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A few months ago, an article appeared in the *Washington Post* about a young attorney, three years out of law school, who had been engaged in a solo practice in New York for about two years.[1] This young man earned "more than a hundred thou" during his first year of practice, and expected to make probably twice as much during his second year. He earns his living giving advice to clients who want to sell securities to the public for companies which often have no actual products—just a trendy idea, like solar energy, gene-splicing, cancer cures, and oil and gas tax shelters. As the *Post* article noted, once the registration statement clears the Securities and Exchange Commission (SEC), the clients are free to sell the securities to the public. If the attorney's clients take his advice, they can unload the stock for a quick profit. The *Post* also noted that, during the first six months of 1981, 259 companies sold new issues of common stock, raising nearly $2 billion.

The attorney showed the reporter a recent prospectus. When the reporter noted that the prospectus didn't state precisely what the company produced, he asked if any product existed. The attorney replied,

> Are you crazy? These guys have a fantastic product. It converts sunlight directly into money for the investors and promoters. And it's fully reversible. It converts the investor's money into sunlight. It's a remarkable chemical achievement.

The attorney in question went on to estimate that there are at least $100 million in worthless new issues sold to the public each year, but added, "If you told me that it was five times that, well, I wouldn't argue with you. The fact is, nobody knows."

It seems significant that the young man operates in New York. New York and some of its neighboring states do not apply their state securities laws to securities which are registered with the SEC.[2] Thus, no state official in these states examines the merits of a proposed securities offering. All that an offering needs, then, is to comply with the disclosure requirements of the Securities Act of 1933 (the "'33 Act").[3]

Recently, many commentators have criticized the federal disclosure requirements as being too burdensome, and as consisting largely of

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1 Wash. Post, Sept. 6, 1981, at G-1, col. 1.

2 N.Y. GEN. BUS. L. § 359 ff(1) (1980); N.J. STAT. ANN. § 49:3-60(c) (1967), as amended.

3 Act of May 27, 1933, 48 Stat. 74, 15 U.S.C. §§ 77a-77aa (1976), as amended.

"boiler plate" rather than information that is truly of value to the investor.[4] The proposed Federal Securities Code (the "Code")[5] presently pending before Congress takes some steps to shift the emphasis from the current predominance of the '33 Act registration statement to the reporting requirements under the Securities Exchange Act of 1934 (the "'34 Act").[6] However, the Code preserves the emphasis on disclosure as the appropriate means of regulating the business of selling securities to the public, rather than applying some sort of substantive standards to determine whether or not a particular security should be sold to the public. As our young attorney noted, however, "The new-issues market attracts the least knowledgeable investors. These people have to be killed before they give up and get out of the market."[7] Query whether a disclosure-oriented system can or will protect such investors.

I acknowledge that this attorney is not typical of the securities bar. Neither are his clients necessarily typical of the majority of those offering new issues to the public, nor of promotional companies going public for the first time. Still, assuming that the attorney's estimate, perhaps a conservative guess, is approximately accurate, $100 millon worth of worthless securities represents a substantial transfer payment from the hapless investors to those who mulct them in this fashion. Perhaps even more important from a public policy standpoint is the economic loss resulting from public loss of confidence in the securities markets. Many bona fide entrepreneurs turn to financing through the public sale of securities because other sources of financing—banks or other financial institutions—are either not available or are too expensive in terms of the proportion of control or other terms exacted.[8] As naive investors—apparently the most likely source for such equity financing—are "killed" by spurious ventures like those described above, they will be less likely to invest in other new ventures, even those which are bona fide. I know of no means by which the costs to the economy of foreclosing this avenue of financing to honest entrepreneurs can be determined.

As a former "blue sky" regulator, I found the saga of the young attorney compelling. Although, again, it falls far short of proving the value of strict "merit" regulation, it does seem to undercut the arguments against state securities regulation ("blue sky" regulation). Some have argued for the abolition of state securities regulation.[9] Others, recogniz-

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[4] *See, e.g.*, Kripke, *The SEC, The Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151 (1970) [hereinafter cited as Kripke]; Marsh, *Disclosure in Registered Security Offerings*, 28 BUS. LAW. 505, 527-28 (1973).

[5] A.L.I. FEDERAL SECURITIES CODE (1980) [hereinafter cited as CODE].

[6] Act of June 6, 1934, 48 Stat. 881, 15 U.S.C. §§ 78a-78jj (1976).

[7] *See* text accompanying note 1 *supra*.

[8] *Cf.* J. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS 24-25 (1971) [hereinafter cited as MOFSKY, 1971].

ing the political forces supporting some form of state involvement, yet despairing of the probabilities of achieving true uniformity among the various states, have advocated partial federal preemption for securities registered with the SEC.[10] The latter position would preserve some range of action for the states, but would permit states to apply substantive standards only with respect to securities which are exempt from federal regulation.

Total federal preemption would make the approach now taken by New York applicable to all states, including those which have historically imposed a strict form of merit regulation on all securities sold within the state.[11] The proposed Code has taken an intermediate position. Although the Code precludes the states from imposing additional disclosure requirements on SEC-registered offerings, it does retain the states' power to impose substantive standards.[12] Congress may soon hold hearings on the proposed Code.[13] At that time, it seems likely that the preemption argument may rear its head again. Thus, it seems an appropriate time to reflect a bit about the advantages of merit regulation under blue sky laws.

The history of blue sky legislation has been adequately covered elsewhere.[14] This article first will focus on the existing standards for merit regulation of the sale of securities, then will consider the objections most frequently raised to that type of regulation, and finally will conclude with some thoughts as to how the Code, if Congress ever adopts it, ought to accommodate state authority to regulate the sale of securities.

I. MERIT REGULATION OF THE SALE OF SECURITIES

Focus on the provisions covering the regulation of the sale of

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[9] *Id.* at 36, 37. Mofsky later expresses reservations about the desirability of federal preemption. *Id.* at 84-85. *See also* Mofsky, *State Securities Regulation and New Promotions: A Case History*, 15 WAYNE L. REV. 1401, 1402 (1969) [hereinafter cited as Mofsky, 1969]; Bloomenthal, *Blue Sky Regulation and the Theory of Overkill*, 15 WAYNE L. REV. 1447, 1478-90 (1969) [hereinafter cited as Bloomenthal].

[10] Bateman, *State Securities Regulation: An Unresolved Dilemma and a Suggestion for the Federal Securities Code*, 27 SW. L. J. 759, 779 (1973) [hereinafter cited as Bateman]. Bateman suggests only precluding the state from imposing substantive requirements on federally registered issues, leaving states free to experiment with new means of providing disclosure.

[11] The "strict" states would include at least Wisconsin, Iowa, Missouri, Minnesota and Illinois; some would include California and possibly Michigan. *Cf.* Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements?*, 1976 WIS. L. REV. 79, 86 n.46 [hereinafter cited as Goodkind].

[12] *See* CODE, *supra* note 5, at § 1904(a)(3), and accompanying Reporter's Notes.

[13] SEC. REG. & L. REP. (BNA) 27 (Jan. 6, 1982).

[14] L. LOSS & E. COWETT, BLUE SKY LAW 3-10 (1958); H. SOWARDS & N. HIRSCH, BUSINESS ORGANIZATIONS, Part I, § 11-C, at 1-1 to 1-10 (1981) [hereinafter cited as SOWARDS & HIRSCH].

securities under the Uniform Securities Act (the "Act"),[15] which is in effect in over 30 states.[16] Technically, of course, the title is a misnomer, for almost every state which has adopted the Act has added its own pet provisions.[17] Even where language identical to that in the Act is retained, many provisions require interpretation. Different officials in different states, and even in the same state at different times as personnel changes, interpret identical provisions differently. The North American Securities Administrators Association (NASAA), an organization composed of the securities administrators of all the states, has attempted to introduce a measure of uniformity to the area by adopting guidelines for registration, many of which have been adopted as regulations by the member states. I will address these problems of uniformity later. For the moment, focus on the provisions of the Act, because they are representative of the sorts of regulation encountered.

Consider first that provision of the Act which creates the most controversy, the provision that permits the administrator to deny registration to a proposed securities offering if he finds that the offering would not be "fair, just, and equitable" to public investors.[18] Many Uniform Act states have this provision. Many also have local peculiarities, some of which repose even broader discretion in the administrator.[19] Still, it is

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[15] Nat'l. Conf. of Commissioners on Uniform State Laws, UNIFORM SECURITIES ACT (1956) [hereinafter cited as UNIFORM ACT].

[16] The Uniform Act comes in three parts which deal with anti-fraud provisions (§§ 101 & 102), registration of securities (§§ 301-306), and registration of security dealers (§§ 201-206). Some states have adopted some portions of the Act, but omitted others. *See* 7A UNIF. L. ANN. 563 (1978). Nonetheless, the following states have based their state securities laws substantially on the Uniform Act: Alabama, Alaska, Arkansas, Colorado, Delaware, District of Columbia, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, New Jersey, New Mexico, North Carolina, Oklahoma, Oregon, South Carolina, Utah, Virginia, Washington, West Virginia, Wisconsin, Wyoming. *See* SOWARDS & HIRSCH, *supra* note 14, at 1-14; 1 BLUE SKY LAW REP. (CCH) ¶ 1503 (1982).

[17] *E.g.*, MO. REV. STAT. § 409.306(a)(2)(E)(iii) (1978) includes, as a ground for denial of an application for registration, that "the enterprise or business of the issuer is based upon unsound business principles." This provision appears to have been drawn from § 10(8) of the old Uniform Sale of Securities Act, which was withdrawn by the Commission on Uniform State Laws in 1944. MO. REV. STAT. § 409.306(a)(E)(ii) (1978) retains the "fair, just, and equitable" standard which a number of other states also retained, although the Uniform Act omits that basis for denial of registration. *See* UNIFORM ACT § 306.

[18] *Cf.* MO. REV. STAT. § 409.306(a) (1978). "The commissioner may issue a stop order denying effectiveness to, or suspending or revoking the effectiveness of, any registration statement if he finds (1) that the order is in the public interest and (2) that . . . (E)(i) the offering has worked or tended to work a fraud upon purchasers or would so operate; or (ii) any aspect of the offering is substantially unfair, unjust, inequitable or oppressive; . . . ." Other states have chosen slightly different wording. WIS. STAT. § 551.28(e) (1980) authorizes the commissioner to issue a stop order if: "The issuance or sale of the securities is or would be unfair or inequitable to purchasers or has worked or tended to work a fraud upon purchasers or would so operate." WIS. STAT. § 551.28(e) (1980).

[19] *E.g.*, MO. REV. STAT. § 409.306(a)(2)(E)(iii) (1978); *see* text accompanying note 17 *supra*.

the "fair, just, and equitable" standard that is used most frequently. The "tough" regulatory states, sometimes by regulation and sometimes by unwritten policy, have guidelines which they employ to determine whether or not a proposed offering meets the "fair, just, and equitable" standard. These states will deny registration where:

1. The promoters have invested insufficient equity capital in relation to the total capitalization that will exist after the completion of the proposed public offering;[20] or
2. there is an excessive amount of "cheap stock"—shares issued to promoters and insiders at prices significantly less than the proposed public offering price—in the registrant's capital structure;[21] or
3. an excessive number of options and warrants have been issued, or are reserved for issuance, in relation to the total capital structure that will exist after completion of the offering;[22] or
4. the proposed public offering price is too high in relation to the market price, if a market exists, or in relation to the issuer's earnings history, or other factors;[23] or
5. the underwriter's commissions and/or the selling expenses of the proposed offering are excessive;[24] or
6. voting rights of the shares being offered to the public are inequitable;[25] or,
7. the issuer's historical earnings, calculated in accordance with generally accepted accounting principles, are insufficient to cover the interest charges on debt securities being registered or the preferred dividend on preferred shares being registered.[26]

In a mid-1970's comparison of securities registered in Wisconsin with securities denied registration there, the Assistant Commissioner of Securities found that the above-listed items, plus an eighth "miscellaneous" factor which included an issuer's unsound financial condition and unfairness of insider transactions, were the reasons most frequently invoked for denying registration.[27]

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[20] Goodkind, *supra* note 11, at 87; *cf.* Mo. CODE OF STATE REG., tit. 15, § 30-52.080 (1980); WIS. ADMIN. CODE, § 3.05 (1970).

[21] *E.g.*, Mo. CODE REG. tit. 15, § 30-52.070 (1980); WIS. ADMIN. CODE § 3.04 (1970).

[22] Mo. CODE OF STATE REG. tit. 15, § 30-52.060 (1980); WIS. ADMIN. CODE § 3.03 (1970).

[23] Mo. CODE OF STATE REG. tit. 15, § 30-52.050 (1980); WIS. ADMIN. CODE § 3.02 (1970).

[24] Mo. CODE OF STATE REG. tit. 15, § 30-52.040 (1980); WIS. STAT. § 551.28(f) (1980); WIS. ADMIN. CODE § 3.01 (1970).

[25] Mo. CODE OF STATE REG. tit. 15, § 30-52.110 (1980); WIS. ADMIN. CODE § 3.07 (1970).

[26] Mo. CODE OF STATE REG. tit. 15, § 30-52.120 (1980); WIS. ADMIN. CODE §§ 3.06, 3.08 (1970).

[27] Goodkind, *supra* note 11, at 87.

Of course, if the issuer modifies its proposed offering to comply with the administrator's objections—by lowering the offering price, for example—registration may be granted. Even where it is granted, however, the administrator may impose additional conditions upon it. For example, he may require that "cheap stock" be escrowed either for a fixed term (3-5 years) or until the issuer has demonstrated earnings from operations for one or more fiscal years. Or, he may insist that promoters contribute additional equity to the corporation, or that they surrender a sufficient number of shares to reduce their proportionate ownership, upon completion of the public offering, to some percentage that the Administrator deems appropriate. It is not unusual for an administrator to impose several such conditions upon an issue.

In my own experience applying these sorts of standards in Minnesota, a very high proportion of the securities denied registration in the state were SEC-registered—over half, in fact. Such seems also to have been the case in Wisconsin in the period covered by the study.[28] Telephone conversations with the current Commissioner in Missouri indicate that his experience is consistent with this finding. Judging from the Wisconsin study, refusal of registration in that state did not preclude the issuers' selling the securities elsewhere.[29] Thus, the disclosure-only approach taken under the federal laws, and in effect advocated by the critics of blue sky regulation, does not protect investors as well as merit regulation. One can argue, however, that merit regulation's costs exceed any benefits derived from it. None of the critics have produced any statistics to establish what those costs might be.[30] Nevertheless, it is worthwhile to examine the criticisms that have been advanced.

II. OBJECTIONS TO MERIT REGULATION

Those who object to the concept of merit regulation focus on the standards for registration of securities—specifically, the fair, just, and equitable test, and the guidelines used to implement that standard. Therefore, it is appropriate to summarize the objections raised.

One of the most basic objections to the philosophy is that the use of merit standards gives an anticompetitive edge to established firms by

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[28] *Id.* at 107-08. Because Assistant Commissioner Goodkind compared the performance of securities which were registered in Wisconsin with that of securities which were denied registration there, it is apparent that many, perhaps most, of the securities included in the study were registered with the SEC.

[29] *Id.*

[30] Mofsky & Tollison, *Demerit in Merit Regulation*, 60 MARQ. L. REV. 367 (1977), [hereinafter cited as Mofsky & Tollison]. In a 1977 criticism of Goodkind, the authors cite to an unpublished 1976 manuscript by Poole, comparing merit regulation in North and South Carolina. *Id.* at 377. I have been unable to obtain that manuscript. Goodkind is the only published study of blue sky regulation which has come to my attention.

discriminating against new businesses.[31] The argument goes somewhat as follows: Virtually all state securities laws contain exemption for securities listed on designated stock exchanges.[32] Under the listing requirements of the various exchanges, a firm must have a minimum number of shares held by members of the public, and must have attained a certain size (in terms of net worth) and have enjoyed earnings of a certain minimum level.[33] Obviously, newly organized companies will not qualify for this exemption. If they are successful in their offering, they might acquire a sufficient number of public shareholders and an adequate "float"—number of shares outstanding—and even an adequate net worth, but they will still fail to meet the earnings test. Many strict states apply different standards to companies in the "promotional" category—usually defined as companies formed within the three years immediately preceding the filing date which have not had net earnings from operations in at least one of the most recent two fiscal years—than the state applies to companies having an established earnings history.[34] Therefore, the strict requirements are applied most vigorously to companies in the promotional or developmental stage.[35] The brilliant young entrepreneur with a bold idea but no cash is inhibited in his ability to seek public financing for his venture. The public is injured in two ways,

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[31] Bateman, *supra* note 10, at 767, 778; MOFSKY, 1971, *supra* note 8, at 12, 36-37.

[32] *E.g.*, MO. REV. STAT. § 409.402(a)(8) (1978) exempts securities listed or approved for listing on the New York, American, and Midwest Stock Exchanges, and empowers the commissioner to add additional exchanges by rule or order. MO. CODE OF STATE REG. tit. 15, § 30-54.060 (1980) adds the Pacific Coast Stock Exchange to the list. The exemption in § 409.402 (*i.e.*, the statutory exemption) extends to any other security of the same issuer which is of senior or substantially equal rank to the listed security, and any security called for by subscription rights or warrants listed or approved for listing, and any warrant or right to subscribe to any of the above. *Id.* The exemptions in other states are similar, although the precise list of approved stock exchanges varies.

[33] For example, the Standards of Eligibility for Listing on the New York Stock Exchange are 2,000 holders of 100 shares or more; 1,000,000 shares publicly held, and the market value of publicly-held shares must be at least $8,000,000. An alternative measure of size is that the issuer have $16,000,000 in net tangible assets, although greater emphasis is placed on market value of securities, and the company must have demonstrated earning power before federal income taxes and in competitive conditions of $2,500,000 in the last fiscal year and $2,000,000 in each of the preceding two years. Finally, if there is an indication of a lack of public interest in the securities—evidenced by low trading volume in the over-the-counter market or on another exchange, or an unusual geographic concentration of shareholders, or a low rate of transfers—higher distribution standards may be imposed. 2 NEW YORK STOCK EXCHANGE GUIDE ¶ 2495B (1976).

[34] *E.g.*, WIS. ADMIN. CODE § 3.02(3) (1970) defines an issuer in the "promotional or developmental stage" as one which has no significant record of operations or earnings prior to the public offering date. *Id.* For such companies, § 3.02(2) judges the reasonableness of the offering price to the public by the relationship that price bears to the price paid for stock by promoters and controlling persons in transactions occurring prior to the public offering date. Other strict merit states apply even more stringent standards. *See* Goodkind, *supra* note 11, at 96-97.

[35] MOFSKY, 1971, *supra* note 8, at 16; Bateman, *supra* note 10, at 778.

according to this argument. First, those members of the public who have a taste for risk are denied the opportunity to invest in such ventures. Second, society is deprived of a potentially viable, profitable business.[36]

A second argument against merit regulation begins with the observation that the degree of risk associated with a security is correlated to the market price for that security.[37] Administrators applying the strict merit standards are, in effect, passing on the degree of risk that they will permit issuers to offer to the public. Thus, these administrators are inevitably involved in setting price.[38] As already noted,[39] many of the rules applied under the fair, just, and equitable standard expressly consider the proposed offering price to the public. For example, one of the Wisconsin rules limits the proposed offering price to 25 times the reported earnings, unless the persons seeking registration can justify a higher multiple. Other states apply even more restrictive earnings tests.[40] The opponents of merit regulation go on to argue that such restrictions actually contribute to the "hot issue" problem which has occurred from time to time.[41] If, indeed, the issuer sets the offering price too low, the fact that the stock moves to a premium immediately upon being released for trading suggests that the issuer might have received more consideration for its stock initially. In addition, speculators who buy the issue at the public offering price may garner a quick profit by selling out as soon as the issue has moved to a premium price. Thus, the merit rules which limit the public offering price may contribute to this problem.

Another serious criticism of merit regulation deals with the degree of discretion imposed in the administrator of the state securities law.[42] The broad legislative language, "fair, just, and equitable," cries for interpretation, especially where the statute does not define those terms. The rules and informal guidelines developed to pass on securities offerings enhance administrative discretion.[43] This raises the specter of an administrator's personal prejudices affecting his regulatory decisions.[44] Also, the high degree of discretion imposed in the administrator gives him the power to direct and control the flow of investment capital among business and industry.[45] In that view, a bureaucrat, rather than the im-

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[36] Bateman, *supra* note 10, at 777; MOFSKY, 1971, *supra* note 8, at 16.

[37] MOFSKY, 1971, *supra* note 8, at 12; Bateman, *supra* note 10, at 777.

[38] MOFSKY, 1971, *supra* note 8, at 12.

[39] *See* text accompanying note 23 *supra*.

[40] WIS. ADMIN. CODE § 3.02(1) (1970); *see* Goodkind, *supra* note 11, at 96-97.

[41] Bloomenthal, *supra* note 9, at 1486. A "hot issue" is one which is immediately bid up to a premium above the public offering price because of high demand for the securities.

[42] Bateman, *supra* note 10, at 778; MOFSKY, 1971, *supra* note 8, at 16.

[43] MOFSKY, 1971, *supra* note 8, at 16.

[44] Bloomenthal, *supra* note 9, at 1479; Bateman, *supra* note 10, at 776.

[45] Bateman, *supra* note 10, at 778.

personal operation of the marketplace, determines the course of development of American industry and commerce.

Focussing on the problems of the impecunious entrepreneur with a brilliant idea, some of the critics have noted that it might be possible for him to raise initial capital through the exemption contained in most blue sky laws for limited offerings.[46] Most of these states impose limits on the number of offerees in such an exempt offering. Many of them also include shares given to insiders for promotional consideration such as services, intangibles, or property for which the cost basis cannot be established with precision in computing either or both the allowable number of offerees or the total amount that can be sold pursuant to such an exempt offering. These rules may operate to limit the number of outsiders who can be brought in to supply the necessary initial capital. As the number of investors is reduced, a larger amount must be obtained from each. This, in turn, increases the investors' bargaining power vis-a-vis the promoter, and it is feared that the investors will insist on receiving such a large number of shares that they will deprive the entrepreneur of control of the venture.[47] If the initial investors do not acquire control themselves, they may create a situation in which they, together with public investors brought in through a subsequent registration, will have control. If the entrepreneur recognizes at the outset that he may not be able to control his brainchild, he may give up the whole idea of seeking public financing. If he does, society is again deprived of a potentially profitable, productive business, and those public investors willing to assume a high degree of risk are denied the opportunity to make that investment.[48]

Merit regulation is also criticized for increasing the costs of making a public offering.[49] SEC requirements for audited financial statements and the legal fees incurred in preparing the registration statement are already high (not to mention printer's fees and underwriters' discounts). The need to adapt an offering to meet the varying requirements of the states in which the offering is made, some of which may have conflicting policies,[50] enhances the expenses associated with the offering.

Critics also object to the limits imposed on the number of shares issued for promotional consideration and on the number of options permitted, as well as to the escrow of promotional shares.[51] Again, the basis of their argument appears to be that such rules discourage promoters from attempting to raise public financing. Instead, they will seek alternatives, such as selling their idea to an existing firm which may be suf-

[46] MOFSKY, 1971, *supra* note 8, at 21ff.
[47] *Id.* at 24-25.
[48] *Id.* at 25-26; Bateman, *supra* note 10, at 781.
[49] MOFSKY, 1971, *supra* note 8, at 31-32.
[50] Bateman, *supra* note 10, at 769.
[51] MOFSKY, 1971, *supra* note 8, at 32.

ficiently financed to exploit it or which may be better able to comply with the less stringent rules imposed on established companies. The promoter might seek private financing,[52] or may simply give up the hope of establishing the business. Alternative sources may not be available, or alternate financiers may extract so high a price as to make it prohibitive to the entrepreneur.[53]

Another serious objection to merit regulation is that it does not work.[54] For one thing, administrators tend to ignore the antifraud provisions of the statutes, focussing instead on disclosure and regulation of the merits of offerings.[55] For another thing, the really serious frauds—the brazen scoundrels—simply ignore state registration requirements.[56] Given the states' preoccupation with the registration process, and their limited staffs, there is little likelihood that the fraud will be detected. Most states' enforcement efforts are limited to opening the mail and seeing what complaints have come in, and responding to as many of those as seem serious or as they have the personnel to deal with. Imposition of merit requirements did nothing to protect the public from the stock market crash in 1929, nor did merit requirements prevent the misdeeds associated with *Equity Funding*,[57] *National Student Marketing*,[58] and other notorious scams.

The most careful, thoughtful critique of merit regulation was done by Professor Bateman. He begins from the premise that the securities and financial markets have evolved into a very different world from that

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[52] *Id.* at 25-26.

[53] *Id.* at 19-20.

[54] Bloomenthal, *supra* note 9, at 1480, 1482; Bateman, *supra* note 10, at 767, 776-777.

[55] MOFSKY, 1971, *supra* note 8, at 74-75; Bloomenthal, *supra* note 9, at 1481.

[56] Bloomenthal, *supra* note 9, at 1481.

[57] *See In re* Equity Funding Corp. of America, 438 F. Supp. 1303 (C.D. Cal. 1977). This case arose under rule 10b-5, and not under the registration provisions of the various securities acts. The claimed violations involved schemes by Equity Funding and various of its subsidiaries to inflate assets and earnings by creating and selling to reinsurers bogus life insurance policies in order to create an image of a growing, prosperous insurance company. Probably the most complete statement of the facts can be found in the report of the Administrative Law Judge in a related administrative proceeding brought by the SEC against an investment advisor and certain of his clients. *See In re* Boston Co., [1978] FED. SEC. L. REP. (CCH) ¶ 81,705.

Because of the intricate nature of the fraudulent conduct in this case, involving falsifications on computer records which were extremely difficult to uncover, it is very doubtful that any regulator would or could have uncovered the deceptions. Indeed, it required several days of auditing by state insurance regulators, who had been alerted to the claimed fraud and advised where and how to look to unmask it.

[58] SEC v. National Student Marketing Corp., 457 F. Supp. 682 (D.D.C. 1978), involved misstatements in proxy statements for a merger between National Student Marketing and another corporation. The misstatements occurred in interim financial statements included in the proxy soliciting materials used to secure shareholder approval of the merger, which were available to the investing public generally. The misstatements indicated that National Student Marketing had earned a profit of approximately $700,000 during the nine-month

which spawned the original blue sky laws.[59] The shareholder population has expanded formidably, and the current population of shareholders is a good deal more sophisticated than the poorly educated, largely rural population that gave rise to the Populist movement which produced blue sky laws.[60] Furthermore, as a result of developments in the financial markets and in SEC-mandated disclosure, the shareholder population has access to a great deal more information than ever before. All of these factors reduce the need for the paternalistic approach inherent in the merit system. (Other commentators have pointed out that under the "efficient market" hypothesis, the market digests new information and the market price reflects the new information long before the SEC disclosure rules come into play.)[61] In this view, a disclosure-oriented philosophy is more compatable with a free society and with free financial markets than the merit standard philosophy since:

> No public official is given the impossible task of passing on the merits of each securities distribution on behalf of all members of the public under the disclosure philosophy. Instead, each investor is free to make his own investment decision on the basis of his own assessment of the potential risks and the potential rewards involved in each distribution, and in order to do so he is supplied with complete and reliable investment information. If he chooses to do so, he may take large risks in the hope of large returns on speculative investments. He is not denied this liberty by a public official who may have a more conservative investment philosophy and who will not permit high risk or speculative securities offerings to be made to the public under his interpretation of the traditional merit standards.[62]

Bateman goes on to note that the securities markets are now inherently national and interstate in scope, and questions whether state regulation of the sale of securities may not constitute an undue restriction on interstate commerce.[63] Further, the diversity of regulations and

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period ending May 31, 1969, whereas certain adjustments would have shown it to have incurred a loss for that period. Again, the SEC action charged violation of rule 10b-5, not the registration provisions of the '33 Act.

As in the case of Equity Funding, it is doubtful that even a strict merit state regulator would have caught the misstatements involved in this case, because state personnel typically limit their view to the materials presented in the Application for Registration. *See* text accompanying note 57 *supra*. The year-end financial statements, audited by Peat, Marwick, Mitchell & Co., were still current, and it would not have been necessary for the "stub" interim financials to be audited. State regulators probably would not have inquired further unless they had noted some glaring inconsistency in the stub financials.

[59] Bateman, *supra* note 10, at 764, 776.

[60] *Id.* at 776.

[61] *Cf.* Kripke, *supra* note 4, at 1170-73; Mofsky & Tollison, *supra* note 30, at 36.

[62] Bateman, *supra* note 10, at 781.

[63] *Id.* at 783.

interpretations create a pointless degree of confusion and complexity in public financing of new businesses.[64] In addition, the strict merit standards are weighted unduly toward protection of investors; they do not give appropriate consideration to the financial needs of the business community.[65] It is only necessary to fool one administrator under the merit approach, whereas under a disclosure philosophy, the fraudulent promoter must deceive all the investors.

The final criticism of merit regulation is that the existence of merit regulation may lull the investing public into a false sense of security.[66] Investors may come to rely on the fact that some state agency has decided that the security is acceptable, and may not exercise their own judgment in deciding whether or not a particular offering is appropriate for them. There is also the risk that unscrupulous securities salesmen may point to the fact that a security has been registered in a "tough" state as a selling feature, implying that the fact of the state's having registered it is an indication that it is of sufficient quality to merit consideration.

III. RESPONSE TO THE OBJECTIONS

My response to the criticisms of blue sky merit regulation begins with the purposes served by the rules and guidelines that regulating agencies use to pass on proposed securities offerings.[67] Although in my view these purposes adequately rebut most of the criticisms, some of the objections are not so rebutted. I will address these objections separately. These notions are, of course, my own. I do not pretend to know to what extent they may underlie the guidelines or may have influenced the thinking of those officials who participated in drafting the guidelines or rules. I suspect that many of these rules and guidelines were developed in response to particular perceived needs. The rules may or may not have been enlightened by input and advice from the financial and investment community. They are essentially administrators' pragmatic responses to problems encountered in administration. Thus, they have evolved somewhat in the way the convolutions in the Internal Revenue Code have evolved. In recent years, the NASAA has received suggestions, criticisms, and advice from members of the investment banking community.[68] To that extent, the advice may have been influenced by con-

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[64] *Id.* at 760, 768-69, 772.

[65] *Id.* at 772.

[66] Bloomenthal, *supra* note 9, at 1487.

[67] *See* text accompanying notes 20-26 *supra*.

[68] For example, the Committee on State Regulation of Securities of the Section of Corporation, Banking and Business Law of the American Bar Association, through a Subcommittee on Uniform Laws, assisted in the development of the Uniform Application to Register Securities, which is accepted by many of the state administrators. *See* 1 BLUE SKY LAW REP. (CCH) ¶ 5101 (1962). In addition, representatives of the investment banking community do attend the periodic meetings of the NASAA, during which there are oppor-

siderations of economic and financial theory. I do not know the extent to which the investment bankers contributed to the development of blue sky rules in earlier years. Many of the persons offering advice to the NASAA have come from the larger investment banking houses and Wall Street law firms. This may lend some color to the claim that blue sky regulations tend to maintain an anticompetitive bias in favor of established businesses and against the new enterprise which might compete with existing firms.[69] In my limited experience in the area, and perhaps in my naivete, I have not observed any overt manifestations of such objectives. Rather, those persons who have offered suggestions and advice have appeared to be motivated by the desire to protect investors and the marketplace, desires which coincide with those of most blue sky administrators.

A. *Minimum Equity Investment*

The first rule or guideline I will address is the one which requires that the promoters have made at least a minimum amount of investment to the capital of the company.[70] Although the precise amounts vary,[71] most rules require that the insiders and promoters contribute an amount sufficient to constitute a designated percentage of the total capitalization that will exist after completion of the proposed public offering. This requirement closely relates to the restrictions on "cheap stock", options and warrants, and public offering price. The minimum investment requirement appears to be designed to achieve two objectives: it limits the "dilution"[72] of the public investors' investment and it attempts to make sure that the promoters have a "stake" in the success of the company. Many states impose the requirement that promoters' shares be escrowed for a period of time, or until the company reports earnings. This requirement complements the minimum equity investment requirement by

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tunities for exchanges of views, and industry representatives discuss problems and mutual concerns with the members of the various working subcommittees of the NASAA.

[69] *Cf.* MOFSKY, 1971, *supra* note 8, at 12, 36-37; Bateman, *supra* note 10, at 767.

[70] *See* text accompanying note 20 *supra.*

[71] *See* Goodkind, *supra* note 11, at 103-104.

[72] Dilution occurs whenever there is a disparity between the price paid by the public for shares in the company and the price which insiders and controlling persons have previously contributed to the company. In such cases, the infusion of public capital results in an immediate increase in the "book value" of the shares already held by existing shareholders, while the book value of the shares purchased by the public falls to something less than the public offering price.

The SEC's concern for dilution is reflected in Securities Act Release No. 5278 (July 26, 1972), which amended the Guides for the Preparation of Registration Statements to require explicit disclosure of the amount of dilution, including charts or graphs depicting the amount of dilution. A number of the states emphasize the dilution aspects in their requirements concerning minimum equity investment. *See* Goodkind, *supra* note 11, at 103-104.

making it more difficult for the promoter to sell his shares and run as soon as the public offering is complete.[73]

Although I suspect that the rule was originally proposed for the purpose suggested in the preceding paragraph—to make it more difficult for the promoter to make a fast buck and get out—I think it can be justified by comparing the practice of banks in deciding to extend credit to a corporation or to the practice of financial institutions (such as small business investment companies) in deciding whether or not to advance money to, or take an equity position in, a new corporation. Both the banker and the institution will want to see that the promoters have a significant capital investment in the company, and both will probably place restrictions on the promoters' disposition of their shares. This is not to equate the undifferentiated public investor with a bank or other creditor. Certainly the creditor will and should enjoy a priority in the event of insolvency, while the shareholder will not. Further, the banker accepts a lower, fixed return in exchange for that priority, while the shareholder accepts a higher degree of risk and hopes for a much larger return.[74] These institutions are, by any definition, sophisticated investors. If such investors seek these protections, it seems reasonable for regulators to require that the same protections be accorded public investors.

B. *Cheap Stock*

As one of the principal critics of merit regulation has noted,[75] the promoter seeks to maintain control over his enterprise while obtaining financial support from the public. One way to achieve this, in the absence of merit regulation, is to issue a large number of shares to the promoters for little or no consideration, or consideration incapable of precise evaluation, and issue a small number of shares to the public at a higher price per share. One effect of this practice would be to cause an immediate, large dilution of the public shareholders' investment.

To illustrate, suppose that the corporation initially issued 10,000 shares to the promoters for cash consideration of $1,000 and there were no assets in the corporation other than the $1,000 cash. The book value would be $.10 per share. Now suppose the corporation succeeds in selling 1,000 shares to the public at $10 per share. Total assets rise to $11,000 and, with 11,000 shares outstanding, the book value per share becomes $1. The promoters' wealth increases $9,000 or $.90 per share, while the investor's investment is diluted $9 per share. The critics respond that

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[73] Many of the merit states, as a condition of registration, require that promotional or "cheap" stock be escrowed. *See, e.g.*, WIS. ADMIN. CODE § 3.04(4) (1970); MO. CODE OF STATE REGS. tit. 15, § 30-52.070(3) (1974). *See also* NASAA Statement of Policy on Cheap Stock, 1 BLUE SKY L. REP. (CCH) ¶ 5311 (1980).

[74] *Cf.* W. KLEIN, BUSINESS ORGANIZATION AND FINANCE 166-70 (1980) [hereinafter cited as KLEIN].

[75] Bloomenthal, *supra* note 9, at 1483.

the investor is not interested in book value.[76] The investor is interested in future earnings, and dilution tells us nothing about potential future earnings. The critics' contention may be true. Book value is a pretty meaningless figure, unless the company were immediately liquidated, and even then it is not very significant. So long as the dilution is disclosed, which SEC disclosure requirements ensure, the critics intend that the investor ought to have the "liberty" to make that investment if he so desires.[77]

This objection overlooks another result of the issuance of cheap stock—or, perhaps, another aspect of dilution—the dilution of control. The degree of risk in a security is correlated to its price in the market.[78] However, it is also correlated with control.[79] This is to say, the common stock, as the residual interest in the company, has the highest exposure to risk of the entire mix of securities in the company's capital structure. Correspondingly, the common stock exercises control over the company, through its election of the board of directors who will manage the company's business and affairs.[80] In fact, if a company seeks to finance with debt—use leverage, in other words—at some point, it will have so much debt outstanding that lenders will begin to seek additional safeguards, and the debt will begin to take on more of the characteristics of equity.[81] Those who criticize blue sky regulators' "preoccupation" with dilution ignore this point. In effect, the promoters issuing cheap stock are imposing most of the risk of loss on public investors, but are not giving those investors a concomitant degree of control. In my simple example above, the public investors put up 90.9% of the equity investment, but received only 9.1% of the voting power. This is the true and appropriate focus of the restrictions on the amount of cheap stock that can be permitted in a company's capital structure. If the promoter seeks to use public financing, he must grant the public a degree of control commensurate with the degree of risk the public undertakes. Alternatively, the promoter can make a larger investment himself, thus bearing more of the risk, and retain a larger proportion of the capital stock. Some blue sky regulations are phrased in terms of permitting the amount of stock retained by the promoter to vary with the proportion of equity he has provided.[82]

C. *Options and Warrants*

One way to avoid the restrictions on cheap stock and promotional

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[76] *E.g.*, Bloomenthal, *supra* note 9, at 1483; Bateman, *supra* note 10, at 778-81.

[77] *See* text accompanying note 60 *supra*.

[78] MOFSKY, 1971, *supra* note 8, at 15.

[79] KLEIN, *supra* note 74, at 156.

[80] *Id.* at 126-27; *see also* A. CONARD, CORPORATIONS IN PERSPECTIVE 318-79 (1976) [hereinafter cited as Conard].

[81] KLEIN, *supra* note 74, at 235.

[82] Goodkind, *supra* note 11, at 97, 103.

stock is to issue to insiders, or reserve for issuance to them, options to acquire additional shares after the public offering is completed.[83] Securities regulators recognized this technique, and adopted limitations on the total number of options and warrants which could be issued or reserved for issuance.[84] The restrictions are sometimes phrased in terms of requiring that the number of options and warrants be "reasonable"; at other times they are expressly restricted to a designated percentage of the total capitalization that will exist upon completion of the public offering.[85] This same result often is reached by administrators where the limitation is couched in terms of "reasonableness".

Because options circumvent the restrictions on promotional securities, critics object to them basically on the same grounds as those discussed above.[86] Options, too, represent potential dilution of public shareholders' investment. They may operate to interfere with future financing by the company, should it need to seek additional equity capital. Logically, the options would only be exercised at a time when the market price for the underlying securities was above the exercise price. If the company needed additional capital at that time, it could obtain that capital by selling shares to the public at the then-existing market price. If the options are exercised, the company will receive only the stipulated exercise price. Further, the existence of a large number of options overhanging the market may prevent the company from selling shares, even if the options have not been exercised. Prospective purchasers, looking at the block of options overhanging the market, probably would decline to purchase newly issued shares.

The SEC does require that the existence of options, and their terms, be disclosed in a '33 Act registration statement, along with a notation that the existence of such options represents potential dilution of shareholders' investment, and may interfere with future financing needs of the company.[87] Thus, those who purchase on the initial offering are apprised of the existence of the options, and of the potential problems associated with them. This disclosure, however, does not address my concerns about dilution, either financial dilution or dilution of control. As the young attorney with whom this article began noted,[88] because the new issues market appeals primarily to the least knowledgeable investors (sophisticated investors rarely touch them) and because new

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[83] MOFSKY, 1971, *supra* note 8, at 53.

[84] *E.g.*, WIS. ADMIN. CODE § 3.03 (1970) limits options and warrants to not more than 10% of the shares that will be outstanding upon completion of the public offering. *Id.* This includes options and warrants to underwriters and to financing institutions, as well as to insiders. *Cf.* Goodkind, *supra* note 11, at 93-95.

[85] *Id.*

[86] *See* text accompanying notes 73-80 *supra.*

[87] *See, e.g.*, Item 10 on Form S-1.

[88] *See* text accompanying note 1 *supra.*

issues are sold, not bought (as will be discussed in a subsequent section), disclosure alone is insufficient.[89]

D. *Excessive Offering Price*

Most strict merit states place a limit on the proposed offering price to the public.[90] If there is a market for shares of the same class, regulators phrase the restriction in terms of that market price.[91] If the stock has not been traded previously, and thus there is no existing market, regulators must use some other yardstick to determine the maximum permissible offering price. Some states, like Wisconsin, say that the price is deemed reasonable if it remains less than some multiple of the issuer's historical earnings record.[92] For a promotional company without an earnings history, the regulators will look to the amount the insiders paid for their stock, and permit the company to sell to the public at some multiple of the price the insiders paid. The multiple may be as low as two, or as high as eight or ten.[93] Regulators will also consider the prices being paid for the stock of companies deemed comparable to the issuer, as a guide to a reasonable public offering price.[94] Of course, the registrant is always free to try to convince the registering authority that a price higher than that which would be set under guidelines such as these is appropriate in its particular case. The burden will be on the registrant to justify a higher price, and it will be a very difficult burden to meet.

The justification for such a restriction lies in the necessity to correlate the price to the riskiness of the proposed venture. In attempting to value a company by capitalizing its earnings, which may be the most accurate way to value it,[95] the degree of risk involved, in terms of the variance of the expected earnings, is a crucial factor in setting the capitalization rate.[96] As the degree of risk increases, so does the capitalization rate. For a relatively stable company in a stable industry, a capitalization rate of 15% might be appropriate. For a more risky company in a riskier industry, a rate of 20% or higher might be appropriate. The earnings multiple, of course, is simply the reciprocal of the

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[89] *See* text accompanying notes 96-113 *infra*. In computing the allowable number of options, state regulators include options and warrants granted to underwriters in connection with the underwriting.

[90] Goodkind, *supra* note 11, at 95-98; *cf.* WIS. ADMIN. CODE § 3.02 (1970).

[91] *Id.* Obviously, if there is an adequate public market in which the shares are traded, at prices determined by the free interaction of buyers and sellers in that market, the market price will be the best approximation of the "value" of the securities.

[92] WIS. ADMIN. CODE § 3.02(1)(a) (1970).

[93] Goodkind, *supra* note 11, at 96-97.

[94] *Id.*

[95] *See* V. BRUDNEY & M. CHIRELSTEIN, CASES AND MATERIALS ON CORPORATE FINANCE 1-79 (2d ed. 1979) [hereinafter cited as BRUDNEY & CHIRELSTEIN]. *Cf.* KLEIN, *supra* note 74, at 211-13.

[96] BRUDNEY & CHIRELSTEIN, *supra* note 95, at 59-70; KLEIN *supra* note 74, at 147-49.

capitalization rate. A 15% capitalization rate in a company would translate into an earnings multiple of 6.67; a 20% capitalization rate produces an earnings multiple of 5. As the capitalization rate increases, the earnings multiple decreases. Untried companies, such as promotional companies, are likely to be very high-risk ventures, especially if they are also in new industries like genetic engineering. Therefore, high capitalization rates (low earnings multiples) seem particularly appropriate for such companies.

For companies lacking an earnings history, capitalization rates are of no use. Comparables, such as looking to the market prices for similar companies' securities, might be a substitute, if similar companies can be found. Most regulators are understandably somewhat skeptical of the degree of similarity between an untried company, with untried management, and existing operating companies. Looking at the price insiders paid for their shares gives some indication of what the insiders felt the shares were worth.[97] Hence, the rules look to the amount of consideration insiders paid for their shares. Of course, an administrator should consider *when* the insiders made their investment. If the company has just been formed, and the shares have just been issued to the insiders, the price would be a better indication of their estimate of its worth than it would be if the company had been formed two or three years previously, and had gone through some of the development of a product, or other development, before seeking public financing. If the latter situation obtains, there may be more justification for some disparity between the prices paid by the insiders and those being charged to the public.

E. *Underwriters' Commissions and Selling Expense*

Merit states limit the maximum commission that can be paid to underwriters, and the maximum selling expense that can be incurred, in connection with a public offering.[98] Usually the limit is stated in terms of a percentage of the total amount the public investors pay. It includes the value of options and warrants granted to underwriters, as well as cash commissions. Regulators scrutinize proposed offerings for any signs of indirect compensation (from promoters or large shareholders) as well as direct cash commissions. In the case of "firm commitment" underwritings, the limits apply to the "spread" between the public offering price and the amount of proceeds going to the issuer, after deduction of the underwriters' compensation. In the case of "best efforts" underwritings, regulators examine the amount of the underwriters' commissions.

Presumably, the objection to this basis for denial of registration originates in the fact that a successful initial public offering ("IPO"),

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[97] Goodkind, *supra* note 11, at 96-98.

[98] *Id.* at 87-90; *see* WIS. ADMIN. CODE § 3.01 (1970).

especially of the securities of a company in the promotional or developmental stage, requires more effort from the underwriters than an offering by an established company. Thus the underwriters feel that they are entitled to higher compensation and that allowable expenses of selling the issue should be higher. If the regulatory states set low limits on underwriters' compensation, it is not worth an underwriter's time to try to bring the issue to market. The limits on underwriters' compensation, then, may make it more difficult for untried companies to obtain public financing.

The recently published report on Phase II of a study conducted by the SEC and the National Association of Securities Dealers (NASD) (the "Phase II Report")[99] lends some support to this argument. Surveying all federally registered IPO's during the period from 1972-1980 the Phase II Report noted that 70% were handled by regional broker-dealer firms.[100] Of the 262 firms included in one of the study's surveys, 227 were regional broker-dealer firms, and only 35 were national broker-dealer firms.[101] As might be expected, regional broker-dealers play an even more important role in connection with offerings made by smaller companies and companies involved in high-technology industries. Regional broker-dealers handled 92% of the offerings made on behalf of companies with less than $10 million in annual revenue, and 82% of the offerings made by natural resource and high technology firms.[102] Note that the Phase II Report deals only with offerings registered with the SEC under the '33 Act. If one were to examine offerings conducted under Regulation A,[103] or pursuant to an exemption from federal registration, the role of regional and local firms would be still larger, because national firms rarely, if ever, underwrite such offerings.

A partial explanation for this predominance of regional firms in these types of offerings lies in the firms' underwriting criteria. Of 17 national firms responding to another survey form, 41% used as one of the criteria for taking on an underwriting the requirement that the issuer be incorporated for at least three years. Only 29% of 62 regional firms applied

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[99] *The Role of Regional Broker-Dealers in the Capital Formation Process: Underwriting, Market-Making and Securities Research Activities, Phase II Report*, published by the U.S. Securities and Exchange Commission and the U.S. Small Business Admininistration (August, 1981) [hereinafter cited as *Phase II Report*].

[100] A "regional" broker-dealer firm is any firm that is not classified as a "national broker-dealer firm" and is defined as a New York Stock Exchange member firm classified as a National Full-Line Firm, Large Investment Banking House or Institutional Firm, or one of certain NASD member firms which are engaged in substantial over-the-counter market-making activities. *Phase II Report, supra* note 99, at ii.

[101] *Id.* at 5, Table 2.

[102] *Id.* at ii.

[103] 17 C.F.R. §§ 230.257-.263(1981). Regulation A comprises Rules 251 through 263, and was adopted pursuant to section 3(b) of the '33 Act, 15 U.S.C. § 77c(b) (1976). The Regulation provides a much simplified form of disclosure for offerings up to $1,500,000. 17 C.F.R. § 230.254(1981).

that criterion. Further differences appear in the criteria applied as to size of the offering ($4.7 million for national firms; $2.1 million for regional), issuer revenues ($13.9 million vs. $4.4 million), issuer net worth ($8.1 million vs. $1.7 million), and issuer net income ($1.6 million vs. $0.6 million).[104] Thus, the promotional company, in existence less than three years and without any significant operating history, is unlikely to find a national underwriting firm willing to manage an initial public offering for it. Indeed, many regional firms will not be interested either. The study did not attempt to identify the reasons for these criteria since the study looked only to the issue of whether or not small businesses had access to public financing, and concluded that they did. The regulatory limits on underwriters' compensation might contribute to the prominence of smaller regional or local firms in managing these types of offerings.

The Phase II Report also indicated that smaller issuers were more likely to have the underwriting done on a "best efforts" basis than on a "firm commitment."[105] This is consistent with the greater degree of risk involved for the underwriters in a firm commitment underwriting. Although the underwriting agreement typically contains protective clauses enabling the underwriter to avoid his obligations in the event of war or other specified events,[106] such "out" clauses are rarely invoked.[107] As a practical matter, the underwriter in a firm commitment underwriting bears the risks of the underwriting. In a "best efforts" underwriting, on the other hand, title remains in the issuer: the underwriter simply acts as an agent, attempting to find investors who will buy the securities directly from the issuer, and is compensated by a commission based upon a percentage of the public offering price. There is also an intermediate type of underwriting called a "best efforts, all or none", or "best efforts, 75% or none." In a "best efforts, all or none" underwriting, unless all of the shares are sold, none will be sold. In the latter case, at least 75% of the issue must be sold or none will be sold. In this latter type of underwriting, the proceeds are placed in an escrow account until

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[104] *Phase II Report, supra* note 99, at 24, Table 13.

[105] *Id.* at 19. In firm commitment underwriting, the underwriter actually buys the securities from the issuer and hopes to be able to resell them to investors at a mark-up above the price to the issuer.

[106] The Underwriting Agreement, which is the definitive agreement between the issuer and the underwriters, contains a number of conditions on the underwriters' obligations, such as the requirement that the registration statement, including the prospectus filed with the SEC, does not contain any material misstatement of a material fact, or omit to state material facts necessary to make the statements made not misleading, as well as a number of general escape clauses, such as war or national emergency, or major change in market conditions. *See* D. RATNER, SECURITIES REGULATION 1022-43 (2d ed. 1980), for a sample underwriting agreement; the "out" clauses are set out in ¶ 7.

[107] Kaiser-Frazer Corp. v. Otis & Co., 195 F.2d 838 (2d Cir. 1952), is a celebrated case in which the underwriters took advantage of the "out" clause to avoid their obligations under the underwriting agreement. The notoriety of the case reflects the infrequency with which these clauses are invoked.

the designated percentage is sold, at which point the issuer issues the securities to the purchasers and the issuer receives the amount of proceeds received, after deducting the underwriters' commissions.

If an issuer is unable to find an underwriter to help it in an IPO, it can still seek public financing. Most states permit the issuer to sell its securities directly to the public without the intervention of an underwriter. In such cases, the officers and directors may sell the securities, even though they are not licensed as securities agents or broker-dealers.[108] Many states do permit issuers to avail themselves of the services of securities salesmen who have passed the requisite licensing examination, licensed as agents for the issuer.[109] Of course, if the issuer's officers and directors are busy trying to sell securities, they are not managing the issuer's business, and operations may suffer. Also, the individuals who are licensed as agents for issuers are not as financially responsible as broker-dealers, and may not have extensive networks of contacts through which to sell the securities. Therefore, these types of offerings are much less certain to raise the capital the issuer needs. Still, it is possible to obtain public capital without the intervention of a broker-dealer.

The starting point for analyzing the limits imposed on underwriters' compensation and selling expense is to recognize that, especially in an IPO, the securities are sold, not bought. Indeed, it is the heavy selling effort required in a public distribution of securities which prompted the initial emphasis on the federal level at the initial public distribution of securities, rather than the trading markets.[110] The higher profits earned from underwriting, as opposed to handling trading transactions, often tempts securities salesmen to engage in hard-sell techniques. This, then, is one basis for regulators' concern with these items.

Regulators are also interested in seeing that the largest possible proportion of the funds obtained from the investing public actually reach the issuer, and that the public offering is not being done primarily for the benefit of the underwriter. Issuers, especially newly organized issuers, are not in a particularly strong bargaining position vis-a-vis the underwriter, at least during periods when many companies are seeking access to the public securities markets. In some sense, then, regulators help to protect issuers from being disadvantaged by underwriters.

Securities regulators are aware of the screening process conducted by broker-dealers in deciding which underwritings they will undertake.

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[108] *See, e.g.*, MINN. STAT. ANN. § 80A.14(4) (1980).

[109] *Id.* § 80A.04.

[110] *See, e.g.*, Douglas, *Protecting the Investor*, 23 YALE L. J. 521 (1934); Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171 (1933). One commentator pointed out that the pattern of federal securities regulation undoubtedly would have evolved differently if the '33 and '34 Acts had been enacted in reverse order. Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340 (1966).

As the criteria outlined above suggest,[111] the criteria used by national broker-dealer firms tend to insure that the issuers are fairly substantial companies. Broker-dealers, as underwriters, vouch for an issuer to some extent: their reputations help to sell the issue. This is not to suggest that administrators do not scrutinize an issue underwritten by a national firm closely. Administrators do scrutinize such an issue, but they draw comfort from the fact that a reputable underwriter stands behind it. That screening process alone provides a degree of public protection in and of itself.

The stock exchanges and the NASD also consider the permissible amounts of commissions to brokers and underwriters.[112] The regulatory states impose limits similar to, although usually slightly lower than, the limits these industry bodies give as guidelines. Therefore, it does not seem that the limits imposed by the blue sky authorities are unreasonable. As noted above, the Phase II Report concluded that small businesses were gaining access to the public securities market.[113]

F. *Inequitable Voting Rights*

The entrepreneur who wishes to secure public financing, but not to surrender control of his venture, has yet another option. He can issue to the public a class of non-voting stock, or a class having fewer voting rights than the existing common stock. In this way, he can retain control even though he has a relatively small number of shares. Again, state regulators became aware of this device, and therefore deny registration if the shares being offered to the public do not carry voting rights equivalent to those of shares already outstanding.[114]

I believe that the justification for this attitude lies again in the correlation noted above between risk and control. Normally, the class of securities which bears the greatest risk also exercises control. In most IPO's, the public shareholders are being invited to bear the brunt of the risk. Therefore, it is appropriate that those shareholders exercise control, through election of directors and voting on such other matters as are reserved for shareholder approval under local law and the articles of incorporation. Because the basic concern is with the dilution of control,

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[111] *See* text accompanying note 104 *supra*.

[112] *E.g.*, Art. III, § 1 of the NASD's Rules of Fair Practice requires that the managing underwriter insure that the underwriting agreements are fair and reasonable. NASD SECURITIES DEALERS MANUAL (CCH) ¶ 2151 (1981).

[113] *Phase II Report*, *supra* note 99, at 7-10.

[114] *See* text accompanying notes 77-80 *supra*. The non-voting stock device also attempts to circumvent the state regulators' focus on the consideration the promoter has given for his shares. The promoter can pay whatever proportion of the amount paid by public investors that local authorities deem proper, take a fewer number of shares, but still maintain control because of those shares' disproportionate voting rights.

many of the comments made above with regard to restrictions on cheap stock are equally applicable here.[115]

The importance of equitable voting rights is made clearer by considering that, following a successful public offering, a promotional company will still be relatively small in terms of the total number of shareholders and number of shares outstanding. The concept of "shareholder democracy" is therefore more valid in this context than it is, for example, in the very large corporations like American Telephone & Telegraph Company, which has thousands of shareholders, none of whom owns as much as 1% of the outstanding stock.[116] Professor Conard points out that the relationships between shareholders and management in the large public corporations are very different from the corresponding relationships in medium sized and smaller corporations.[117] If a shareholder in AT&T is unhappy with the policies being pursued by the board of directors, he has little hope of influencing the board to change, or of mounting a successful challenge to the incumbent board. His recourse is to sell his shares in the broad public market that exists for AT&T shares. In the smaller corporation, however, a shareholder with any significant holdings is more likely to be able to influence board policies or to launch a successful challenge to the board. Moreover, he may lack the remedy of selling out that is available to the AT&T shareholder—there may be no public market, or the market may not be active so that he is less sure of receiving a market-determined price; or any market that exists may be susceptible of manipulation, to the shareholder's disadvantage. Therefore, equitable voting rights are particularly important to the smaller corporation.

Disclosure alone is not an adequate safeguard. The disclosure concerning the voting rights of shares may be buried deep in a complex, confusing prospectus, which the shareholder may not read anyway.[118] Even if the issuer is required to include a warning paragraph in bold-face type on the cover page or in a "Special Risk Factors" paragraph prominently featured near the front of the prospectus, the fact that new issues are sold, not bought, militates against the prospectus' giving it adequate consideration.[119] Usually, the issuer depends heavily on the broker or

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[115] *See* text accompanying notes 73-80 *supra*.

[116] During 1981, the weighted average number of shares outstanding was 788,178,000. *1981 Annual Report*, at 31. As of Dec. 31, 1981, AT&T had 3,055,495 shareholders of record. *Id.* at 28. Institutions hold 21% of the outstanding stock. 1 STANDARD & POOR'S STOCK REPORTS 182 (1982). With the average price of AT&T common stock hovering in the neighborhood of $50, 1% of the outstanding stock would represent an investment on the order of $40 million, a pretty healthy bite even for most institutional investors.

[117] CONARD, *supra* note 80, at 337-355.

[118] *See, e.g.*, Kripke, *supra* note 4; *see also* In the Matter of Rucker Corp., 26 S.E.C. 249 (1947) (recognizing that disclosure is often insufficient).

[119] *See* text accompanying note 110 *supra*.

salesman, who emphasizes the company's bright prospects while glossing over potential hazards such as inequitable voting rights.

G. *Inadequate Earnings*

Where an issuer seeks to register debt securities or preferred stock, regulators examine the company's earnings history.[120] A company which has no history of operations will usually be prohibited from offering debt securities or preferred stock in a strict merit state, so these types of securities are not available to a start-up company. The reasoning is straightforward. In the case of a debt offering, a failure to pay interest when it falls due is an act of default. The regulators are interested in seeing that the company has some chance of success without risking a default at the first interest payment date. They will therefore ask whether the historical earnings of the last several years are adequate to service the debt.

Although it is not an act of default for a company to pass a preferred dividend, even one that is cumulative, regulators justifiably are concerned that a company have demonstrated sufficient operating earnings to show a reasonable probability that preferred dividends will be paid regularly. Regulators may also insist that preferred dividends, if permitted, be cumulative, and that preferred shareholders be granted contingent voting rights—that is, the right to elect a majority or some portion of the board if a certain number of preferred dividends are passed or omitted.

Both debt and preferred stock are devices to achieve the advantages of "leverage".[121] Although there is debate among theorists concerning the advantages of employing leverage,[122] many companies do want to in-

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[120] *E.g.*, WIS. ADMIN. CODE § 3.06 (1970) will deem an offering of preferred stock or debt unfair and inequitable to purchasers unless the net earnings of the issuer, for its last fiscal year prior to the offering and for the average of its last three years prior to the offering, are sufficient to cover the preferred dividend or the interest charges, as appropriate. *See also* Goodkind, *supra* note 11, at 102.

Usually regulators will want to see a company's earnings that are one and one-half to two times the annual interest charges. This is not very different from the attitude of a banker deciding whether or not to extend credit to a corporation. Although he may take a security interest in corporate property, he is not really interested in becoming the owner of that property through a foreclosure sale. Rather, he wants to satisfy himself that the company has a reasonable prospect of repaying the debt out of current operating earnings since bankers do not like to contemplate the necessity of the company's refinancing the debt at the maturity date, and they want to know that the specified interest can be paid when it falls due. Therefore, bankers will examine historical earnings with a good degree of care, just as state regulators do.

[121] KLEIN, *supra* note 74, at 158-170, 186-191; BRUDNEY & CHIRELSTEIN, *supra* note 95, at 318-323 and 387-415. Although preferred stock is technically considered equity, because preferred dividends are usually limited to a specific percentage of the par value, or a specified dollar amount per year, preferred stock provides an opportunity for leverage.

[122] KLEIN, *supra* note 74, at 230-252, sets out the advantages and disadvantages of applying leverage quite well. *See also* BRUDNEY & CHIRELSTEIN, *supra* note 95, at 387-415.

clude at least some debt or preferred stock in their capital structure. As the proportion of debt increases in relation to the amount of equity (common stock) investment (as the leverage becomes larger, in other words), the lenders assume more and more risk. Sophisticated lenders then begin seeking additional protections, such as veto powers over certain types of management decisions. In effect, the debt takes on some of the attributes of common stock. It seems fair, then, that the debt have the ability to exercise control, the most important attribute of common stock.

Viewing the situation from a slightly different perspective, if a company does not have historical earnings sufficient to cover interest charges or preferred dividends, then the "debt" or "preferred stock" is, in fact, bearing the major share of the risk of the enterprise. As was discussed above in connection with cheap stock[123] and with voting rights,[124] it is appropriate that the security holders receive the right to control the enterprise that is normally granted to those who bear the risks. Regulators, however, have not stated this directly. Instead, regulators have taken the alternative route of saying that it will be deemed inequitable for a company without an adequate earnings history to offer debt or preferred stock.

Suppose, however, the company presents forecasts of the earnings that will be possible once the public financing is obtained. Shouldn't those forecasted earnings be considered in determining the company's ability to service debt or preferred stock? State regulators, like the SEC, are very suspicious of forecasts[125] and "projections." Regulators recognize projections as little more that guesstimates. Often, they reflect optimism more than anything else. A moment's reflection on the inability of economic "experts" to assist in developing government policies to resolve economic problems confronting the nation should confirm the regulators' wisdom in this regard.

H. *Lack of Uniformity*

It is true, as critics of merit regulation note, that there is a lack of uniformity in state securities regulation, even among states which have adopted the Uniform Act and including the strict merit states, which confer frequently. This does lead to some confusion in the field, complicates the process of clearing a registration in several states, and prob-

[123] *See* text accompanying notes 75-82 *supra.*

[124] *See* text accompanying notes 114-119 *supra.*

[125] Rule 175, 17 C.F.R. § 230.175 (1978), permits projections of revenues, income, capital expenditures, dividends and other financial items by companies subject to the continuous reporting requirements of the '34 Act and under stringent conditions. Such financial projections may also be included in '33 Act registration statements. *See* Guide 62, *Guides for the Preparation of Registration Statements,* 1 FED. SEC. L. REP. (CCH) ¶ 3822 (1978); 17 C.F.R. § 231.4936 (1978).

ably adds somewhat to the costs of registration.[126] Furthermore, the confusion is more likely to affect the issuer who is advised by an attorney who is not a specialist in securities law. The confusion therefore reinforces any tendency of the state securities laws to discriminate in favor of established firms, which are more likely to have counsel experienced in the securities field, and against promotional companies.[127] I submit that the lack of uniformity, although it is a problem, is not as severe a problem as the critics say, and does not justify elimination of state securities regulation, whether by federal preemption or some other device.

The first reason that lack of uniformity is less of a problem than it might appear to be lies in the division of labor among the parties to an offering that is underwritten by a broker-dealer, whether the dealer be a regional or a national firm. The entire process of bringing a securities issue to market is complex and requires a high degree of coordination of diverse talents.[128] Over the years, a pattern has evolved. Counsel for the issuer takes the lead in preparing the registration statement and the exhibits, and counsel for the underwriters (usually counsel to the managing underwriter) does the blue sky work, in addition to making certain investigations of the issuer's corporate records to satisfy the underwriters' "due diligence" requirements.[129] Like most business clients, underwriters tend to establish long-term relationships with their counsel. Thus, over the years and through participation in large numbers of underwritings, counsel for the underwriters become very familiar with the idiosyncracies of the various states' blue sky laws and regulations. They also become more or less acquainted with the operational personnel of the various state securities administrators' offices. As a result of this familiarity, if the underwriters' counsel anticipates problems in Wisconsin, for instance, because of some feature of a proposed offering, they will have an idea of how likely the Wisconsin administrators are to grant an exemption or waiver of some requirement, and they will be able to telephone the Wisconsin Securities Division and discuss the file with the examiner who is processing it, or with his or her

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[126] *See* text accompanying notes 49-50 *supra*.

[127] *See* text accompanying notes 31-36 *supra*.

[128] *Cf.* C. ISRAELS & G. DUFF, WHEN CORPORATIONS GO PUBLIC (1962); Schneider & Manko, *Going Public—Practice, Procedure and Consequences*, 15 VILL. L. REV. 283, 290-300 (1970).

[129] Under § 11(b) of the '33 Act, a defendant can escape liability for a misleading statement or an omission in a registration statement if he can show that he had, after reasonable investigation, reasonable ground to believe, and believed in fact, that the statements contained in the registration statement were true and that there was no failure to state a material fact necessary to make the statements made not misleading. 15 U.S.C. § 77k(b) (1976); *see* Feit v. Leasco Data Proc. Equip. Co., 332 F. Supp. 544 (E.D.N.Y. 1971), in which the underwriters were held to have sustained their defenses on the strength of the lead underwriter's investigations.

superiors. Often, they will work something out directly with the Division, especially if the problem results from a conflict between the requirements of Wisconsin and those of another state. If the issuer and the underwriters meet an impasse they must decide which state is more important to the success of the offering, and either withdraw an offering which has already been filed with that state or not file in the state. If they withdraw, they will have to notify the SEC and each of the other states in which they have filed an application for registration that they have withdrawn and the reasons for withdrawal. Most state regulators will accept the explanation that the withdrawal was due to inconsistent requirements of two states that the issuer was unable to accommodate. In my experience, this sort of informal conference occurs frequently with offerings which are underwritten. Blue sky counsel's job would be easier, and the issuer's legal fees might be reduced somewhat, if there were greater uniformity between the states. The lack of uniformity, however, does not seem to be an insuperable obstacle to underwritten offerings.

What about the offering which is not underwritten, but which the issuer makes through its officers and directors or through someone licensed as agent to the issuer? Obviously, this offering is at a certain degree of handicap at the outset, because it does not have the advantage of an underwriting firm with extensive contacts available to assist in the offering. To the extent that its counsel is not familiar with the requirements of the various securities laws, it may be at a slight additional handicap. Such issues tend to be smaller in size, however, and tend to be primarily of local interest, appealing to investors in the issuer's home state (the state in which it is domiciled, or in which its principal offices and operations are located) and, perhaps, in one or two neighboring states. It does not seem to be imposing too high a standard to expect an attorney who undertakes to assist a corporate client in selling its securities to the public to become familiar with the securities law of his own state, or even of one or two neighboring states. If the attorney is totally inexperienced in securities law and practice, he may find it heavy going at first, but he can obtain formal advice and guidance from the personnel of the state securities administration.

Again, in my experience, the personnel of the state securities administrations do not object to consulting with counsel, especially with counsel who are unfamiliar with the requirements of the particular state. The administrators would rather consult in advance than try to untangle a poorly prepared registration statement. The state personnel will not write an attorney's registration statement for him (nor should they), but they will point out potential pitfalls and provide guidance on rules and standards, and they will discuss problems peculiar to the particular offering or issuer. This is not a perfect substitute for the wealth of practical advice available to assist an attorney in complying with the federal securities laws.[130] There is a regrettable lack of good material written for the practitioner in the area of blue sky law. It is a means for the uninitiated lawyer to "learn the ropes". In short, I am not persuaded that the lack of uniformity and the complexity of blue sky laws is a serious handicap to any company seeking to avail itself of public capital.

From the standpoint of the practitioner, I have to agree that it would be desirable to achieve uniformity among the states' securities laws. However, I am no more sanguine about the chances of achieving such uniformity than is Professor Bateman.[131] Proceeding from their differing political and social histories, the states have evolved differing policies for dealing with regulation of the sale of securities. It sometimes seems impossible to get agreement even on the wording of a statute. The Uniform Securities Act has been around for a quarter of a century, and a significant number of states still have not adopted it. Even if the states could agree on particular language, it is probably impossible to draft language that is clear enough not to require interpretation. (Indeed, as the Internal Revenue Code demonstrates, the attempt to draft all-inclusive language merely invites astute counsel to devise means to skirt the boundaries of the statutory language. In an area as fluid as the securities industry, a broad range of administrative discretion is probably needed to adapt policies and procedures to novel schemes devised by those who prey upon their fellow man.) It is true, as Bateman also points out, that the financial markets have evolved considerably since the Uniform Act was promulgated in 1957.[132] It is probably time for the Commissioners on Uniform State Laws to review the Act in the context of these developments and determine whether or not revision is appropriate. Probably such a reconsideration should await the future of the proposed Code, so that any modifications can take the Code's provision into account. But, if the Code appears to be bottled up indefinitely, perhaps state administrators can achieve something by reexamining the premises of blue sky regulation on their own.

I. *Anticompetitive Effect*

Merit regulation has been criticized as being anticompetitive, dis-

[130] The classic treatise on the federal securities law is, of course, L. LOSS, SECURITIES REGULATION (2d ed. 1961). There are many other textual treatments available, including several on particular topics published each year by the Practicing Law Institute. In addition, the loose-leaf services provide up-to-date proposed rule changes and new cases. FED. SEC. L. REP. (CCH) (5 vols.); SEC. REG. (P-H) (4 vols.); SEC. REG. L. REP. (BNA) (2 vols.). In the area of blue sky law, on the other hand, there is one textual treatment giving historical background on the Uniform Act. LOSS & COWETT, *supra* note 14, is now out of print and 25 years out of date. SOWARDS & HIRSCH, *supra* note 14, is a textual survey of blue sky law, but cannot compare to the volumes of detailed analysis of the federal system that appear each year. The states do not attempt to match the detailed rules, instructions and guides promulgated by the SEC. Even the loose-leaf services are much less detailed in this area.

[131] Bateman, *supra* note 10, at 769-74.

[132] *Id.* at 776.

criminating in favor of established firms and against promotional companies.[133] The consequence is stated to be that the entrepreneur with an idea for a new business is hindered in obtaining financing for that business. The sources of this alleged discrimination are the exemptions contained in most blue sky laws for securities listed on designated stock exchanges and the policies of blue sky administrators which impose harsher standards on companies in the promotional or developmental states. We shall consider the objections in that order.

The blue sky statutes exempt from the state registration requirements securities listed on designated stock exchanges and, usually, securities of the same issuer which are senior to the listed securities.[134] The state securities administrator may have discretion to designate exchanges in addition to those specified in the statute, and thus be able to expand the scope of the exemption, if he finds that the exemption is consistent with the enforcement of the Act.[135] The basis of this exemption lies partly in the minimum requirements which the exchanges impose on the securities which will be listed for trading.[136] These requirements help to insure that a company is substantial, and that a reasonable amount of information about the company is publicly available. The exchanges, through their own rules, insist on prompt dissemination of information regarding the company, even before such information would have to be reported to the SEC under the periodic reporting requirements of the '34 Act.[137]

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[133] *See* text accompanying notes 31-36 *supra*.

[134] *E.g.*, WIS. STAT. ANN. § 551.22(7) (1970).

[135] *Id.*

[136] The New York Stock Exchange imposes the following numerical requirements: The company seeking an exchange listing must have at least 2,000 holders of 100 shares or more; there must be at least 1,000,000 shares held by the public; and the market value of the publicly-held shares must be at least $8 million. An additional measure of size which the listing authorities consider is that the company have at least $16 million in net tangible assets. 2 NEW YORK STOCK EXCHANGE GUIDE (CCH) ¶ 249B.10 (1982). Also, there must be some indication of public interest in the securities, evidenced by trading volume on another exchange or dealer interest in the over-the-counter market, and there should be no unusual geographic concentration of shareholders. The listing authorities will also examine the rate of growth of the number of shareholders and the rate of transfers in passing on a listing application. *Id.* Of course, the securities must also be registered under the '34 Act. Securities Exchange Act of 1934, 15 U.S.C. § 781 (1976). The listing requirements of the other exchanges are similar, although the numerical limits of the other exchanges may be smaller. 2 AMERICAN STOCK EXCHANGE GUIDE (CCH) ¶ 10.001 (1982). For example, the American Stock Exchange requires net tangible assets of at least $4 million, net income of at least $400,000 after all charges (including federal income tax) in the fiscal year preceding filing of the listing application; net income before income taxes, extraordinary charges and credits of $750,000; a minimum public distribution of 400,000 shares, of which at least 150,000 must be held in lots of 100-500 shares; a minimum of 1,200 public shareholders, at least 800 of whom hold lots of 100 shares of more, and an aggregate market value of at least $3 million.

[137] For example, one of the grounds upon which the New York Stock Exchange may "delist" a stock is the failure of the company to make timely, adequate, and accurate disclosures of information to its shareholders and the investing public. *New York Stock Ex-*

In addition to the listing requirements' helping to insure that a company is substantial and therefore presumably less risky than a newly-formed company, the exchanges tend to police companies which have shares listed on the exchange. This policing function generally takes the form of publicity concerning any questionable transactions affecting the public. For example, exchange authorities might suspend trading in a stock if they suspected that something untoward was occurring. The fact of a trading suspension is widely noted, and the exchanges usually publicize their reasons for doing so. In this way, the investing public is made aware of any problems. The SEC and other regulatory authorities will often be stimulated to take appropriate remedial action. These sorts of actions serve to protect investors much more effectively than the individual states could protect them.

The exemption for listed securities certainly does discriminate in favor of established companies. However, such discrimination seems appropriate, because the securities of such companies involve less risk than the securities of promotional companies. In addition, the states do not have unlimited resources to devote to policing the securities markets. This statutory exemption, then, can be seen as an attempt to allocate scarce resources. It is better to assign one's limited resources to areas which are not covered by any other agencies than to duplicate the efforts already being performed by the exchanges. Although the exemption is not fool-proof (frauds *have* been perpetrated in listed stocks), it is a pragmatic approach.

The merit policies which impose more stringent standards on companies in the promotional or developmental stage reflect the greater degree of risk associated with such companies, as well as the fact that such securities are aggressively sold.[138] Indeed, concern with precisely this situation promoted the first blue sky laws near the turn of the century.[139] In addition to the greater degree of risk associated with an untried company, there is a greater likelihood of the sorts of fraudulent promotions with which this article began.[140] Again, it is true that these policies favor established companies with "track records" which have demonstrated through their ability to generate earnings from operations that they are reasonably well managed, and that their risk level is lower. It is true, as Bloomenthal once pointed out, that a number of small uranium companies which could not have passed a strict merit scrutiny went on to locate substantial resources and introduced more competition

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change Company Manual, at A-18 to A-24, *reproduced in* 2 FED. SEC. L. REP. (CCH) ¶ 23,121 (1982). The Exchange requires that pertinent data be released immediately, while the "current reports" on Form 8-K need only be filed within 10 days of the end of the month in which a significant event occurs. 2 FED. SEC. L. REP. ¶ 23,120A (1982).

[138] *See* text accompanying notes 90-97 *supra*.

[139] Bateman, *supra* note 10, at 764-67.

[140] *See* text accompanying note 1 *supra*.

in that industry.[141] But Professor Bloomenthal overlooked the very large number of fraudulent promotions in that industry during the 1950's and 1960's which bilked eager investors of millions of dollars and became notorious in blue sky circles, turning the phrase "penny uranium stocks" into an epithet.[142]

I concede that blue sky regulation does favor established companies, and thus serves as an entry barrier in some sense of the word. However, it is not the sort of entry barrier which I condemn. It seems a legitimate exercise of state police power to protect the state's citizenry from insubstantial schemes.

J. *Market Developments and Investor Sophistication*

Professor Bateman[143] is quite correct that the financial markets have experienced substantial development from the primitive state in which they existed when state legislators enacted the first blue sky laws. The investing public is probably also more sophisticated and well-informed than that public the early blue sky laws sought to protect. The populace is more highly educated than at the turn of the century, and the media provide more rapid, complete, and sophisticated information germane to investors' interests. Despite these developments, I would argue that the current situation makes the sort of regulation embodied in the blue sky laws more, rather than less, necessary in the contemporary environment.

As the financial markets have matured, we have been exposed to a much wider variety of investment media. In addition to the traditional stocks, bonds and investment companies (mutual funds), we can choose from investments in orange groves,[144] precious metals,[145] various mechanisms for raising fur-bearing animals,[146] diamonds,[147] real estate limited partnerships,[148] tung groves,[149] agricultural limited partnerships,[150]

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[141] Bloomenthal, *supra* note 9, at 1480.

[142] "The State was the happy hunting ground of promoters of fraudulent enterprises; in fact their frauds became so barefaced that it was stated that they would sell building lots in the blue sky in fee simple. Metonymically they became known as the blue sky merchants and the legislation intended to prevent their frauds was called Blue Sky Law." LOSS & COWETT, *supra* note 14, at 7 n.22, *quoting*, Mulvey, *Blue Sky Law*, 36 CAN. L.T. 37 (1916).

[143] Bateman, *supra* note 10, at 764.

[144] SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

[145] Texas Arizona Mining Co., Inc., [1971-72] S.E.C. DEC. ¶ 78,625 (silver purchase contracts).

[146] Continental Market Corp. v. SEC, 387 F.2d 446, (10th Cir. 1967) (chinchillas).

[147] Investment Diamonds, Inc., [1971-72] S.E.C. DEC. ¶ 78,350.

[148] Pawgan v. Silverstein, 265 F. Supp. 898 (S.D.N.Y. 1967) (general partnership). A limited partnership is almost by definition an "investment contract" under the test enunciated in *Howey*, 328 U.S. 293 (1946); NYSE, Inc. v. Sloan, [1974-75] S.E.C. DEC. ¶ 95,083 (S.D.N.Y. 1975).

[149] SEC v. Earl, 41 F. Supp. 647 (D. Fla. 1941).

[150] Riegel v. Haberstro, 30 A.2d 645 (Pa. Super. 1943).

a variety of forms of investing in exploration for oil and other natural resources,[151] multi-level distributorships,[152] and an almost unlimited number of other investments. The only boundary appears to be the ingenuity of promoters in devising vehicles to obtain public financing.

If the universe of investment vehicles were limited to common stocks, or even to those common stocks listed on a major stock exchange, it would be difficult enough.[153] Recall that our investor is not trying to decide which of a select group of common stocks is best for him; rather, he is trying to select the appropriate mix of investment vehicles, taking account of his personal tax situation, age, family situation, and investment objectives. I submit that even the mythical sophisticated investor, armed with his Apple II computer and the latest package of investment software, is confronted with an impossible task, and that he needs whatever protections the blue sky laws can give him.

In this complex, confusing environment, the state regulatory offices, hampered as they are by small staffs and relatively inexperienced personnel, provide a real service to investors. They cannot and should not be regarded as investment advisors. They can, and should, however, screen out the unfair and inequitable offerings, such as those which assign all the risk to the public investors and offer returns far lower than the risk should command. In addition, although the staffs are often inexperienced initially, they are reasonably intelligent. Many are lawyers or accountants. Over the course of a few months, by examining large numbers of applications for registration they soon develop the ability to analyze a filing, applying the criteria discussed above, and identify those proposed offerings which fail to pass muster. At the very least, because of the numbers of applications they review, staff examiners are in a far better position to evaluate an offering than is the average investor, even one who is fairly sophisticated and reasonably well-informed.

I am not so naive as to think that blue sky regulators are endowed with some special second sight which enables them to select the "best" types of securities to be offered to the public. Indeed, I do not believe that the administrator's decision should be based at all on whether or

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[151] *See generally* 1 FED. SEC. L. REP. (CCH) ¶ 1071.45-.49 (1982).

[152] *See* Release 33-5211, Nov. 30, 1971, 17 C.F.R. 231.5211 (1971).

[153] J. KEYNES, GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY 156 (1936): Suppose a major metropolitan newspaper offered its readers a contest. It published photographs of 100 beautiful women, and offered a prize to the contestant who picked the 10 women judged most beautiful by the majority of the entrants to the contest. Note that each entrant is confronted with the problem not of identifying the 10 women he thinks are the most beautiful, but the 10 whom the majority of the newspaper's readers will find the most beautiful, one level of abstraction removed. The problem of the person trying to select a portfolio of securities is at least one further level of abstraction removed from that of the entrant in the hypothetical contest.

not he or she thinks a particular security is a "good investment." The only standard I advocate is the one specified in the statute. The proposed security offering should be "fair, just, and equitable" to the public investor, by which I mean that the security should offer the investor a potential return commensurate to the risk he undertakes. Where the public investor assumes the heaviest burden of risk, he should be accorded the power to exercise control concomitant to that risk. That determination would of course be influenced by the factors discussed above,[154] including an extreme degree of dilution of the public investment, the existence of a product, or the appearance that the issue was primarily for the benefit of the promoters or underwriters based upon the overall tone of the prospectus. Indeed, this seems to be the standard employed by most blue sky regulators today. I would also be guided, as I believe regulators generally are guided, by recognition that it is in the public interest to facilitate capital formation by business, where that can be done consistently with the protection of investors. A balance must be struck, and generally is struck, between those two public policies.

I think it goes without saying that these standards do not include such ambiguous grounds for denying registration as that embodied in the Missouri Securities Act, which requires that "the issuer's business is not based upon sound business principles."[155] No one knows precisely what this carry over from the Uniform Sale of Securities Act[156] means. It is objectionable on principle, due to the unlimited range of discretion this meaningless language reposes in the securities administrator.

K. *Costs v. Benefits*

The question of whether the benefits of blue sky merit regulation are worth its costs is probably unanswerable. It is difficult to determine the value of benefits conferred, in terms of investor dollars saved. As our young New York attorney who prompted this article observed, no one really knows how many worthless securities are sold each year, either in states lacking strict merit regulation or in those which attempt to apply it.[157] The Wisconsin study[158] suggests some tangible benefits, but they are not very quantifiable. Intangible benefits, such as an increase in investor confidence in the legitimacy of the public securities markets, which thereby facilitates the financing of legitimate ventures, are not readily determinable.

Costs, of course, must be thought of as more than simply the direct costs of operating the various state securities offices. The budgets of

[154] *See* text accompanying notes 20-27 *supra*.

[155] Mo. Rev. Stat. § 409.3069(a)(E) (1978), *paraphrased* at note 17 *supra*.

[156] Commissioners on Uniform State Laws, Uniform Sales of Securities Act (1929). This Act was withdrawn by the Commissioners in 1943.

[157] *See* text accompanying note 1 *supra*.

[158] *See* text accompanying note 27 *supra*.

these offices are miniscule compared to the budgets of state highway departments, for instance. Taken in the aggregate, however, the nationwide direct costs of administering blue sky laws must be substantial. One must also add as direct costs the increases in costs of preparing a public offering, such as increased attorneys' fees and accounting costs,[159] increased underwriters' expenses, and increased printing expenses. The proceeds of the offering typically cover these costs, so that they are paid, in the first instance, by the investors who are the objects of state concern. They do not contribute (at least not directly) to additional productive capacity, or an increase in the output of goods. Again, I know of no estimates of the magnitude of these costs, although it should not be too difficult to arrive at a fairly close estimate.

The really unmeasurable costs are those of lost production from companies which are never organized because the promoter is dissuaded by the problems of complying with blue sky merit requirements from seeking the needed public financing. Although some of the critics of merit regulation have wailed long and loud about this deterrence,[160] I question whether the problem is really as severe as they would have us believe. As the same author has pointed out, the entrepreneur with a brilliant idea but no resources has four options:

1. He can seek financing from a small group of investors, relying on an exemption from registration under the blue sky laws.
2. He can give in to the state requirements and adjust his holdings or consideration for his shares and raise whatever public funds he can successfully raise.
3. He can sell his idea to an established company, which may be able to finance the development through internally generated funds, or may be better able to satisfy the conditions imposed by merit regulators (perhaps by virtue of not being classified as a "promotional" company).
4. He can give up his idea.

If he chooses the first option, the business will still be formed. The entrepreneur may have a smaller stake in it than he would prefer, however, because the small group of investors may have sufficient bargaining leverage to require the entrepreneur to secure for the investors a large slice of the action. If he chooses the second option, again

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[159] Some states require financial statements to be audited, even in situations in which the SEC would not. For example, the financial statements filed with a Regulation A offering need not be certified. *See* Item 11 on Schedule I, specifying the information to be included in the Offering Circular required by Rule 256, 17 C.F.R. § 230.256 (1981). Nevertheless, Minnesota appears to require certified financial statement even in such cases. *See* MINN. RULE S. DIV. 2132 (1980).

[160] *See, e.g.*, Mofsky, 1969, *supra* note 9, at 19ff, 40ff.

the business will be formed, and again the entrepreneur may retain less control than he wants. In the third case, the public will still get the benefit of the opportunity to invest, but the entrepreneur's reward may be less than with either of the first two options. This will depend on his ability to negotiate with the buyer. Only if the entrepreneur takes the fourth option and gives up in disgust is the public deprived of the benefit of his idea. I suspect that this is the option the entrepreneur is least likely to take.[161] The potential rewards, if he truly believes in his idea, are simply too large for an ambitious promoter to pass up. In any case, I know of no way to determine how many businesses are not formed because potential promoters are discouraged by the requirements of merit regulators. As the anecdote with which I led off illustrates, large numbers of virtually worthless securities are probably sold each year in states which do not impose merit standards.

This is not to make the claim that merit regulators catch all spurious offerings. It is possible, although more difficult, for unscrupulous promoters to meet the strict letter of the state requirements. Certainly, a number of scandals, such as *Equity Funding* and *National Student Marketing*,[162] occurred in spite of merit regulation, although I have not made a survey to ascertain whether those particular offerings were registered or exempt in all of the merit states. The truly fraudulent venturers may simply ignore state regulation, relying on small staffs and heavy workloads to prevent detection, at least before the unscrupulous promoters have obtained a substantial sum and have had the opportunity to decamp. To suggest that this is a basis upon which to abolish blue sky regulation, however, is akin to suggesting that the criminal codes should be abolished because some people still commit murder.

Critics argue that the proponents of merit regulation should be required to demonstrate that the benefits exceed the costs.[163] Given the difficulties in establishing the indirect costs just alluded to, this is equivalent to saying merit regulation should be abolished. I would argue the reverse proposition. We know that abuses occur in states which lack merit regulation, although no one has established with precision the aggregate amount of money lost in such abuses. It would appear to be incumbent on those who would abolish merit regulation on a cost/benefit basis to establish with some accuracy just what the costs are, in terms of

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[161] MOFSKY, 1971, *supra* note 8, at 25-26, also sets out the four options. Mofsky seems genuinely concerned that a significant number of entrepreneurs do in fact take this fourth option, but he offers no evidence that this is so. *Id.* at 36-37. Mofsky would put the burden on the proponents of merit regulation to establish that merit standards do not deter potential entrepreneurs. *Id.* at 37. Of course, it is virtually impossible to prove the negative. Thus, Mofsky would have the benefit of the burden of proof to achieve his goal of eliminating merit regulation. Obviously, I do not share his belief, for the reasons set out in the text.

[162] *See* text accompanying notes 57-58 *supra*. As noted, neither case was litigated on a theory involving misstatements in a registration statement.

[163] *See* text accompanying notes 56-59 *supra*.

business opportunities foregone, if they are to prove their case. It would seem that the burden should be on those who wish to change the existing order to justify the change, and propose an alternative that would achieve the objectives of merit regulation at lower cost.

L. *Quality of Review*

As already noted,[164] the quality of administrators' review of applications for registration varies widely from state to state, and even within a particular state from time to time. Most state securities offices are chronically underfunded and understaffed. Operating under severe limitations on the salaries they can pay, they often are able to employ only relatively inexperienced personnel, and have difficulty retaining personnel for more than a few years. As a result, valuable experience is lost when an examiner gets fairly competent, and then leaves for a higher-paying job. The administrators in charge of the office also change frequently. Considering their relative inexperience in their jobs, it would not be surprising if the judgments of the administrators were sometimes erroneous, biased, or even corrupt. Given the amounts of money that can be raised through a public offering, and the critical role of the judgments of the securities regulators, the merit system might even foster corruption.

In a state imposing merit regulations, errors in approving or denying applications for registration can have serious consequences. All securities, even those of high quality companies, involve some risk of loss. Some of the securities deemed unsound under merit standards might have turned out to be highly successful companies. Denial of registration in those cases causes the two losses noted above.[165]

Conceding the possibility of errors in judgment, and the losses that may result from erroneous denials, to argue that merit regulation should be abolished is to throw out the baby with (or perhaps instead of) the bath water. A more appropriate remedy would be to upgrade the securities offices, increasing budgets and staffing levels and offering salaries adequate to attract and retain highly competent personnel, in order to develop some continuity of service and avoid losing experienced personnel just when they are becoming most effective. This need not be a drain on the state treasury. At the present, the fees collected for registration of securities go into the states' general revenues, and the securities offices are funded by direct appropriations, usually far less than the amount of the fees collected. Thus, the registration fees are revenue-raising devices. It would be a simple matter to place the state

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[164] MOFSKY, 1971, *supra* note 8, at 27, 37, 54.

[165] *See* text accompanying notes 126-132 *supra*. When an issuer is denied registration, investors are denied the opportunity to make what might have been a profitable investment. The public loses the benefit of a successful, publicly financed and publicly owned company.

securities offices on a revolving fund, created from a percentage of the fees received, with the excess reverting to the state treasury. This could result in higher quality regulation, and greater public protection.

The state offices could also improve their cooperative efforts, taking advantage of technological advances in communications and computer technology to pool their resources and enhance all of their effectiveness. There is already a fair amount of communication between the offices, but more could be done. Better coordination with the SEC, NASD, and the exchanges would also help. As NASDAQ, the automatic quotation system developed by NASD, evolves, there may be ways in which the states can use its facilities to the states' advantage.

M. *The Liberty Argument*

Merit regulation is seen as a restriction on liberty in two ways.[166] First, entrepreneurs are denied the liberty of gaining access to public securities markets to secure financing for their promotions. Second, investors in a merit state which denies an application for registration are denied the liberty of making an investment in that particular security. From what I have said, it is apparent that I do not believe that any significant number of legitimate entrepreneurs are precluded from obtaining public financing.[167] At any rate, I do not believe that those who make this argument have presented any persuasive evidence that this is so. As for the scalawags, I do not recall that my freedom to fleece my fellow man is enshrined anywhere in the Bill of Rights, or in any of the state constitutions, even if I tell him in advance that this is what I intend to do. Merit regulation does make it more difficult and expensive to obtain public financing, but it offers countervailing benefits in terms of investor confidence in the new issues market, without which no one would be able to draw upon public capital to finance a business venture. It does not seem to be any greater an infringement on liberty than the highway speed limits.

The Wisconsin study is relevant in assessing the degree to which merit regulation interferes with investor liberty.[168] That study has, of course, been criticized.[169] Still, it is the only published study which has come to my attention that attempts to compare the performance of securities which were registered in a strict merit state to that of securities which were denied registration there.[170] The results indicate that Wisconsin investors should not have felt their liberties greatly in-

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[166] *See* text accompanying note 36 *supra*, Bateman, *supra* note 10, at 781.

[167] *See* text accompanying notes 102-113 *supra*.

[168] *See generally* Goodkind, *supra* note 11.

[169] *See generally* Mofsky & Tollison, *supra* note 30.

[170] *See* text accompanying note 30 *supra*. Mofsky & Tollison cite to an unpublished manuscript which apparently would call some of Goodkind's conclusions into question. I have been unable to obtain a copy of that manuscript.

fringed by being denied the "opportunity" to "invest" in those securities which were denied registration.

Of course, a security which is denied registration in a strict merit state may still be sold in other less stringent states. In that case, the investor in the strict state who genuinely wants to buy that particular security, has two choices. The investor can try to contact a broker in the state in which the security will be offered and attempt to buy in the initial offering or, failing that, he can buy the security in the trading market. In the latter case, he may pay more for the security than he would have if he had been able to buy on the initial offering.[171] In addition, he is put to the extra nuisance of trying to locate a broker in the other state with whom to do business. His freedom is restricted to some degree, certainly, and he may resent the state's "paternalistic" attitude about protecting him from himself. We all surrender some of our liberty by living in a pluralistic society. In view of the demonstrated dangers of fraud and deception in unregulated states, I do not see that the restrictions on investor liberty resulting from merit regulation are any more severe than the degree of freedom surrendered by joining society.

N. *Some Other Thoughts*

Most of the criticisms of merit regulation sound in terms of economic theory, primarily the theory usually associated with the "Chicago school" of theorists. The basic idea espoused by that fraternity seems to be that only values derived from economic theory are relevant in determining public policy.[172]

Economics, properly used (and I do not concede that the critics of merit regulation have employed economic theory properly), is a useful tool from which many valuable insights about public issues can be obtained. Current theorizing, especially by the Chicago school, however, suffers from one major flaw. Unless something can be quantified in some fashion, so that it can be submitted to a gigantic number cruncher, it has no value for deciding public issues.

Many of the values inherent in merit regulation are not susceptible of quantification. In many cases, the data are simply not available. We do

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[171] This is the "hot issue" problem which concerned Bloomenthal. *See* Bloomenthal, *supra* note 9, at 1486. Of course, whether or not the determined investor pays more for the shares may depend on how soon after the public offering the investor purchased. Goodkind notes that some of the companies denied registration in Wisconsin actually outperformed registered companies over a short time frame (up to one year), but that over three years, registered securities outperformed unregistered from the standpoint of price performance. Goodkind, *supra* note 11, at 111.

[172] *See, e.g.*, R. POSIVER, ANTITRUST LAW: AN ECONOMIC PERSPECTIVE (1976), especially chapter 2; Bork, *The Rule of Reason and the Perse Concept: Price Fixing and Market Division*, 74 YALE L.J. 775, 781 (1965); Bork & Bowman, *The Crisis in Antitrust*, 65 COLUM. L. REV. 363, 369-70 (1965). *See also* L. SULLIVAN, HANDBOOK OF THE LAW OF ANTITRUST 2-10 (1977).

not know what dollar amount of worthless securities are foisted upon the public each year. We cannot assess the economic value of public confidence in the securities markets. We have no way of knowing how many businesses are never formed because promoters are deterred by merit regulation. Neither do we know how many flagrant frauds operate in casual disregard of state securities law. Some values, like honesty and morality, do not lend themselves very well to quantification anyway. Searching inquiry might develop some of the missing data, but how can political and social values be expressed in a form suitable for manipulation by a computer?

IV. THE PROPOSED FEDERAL SECURITIES CODE

The Proposed Securities Code[173] requires that the states procedurally coordinate their registration with the requirements of the Code for "distributions."[174] The Code also preempts state securities law entirely, whether or not the state has coordinated its procedures with those of the SEC, for companies which are three-year registrants and which meet certain other conditions.[175] For companies which are one-year registrants, some of the disclosure provisions of the Code are applied less strictly.[176] With respect to those distributions which are not preempted, the Code preserves the states' power to impose substantive requirements on the proposed offering without losing the status of being "substantially coordinated."[177] The Code also expands the exemption from federal registration for "local distributions" beyond the current "intrastate" exemption.[178] The NASAA has endorsed the Code and has recommended its enactment.[179]

One of the purposes behind the Code is the need to eliminate conflicts between the various federal securities laws, and to rationalize the federal system in general.[180] In the process, the Code shifts the emphasis from the "static" registration of a particular issue of securities under the '33 Act to something similar to the continuous reporting requirements

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[173] *See* text accompanying note 5 *supra*.

[174] *See* CODE, *supra* note 5, § 1904(a).

[175] *Id.* § 1904(b).

[176] *Compare* CODE, *supra* note 5, § 502(c) *with* § 505(a).

[177] CODE, *supra* note 5, § 1904(a)(3). The comments to § 1904 reflect the concern that Congress originally expressed for accepting the disclosure approach of the federal system, and the draftsmen of the Code appeared concerned that if blue sky merit regulation were completely preempted, Congress might insert substantive standards in the Code. The Code adopts its policy of limited preemption to avert this. Bateman, *supra* note 10, at 771; MOFSKY, 1971; *supra* note 8, at 84-85. Both expressed concern that federal preemption in this area might lead to the imposition of substantive standards at the federal level, which neither of these critics of blue sky regulation desires.

[178] CODE, *supra* note 5, § 514.

[179] *Id.* § 1904 (comment 2).

[180] Reporter's Introduction, 1 A.L.I. FED. SEC. CODE xix (1980).

currently embodied in the '34 Act. In effect, companies will register as soon as they reach $1 million in total assets and 500 holders of all securities or when they first make a "distribution" of their securities.[181] For companies so registered, the process of distributing securities will be greatly simplified. Both with respect to primary distributions (by the issuer) and secondary distributions (by shareholders), exemptions for trading transactions are broadened.[182] Where the company has been continuously registered for at least one year,[183] the SEC is directed to consider the year long registration in its regulation of the contents of prospectuses.[184] When the company first registers, extensive disclosure will be required regarding the company and its business.[185] It seems probable that the expanded exemption for local distributions will permit many more distributions to be made without federal scrutiny.

It is difficult to say anything definitive in this area until the Code wends its way through the legislative process.[186] Assuming, however, that it does not suffer excessive mutilation in that process, so that it emerges with substantially the philosophy embodied in it at present, it seems that merit regulation probably will play an even more vital role under the Code than it does now. Of course, the effect of the partial preemption with respect to distributions—precluding the states from requiring additional disclosure unless the SEC staff acquiesces—should simplify the process of "blue-skying" an offering in several states, but may affect the quality of disclosure. The Code exhorts the staff to communicate with the states, and vice-versa.[187] Presumably the staff would acquiesce if a state felt strongly that additional disclosure were required as to some aspect of a particular offering. Still, the shift in emphasis from registration of particular securities to registration of companies suggests that there may be reduced staff scrutiny of disclosure documents. This will be especially true for companies which have been registered for at least one year, because the Code directs the staff to adapt its rules regarding disclosure contents of the offering statement to that situation.[188] Because the states are required to seek staff acquiescence before insisting on additional disclosure, they may give up

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[181] CODE, *supra* note 5, §§ 402, 403.

[182] *Id.* § 202.

[183] *Id.* § 202(113).

[184] *Id.* §§ 502(c), 505(a).

[185] *Id.* § 404. Section 404 authorizes the SEC to specify the information, financial statements, material contracts, and other documents to be filed as part of a registration statement.

[186] Although the Code fell by the wayside during 1981 when no hearings were held on it, the SEC reportedly hopes to move the project along during 1982, and hopes to have hearings held by the appropriate House and Senate committees concerned with securities laws. 14 SEC. REG. & L. REP. (BNA) 26 (Jan. 6, 1982).

[187] CODE, *supra* note 5, § 1904(i).

[188] *Id.* § 505(a).

and reduce their own scrutiny of the disclosure aspects of an offering statement—especially if the staff is reluctant to acquiesce in additional disclosure requirements when requested to do so. Thus, this partial preemption may be counterproductive and may disadvantage investors. Perhaps in this area the Code overemphasizes its goal of facilitating business' capital formation at the expense of the twin goal of investor protection.

The total preemption with respect to three-year registrants is akin to, but broader than, the exemption found in most blue sky laws for securities which are listed for trading on designated stock exchanges.[189] It does seem likely that companies which meet these requirements, in terms of earnings, number of shareholders, and volume of shares available for trading, pose somewhat less risk to investors than initial distributions by promotional companies. The reporting requirements of the Code help to insure that adequate public information will be available concerning the issuer. These factors should help the market to reflect accurately developments regarding the company to insure that the market price of the securities will bear some relationship to their value. An additional advantage of the preemption is that it will free state regulators to concentrate on distributions by less well-established companies where the risks are likely to be greater and selling efforts are likely to be more intense. Given the states' limited resources to devote to securities regulation, this seems an appropriate area on which the states can concentrate.

The Code fortunately preserves the states' power to impose substantive rules, which will presumably be the merit standards already discussed. This may represent at least in part recognition of the political realities that the states would not easily surrender their role. It also seems to represent a recognition that the imposition of substantive standards by a few key states effectively complements the federal disclosure system. Indeed, if the Code totally preempted state regulation, the federal system might well tend to become more regulatory.[190]

The expanded exemption for local distributions will accentuate the problems of regulating initial public offerings at the state level simply because there will be more offerings. In these cases, there will be no preemption at all, and the situation will be much as it now is, except that it is possible that several states may be involved in metropolitan areas that lie on or near state borders. The only other change, then, will be that the SEC may play a smaller role in the initial financing of new ventures than it presently plays. Now seems an opportune time for the states to reexamine their policies and procedures to determine how they

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[189] *E.g.*, WIS. STAT. ANN. § 551.22(7) (1970).

[190] *See* CODE, *supra* note 5, § 1904, comment I (a). The revolving fund idea mentioned above would provide adequate funding to alleviate this problem, but it is doubtful whether this idea will take root with state legislatures in this era of proposition 13 and deregulation.

can improve their regulatory efforts to maximize investor protection without unduly interfering with the process of capital formation.

V. WHITHER MERIT REGULATION?

It is apparent by now that I believe merit regulation plays a vital role in the current investment climate and that, if anything, it will be more important in the future if the Code is enacted. It is obvious that the securities industry is in the throes of a transition period, influenced by technological improvements in communications and data dissemination, increased internationalization of business and markets, shifting roles of institutional investors, and changing public perception of established institutions. Financial theory is evolving rapidly with the application of advanced data processing techniques to generate and evaluate market models, more sophisticated investment analyses, and more refined theories of portfolio design. Finally, the federal government is rethinking its role in the regulation of these matters. It is, therefore, an appropriate time for state regulators to reassess their roles and determine what, if any, changes may be appropriate. The Uniform Act has been around for 25 years or so, we have a good deal of experience with it, and perhaps we can improve the present situation.

Certainly the probable impact of the Code on the states needs to be examined. An organization like the NASAA, with input from representatives of the securities industry and financial theorists, could do an effective review and identify the changes needed in legislation or regulations.

I also believe regulators need to reassess the role they can play effectively in the modern investment world. The starting point for such a reassessment is to recognize the need to balance the protection of investors with the needs of business to raise capital. In addition, it is important to recognize that state securities offices probably will never be funded and staffed adequately to accomplish the mission with which they are charged.[191] Therefore, regulators need to examine what other agencies are involved in regulating securities offerings in order to avoid wasting scarce resources in duplicating the efforts of others, if those efforts in fact achieve the goals of merit regulation. In other words, regulators need to determine how best to allocate their limited resources to achieve their proper goals.

As the SEC itself adapts to limited resources, expanding the exemptions from federal registration, the states will have a still larger role to play in the regulation of the new issues market where companies seek their initial infusion of public equity financing. This is already the area in which state regulators are most active. The standards developed to date seem to work tolerably well, and should form the basis for future

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[191] *See* text accompanying note 165 *supra*.

development. Financial theorists might be able to help build upon this groundwork. However, if state regulators are to be effective in regulating the new issues market, they must adjust their workload. Thus, exemptions from registration need to be reexamined to eliminate or reduce registration requirements where some other agency does an effective job. Also, states could improve their procedures through more complete communication and coordination, which should be facilitated by greater use of modern communications media.

These preliminary ideas could be a starting point for a reappraisal of the roles of the states. Certainly, a greater degree of uniformity among the various states would improve the lot of the securities practitioner, and ultimately of registrants, if conflicting policies could be eliminated. The NASAA has made considerable progress in this area through its promulgation of Guidelines for Registration and development of the uniform application form to register securities.[192] Again, however, more could be done under the auspices of NASAA. It would probably require some compromises between the strict merit states and those which presently pursue less regulatory approaches. I believe such accommodations could be reached, but I hope that it would not be all at the expense of merit regulation, which plays an important role and promises to be more important in the future.

[192] Form U-1, the Uniform Application to Register Securities, was promulgated by the NASAA in 1962, and is accepted in at least 40 states. 1 BLUE SKY L. REP. (CCH) ¶¶ 5101, 5102 (1981). A specimen copy of the form is set out at ¶ 5103.