a statute ought, upon the whole, to be construed'" in a manner that ensures that "'no clause, sentence, or word shall be superfluous, void, or insignificant.'" *TRW Inc. v. Andrews*, 534 U.S. 19, 31 (2001) (citation omitted); *see also Reiter v. Sonotone Corp.*, 442 U.S. 330, 339 (1979) (duty in construing statute is "to give effect, if possible, to every word Congress used"). Here, the Commission's rule renders the term "qualified purchaser" surplusage by defining it to mean "any person" who purchases a particular kind of security. The Commission similarly nullifies the requirement that any definition be consistent "with the public interest and the protection of investors" by promulgating a definition that provides no protection for vulnerable investors.

Second, it is a "fundamental canon of statutory construction that the words of a statute must be read in their context and with a view to their place in the overall statutory scheme." *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 133 (2000) (quoting *Davis v. Mich. Dept. of Treasury*, 489 U.S. 803, 809 (1989)). "A court must therefore interpret the statute 'as a symmetrical and coherent regulatory scheme,' and 'fit, if possible, all parts into an harmonious whole.'" *Id.* (citations omitted); *accord Roberts v. Sea-Land Servs., Inc.*, 132 S. Ct. 1350, 1357 (2012).

Here, the statutory structure makes clear that while Congress may carve out, by statute, particular kinds of "covered securities" subject to state preemption, the Commission's authority is far more limited. As amended by NSMIA, Section 18(b) of the Securities Act lists multiple categories of "covered securities," including securities listed on national stock exchanges, securities issued by registered investment companies, and securities issued in other specified exempt transactions. 15 U.S.C. § 77r(b). All but one of those categories is self-executing; no further act by the Commission is required for them to take effect. The exception is Section 18(b)(3), the provision that allows preemption for the offer or sale of certain securities "to qualified purchasers, as defined by the Commission by

rule" and "consistent with the public interest and the protection of investors." *Id.* at § 77r(b)(3). This structure is mirrored by Section 18(b)(4)(D), as added by the JOBS Act, which provides that to qualify as "covered securities" for purposes of Regulation A, the securities must be either:

> (i) offered or sold on a national securities exchange, or
>
> (ii) offered or sold to a qualified purchaser, as defined by the Commission pursuant to [Section 18(b)(3)] with respect to that purchase or sale.

Id. at § 77r(b)(4)(D).[2] Again, Congress directly designated the first category of securities (those offered or sold on a national exchange) as "covered securities," but allowed the second category to take effect only to the extent that the Commission defined the securities as "offered or sold to a qualified purchaser." *Id.*

This statutory framework plainly prohibits the Commission from designating whatever additional categories of securities it likes as "covered securities." That power is reserved to Congress alone. Nor may the Commission circumvent this

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[2] The parallel structure of Sections 18(b) and 18(b)(4)(D) undermines the Commission's attempt to defend its definition on the ground that it "serves a different purpose because it applies only in Regulation A offerings." *See* 80 Fed. Reg. at 21,860. Even in the context of Regulation A, any attempt by the Commission to preempt state protections requires a meaningful definition of "qualified purchaser."

requirement by defining "qualified purchaser" to mean everyone to whom particular securities are offered or sold. Such an approach, if upheld, would amount to a vast expansion in the Commission's authority to override state regulation and disrupt the nation's longstanding system of dual regulatory enforcement. The Commission would be enabled, merely by defining "qualified purchaser" as it likes, to preempt state authority with respect to any category of security that it likes. "Congress could not have intended to delegate a decision of such economic and political significance to an agency in so cryptic a fashion." *Brown & Williamson*, 529 U.S. at 160. Because "nothing in the statute's text or the legislative record contemplates that vast expansion of the [the Commission's] authority," *Loving v. IRS*, 742 F.3d 1013, 1021 (D.C. Cir. 2014), the rule should be vacated under *Chevron* step one.

C. The Commission's Definition Conflicts with How "Qualified Purchaser" Has Been Used in Federal Securities Laws and Regulations.

The meaning of "qualified purchaser" as used in the Securities Act is further evident from the manner in which closely related terms have been used in other federal securities laws and regulations. As the Supreme Court has observed, "the meaning of one statute may be affected by other Acts, particularly where Congress

has spoken subsequently and more specifically to the topic at hand." *Brown & Williamson*, 529 U.S. at 133 (citations omitted); *see also Loving*, 742 F.3d at 1017 (stating that "an agency's use of a term can be valuable information not only about ordinary usage but also about any specialized meaning that people in the field attached to that term," particularly when "the term is one that the agency uses in a number of contexts"). Until now, when the terms "qualified investor" or "qualified purchaser" have been used in the federal securities laws and regulations, they have always referred to a limited group of investors with the capacity to take on certain risks due to their sophistication, size, or risk-bearing ability (based on high income or net worth). Given this longstanding use of the term, it is inconceivable that Congress intended to allow the Commission to read the "qualified purchaser" requirement out of Section 18(b)(3) of the Securities Act and Title IV of the JOBS Act by promulgating a definition that imposes no limit based on investors' wealth, income, or sophistication.

For example, SEC Rule 144A, promulgated in 1990, is a safe-harbor exemption from the federal registration requirements of the Securities Act for resales of certain restricted securities to "qualified institutional buyers." As defined by the Commission, the term "qualified institutional buyer" limits Rule

144A to large sophisticated institutional investors, such as specified institutions that own and invest on a discretionary basis at least $100 million in securities and banks and other specified financial institutions with a net worth of at least $25 million. 17 C.F.R. § 230.144A(a)(1). This definition, the Commission explained, "identif[ies] a class of investors that can be conclusively assumed to be sophisticated and in little need of the protection afforded by the Securities Act's registration provisions." *See Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145*, 53 Fed. Reg. 44,016, 44,028 (proposed Nov. 1, 1988).

The term "qualified investor" is defined in section 3(a)(54) of the Securities Exchange Act, as amended by the Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended in scattered sections of 12 U.S.C. and 15 U.S.C.). The term applies to several bank exceptions from broker-dealer registration under the Exchange Act. *See, e.g.*, 15 U.S.C. § 78c(a)(5)(C)(iii) (providing that banks shall not be considered to be dealers insofar as they engage in "issuance or sale to qualified investors" of asset-backed transactions). Under this definition, "qualified investors" refers to investment companies, banks, small business investment companies, state-sponsored employee benefit plans,

institutional trusts, market intermediaries, and natural persons, corporations or partnerships that own and invest on a discretionary basis more than $25 million (or, in some circumstances, $10 million). *Id.* at § 78c(a)(54)(A), (B). Congress also allowed the Commission to define "qualified investor" to include other persons – provided that the Commission consider "such factors as the financial sophistication of the person, net worth, and knowledge and experience in financial matters." *Id.* at § 78c(a)(54)(C).

Similarly, under Section 205(e) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 *et seq.*, Congress authorized the Commission to exempt by rule persons who do not require the statute's protections from performance fees charged by investment advisers – based on those persons' "financial sophistication, net worth, knowledge of and experience in financial matters, amount of assets under management," and other factors. *See id.* § 80b-5(e). The Commission implemented this exemption by promulgating a definition of "qualified client" that includes only persons with at least $1 million under management or a net worth above $2 million; highly knowledgeable employees of the investment adviser; and "qualified purchasers" as defined for purposes of the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.* *See* 17 C.F.R. § 275.205-3(d)(1).

Significantly, that last category of "qualified clients" ("qualified purchasers" under the Investment Company Act) was added by Congress in NSMIA – the very statute that also established the "qualified purchaser" provision under Section 18(b)(3) of the Securities Act. Under the Investment Company Act, the term "qualified purchaser" refers to natural persons and family-owned companies with more than $5 million in investments and other persons with more than $25 million in aggregate investments. 15 U.S.C. § 80a-2(a)(51); *see also id.* § 80a-3(c)(7). The intent of Congress was the same with respect to both NSMIA provisions. Just as Congress amended the Securities Act to exempt from state registration and qualification requirements only those investors who do not require such protections based on their wealth, income, and sophistication, *see* Section I.D, *infra* (discussing S. Rep. 104-293, at 15 (1996)), Congress amended the Investment Company Act in order to withhold that Act's protections from only those "financially sophisticated investors . . . in a position to appreciate the risks," S. Rep. 104-293, at 10. "A standard principle of statutory construction provides that identical words and phrases within the same statute should normally be given the same meaning." *Powerex Corp. v. Reliant Energy Servs., Inc.*, 551 U.S. 224, 232 (2007) (citation omitted). Accordingly, the Commission's attempt now to define

"qualified purchaser" to mean "any person" who makes a particular purchase, financially sophisticated or not, cannot stand under *Chevron* step one.

D. The Legislative History Makes Clear that Congress Intended to Limit "Qualified Purchaser" Preemption to Wealthy and Sophisticated Investors Who Do Not Require the Protection of State Registration and Qualification Requirements.

Finally, the legislative history of NSMIA and the JOBS Act confirms that Congress intended to limit the scope of state preemption for "qualified purchasers" to investors with high levels of wealth, income, and sophistication. *See Dunn v. CFTC*, 519 U.S. 465, 473-74 (1997) (holding that legislative history supported Court's conclusion that statute is clear and agency's interpretation is untenable). Indeed, it is rare that legislative history so squarely contradicts an implementing agency's interpretation.

The provision that ultimately became Section 18(b)(3) of the Securities Act was addressed by the responsible House and Senate Committees in 1996. In its report on NSMIA, the Senate Committee on Banking, Housing, and Urban Affairs recognized that the "securities registration structure in the United States is one of dual Federal and state regulation," and explained that the purpose of its prohibition on state registration and qualification for "covered securities" was to establish a uniform national standard for exemptions already in place in many states. S. Rep.

104-293, at 14 (1996). One example was existing state exemptions for "securities traded on the New York Stock Exchange, the American Stock Exchange and the National Market System of Nasdaq." *Id.* Another was "the preemption from state 'blue sky' registration for offers and sales to qualified purchasers." *Id.* at 15. With respect to the latter, the Senate Committee explained that NSMIA created "a uniform standard among the states for the 'qualified purchaser' exemption," observing: "Based on their level of wealth and sophistication, investors who come within the definition of 'qualified purchasers' do not require the protections of registration." *Id.*

The House Commerce Committee similarly believed that Section 18(b)(3) would establish "a uniform national rule for qualified purchasers." H.R. Rep. No. 104-622, at 31 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3893. And even though the Commission has "flexible authority to establish various definitions of qualified purchasers," the Committee emphasized its intent that "[i]n all cases" the Commission's definitions must be "rooted in the belief that 'qualified' purchasers are sophisticated investors, capable of protecting themselves in a manner that renders regulation by State authorities unnecessary." *Id.*, *reprinted in* 1996 U.S.C.C.A.N. at 3894.

The House Committee further offered "guidance" that in defining "qualified purchaser" for this purpose under the Securities Act, the Commission should consider the definition of that term "provided in Title II of this legislation under Section 3(c) of the Investment Company Act." *Id.* at 31-32, *reprinted in* 1996 U.S.C.C.A.N. at 3894. That definition of "qualified purchaser" refers to individuals and family companies with at least $5 million in investments and other companies with at least $25 million in investments. *See* 15 U.S.C. § 80a–2(a)(51); Section I.C, *supra*. Such "qualified purchasers," the House Committee observed, are "deemed to be sophisticated investors." H.R. Rep. No. 104-622, at 18 (1996), *reprinted in* 1996 U.S.C.C.A.N. at 3880; *see also* S. Rep. 104-293, at 10 ("The qualified purchaser pool reflects the Committee's recognition that financially sophisticated investors are in a position to appreciate the risks associated with investment pools that do not have the Investment Company Act's protections.").

In the JOBS Act of 2012, Congress confirmed its intentions regarding the scope of "qualified purchaser" preemption by referring explicitly to the limited definitional authority given to the Commission six years earlier. *See* 15 U.S.C. § 77r(b)(4)(D)(ii) (referring to Section 18(b)(3)). The final JOBS Act provision resulted from a bipartisan compromise that eliminated an earlier provision

exempting not just securities offered or sold on a national securities exchange or to "a qualified purchaser," but also those "offered or sold through a broker or dealer." *See* H.R. Rep. No. 112-206, 2 (2011). In reaching this compromise, members of the House Committee emphasized that "the protections provided by state review" remained essential, particularly since "Regulation A securities are sometimes high-risk offerings that may be susceptible to fraud." *Id.* at 13 (minority views); *see also* 157 Cong. Rec. H7231 (daily ed. Nov. 2, 2011). At no point did any member suggest that the authority Congress gave to the Commission to define "qualified purchasers" allowed it to preempt state registration and qualification requirements for entire categories of securities. Because Congress "unambiguously expressed" its intent, "that is the end of the matter." *Chevron*, 467 U.S. at 842-43.

II. THE RULE IS NOT A REASONABLE EXERCISE OF THE COMMISSION'S AUTHORITY.

For all the reasons set forth above, the intent of Congress is clear and this case should be decided at *Chevron* step one. Even if this Court proceeds to *Chevron* step two, it should still vacate the Commission's rule because it is not based on a permissible construction of the Securities Act, and because the Commission did not offer a reasoned explanation for why it chose that interpretation or why it rejected its earlier proposal equating "qualified purchaser"

with "accredited investors." *See, e.g.*, *Goldstein v. SEC*, 451 F.3d 873, 881-82 (D.C. Cir. 2006) (striking down Commission's definition of "client" under Investment Advisers Act because it came "close to violating the plain language of the statute" and Commission did not "adequately explain[] how the relationship between hedge fund investors and advisers justifies treating the former as clients of the latter").

A. The Rule Is Not Based on a Permissible Construction of the Securities Act and the JOBS Act.

In determining whether an agency's interpretation "is permissible or instead is foreclosed by the statute," a court must "employ all the tools of statutory interpretation, including 'text, structure, purpose, and legislative history.'" *Loving*, 742 F.3d at 1016 (quoting *Pharm. Research & Mfrs. of Am. v. Thompson*, 251 F.3d 219, 224 (D.C. Cir. 2001)). "No matter how it is framed, the question a court faces when confronted with an agency's interpretation of a statute it administers is always, simply, *whether the agency has stayed within the bounds of its statutory authority*." *City of Arlington v. FCC*, 133 S. Ct. 1863, 1868 (2013) (emphasis in original). Furthermore, even under *Chevron* step two courts "do not defer to an agency's ultimate conclusion about whether state law should be pre-empted," *Pliva*, 131 S. Ct. at 2575 n.3 (citation omitted), but rather apply a presumption

against preemption that may be overcome only if the court finds that the preemptive purpose of Congress was "clear and manifest," *Medtronic*, 518 U.S. at 485.

Here, it is actually "manifestly contrary to the statute," *see Chevron*, 467 U.S. at 843, for the Commission to preempt state securities registration and qualification requirements based on a definition of "qualified purchaser" that imposes no qualification based on purchasers' wealth, income, or sophistication. The term "qualified purchaser" in Sections 18(b)(3) and 18(b)(4)(D) of the Securities Act plainly requires a meaningful limitation on potential purchasers, and Congress and the Commission have elsewhere used the term to mean a limited group of investors with the wherewithal and experience to assume greater risk. *See* Sections I.A.1-2, I.C, *supra*. Congress intended the same here, stating that "[i]n all cases" the Commission's definitions under Section 18(b)(3) must be "rooted in the belief that 'qualified' purchasers are sophisticated investors, capable of protecting themselves in a manner that renders regulation by State authorities unnecessary." H.R. Rep. No. 104-622, at 31 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3894.

By defining "qualified purchaser" to mean "any person" who purchases Tier 2 offerings, the Commission contravened the statute's plain meaning and

legislative intent. The Commission further undermined Section 18(b)(3)'s requirement that any definition be "consistent with the public interest and the protection of investors" by allowing non-wealthy, unsophisticated investors to lose up to 10 percent of their net worth in Regulation A offerings – and by refusing even to require issuers to verify investors' compliance with that limitation. *See* Section I.A.3, *supra*. Finally, the Commission circumvented the statutory framework underlying Sections 18(b)(3) and 18(b)(4)(D) by wholly preempting state authority for a particular category of securities – a power reserved to Congress alone. *See* Section I.B, *supra*. This naked attempt to expand the Commission's authority beyond the purposes and limits of the Securities Act should be vacated under *Chevron* step two.

B. The Commission Did Not Provide a Reasoned Explanation for Its Interpretation.

Furthermore, even a permissible interpretation of a statute receives deference "only if the agency has offered a reasoned explanation for why it chose that interpretation." *Village of Barrington v. Surface Transp. Bd.*, 636 F.3d 650, 660 (D.C. Cir. 2011) (citation omitted). "Not only must an agency's decreed result be within the scope of its lawful authority, but the process by which it reaches that result must be logical and rational. Courts enforce this principle with regularity

when they set aside agency regulations which, though well within the agencies' scope of authority, are not supported by the reasons that the agencies adduce." *Fox v. Clinton*, 684 F.3d 67, 75 (D.C. Cir. 2012) (citation omitted). Nor may a court uphold a challenged regulation based upon "appellate counsel's post hoc rationalizations for agency action." *State Farm*, 463 U.S. at 50 (1983) (citation omitted).

Here, the Commission failed to provide a reasoned explanation for its decision to issue a definition of "qualified purchaser" that is not "based on attributes of the purchaser, such as a person's wealth, income, or sophistication." *See* 80 Fed. Reg. at 21,859. The Commission argued that "Section 18(b)(3) contemplates that the term 'qualified purchaser' can be defined 'differently with respect to different categories of securities.'" *See* 80 Fed. Reg. at 21,859-60. But the mere fact that the Commission may tailor its definitions to different securities does not mean that it may issue a definition of "qualified purchaser" that is unqualified as to who may purchase them. *See* Section I.A.2, *supra*.

Similarly, the Commission argued that the "mandatory features" provided and "discretionary features" allowed under Section 3(b)(2) somehow gave it "discretionary authority" to adopt a "qualified purchaser" definition that specifies

only "the particular characteristics of transactions exempt from registration." *See* 80 Fed. Reg. at 21,859. But the Commission's authority to develop general procedures for Regulation A does not allow it to expand the limited preemption authority carved out under Sections 18(b)(3) and 18(b)(4)(D). Moreover, the "features" that the Commission points to in its rule – namely, the "specified investment limitations" for non-accredited investors – do not function as a "qualified purchaser" requirement, but rather allow all purchasers to lose up to 10 percent of their net worth in Regulation A offerings (and even more if they overstate their net worth). *See* Section I.A.3, *supra*. Certainly, no provision that effectively allows an unlimited number of investors to lose a limited, but meaningful, amount of their money can be reasonably said to advance "the public interest and the protection of investors." 15 U.S.C. § 77r(b)(3). The rule fails *Chevron* step two.

C. The Commission Failed to Explain Why It Rejected Its Initial Interpretation of "Qualified Purchaser."

Not only has the Commission defined the term "qualified purchaser" in other statutory and regulatory contexts to mean what it plainly says – *i.e.*, as a limitation based on investors' wealth, income, and sophistication, *see* Section I.C, *supra*, it did precisely that in 2001 with the provision at issue in this case. In its 2001

Proposing Release, the Commission equated "qualified purchaser" under Section 18(b)(3) (which had been enacted five years earlier) with the existing definition of "accredited investor" under Rule 501(a) of Regulation D. *See Defining the Term "Qualified Purchaser" Under the Securities Act of 1933*, 66 Fed. Reg. 66,839 (proposed Dec. 27, 2001). Both terms, the Commission observed, are "based upon similar notions of the financial sophistication of investors." *Id.* at 66,840. It further acknowledged Congress's intent that "qualified purchasers for purposes of the Securities Act preemption of state regulation should include investors that, by virtue of their financial sophistication and ability to fend for themselves, do not require the protections of registration under the state securities laws." *Id.* at 66,841.

To be sure, an "initial agency interpretation" like the 2001 Proposing Release, which was never finalized, "is not instantly carved in stone." *Chevron*, 467 U.S. at 863. An agency may generally refine its interpretation of a statute it administers, provided that its new interpretation is "consistent with the statute." *Loving*, 742 F.3d at 1021 (citing *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 514-15 (2009)). At the same time, an agency's revised interpretation is entitled to less deference than its "contemporaneous construction" of a statute. *See*

Watt v. Alaska, 451 U.S. 259, 272-73 (1981) (citations omitted); *see also Fin. Planning Ass'n v. SEC*, 482 F.3d 481, 490-91 (D.C. Cir. 2007) (finding agency's initial and longstanding "understanding of its authority" suggestive of statute's actual meaning). At the very least, the agency must provide "a reasoned explanation," including a display of "awareness that it *is* changing position." *Fox Television Stations*, 556 U.S. at 515 (emphasis in original).

The Commission has not done so here. To the contrary, it implausibly denied in its Adopting Release that there was any inconsistency between its new rule and its prior proposed definition. *See* 80 Fed. Reg. at 21,859-60. The Commission acknowledged that its examination of NSMIA's legislative history in the 2001 Proposing Release found that "a qualified purchaser definition should include investors that are sophisticated and capable of protecting themselves." *Id.* at 21,859; *see also* 66 Fed. Reg. at 66,841. But it rejected the relevance of that finding on the ground that "[w]hile it may have been appropriate to focus on attributes of the purchaser when crafting a 'qualified purchaser' definition that would have applied in a broad set of possible transactions, as in the 2001 Proposing Release," the definition in its new rule "serves a different purpose because it applies only in Regulation A offerings." 80 Fed. Reg. at 21,859-60.

That is a non sequitur. The fact that Congress intended the "qualified purchaser" provision to be limited in a certain way – *i.e.*, applicable only to wealthy, sophisticated investors – cannot be disregarded based on the perceived "purpose" of its application or the category of securities at issue. The Commission's failure to come to terms with its earlier interpretation is one more reason why the final rule cannot stand under *Chevron* step two.

III. THE COMMISSION ADOPTED THE RULE BASED ON A FUNDAMENTALLY FLAWED COST-BENEFIT ANALYSIS OF ITS IMPACT ON INVESTOR PROTECTION.

In addition to the rule's substantive violations of the APA and the Securities Act, the Commission violated its procedural obligations under the APA and Section 2(b) of the Securities Act by failing to conduct the required cost-benefit analysis. The potential impact of the rule on investors is vast: it categorically preempts state "blue sky" laws for Tier 2 transactions under Regulation A; imposes no limitation based on investors' wealth, income, or sophistication; refuses to require verification that investors are limiting their investments to 10 percent of their income or net worth; and eliminates the pre-filing requirement for "testing the waters" materials. Numerous commenters cited the heightened potential for fraud raised by the proposed rule. NASAA, for example, observed the significant

similarities between the proposed rule and offerings under Rule 506, Regulation D – which NASAA described as "the single most common investment product or scheme involved in state enforcement actions" – and predicted a similar proliferation of fraud in offerings under Regulation A. NASAA Letter (Mar. 24, 2014) (CRI 75) at 3. Yet the Commission did not adequately consider the effects of any of its changes to Regulation A on investor protection. It provided no reasoned analysis justifying its conclusions, failed to correlate the significant identified harms of preemption and the asserted mitigating factors, insufficiently assessed the new coordinated process for reviewing offering registrations across states, and ignored commenter concerns and supporting evidence. These procedural violations render the rule arbitrary and capricious, *see Public Citizen*, 374 F.3d at 1216, and require vacatur, *see Business Roundtable v. SEC*, 647 F.3d 1144, 1156 (D.C. Cir. 2011) (vacating Commission rule for inadequate cost-benefit analysis); *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 179 (D.C. Cir. 2010) (same).

A. The Commission Failed to Provide a Reasoned Basis for Concluding That Its Rule Will Not Undermine the Protection of Investors.

Rather than offer conclusory statements in support of a cost-benefit analysis, the Commission must "disclose a reasoned basis for its conclusion." *Am. Equity*, 613 F.3d at 177. The Commission violated this requirement when it concluded that the rule provides sufficient investor protection for Tier 2 transactions.

In its Adopting Release, the Commission offered only a single paragraph to explain why existing state law and the new rule might lessen the adverse effects of "blue sky" preemption. *See* 80 Fed. Reg. at 21,887. Summarizing the states' retained regulatory authority (involving anti-fraud investigations and limited issuer filing) and provisions of the new rule (primarily investor limitations and "bad actor" disqualifications), the paragraph asserted without elaboration that these features "could mitigate [the] potential impacts" of state preemption. *Id.* This bare summary of existing and proposed law and a speculative assessment of their possible effects fall far short of providing a reasoned basis for the Commission's determination.

The Commission's approach essentially reduces the Section 2(b) analysis to a pro forma recitation of the rule, not an analysis of the substantive issues

implicated by it. That approach has been rejected by this Court. In *American Equity*, the Commission had adopted a rule exempting fixed indexed annuities from the Securities Act's definition of "annuity contracts," and in its Section 2(b) analysis the Commission claimed that the rule would encourage competition by resolving the annuities' "uncertain regulatory status." *See* 613 F.3d at 171-72. The Court held that the Commission "cannot justify the adoption of a particular rule based solely on the assertion that the existence of a rule provides greater clarity to an area that remained unclear in the absence of any rule." *Id.* at 177-78. Similarly, the Commission cannot discharge its obligation in this case to assess the rule's impact on investor protection simply by reciting the various provisions of the rule and positing that they "could mitigate" the negative impact of state preemption on investor protection. That approach is no substitute for the reasoned analysis of costs and benefits required under Section 2(b). *Public Citizen*, 374 F.3d at 1219 (criticizing circularity and irrationality of cost-benefit analysis that "assumes away the exact effect that the agency attempted to use it to justify").

B. The Commission Failed to Show How the Cited "Mitigating Factors" Relate to the Costs of Preemption.

Even though the Commission acknowledged several investor protection concerns resulting from state preemption, including the increased risk of fraud in

Regulation A offerings, it failed to show how existing state authority and the rule's provisions mitigate those concerns, or even to draw any correlation between the two. *See* 80 Fed. Reg. at 21,886-87. For example, the Commission mentioned a concern raised by many commenters: the loss of the "knowledge of local issuers, which could help in detecting fraud . . . by small, localized issuers." *Id*. at 21,887. Yet the Adopting Release completely failed to address how the listed mitigating factors might ameliorate this loss. Similarly, the Commission acknowledged the qualitatively distinct benefits of state merit-based reviews, but provided no evidence or rationale demonstrating that any of the mitigating factors incorporates similar protections sufficient to justify eliminating this safeguard. *See id.* at 21,886-87. Indeed, the Commission failed to consider the benefits to investor protection that would be afforded by newly coordinated state regulation, and instead addressed only the perceived costs and complexity of that coordinated review "when compared to Commission review and qualification alone." *Id.* at 21,887.

Absent some showing that the cited factors will actually mitigate the identified costs of preemption, the Commission's analysis constitutes mere speculation insufficient to satisfy a Section 2(b) analysis. In *Business Roundtable*,

the Commission analyzed the expenses an issuer would incur opposing shareholder nominees under a director election mechanism and posited that they might be limited because directors might opt not to oppose such nominees for fiduciary reasons. 647 F.3d at 1149-50. This Court held that this analysis was deficient because it "had no basis beyond mere speculation." *Id*. at 1150. While it was possible that a board of directors might refrain from opposing shareholder nominees, the Commission "presented no evidence that such forbearance is ever seen in practice." *Id.*

Here, the Adopting Release's analysis of state preemption is even more speculative. The Commission neither demonstrated a relationship between the costs and supposed mitigating factors, nor provided any evidence that those factors would actually outweigh the costs of state preemption. By failing to provide a non-speculative, reasoned basis for its conclusions, the Commission violated its obligation to assess the consequences of its rule. *Business Roundtable*, 647 F.3d at 1150.

CONCLUSION

The longstanding authority of the states to protect their citizens from securities fraud may not be eliminated unless the party asserting preemption proves

that the clear and manifest purpose of Congress supports it. Here, Congress expressly limited the Commission's ability to preempt state registration and qualification requirements to only those investors with sufficient wealth, income, and sophistication to protect themselves in the absence of those requirements. The Commission's final rule contravenes that clear Congressional intent and places millions of vulnerable investors in needless jeopardy. For these reasons, petitioners request that the rule be vacated and the Commission be enjoined from enforcing it.

Respectfully submitted,

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Date: August 26, 2015

CERTIFICATE OF COMPLIANCE

I certify that the foregoing brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because it contains 13,979 words, as determined by word-processing software and excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii). This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(6) because it has been prepared in a proportionally spaced typeface using Microsoft Word using 14-point Times New Roman font.

/s/ Robert E. Toone
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CERTIFICATE OF SERVICE

I certify that the above document will be served on August 26, 2015, by electronic notice for registered counsel and a copy will be served by first-class mail, postage pre-paid, for non-registered counsel.

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