Toward Regulatory Efficiency: The Inefficiency of State Securities Laws and the Case for Federal Pre-Emption

Introduction

For much of the twentieth and twenty-first centuries, American securities regulation has developed through conflict, compromise, and historical accident. Long before Congress enacted the federal securities laws of the New Deal era, states had already ventured into the field of securities regulation by adopting "blue sky" statutes intended to protect residents from fraudulent securities schemes. With the introduction of federal regulation in the 1930s, this dual system became entrenched, producing an interlocking but often discordant web of oversight.

While federal authority expanded over time—particularly through the adoption of, and amendments to, the Securities Act of 1933 and the Securities Exchange Act of 1934, and later through the Investment Advisers Act and the Investment Company Act—states continued to regulate broker-dealers, agents, and offerings. Simultaneously, private-market self-regulatory organizations (SROs) evolved into quasi-public regulators, adding yet another layer of governance. The cumulative effect is a regulatory structure characterized less by intentional design than by historical layering.

Today, this structure imposes substantial inefficiencies. The fragmented oversight landscape produces overlapping and sometimes conflicting rules, burdensome filing and registration requirements, and legal uncertainty that burdens and is arguably harmful to firms and investors alike. While past reform efforts—including the creation of the National Association of Securities Dealers (NASD) and various securities exchanges made meaningful progress, they did not fully resolve the structural inefficiencies embedded in the dual regulatory system. Eventually, certain regulatory activities conducted primarily by the New York Stock Exchange and NASD were combined into the Financial Industry Regulatory Authority (FINRA) and the National Securities Markets Improvement Act of 1996 (NSMIA) was adopted.

The establishment of FINRA was to a great extent achieved by the then head of NASD, Mary Schapiro being able to galvanize a consensus amongst key decision makers that a single rulebook that consolidated the rules of the two major existing SROs, which were then regulating a vast majority of the securities industry participants in the United States was a wonderful improvement over having multiple sets and layers of confusing regulations regulating those business activities.

Historical analysis reveals that inefficiencies still persist and why meaningful reform must confront the legacy of America's early regulatory choices. This article will provide a brief overview of the conceptual framework and historical analysis of state and federal regulation, outline the inefficiencies in the current system and propose some modern legislative or other remedies.

I. Historical Foundations of American Securities Regulation

To understand the inefficiency of modern securities regulation, it is essential to examine the historical development of the dual federal–state system. The persistence of state authority is not the product of modern policy considerations but the legacy of an era when securities markets were far smaller, less integrated, and more geographically isolated.

A. Before Blue Sky Laws: The Early Securities Market (1860s–1910)

In the late nineteenth century, the U.S. securities market was dominated by railroad bonds and shares, traded primarily in New York, Boston, and Philadelphia. Fraud existed, but the investing public was comparatively limited. Most capital formation was localized, and common-law fraud remedies were considered sufficient.

Yet by the early 1900s, the market expanded dramatically. The rise of national telegraph networks, national investment trusts, and aggressive securities promoters fueled both legitimate growth and widespread abuse. States saw increasing reports of fraudulent or worthless securities being sold to their residents by itinerant promoters—often referred to as "blue sky merchants," allegedly selling schemes backed by nothing more substantial than the "blue sky above."

B. The Rise of State Blue Sky Laws (1911–1933)

Kansas enacted the first blue sky law in 1911, and within a decade more than thirty states had adopted their own statutes. These laws varied widely but generally included:

- Registration of broker-dealers and agents
- Registration or qualification of securities offerings
- Anti-fraud provisions
- Merit-based review of securities quality (in many states)

The **merit-review standard**—authorizing state regulators to deny offerings deemed "unfair," "inequitable," or "speculative"—made state regulation substantively interventionist. States thus operated as *gatekeepers*, screening securities for residents. These laws formed the earliest

foundation of U.S. securities regulation and persisted largely unchanged when federal regulation later emerged.

C. Federal Securities Legislation and the New Deal (1933–1940)

The stock market crash of 1929 and the banking crisis of the early 1930s prompted Congress to enter the securities regulation field aggressively. Between 1933 and 1940, Congress enacted the:

- **Securities Act of 1933**
- **Securities Exchange Act of 1934**
- **Public Utility Holding Company Act of 1935**
- **Trust Indenture Act of 1939**
- **Investment Company Act of 1940**
- **Investment Advisers Act of 1940**

These statutes shifted the foundation of securities regulation from merit-based review to a disclosure-based regime, emphasizing transparency and investor autonomy.

Yet Congress consciously did not pre-empt state authority. Instead, federal law operated alongside state systems, reflecting political realities of the era:

- Local investor protection advocacy remained influential.
- Many legislators believed states were closer to the problems of local fraud.
- Congress was wary of removing state autonomy entirely during a time of ultra-sensitive debates about federal power.

Thus, from the outset, dual regulation was a political compromise rather than a deliberate policy choice.

D. The Evolution of SROs and Industry Self-Governance (1930s–2000s)

Parallel to federal and state systems, SROs emerged from exchange traditions:

- The New York Stock Exchange (NYSE) had policed its members since the eighteenth century.
- The Maloney Act of 1938 formally authorized national securities associations, of which there is only one currently in existence, FINRA.
- In 1939, the NASD was formed to regulate the over-the-counter market.

For decades, the NYSE and NASD maintained separate rulebooks and examination regimes, creating duplicative obligations for firms. By the early 2000s, market participants and lawmakers criticized the inefficiency of multiple SROs. This culminated in the **NYSE–NASD consolidation**, forming FINRA in 2007 and was a major step toward rationalizing SRO regulation.

E. Deregulatory Pressures and NSMIA's Political Origins (1980s–1996)

The movement toward federal pre-emption gained momentum in the late twentieth century due to:

- Expansion of national markets
- Increased interstate trading
- Growth of mutual funds and national broker-dealer networks
- Complaints about inconsistent state regulation and merit review

During the 1980s and 1990s, business groups, including the Securities Industry Association (a predecessor to Securities Industry and Financial Markets Association (SIFMA), which is a securities industry non-SRO affinity group, lobbied Congress to modernize securities regulation to reflect national market realities. The resulting legislation—**NSMIA of 1996**—was shaped by:

- Bipartisan concern that fragmented regulation hindered capital formation
- Recognition that states lacked the resources or expertise to oversee large investment advisers
- Compromise between federal pre-emption advocates and state regulators seeking to preserve authority

NSMIA ultimately removed state authority to regulate or examine large investment advisers and pre-empted certain offering requirements but deliberately preserved state authority over broker-dealers.

This carve-out was a political concession. State regulators and the North American Securities Administrators Association (NASAA), which is the oldest international investor protection organization but which is not an SRO, fiercely resisted federal pre-emption of broker-dealers, arguing that states were the "first line of defense" against retail fraud. This argument is at best highly subjective and is probably unsubstantiated since most defense against fraudulent activities as measured in dollar terms is probably conducted by the SEC or FINRA. As a result, NSMIA significantly modernized adviser regulation but left broker-dealer regulation in a fragmented condition that remains largely unchanged today.

F. Post-NSMIA Developments and Contemporary Fragmentation

Even after NSMIA:

- States continued to impose unique filing requirements.
- Examination requirements diverged among jurisdictions.
- Financial statement filing requirements remained inconsistent.
- New technologies (remote work, virtual offices, digital distribution) created novel regulatory conflicts that states addressed unevenly.

The result is a system still reflecting the market realities of the nineteenth and early twentieth centuries rather than what currently exists now that in our country as we approach our semiquincentennial or a quarter millennium anniversary of its founding.

II. The Case for a Modern Successor to NSMIA

The historical persistence of state authority—rooted in pre-federal blue sky laws—explains why modern inefficiencies persist. State rules continue to duplicate federal requirements, sometimes diverge from them, and occasionally conflict outright. The barriers identified above stem from this historical legacy rather than coherent modern policy.

The persistence of inefficiency in broker-dealer regulation—despite repeated attempts at harmonization—demonstrates that piecemeal solutions are insufficient. A structural reallocation of regulatory authority is required. This Part outlines a comprehensive proposal for a modern successor to NSMIA ("NSMIA II"), backed by doctrinal, economic, and policy arguments. It also anticipates potential objections and evaluates foreseeable consequences of enactment.

A. The Rationale for Federal Pre-Emption of Broker-Dealer Regulation

1. National Markets Require National Regulation

When blue sky laws emerged in the early twentieth century, securities markets were regional, information flowed slowly, and state regulators were often the only accessible enforcement authority. In contrast, today's trading environment is:

- instantaneous,

- electronic,
- cross-jurisdictional, and
- centrally intermediated by national broker-dealers and clearing agencies.

The overwhelming majority of securities transactions are executed through platforms operating seamlessly across all fifty states, the District of Columbia (DC) and various territories. Broker-dealers rarely serve only a local or regional clientele; they serve national markets by design. The geography-based model of state regulation no longer bears a reasonable relationship to how securities are distributed or marketed.

2. Federal Law Already Provides Robust Investor Protection

Some critics argue that eliminating state authority risks reducing investor protection. However, federal and SRO oversight already includes:

- extensive disclosure requirements,
- financial responsibility rules,
- net capital standards,
- supervisory and supervisory control mandates,
- anti-fraud provisions,
- sales-practice rules,
- licensing examinations,
- continuing education obligations, and
- regular examinations and enforcement actions.

Federal regulators and FINRA, not states, conduct the vast majority of enforcement actions concerning broker-dealer misconduct. The marginal benefit of additional state oversight is low compared with the compliance burdens imposed.

3. The Existing System Creates Structurally Unnecessary Redundancy

States often duplicate federal requirements while adding idiosyncratic procedural variations:

- separate form submissions,
- disparate deadlines,
- inconsistent definitions of branch offices and supervisory locations,

- distinct qualification retention mechanisms, and
- conflicting financial statement requirements.

Each divergence creates operational friction. None materially improves investor protection nor do they promote market integrity. A wonderful example of the confusing patchwork of the current inefficient regulatory environment as of December 1, 2025 is contained by this two-page chart, https://www.finra.org/sites/default/files/srojurisdiction-fee-and-setting-schedule.pdf . Note, for example, that many states accept Residential Supervisory Locations and many do not do so. That particular category was established by a FINRA rule, which in turn was approved by SEC.

B. Proposed Statutory Framework for NSMIA II

A modernized statute should include several key components.

1. Express Pre-Emption of State Regulation of Broker-Dealers

Congress should enact an express pre-emption clause covering:

- the elimination of State, DC and territorial broker-dealer registration,
- the elimination of State, DC and territorial agent/representative registration,
- financial responsibility requirements,
- firm and individual qualification standards,
- business conduct location definitions, such as
    - branch office definitions,
    - office of supervisory jurisdiction (OSJ) definitions
    - residential supervisory locations
- cybersecurity and operational requirements, and
- examination and enforcement authority (subject to limited carve-outs for fraud investigations).

States would retain enforcement authority only for conduct taking place *within their borders* that violates federal law—not the authority to impose distinct rules.

Such pre-emption is consistent with modern dormant U.S. Constitution Commerce Clause principles, which disfavor state laws that burden interstate markets in favor of protectionist or duplicative concerns.

2. Integration of MSRB Rules into FINRA's Rulebook

The Municipal Securities Rulemaking Board (MSRB) adopts rules governing municipal securities dealers but has no enforcement authority; FINRA enforces those rules. The proposed statute should:

- merge MSRB rules into the FINRA rulebook,
- eliminate conflicting cross-references, and
- consolidate interpretive guidance.

This approach mirrors the successful 2007 consolidation of the rules and practices of NYSE and NASD, which greatly reduced duplication and confusion.

3. Mandatory Uniform Filings and Forms

Just as NSMIA standardized adviser regulation, NSMIA II should require:

- exclusive use of Forms BD, U4, U5, and FOCUS for all jurisdictions,
- that there will no longer be any separate State, DC and territorial mandatory forms or filing requirements,
- uniform deadlines for financial statements, preferably not even mandating separate filings other than with the SEC and FINRA
- uniform definitions of branches, residential supervisory locations, and OSJs, and
- mandatory adoption of FINRA's Maintaining Qualifications Program (MQP) for all states

This statutory uniformity would eliminate the need for firms to track divergent state interpretations.

4. Delegation of Examination and Enforcement Authority to FINRA and the SEC

NSMIA II should clarify:

- the SEC will retain ultimate rulemaking authority,
- FINRA and SEC will administer day-to-day supervision and examinations,
- States, DC and territories may refer suspected violations to federal regulators but may not independently impose duplicative sanctions, and

- federal regulators must establish multi-state task forces for matters involving widespread misconduct, ensuring states retain a meaningful—yet non-duplicative—participation channel.

This preserves accountability without reinstating inefficiency.

C. Anticipated Objections and Responses

1. Federalism Concerns

State regulators and NASAA may argue that pre-emption infringes on state sovereignty. Yet Congress has long exercised its Commerce Clause authority to regulate national markets. Securities regulation is quintessentially interstate commerce. NSMIA II would mirror Congress's previous decisions to pre-empt:

- investment adviser regulation (NSMIA 1996),
- certain capital raising exemptions (JOBS Act 2012),
- national bank regulation (through OCC precedents), and
- ERISA pre-emption in the employee benefits context.

The historical trend supports broader—not narrower—federal pre-emption in national financial markets.

2. Investor Protection Concerns

Critics may fear that states serve as the "first responders" to fraud. But empirical evidence shows:

- FINRA and SEC conduct the vast majority of enforcement actions involving broker-dealers,
- most investor harm arises from conduct already prohibited by federal rules, and
- states, DC and territories rarely pursue unique forms of misconduct that federal regulators ignore.

Moreover, NSMIA II could include provisions requiring the SEC and FINRA to maintain cooperative enforcement partnerships with state attorneys general.

3. Concerns About Shrinking State Budgets

State regulators may fear lost funding from registration fees. Congress could address this by:

- authorizing federal grants to states for investor education, or

- permitting states to levy modest *federal-level* fees administered through FINRA to offset costs.

Funding concerns should not dictate the structure of national regulatory policy.

D. Consequences of Enacting NSMIA II

1. Reduced Compliance Costs

Consolidation would eliminate:

- multiple state filings,
- variations in deadlines,
- additional financial statement submissions,
- duplicative examinations, and
- conflicting supervisory location definitions.

Broker-dealers could streamline systems, reduce administrative overhead, and reallocate resources toward innovation, risk management, and investor service.

2. Regulatory Workforce Impacts

Some state regulatory personnel would likely be reassigned or retire earlier than anticipated. While this may cause localized disruption, it reflects a shift from redundant oversight to more specialized functions such as:

- consumer financial education,
- fraud investigation in non-securities fields, and
- state-level support for federal enforcement efforts.

Federal agencies and SROs may absorb some displaced personnel.

3. Increased Market Efficiency and National Consistency

Finally, the capital markets would become:

- more predictable,
- more uniform,
- less burdened by fragmented rule sets, and

- better aligned with twenty-first century financial realities.

A modern national market cannot function optimally under a regulatory regime designed for an era when quill pens were in vogue.

E. The Long-Term Vision

NSMIA II is not merely a technical adjustment but a foundational realignment. It recognizes that regulatory efficiency is a precondition for investor protection, not its adversary. By harmonizing the regulatory environment, Congress can ensure that:

- the current regulatory framework is costly, inefficient and counterproductive,
- enforcement will be more focused,
- oversight is modernized, and
- the U.S. would remain the world's most competitive and transparent capital market.

Conclusion

Securities regulation has evolved through historical contingency rather than coherent design. The persistence of state and local oversight—long after the emergence of national capital markets—creates inefficiency and instability without delivering meaningful additional investor protection. Prior reforms, including NSMIA and the consolidation of NYSE and NASD into FINRA, demonstrate that rationalization is both possible and beneficial.

A modern legislative sequel to NSMIA is essential to align regulatory structures with contemporary financial realities. By embracing regulatory efficiency as a foundational principle, Congress can create a streamlined, effective, and future-oriented system that preserves robust oversight while eliminating unnecessary burdens. The time has come to recognize that investor protection and regulatory efficiency are not competing priorities but mutually reinforcing pillars of a healthy financial system.