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FEDERALISM TO AN ADVANTAGE: THE DEMISE OF STATE BLUE SKY LAWS UNDER THE UNIFORM SECURITIES ACT

by

MARIANNE M. JENNINGS,* BRUCE K. CHILDERS** AND RONALD J. KUDLA***

I. INTRODUCTION

They come at an opportune time. "They" are the changes to the Uniform Securities Act.[1] Although some of the changes are perfunctory, the significant changes have a fascinating common thread running through them. That fascinating thread is federalism. Changes in the Act could move regulation away from the hands of the states and make federal registration, more or less, a ticket for sales without state approval. The changes are not without opposition. This article will discuss the changes, the reactions of particular concerned groups and the perceived effects of such changes.

II. THE EXISTING REGULATORY SCHEME

A. *The Two-Tier System*

Currently, a two-tier system for the regulation of securities sales exists. At the federal level, there is the Securities Act of 1933 and the Securities Exchange Commission (SEC).[2] At the state level, some thirty-six states, two territories and the District of Columbia[3] have adopted the Uniform Securities Act[4] (hereinafter USA). The two-tier system exists because the Securities Act of 1933 specifically provides that state securities laws are not preempted by that Act.[5] Because of the absence of preemption, registration compliance at the

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[1]NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, Uniform Securities Act of 1985.

[2]15 U.S.C. §§ 77a-77 bbbb (1933).

[3]Some states have adopted only portions of the Act. Other states have used the act as a model, but these states and territories follow the general theory and idea of the Act: Alabama, Alaska, Arkansas, Colorado, Connecticut, Delaware, District of Columbia, Guam, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, Oklahoma, Oregon, Pennsylvania, Puerto Rico, South Carolina, Tennessee, Utah, Virginia, Washington, West Virginia, Wisconsin, Wyoming; 1 BLUE SKY L. REP. (CCH) § 5501 (1985).

[4]NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, Uniform Securities Act, (1956).

[5]*See* 15 U.S.C. § 77r (1976).

federal level is not necessarily compliance with the state "blue sky" laws.[6] However, some states have adopted a position that if the SEC approves a registration, then that registration is approved for state purposes.[7] These states have voluntarily relinquished their regulatory rights in favor of federal standards for registration.[8] Other states[9] not only require SEC approval (at least impliedly), but their regulation goes even further than the SEC disclosure standards. These stricter states[10] review potential offerings for their quality.

B. *The Two-Tier Philosophy at the State Level*

In those states with the strictest standards, some form of "merit review" is followed. The Securities Act of 1933[11] imposes a requirement of full and timely disclosure of all information relevant to the investment decision. Some states examine offerings from an antifraud perspective in addition to that of full disclosure. In other states there is "merit review" of registration offerings — full and timely disclosure is not the standard for registration approval. In addition to full disclosure, the offering must be "fair, just and equitable"[12] to investors. Section 306(2)(v) is the portion of the USA that allows review by these

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[6]"Blue sky" laws are state securities laws. The term was coined in a judicial opinion which labeled some investments "speculative schemes which have no more bases than so many feet of 'blue sky.'" Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917). More details on blue sky law history can be found in LOSS & COWETT, BLUE SKY LAW (1958).

[7]New York and New Jersey are examples. N.Y. GEN. BUS. § 359-ff(1) (1980); N.J. STAT. ANN. § 49:3-60(c) (West 1967).

[8]In these states, no state official examines the offering or its documentation. The only requirement for registration is proof of SEC approval. The following states are those that have adopted § 303 of the USA — Registration by Coordination: Alabama, ALA. CODE § 8-6-6 (1975); Alaska, ALASKA STAT. § 45.55.090 (1972); Arkansas, ARK. STAT. ANNOT. § 67-1243 (1983); California, CAL. CORP. CODE § 25111 (West 1977); Connecticut, CONN. GEN. STAT. § 36-486 (1985); Guam, GUAM GOVT CODE § 45303 (1982); Idaho, IDAHO CODE § 30-1420 (1972); Indiana, IND. CODE § 23-2-1-4 (1982): Iowa, IOWA CODE § 502.206 (1983); Kansas, KAN. STAT. ANN. § 17-1257 (1971); Kentucky, KY. REV. STAT. § 292.360 (1972); Maine, MAINE REV. STAT. ANN. § 10403 (1985); Maryland, MD. CORPS. & ASS'NS CODE ANN. § 11-503 (1957); Massachusetts, MASS. GEN. LAWS ANN. ch. § 302 (West 1975); Michigan, MICH. COMP. LAWS. § 451.703 (1979); Minnesota, MINN. STAT. § 80A.10 (1985); Mississippi, MISS. CODE ANN. § 75-71-403 (1972); Missouri, MISS. REV. STAT. § 409.303 (1978); Montana, MONT. CODE ANN. § 30-10-204 (1985); Nebraska, NEB. REV. STAT. § 8-1106 (1977); New Hampshire, N.H. REV. STAT. ANN. § 421-B:13 (1955); New Mexico, N.M. STAT. ANN. § 58-13-7 (1983); North Carolina, N.C. GEN. STAT. § 78A-26C (1981); Ohio, OHIO REV. CODE ANN. § 1707.091 (Baldwin 1985); Oklahoma, OKLA. STAT. tit., § 303 (1981); Pennsylvania, PA. CONS. STAT. ANN. § 205 (1984); Puerto Rico § 873 (1985); South Carolina, S.C. CODE ANN. §§ 35-1-840, 35-1-850 (1976); South Dakota, S.D. CODIFIED LAWS ANN. § 47-31-18.1 (1975); Tennessee, TENN. CODE ANN. § 48-2-105 (1980); Utah, UTAH CODE ANN. § 61-1-9 (1953); Virginia, VA. CODE § 13.1-509 (1984); Washington, WASH. REV. CODE § 21.20.180 (1983); West Virginia, W. VA. CODE § 32-3-303 (1984); Wisconsin, WIS. STAT. § 551.25 (1983); Wyoming, WYO. STAT. § 17-4-109 (1977).

[9]Arizona, Colorado, District of Columbia, Florida, Georgia, Illinois, Louisiana, Nevada, New Jersey, New York, Oregon, Rhode Island, Texas and Vermont. *Blue Sky Laws and State Takeover Statutes: New Importance for an Old Battleground,* 7 J. CORP. L. 689, 803-11 (1982).

[10]Most commentators include California, Illinois, Iowa, Minnesota, Missouri and Wisconsin as the strictest states. Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements,* 1976 WIS. L. REV. 79, 86 n. 46 (1976), (hereinafter cited as Goodkind).

[11]15 U.S.C. §§ 77-77bbbb (1933).

[12]Maryland is an example of an antifraud/disclosure state, *see,* MD. CORPS. & ASS'NS CODE ANN. § 11-502 (1972) (Registrations by notification), and MD. CORPS. & ASS'NS CODE ANN. § 11-503 (1975). (Registration by coordination effective upon SEC registration).

standards. Under that section, authority is given to deny a registration that could or will tend "to work a fraud upon purchasers."[13]

Regardless of the language chosen by a state in its adoption of the USA, those administrators responsible for registration in "merit" states have great discretion. In implementing their merit standards, these states have adopted the following criteria (either by regulation or policy) to be used in a "merit review"; they determine whether or not:

1. Equity capital invested is insufficient in relation to the total capitalization that will exist after the offering is complete;[14]
2. Excessive amounts of "cheap stock" have been issued to promoters and insiders at prices significantly less than the eventual public offering price;[15]
3. Excessive numbers of options and warrants have been issued or will be issued in relation to the total capital structure which will exist after the offering is complete;[16]

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[13]"Fair, just and equitable" is a generic standard found in some state statutes. *See, e.g.*, FLA. STAT. ANN. § 517.09 (7) (West 1972), ". . . sale of such securities would be fair, just and equitable. . . ." Other states have adopted negative language instead, such as "the sale of securities . . . would be unfair or inequitable to the purchasers." ARIZ. REV. STAT. ANN. § 44-1921 (3) (1967). The Uniform Securities Act of 1985 offers states alternative language: ". . . the offering has worked or tended to work a fraud upon purchasers or would so operate;" "[. . . the offering is being made on terms that are unfair, unjust, or inequitable;]" §§ 306 (2) (v) and 306 (2) [(v)] (1985).

[14]For example, *see* MO. ADMIN. CODE § 30-52.080 (1) (1974) (requires 15% investment up to $1,000,000 and 10% after that); WIS. ADMIN. CODE § 3.05 (1984) (adopts NASAA's guidelines Corporation Commission); TEX. ADMIN. CODE tit. 7 § 113.3 (1984); (requires a 10% of equity capital investment). For example, Arizona has adopted specific percentages for the required minimum of equity capital invested. That state provides for the following schedule:

10% of the first $200,000.00
5% of the second $200,000.00
1% of the balance. ARIZ. ADMIN. COMP. R. § R14-4-107A (1984).

[15]*See* MO. ADMIN. CODE § 30-52.070(B) (1984) (limits cheap stock to 50%); WIS. ADMIN. CODE § 3.04 (1984) (adopts NASAA guidelines which limit cheap stock to 60%); ARIZ. ADMIN. COMP. R. § R 14-4-105 B (1984), which limits "promotional securities" to 15% of the outstanding securities (those that will be outstanding at the end of the offering). "Promotional securities" are defined as

> [s]ecurities issued for services rendered, patents, copyrights or other intangibles, the value of which has not been established to the satisfaction of the Commission by appraisals, by evidence of amounts paid by others for substantially similar services or property, by evidence of a bona fide offer to purchase such services or property, or by other evidence, or for a consideration substantially less in amount than the consideration for which such securities are proposed to be sold to the public. . . .

[16]MO. ADMIN. CODE § 30-52.060 (1984); Texas allows for the escrow of cheap stock, TEX. ADMIN. CODE tit. 7 § 113.3(5) (1983) (limits options and warrants to 10% of aggregate offering and restricts them to 5 years); WIS. ADMIN. CODE § 3.03(c) (1983) (limits number and value of warrants and options to 20% of the total number of shares that will be outstanding after the offer and 20% of their value); TEX. ADMIN. CODE tit. 7 § 113.3(11) (1983) (provides for complicated original and on-going percentage limitations); ARIZ. ADMIN. COMP. R. § R-14-4-106 (1984) allows such options, warrants and rights to purchase so long as:

1. The number of shares covered thereby does not exceed 20% of the number of securities to be outstanding at the completion of the proposed public offering.
2. The initial exercise price is reasonably related to the public offering price.
3. They do not exceed ten years in duration.
4. The prospectus to be used in connection with the proposed public offering contains a full disclosure as to the terms and reasons for their grant.

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4. A proposed public offering price too high in relation to the market price, if one exists, or in relation to the issuer's earnings, or history, etc., (if a marketprice does not exist);[17]
5. Excessive underwriter's commissions and/or selling expenses have been incurred;[18]
6. The shares being offered to the public carry inequitable voting rights;[19]
7. Historical earnings are insufficient to cover interest on debt securities, or to pay preferred dividends on the equity preferred shares which would be issued.[20]

In addition to these seven common factors, most regulators in merit states have a discretionary "miscellaneous" category. In the "miscellaneous" category are items such as poor financial condition, the improbability of success of the business, and unfair transactions by insiders.[21] Some states impose financial and experience requirements on promoters before their offerings can be registered.[22]

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[17] MO. ADMIN. CODE § 30-52.050 (1980); (limits price to 25 times the average annual net earnings per share); WIS. ADMIN. CODE §§ 3.02(2), 3.02(1)(a) (1984) (price must be "reasonably related" and "not exceed 25 times its average annual net earnings per share for the last 3 years"); TEX. ADMIN. CODE tit. 7 § 113.3(2) (1983) (allows examination of price earnings ratio over the past years).

[18] MO. ADMIN. CODE § 30-52.040 (1982) (1590 limit); WIS. STAT. § 551.28(f) (1983); WIS. ADMIN. CODE § 3.01 (1973) (Commissions limited to 10% and other expenses to 15% of the aggregate offering price); ARK. ADMIN. REG. R14-4-108 (1972) provides:

> No issuer shall incur a liability which must be paid by the issuer as a selling expense in connection with the sale of a public issuance greater than 15% of the amount of said issue actually sold to the public.
>
> B. Selling expenses shall include commissions, salaries, advertising and all other expenses directly or indirectly incurred in connection with the sale of securities . . . .

Some states also prohibit officers and directors from earning commissions, *see, e.g.,* ARIZ. ADMIN. COMP. REG. § R14-4-111 (1972); UNIFORM SECURITIES ACT § 306(2)(F) (1958) prohibits "unreasonable amounts".

[19] MO. ADMIN. CODE § 30-52.110 (1974) (unfair or disproportionate); WIS. ADMIN. CODE § 3.07(a)(1), (6) (1984) (Prohibits giving no voting rights or unequal voting rights); TEX. ADMIN. CODE tit. 7, § 113.3(6) (1984) (prohibits "disproportionate" rights).

[20] MO. ADMIN. CODE § 30-52.120 (1984) (three year test); WIS. ADMIN. CODE § 3.06(1) (1984) (net earnings for last 3 years would be insufficient to cover debt interest).

[21] In many states, the "miscellaneous" category is not codified anywhere. The application is discretionary and if written is in the form of a policy statement. Those policies are recorded in 1 BLUE SKY L. REP. (CCH) ¶¶ 5151-5381 (1984). Furthermore, the North American Securities Administrators Association, Inc., (NASAA) has adopted certain statements of policy, 1 BLUE SKY L. REP., CCH ¶¶ 5151-52 (1983). Many states have adopted those policy statements either formally or informally. For example, *see,* BLUE SKY L. REP. ¶ 9605 (1984) in which Arizona takes the following position: "NASAA Statements of Policy. The Securities Division subscribes to the Statements of Policy adopted by the North American Securities Administrators Association, Inc. (NASAA) relating to the registration of securities in Arizona except where in conflict with a state rule or regulation."

For other examples of state regulations, *see, e.g.,* IOWA ADMIN. CODE §§ 510-50.33 to .40 (1983), as reported in 1 BLUE SKY L. REP. ¶¶ 25,434-25.440. Iowa requires a promoter's investment of at least 10%; limits offering expenses to 7% of the first $500,000 (aggregate) and 5% of any aggregate price above that; uses the 3-year earnings test for price; limits commissions to 10% and options or warrants to 20% and requires cheap stock to go into escrow for 10 months.

[22] For example, in Texas, promoters of real estate syndications must contribute at least $50,000 to the syndicate and must have a minimum of two years executive experience in real estate. TEX. ADMIN. CODE tit. 7, § 117.2 (a) and (b) (1982).

C. *Criticisms of Existing State Regulation*

One of the reasons for the dramatic changes in the 1984 version of the USA is the recent and substantial criticism of state laws and regulations, and how they are administered.[23] The problems subject to this criticism have been analyzed by many, but remained unresolved, and of vital concern to the entrepreneurial sector of our economy.[24]

1. Lack of Incentive (Compensation) for Officers and Directors

A major criticism of merit review is the strong control it puts on the compensation of officers and directors. Commissions,[25] warrants, options[26] and promotional stock[27] restrictions are examples of state methods for controlling compensation. The claimed result is a loss of incentive or motivation for entrepreneurs. Even those offerings approved in merit states have usually been negotiated — the promoters and the administrator negotiate terms acceptable to the administrator. Terms acceptable to the administrator tend to be those that are most protective of the investor.[28]

2. Favoritism for Established and Large Businesses — Barriers to Entrepreneurs

A second criticism of the merit review process is that it inherently favors established businesses and so carefully scrutinizes new businesses that the new businesses cannot raise sufficient capital to succeed with their ventures.[29] This criticism is substantiated by the fact that nearly all states have a registration

[23]A cursory review of the pertinent literature reveals the following articles: Hurley and Green, *Florida's Response to the Need for Uniformity in Federal and State Securities Registration Exemption Requirements,* 12 FLA. STATE U.L. REV. 309 (1984); Tyler, *More About Blue Sky,* 39 WASH. & LEE L. REV. 899 (1982); Bloomenthal, *Blue Sky Regulation and the Theory of Overkill,* 15 WAYNE L. REV. 1447 (1969); Bateman, *State Securities Registration: An Unresolved Dilemma and a Suggestion for the Federal Securities Code,* 27 SW. L.J. 759 (1973); Makens, *Who Speaks for the Investor? An Evaluation of the Assault on Merit Regulation,* 13 U. BALT. L. REV. 435 (1984); Mofsky and Tollison, *Demerit in Merit Regulation,* 60 MARQ. L. REV. 367 (1977); Sargent, *The Challenge to Merit Regulation — Part I,* 12 SEC. REG. L.J. 276 (1984); *Blue Sky Laws and State Takeover Statutes: New Importance for an Old Battleground,* 7 J. CORP. L. 689 (1982); Goodkind, *see supra,* note 10. In Illinois, a well-known merit state, the legislature substantially eliminated merit review in 1983. Wisconsin and Iowa had a moderate reduction in merit authority. Wis. Sec. Bill. July 1983, 2-4; Iowa, H.B. No. 514, 15 SEC. REG. & L. REP. (BNA) 963 (1983).

[24]*See, e.g.,* Arizona Corporation Commission, *Hearings on Merit Review,* Sept. 1984, available through AKRON LAW REVIEW.

[25]*See* note 18 and accompanying text.

[26]*See* note 16 and accompanying text.

[27]*See* notes 14 and 15 and accompanying text.

[28]Although the Uniform Securities Act § 306(a) (1958) and most state laws allow merit administrators to issue stop orders, most offerings are either negotiated, resulting in a package acceptable to the administrator, or are withdrawn. Few offerings are actually denied registration. For an evaluation of the role of administrators *see* Honig, *Massachusetts Securities Regulation: An Evolving Matrix,* B. BUS. J. Nov. 1983 at 10-12. *See also,* NASAA Uniform Limited Offering Exemption, 1 BLUE SKY L. REP. (CCH) ¶ 5294, at 12.373-12.374, n.1.

[29]J. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS, 12, 36-7 (1971), (hereinafter cited as MOFSKY).

exemption for securities listed on national stock exchanges.[30] The requirements for exchange listing are so stringent that no new company would ever qualify for this type of streamlined/exempt offering.[31] Even after one public offering, newer firms would have trouble meeting the exchange exemptions because of the substantial earnings required.

Many merit states use a double standard for new companies as opposed to companies with an earnings record. Companies without an earnings record will be subjected to stricter registration requirements.[32] Other states allow the offering to go through, but subject the offeror to impounds[33] and escrows.[34] Young companies are strictly scrutinized and many with good products and services are denied registration because of their lack of size and earnings history. Two harms stem from this apparently inherent bias. First, investors are denied the opportunity to invest in a high risk but potentially profitable venture. Second, in many cases the fledgling company with a good idea but no money, will be unable to raise capital by a means other than a securities offering, and therefore society loses a service or a product, as well as the economic boost provided by a new firm.[35]

3. Affectation of Price and Risk Correlation

Merit review administrators are, in effect, controlling the amount of risk they will allow to be passed on to the public. In some instances, they decide the

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[30]*See, e.g.*, MO. REV. STAT. § 409.402(a)(8) (1978), which exempts securities listed or approved for listing on the New York, American and Midwest Stock Exchanges. The statute empowered Missouri's administrator to add exchanges and the Pacific Coast Stock Exchange was later added. MO. ADMIN. CODE § 30-54.060 (1980).

[31]For example, New York Stock Exchange eligibility requires: (a) 2,000 holders of 100 shares or more; (b) 1,100,000 shares publicly held; (c) market value of publicly held shares of at least $18,000,000. The Exchange does have an alternative method of establishing eligibility — (1) $18,000,000 in net tangible assets; (b) earning power before federal taxes of $2,500,000 in the last year and $2,000,000 in each of the two years preceding. The Exchange can also impose additional requirements for trading shares held in one concentrated geographic area. *New York Stock Exchange Equity Products Listed Company Manual Supplement* #2, §§ 101.00-104.00 (1985).

[32]One restriction is to require the offering price of the security to be near the price promoters and other insiders have paid for the same stock. *See, e.g.*, WIS. ADMIN. CODE § 3.02(2) (1984).

[33]For example ARIZ. ADMIN. COMP. R. § R14-4-112 (1985) allows the impoundment of funds as a condition to registration. Although the funds are held in a bank, they cannot be released until the administrator makes the decision to do so. The maximum time limit is one year. *Id.* at R14-4-113. Iowa also has such a provision. *See*, IOWA ADMIN. CODE § 510-50.31 (502) (1983).

[34]For example, ARIZ. ADMIN. COMP. R. § R-14-4-119 allows the administrator to hold the stock of promoters in escrow as a condition of registration. The stock can be released from escrow after a petitioner establishes a satisfactory earning record of at least one year for the solvent offeror. *See also*, IOWA ADMIN. CODE § 510-50.37 (502) (1983) and Texas, TEX. ADMIN. CODE tit. 7, § 113.3(5) (1983).

[35]*See* MOFSKY, *supra* note 29, at 26-7. Congress had addressed the problems of small business financing. For example in its Omnibus Small Business Capital Formation Act of 1980, Congress authorized the SEC "[T]o cooperate with any association composed of duly constituted representatives of State governments whose primary assignment is the regulation of securities business within those States" for purposes of "the development of a uniform exemption from registration for small issuers which can be agreed upon among several States or between the states and the Federal Government." 15 U.S.C. § 77s(C)(1) and (3)(c) (1982). The result was SEC cooperation with the North American Securities Administrators Association (NASAA) and the development of Regulation D (see notes 79-88 *infra* and accompanying text).

risk cannot be passed along and a registration is either denied or withdrawn. In other instances, they attempt to manipulate the risk in favor of the investor. Risk is reduced through the seven factors generally used by merit review administrators.[36] Violation of even one of the criteria employed under the "fair, just and equitable" standard allows administrators to deny a registration, or at least to require a reduction in an offering price they deem too high in relation to the market price or to an earnings history if there is no market price.[37] If, upon release of the securities, public perception of the issue is more favorable than that of the administrator, the market creates a "hot issue."[38] These hot issues indicate several side effects. First, an immediate and significant rise in price is an indication of underpricing — that the issuer did not raise as much capital as the public was willing to invest. Second, secondary sales allow initial investors to make a profit because of the price increase and that profit is lost to the issuer who had offered the underpriced stock.[39] In short, merit regulation of price is, in effect, artificial price control and manipulation of the free market. Market force is significant in the minds of investors, issuers and legislative bodies.[40] Manipulation or elimination of the effect of efficient market forces is heresy to the financial community. Of key impact upon market efficiency is "full disclosure" rather than a determination of an offering's merits or that it is "fair, just and equitable."[41]

The political forces that have joined in the merit review battle have won legislative support for the theory that a tough merit review state will keep bad businesses out, ostensibly because selling questionable offerings is difficult in an unfavorable regulatory climate.[42]

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[36] *See* notes 14-20 and accompanying text.

[37] *See* note 17 and accompanying text. Wisconsin limits the offeror's proposed offering price to 25 times report earnings. WIS. ADMIN. CODE § 3.02 (1) (1970). Regulations from other states are similar or more stringent. *See*, Goodkind, *supra* note 10, at 96-97.

[38] A "hot issue" is one that will sell for a price well above the initial asking price because it is perceived to be worth more (or potentially worth more) than the asking price at issuance.

[39] Bloomenthal, *Blue Sky Regulation and the Theory of Overkill*, 15 WAYNE L. REV. 1447, 1486 (1969).

[40] SECURITIES AND EXCHANGE COMMISSION, THE WHEAT REPORT, (CCH) (1969); The report, directed by SEC Commissioner Francis M. Wheat, examines the issues of dissemination of information through registration and other means.

[41] Since the federal law provides for full disclosure, many efficient market theorists support the use of federal registration only, and assert that state regulation is neither needed or wanted. (The Efficient Market Theory holds that markets function best when investors have full information, and that full information serves to control stock prices.)

[42] For example, the statement of Jack Bailey, Iowa Development Commission, 15 SEC. REG. & L. REP. (BNA) 1882 (Oct. 7, 1983) provides as follows:

> The decision to locate in a state is based on fundamentals such as the availability of human and material resources, cost of building, leasing or owning facilities, transportation, state tax or workers' benefits structure, attractiveness of the community, and the generation of ideas that give rise to the business opportunity. Financing is an element to consider but the blue sky laws have never been a decisive factor in my experience or those of the attorneys whom I have queried. This argument has been raised in states where merit regulation has been under recent attack as the basis for excluding certain "high tech" companies from developing in those states. A far more likely scenario is that those states do not have an existing industrial base or a strong program of research in their universities that are the bases for development of that type of company, and these factors, combined with the elements for a location decision determine where high tech companies spring forth.

4. Increased Costs

Merit review states increase business costs because there is more paperwork, and more attorneys' and accountants' fees to contend with than in other states. SEC registration is also costly, and even under the USA, each state applies different standards. Although there is a uniform application to register securities among the 50 states, there are no uniform merit standards. Issuers are forced to bargain with regulators on a state-by-state basis in order to get an offering approved.[43]

5. Arbitrary Administrators

A "fair, just and equitable" standard is indefinite. These are words begging for interpretation and open the door for differing application. Personal prejudices,[44] discretion, and the state regulatory climate all influence whether a registration is approved or denied.[45] A registration can be approved in one merit state and denied (or withdrawn) in another merit state.[46] Administrators often claim that they "smell a fraud" in evaluating offerings under merit standards. The regulatory requirements are met, but the administrator has an unfavorable "gut feeling" about the offering.[47] This "gut feeling" leads to a more intense investigation, whereby the administrator delves into the non-routine or miscellaneous factors that merit administrators consider but which are not specifically delineated.[48] Some state administrators even have a reputation for denying registrations to those engaged in particular industries.[49]

[43]Bateman, *supra* note 23, at 781.

[44]*See*, Bateman, *supra* note 23, at 778; MOFSKY, *supra* note 29, at 16; Bloomenthal, *supra* note 23, at 1479.

[45]L. LOSS & E. COWETT, BLUE SKY LAW 5-13 (1958). "A midwestern administrator replied that he looked on uranium issues with a 'jaundiced eye'" and disapproved them "unless they are of such a nature that we might be tempted to invest our own money in them." *Id.* at 77. *See also*, BLUE SKY L. REP. (CCH) ¶ 5294 n.1 (Sept. 21, 1983) (NASSA comment on tax shelter offerings).

[46]Even in the so-called "merit review" states, the standards for merit review are not always applied. Although merit states on the books, in application they are full disclosure states. *See supra* note 12.

[47]These "gut feelings" generally stem from the regulators' experiences. Regulators have usually worked in either state or federal registration for some time and their experiences may allow them to detect more sophisticated frauds. However, "[s]tate administrators are no better able than anyone else to evaluate the riskiness of a given venture. If they were, it is unlikely that they would be administering the securities law rather than maximizing their wealth in a more profitable way." Mofsky, *Reform of the Florida Securities Law*, 2 FLA. ST. U.L. REV. 1, 30 (1974). *See also* Edwards, *California Measures the Uniform Securities Act Against Its Corporate Securities Law*, 15 BUS. LAW. 814 (1960), in which Edwards observes: "The commissioner had established specific little rules that had to be followed by the deputies who could not really exercise basic judgment on the merits of the security as a whole." *Id.* at 823.

[48]*See supra* note 21 and accompanying text. Many who support merit review make the point that the offerors can avoid administrators, as well as difficulty in raising capital simply by qualifying for one of the state's registration exemptions. There are several problems with raising capital through exempt offerings:

(1) There are generally limitations on the number of offerees and purchasers;
(2) Investors have greater bargaining power and may demand more control thus depriving the offeror of discretion (and in some cases control) in the business venture:
(3) Investors in exempt offerings are more difficult to find;
(4) There is public perception of higher risks with exempt offerings and the price is affected accordingly.

MOFSKY, *supra* note 29, at 21-26; Bateman, *supra* note 23, at 777-78.

[49]For example, Arizona has a strong attitude against venture capitalist firms. Experience shows that

6. Merit Review Doesn't Work

a. *Theory of Ineffectiveness*

Perhaps the most serious criticism of merit review (as well as the most researched) is that it doesn't work. Despite all the administrators, mutual funds, and registrations, there are frauds in both merit and non-merit states. Indeed, many of the truly bizarre frauds are committed by people who don't have a mind to register in the first place, therefore, the greater the fraud the easier it is to get away with it.[50]

Many have advanced the theory that front-end regulatory activity is ineffective. For example, merit states did not catch the *Equity Funding*[51] or *National Student Marketing*[52] frauds. However, strict and active enforcement in the area of fraud is a necessary function because of the criminal nature of such schemes. In other words, the theory is that stricter enforcement and harsher penalties do more to deter fraud than the merit review process.[53]

b. *Quantitative Evaluations of Merit Review*

Several studies have evaluated the efficacy of merit review on a quantitative basis. The first study was done by Goodkind on the efficacy of Wisconsin's merit review procedures.[54] Goodkind analyzed corporate issuers who applied for registration in Wisconsin from 1968 to 1971.[55] The corporate issuers' financial performances were analyzed using three measures: stockprice, book value, and dividends.[56] Based on his limited findings,[57] Goodkind concluded

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regulators develop a hostile attitude toward those types of ventures with which their enforcement division has had the problems of fraud. For example, a NASAA opinion of tax shelter offerings followed substantial fraud in those offerings. 1 BLUE SKY L. REP (CCH) ¶ 5294 n.1 (Sept. 21, 1983).

[50]Bloomenthal, *supra* note 39, at 1481.

[51]*In re* Equity Funding Corp. of America, 438 F.Supp 1303 (C.D. Cal. 1977). In this scam, Equity Funding's earnings and assets were inflated by selling reinsurers bogus life insurance policies. Equity presented an image of being a dynamic organization and even many financial advisors were duped into advising their clients to invest. *See, In re* Boston Co. Inst. Inv., Inc., FED. SEC. L. REP. (CCH) ¶ 81,705 (1978).

[52]SEC v. National Student Mktg. Corp., 457 F.Supp. 682 (D.D.C. 1978). In this scam, National Student Marketing overstated its profits substantially in its financial statement, (in fact they had a loss). This type of conduct is generally caught at the state level because additional documentation would not have been required for the CPA audited financials.

[53]W. PRIFTI, SECURITIES: PUBLIC AND PRIVATE OFFERINGS, 6-36.

[54]Goodkind, *supra* note 10, at 107-23.

[55]Goodkind examined both those offerings that were eventually registered and those that were withdrawn. Traditionally, there are not denials of registration in merit states. The offerors usually withdraw after comments from the administrator or after the failure of administrator and offeror to reach an agreement on the terms of the offering. *Id.* at 107-23.

[56]Goodkind, *supra* note 10, at 122. Naturally, Goodkind included information for those companies that failed. Using his definition of failure (a 75% or greater loss of market value), 23.5% of the issuers who were not approved failed within 3 years after the failure to register. *Id.* at 121. The point has been made that failures may be an effect of not being able to raise sufficient capital rather than an indication that the merit administrators were correct in their judgments. *See* Note, *State Securities Regulation: Investor Protection v. Freedom of the Market Place,* 29 U. FLA. L. REV. 947, 970 n.162 (1977).

[57]*See,* Goodkind, *supra* note 10, at 122.

that Wisconsin's merit review system was effective in protecting investors from investments that would result in severe losses.[58] However, Goodkind did note that his conclusions were based on averages and that there were issuers at the top end (those with the great risk), who were not approved but who, in fact, performed very well regardless.[59]

Goodkind's study has been criticized as an "effects" study — that it examined the effects of merit review on the companies involved, but did no analysis of the cost of the merit review process in its operation and lost investment opportunity.[60] The study has been criticized as one that looked for benefits on the investor side, but which did not examine the costs of merit review, its economic effects, or its uniformity of application.[61]

The next study was not published until 1982. This was the Walker and Hadaway study of Texas' merit review system.[62] This study was also limited to corporate issuers[63] and scrutinized the financial performance of those issuers whose registrations were withdrawn from Texas registration during the period from 1975 to 1980.[64] The conclusion of the Walker-Hadaway study is the same as Goodkind's — that merit review is effective.[65]

The final study to date was the Kudla and Jennings evaluation of Arizona's merit review system.[66] Although criticized for its conclusions[67] and for the response rate on its survey of withdrawn companies,[68] the study offers

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[58]Goodkind used the following language: "For those who have attacked the rules [Wisconsin's merit standards] as unnecessary restrictions on free enterprise and unwarranted limitation on promoters' profits, the results provide a convincing rebuttal." Goodkind, *supra* note 10, at 123.

[59]". . . the study concealed tremendous internal variations. Hidden by the averages set forth herein are many issuers who performance was exceptionally good despite their inability to obtain registration in Wisconsin, and some registrants which failed miserably. The range for both groups is large enough to suggest that the present rules [merit standards] even though empirically justifiable, leave room for improvement." Goodkind, *supra* note 10, at 123.

[60]Mofsky and Tollison criticized Goodkind's methodology as "flawed."*See* Mofsky and Tollison, *supra* note 23, at 376.

[61]*Id.* at 370-371; Makens, *Who Speaks for the Investor? An Evaluation of the Assault on Merit Regulation*, 13 U. BALT. L. REV. 435, 454-55 (1984).

[62]Walker and Hadaway, *Merit Standards Revisited: An Empirical Analysis of the Efficiency of Texas Merit Standards*, 7 J. CORP. L. 651 (1982).

[63]Goodkind evaluated corporate issuers also. *See* Goodkind, *supra* note 10, at 108.

[64]Walker and Hadaway, *supra* note 62, at 659-662.

[65]A criticism of both Goodkind as well as that of Walker and Hadaway is that none studied the effect of merit review on partnership offerings. Since corporate issuers are only one part of total registrants, no study is complete without partnership data. However, in fairness to both studies it is very difficult to collect the pertinent financial data on registered as well as withdrawn partnerships. With corporate issuers, it is at least possible to check exchange data. Kudla and Jennings, *An Evaluation Of The Efficacy Of Merit Review By Arizona's Securities Division* (hereinafter cited as Kudla and Jennings). A copy of this unpublished study is available through AKRON LAW REVIEW.

[66]The Federal Trade Commission attempted a study in 1984 which remained uncompleted because of extensive criticism from both NASAA and the American Bar Association.

[67]*See*, Makens, *Who Speaks for the Investor? An Evaluation of the Assault on Merit Regulation*, 13 U. BALT. L. REV. 420, 456-57 (1984).

[68]*Id.*

the first negative evaluation of merit review.[69]

The study focused on registration of common stocks in Arizona during the years 1976 to 1979. A total of 350 registration applications were reviewed. Of the 350 files examined, 260 registrations were approved and 90 were withdrawn.[70] As noted above, denials are rare, but in the 350 files examined, denials were non-existent. It cannot be concluded from these statistics that Arizona's merit review system issues no denials and is therefore ineffective. Many of the withdrawals occurred because of an amendment or comment letter[71] strongly indicating that a denial was forthcoming. Furthermore, many in the regulatory system make the argument that "bad issues" are kept out of Arizona simply because of its reputation as a "tough" merit review state, as opposed to simple disclosure state.[72]

Of the 90 withdrawals, only twelve companies withdrew on their own initiative. For example, six companies withdrew their registration solely because of poor market conditions. Two issuers simply decided not to go through with the issue and withdrew. One firm withdrew its SEC application and correspondingly withdrew all state applications. Two companies withdrew because the expense of the offering became too high. Finally, another company withdrew because of timing and procedure problems. The remaining seventy-eight companies withdrew their registrations because of comment and amendment letters received from a reviewer in the Securities Division.[73]

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[69] A copy of this unpublished study is available through AKRON LAW REVIEW.

[70] *See* Kudla and Jennings, *supra* note 65, at 15. The focus on common stocks results in narrow scope, but financial data on limited partnerships is difficult, if not impossible, to obtain.

[71] *Id.* ARIZ. REV. STAT. ANN. § 44-197 (1967) provides procedurally for a comment letter containing corrections and suggestions.

[72] *Discussion of Possible Amendments to the Securities Act, Arizona A.R.S. 44-1871 & 44-1921 Before the Arizona Corporation Commission,* at p. 17 (Sept. 26, 1984) (statement of Commissioner Royce Griffin). A copy is available through AKRON LAW REVIEW.

[73] *Id.* at 16. The following chart summarizes the reasons for withdrawal.

REASONS FOR WITHDRAWAL

REASON	**NUMBER OF FIRMS**
Excessive dilution	9
Incomplete information	8
Inadequate financial statements	7
Lack of experience	6
Poor market conditions	6
Too high a price	5
SEC withheld approval	4
Application lapsed	3
Poor earnings record	3
Poor financial condition	3
Too many promotional sales	2
Withdrew from SEC	2
Excessive number of nonqualified shares	2
Lack of testing of product	1
Excessive compensation of officers	1
Cheap stock	1
Shares sold in advance of effective date	1
Conversion of funds by officers	1

There is a definite correlation between SEC approval and approval in Arizona. Of the 260 approvals, 249 either had SEC approval or had their Arizona registration become effective upon issuance of SEC approval. In many of the files, the telex from the attorney's office to the Securities Division could be found and the Arizona registration became effective on the day of that telex receipt. Of the withdrawals, seventy-two did not have SEC approval. These issuers had registered with the SEC because their offerings were interstate. Thus, it can be concluded that there is a greater chance of approval in Arizona if there is effective SEC registration.[74]

These findings raise a major policy issue. A large majority of approvals had either SEC approval or had their Arizona registration become effective upon SEC approval. Similarly, most offerings without Arizona approval did not have SEC approval. Therefore, the efficacy of merit review is called into question, because SEC review is based on disclosure standards.[75]

There was a significant size difference between the companies which obtained approval and those which withdrew. Of the approved companies, there was an average asset figure of $76,878,550. Of the withdrawals, the average asset figure was $28,788,706. The nearly $50,000,000 difference indicates that many small firms are having difficulty obtaining registration approval.[76]

This finding supports the hypothesis that the merit review process discriminates against small issuers. The effect of the merit review is to impede economic progress and business development by preventing small, capital-short businesses from raising capital in the marketplace. Merit review standards can thus create barriers to a free enterprise system.[77]

There was also a significant price per share difference. The average price per share for the approved offerings was $14.63, whereas the average price per share for the offerings withdrawn was $7.64. However, there was no significant difference in the size of the offerings. The average offering size for the approved firms was 2,295,893 shares. The average offering size for the withdrawals was 2,663,800 shares. The price differential may be due to the

Underwriter withdrew	1
Failure to provide additional information	1
Insufficient promoters' equity	1
Financial risk on investors	1
Deficiency in share and working capital	1
Excessive warrants and options	1
Differences in public and investor offerings	1
Patent infringement	1
Inequitable voice in control	1
Other	1

[74] *Id.* at 16.

[75] *Id.*

[76] *Id.* at 17.

[77] *Id.*

fact that firms which withdrew were smaller and did not have an established earnings record to warrant a higher price.[78]

There appears to be a correlation between an offering being seasoned and the chances of approval. Of the 260 offerings which were approved, 165 were seasoned. Of the 90 withdrawals, 37 were unseasoned.[79]

There seems to be no correlation between whether an issue is underwritten and whether it will be approved. The number of approvals which were underwritten was 159. The number of withdrawals which were underwritten was 49 or over half. Thus, the presence of an underwriter is no indication that approval will be obtained.[80]

The applications for registrations in Arizona require the applicants to list approvals or denials in other states. The most frequently mentioned states in which applicants had obtained approval were (in order of the number of times they were mentioned): California, Illinois, Texas, Minnesota, Michigan, Wisconsin, Iowa and New Mexico.[81] These same states were also the ones most frequently mentioned when the applicant was asked to reveal the states that denied registration. On the withdrawn applications, the same states were also mentioned in the same frequency as to approval. To assess the economic impact of merit review, a statistical comparison was made of companies that had been approved to issue common stock securities and companies that had withdrawn their request to issue common stock securities in Arizona from 1976 to 1979. Only common stock issues were examined, in order to maintain as much homogeneity among the securities as possible.[82] Other securities such as debt and preferred stock have many different provisions and privileges and are therefore not directly comparable.

Securities that were withdrawn were subsequently sold in other states.[83]

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[78] *Id.* at 18.

[79] *Id.* A seasoned offering is one by a company that has previously issued a public offering of the same type of security.

[80] *Id.*

[81] *Id.* at 18-19. These states have the most detail in their registration regulations. *See supra* notes 16 to 21 and accompanying text.

[82] *Id.* at 19-20. Common stock data is more easily obtained from publications. The problem of mail survey response and statistical insignificance is reduced.

[83] The financial performance measure used was holding period return as shown in equation (1).

$$HPR_T = \frac{P_{j,T} + \sum_{t=1}^{T} D_{j,t}}{P_{j,O}} - 1 \qquad (1)$$

where HPR_T = holding period return where T is the holding period which was 1, 2, 3, and 4 years after the offering.

$P_{j,T}$ = the average of the high and low price for security $_j$ for year T adjusted for stock splits and stock dividends.

$D_{j,t}$ = dividends paid in year $_t$ adjusted for stock splits and stock dividends.

$P_{j,O}$ = the offering price for security $_j$.

The statistical analysis indicated that the withdrawn group had a significantly higher return in year 1 than the approved group, while there were no significant differences between the two groups for years 2, 3, and 4. Although these results cannot be generalized because of the small sample sizes for the withdrawn group, these results suggest that the withdrawn firms did as well financially as the approved group and even better in year 1.[84] Accordingly, Arizona's merit review process did create a barrier to the free flow of capital to a small group of viable firms. Although methodologies are always subject to criticism, the Kudla and Jennings findings demonstrate that there may be some arbitrariness and over-zealousness in the application of merit review standards.

III. UNSPOKEN ALTERNATIVES TO MERIT REVIEW — GETTING AROUND IT

Although much has been written in favor of retaining merit review, there are very few practitioners or business people who hold much respect for or faith in the merit review system. Empirical studies aside, those in the trenches are not happy with merit review. However, these same people are also well aware of the "sacredness" of merit review.[85] For some reason, even with all evidence considered, and other problems aside, merit review is deemed above reproach, and a major movement is required to change the philosophies of merit review states. Recognizing the difficulty of eliminating or even changing merit review standards, those affected by it have undertaken alternatives to alleviate

The average holding period return was computed as shown in equation (2)

$$HPR_T = \frac{\sum_{j=1}^{N} HPR_{j,T}}{n} \qquad T = 1, 2, 3, \text{and } 4 \qquad (2)$$

where n is the number of securities which had available data.

Id. at 19-20.

If the average holding period returns were significantly higher for the approvals than for the withdrawals, this result would be consistent with merit review being efficacious. If, however, the withdrawn group, then serious consideration should be given to revamping the securities laws. *Id.* at 20.

[84]A financial analysis was made of the approved group and withdrawn group. The financial data was obtained from a mail survey. Based on 41 approved firms and 12 withdrawn firms, the withdrawn firms had a statistically significant higher average holding period return one year after the offering, as compared to the approved group. There were no significant differences in returns for the groups 2, 3, and 4 years after the offering. This finding is consistent with Arizona's merit review process impeding economic progress and business development.

[85]For example, in the Arizona hearings on merit review standards the following testimony was offered by Commissioner Royce Griffin, a regulator from Colorado, *supra* note 72:

> I think it's really no coincidence that six states that are now known as free states — seven with Illinois, although Illinois has not been around long enough to have any experience yet. Those six states are Wyoming, Utah, Colorado, New Jersey, New York and Nevada. It comes as no coincidence those six states are also the base points for all the major frauds in this country.
>
> The Climate that is created by a state that has no merit review not only attracts public offerings that are registered with the SEC, it also attracts every other kind of securities crook in the country who believes that, because you have no regulation, you also have no enforcement.
>
> So when the market falls, as it has every time since 1969, this cyclical period, the people who are hurt are not the promoters or the lawyers or the accountants who put the offerings together. They have got their money in the initial run-up of the market. The people who are hurt — It is like musical chairs. The last guy holding the stock losses. It is the small investor the state securities regulation is supposed to protect.

the effects of merit review. Alleviating those effects involves a slow trend toward federalization of securities laws. Much is being undertaken to put more control in the hands of the SEC and less control in the hands of state regulators.

A. *Step One — Regulation D*

Federal preemption is always an alternative in the field of securities. With this in mind, many interest groups lobbied Congress for the Omnibus Small Business Capital Formation Act of 1980.[86] Section (c)(1) of the Act grants the SEC the authority "to cooperate with any association composed of duly constituted representatives of State governments whose primary assignment is the regulation of securities business within those States" for "the development of a uniform exemption from registration for small issuers which can be agreed upon among several States or between the States and the Federal Government."[87]

Pursuant to the Act, the SEC worked with NASAA[88] and developed

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[86] 15 U.S.C. § 77s (1985).

[87] 15 U.S.C. § 77s (c)(3)(1) (1981). The pertinent parts of the Act provide:

(2) It is the declared policy of this subsection that there should be greater Federal and State cooperation in securities matters, including —
  (A) maximum effectiveness of regulation,
  (B) maximum uniformity in Federal and State regulatory standards,
  (C) minimum interference with the business of capital formation, and
  (D) a substantial reduction in costs and paperwork to diminish the burdens of raising investment capital (particularly by small business) and to diminish the costs of the administration of the Government programs involved.

(3) The purpose of this subsection is to engender cooperation between the Commission, any such association of State securities officials, and other duly constituted securities associations in the following areas:
  (A) the sharing of information regarding the registration or exemption of securities issues applied for in the various States;
  (B) the development and maintenance of uniform securities forms and procedures; and
  (C) the development of a uniform exemption from registration for small issuers which can be agreed upon among several States or between the States and the Federal Government. The Commission shall have the authority to adopt such an exemption as agreed upon for Federal purposes. Nothing in this subchapter shall be construed as authorizing preemption of State law.

(4) In order to carry out these policies and purposes, the Commission shall conduct an annual conference as well as such other meetings as are deemed necessary, to which representatives from such securities associations, securities self-regulatory organization, agencies, and private organizations involved in capital formation shall be invited to participate.

(5) For fiscal year 1982, and for each of the three succeeding fiscal years, there are authorized to be appropriated such amounts as may be necessary and appropriate to carry out the policies, provisions, and purposes of this subsection. Any sums so appropriated shall remain available until expended.

Note that by this Act, Congress made it clear that federal law did not preempt state regulation. *Id.* at § 77s(c)(3)(C).

[88] NASAA is the North American Securities Administrators Association and consists of securities administrators from all states, Canada, Mexico, Puerto Rico and Guam. Before the adoption of the NASAA name in 1957, it was known as the National Association of State Securities Administrators. Prifti, *supra* note 53.

Regulation D.[89] The purpose of Regulation D was two-fold: to clarify the federal securities exemptions and to encourage the states to establish uniform standards by adopting a set of exemptions acceptable to the state regulators.[90] One and one-half years after the SEC's adoption of Regulation D, about 28 states had adopted exemption standards coordinated with Regulation D,[91] and NASAA had officially endorsed the Uniform Limited Offering Exemption (ULOE).[92] The regulatory swing is dramatic. The cooperation on Regulation D

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[89] 17 C.F.R. §§ 230.501 to 230.506 (1985). Regulation D was not promulgated quickly. Originally the exemptions existed as Rules 240, 242 and the original Rule 146. However those rules were refined to their present form, *see* 17 C.F.R. at §§ 230.502 to 230.506.

[90] Securities and Exchange Commission and North American Securities Administrators Association Conference on Federal-State Securities Regulation, FED. SEC. L. REP. (CCH) ¶ 83,610.

[91] The following twenty-five jurisdictions have exemptions which are compatible with both Rule 505 and 506 offerings: Alaska, (3 AA 08.501, 1 BLUE SKY L. REP. (CCH) ¶ 8,448A; Arizona, (Rule 14-4-125, 1 BLUE SKY L. REP. (CCH) ¶ 9,536; Colorado (§ 11-51-113(o), 1 BLUE SKY L. REP. (CCH) ¶ 13,113; Connecticut, (Reg. 36.500-22(b)(9)(11), 1 BLUE SKY L. REP., (CCH) ¶ 14,422; District of Columbia, Delaware, (Rule 9(b)(9)(11), 1A BLUE SKY L. REP., (CCH) ¶ 15,419B; Georgia, (Rule 590-4-5-.01), 1A BLUE SKY L. REP. (CCH) ¶ 18,441, Idaho, (Rule 27, 1A BLUE SKY L. REP. (CCH) ¶ 26,426; Kansas, (§ 17-1262(o), Rule 81-5-6,) 1A BLUE SKY L. REP. (CCH) ¶ 26,405E; Louisiana, (Article D), 2 BLUE SKY L. REP. (CCH) ¶ 29,511; Maryland, (Rule .15), 1A BLUE SKY L. REP. (CCH) ¶ 30,441; Massachusetts, (Reg. Section 14.402(1), 1A BLUE SKY L. REP. (CCH) ¶ 31,472; Michigan, (Rule 803.7) 1A BLUE SKY L. REP. (CCH) ¶ 32,483A; Missouri, (Rule 30-54.210) 2 BLUE SKY L. REP. (CCH) ¶ 35,520A; Montana, (§ 36-10-105(16), 2 BLUE SKY L. REP. (CCH) = 36,105; (Rule 6.10.120), 2 BLUE SKY L. REP. (CCH) ¶ 36,430; Nebraska, (Rule 77), 2 BLUE SKY L. REP. (CCH) ¶ 37,415; New Jersey, (as to offerings other than real estate syndications) (§ 49:2-60(b), 2 BLUE SKY L. REP. (CCH) ¶ 40,125; New York, (as to offerings other than real estate syndications), (§ 359ff) 2 BLUE SKY L. REP. (CCH) ¶ 42,132; Oklahoma, (§ 401 (b)(9)(C), 2 BLUE SKY L. REP. (CCH) ¶ 41,151; (Rule 401(b)(9), 2 BLUE SKY L. REP. (CCH) ¶ 46,414; Oregon, (Rule 815-36-500), 2 BLUE SKY L. REP. (CCH) ¶ 47,634, South Carolina, (Rule 113-21), 3 BLUE SKY L. REP. (CCH) ¶ 51,521; Tennessee, (Rule 0780-4-2-.04), 3 BLUE SKY L. REP. (CCH) ¶ 54,414, Vermont, (§ 9-4204(13), 3 BLUE SKY L. REP. (CCH) ¶ 58,104; Reg., 3 BLUE SKY L. REP. (CCH) ¶ 58,404; Virginia, (§ 13.1-514(14), 3 BLUE SKY L. REP. (CCH) ¶ 60,114; Rule 503, 3 BLUE SKY L. REP. (CCH) ¶ 60,439; Utah, (Rule A-67-03-14.2n-1), 3 BLUE SKY L. REP. (CCH) ¶ 57,413; West Virginia, (Rule 15.05(b)(9), 3 BLUE SKY L. REP. (CCH) ¶ 63,496. Kansas and Tennessee follow NASAA and limit their exemptions to Rule 505. Colorado and New York regulate only intrastate offerings (where Regulation D, exemptions apply only if the offering is interstate). Oregon and Alaska register by coordination-federal approval or exemption complies with their requirements.

The following states have exemptions based on the number of purchasers but the exemption does not parallel Regulation D; hence, special structure would be necessary in these states:

Florida, 35 (§ 517.061(12), BLUE SKY L. REP. (CCH) ¶ 17,106, (Rules 3E-5 — .05-.07); BLUE SKY L. REP. (CCH) ¶ 17,445-7; Illinois, 35 (§ 137.4G), 1A BLUE SKY L. REP. (CCH) ¶ 22,123; Iowa, 35 (§ 502.203(9), 1A BLUE SKY L. REP. (CCH) ¶ 25,113; Minnesota, 35 (§ 80A.15(h), 1A BLUE SKY L. REP. (CCH) ¶ 33,115, Reg. 2875.0180, 1A BLUE SKY L. REP. (CCH) ¶ 33,408; Mississippi, 35 (§ 75-71-203(9) and (10), 2 BLUE SKY L. REP. (CCH) ¶ 34,146; Nevada, 34 (90,140), 2 BLUE SKY L. REP. (CCH) ¶ 38,125; Pennsylvania, 25 & 203(d), 2 BLUE SKY L. REP. (CCH) ¶ 48,113; South Dakota, 25 for domestic corporations, 5 for other issuers (§ 47-31-86.1, 86.4) 3 BLUE SKY L. REP. (CCH) ¶¶ 52,224, 52,227, 52,835.

States with only Rule 506 exemptions are:

Alabama, (Rule 830-X-6-11), 1 BLUE SKY L. REP. (CCH) ¶ 7471; Arkansas, (§ 67-1248(b) (14), 1 BLUE SKY L. REP. (CCH) ¶ 10,114; Interpretative Opinion, BLUE SKY L. REP. (CCH) ¶ 10,661; California, (§ 25,102(f) 1 BLUE SKY L. REP. (CCH) ¶ 11,133; Rules 260.102.12-14), 1 BLUE SKY L. REP. (CCH) ¶¶ 11,780A-C; Indiana, (§ 23-2-1-2(b)(10), 1A BLUE SKY L. REP. (CCH) ¶ 24,102; Kentucky, (Rule 808), 1A BLUE SKY L. REP. (CCH) ¶ 27,415; Maine, (§ 32,874-A(c), BLUE SKY L. REP. (CCH) ¶ 29,124; North Carolina, (Rule 12.06), 2 BLUE SKY L. REP. (CCH) ¶ 43,416; Ohio, (§ 1707, 030), 2 BLUE SKY L. REP. (CCH) ¶ 45,103; Texas, (Rule 109.4(11), 3 BLUE SKY L. REP. (CCH) ¶ 55,554; Washington (WAC § 460-44A-501-503, 506), 3 BLUE SKY L. REP. (CCH) ¶ 61,752-61,757; Wisconsin, (§ 551.23(19), 3 BLUE SKY L. REP. (CCH) ¶ 64,113.

The other states (California, Hawaii, Wyoming, North Dakota, New Hampshire, New Mexico and Rhode Island) have peculiar exemption requirements.

Ten jurisdictions (Alaska, Colorado, Delaware, D.C., Indiana, New York, New Jersey, Oklahoma, Oregon and Washington) recognize Rule 504 exemptions.

[92] The NASAA problem with the ULOE is allowing a Regulation D counterpart exemption for offerings over $5,00,000. The latest version of the ULOE allows exemptions for Rules 501-503 and 505. In a footnote it is

is the first time the states, as a group, have shown willingness to defer to federal standards.[93] Furthermore, the movement toward federal regulation is some acknowledgement by state regulators that there are some types of investments that do not require state merit or other types of review. Furthermore, both Regulation D and the ULOE move in the direction of unlimited offers and sales[94] to those investors who do not require protection.[95]

B. *Step Two — Proposed Uniform Securities Act Reforms*

The reporter's memorandum on the draft of the Uniform Securities Act (USA) called the changes in relation to state regulation a process of "moder-

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noted: "it would not be inconsistent with the regulatory objectives of this exemption for a state to elect to accept Rule 506 offerings within the gambit of this exemption."

Furthermore, in spite of the recognition of 501-503 and 505 (and 506 by implication) exemptions, the ULOE imposes additional requirements for state exemptions:

(1) No Commissions to unregistered persons;
(2) Restrictions on issuers criminal background;
(3) Form D filing requirements;
(4) Restrictions on non-accredited investors.

There is substantial variation in state versions of the ULOE.

In May, 1984, the Section of Corporation, Banking and Business Law of the American Bar Association recommended adoption of the ULOE (with some modifications).

[93]Historically, the swing to federal standards appears to be part of a slow movement. The first state blue sky law appeared in 1911 — prior to the existence of any federal legislation (Kansas, KAN. L. 9199 ch. 133 § 5 (1911). Many states patterned their blue sky laws after the Kansas law. The Securities Act of 1933 and the Securities Exchange Act of 1934 encourage new state attitudes and a deference toward federal regulation. During the 1960's and 1970's, state power grew with the use of merit review. At this time, the pendulum is swinging back to the federal arena.

[94]Section 230.505(a) of Regulation D permits offers and sales to an unlimited number of "accredited investors." *Id.* at § 230.505(b)(2)(ii). (*See infra* note 95 for a definition). Some states already have such unlimited sales to "accredited investors." For example, *see* MICH. COMP. LAWS ANN. § 451.802(b)(9)(d)(5) (West 1983); WIS. STAT. ANN. § 551.23(7) (West 1976). The ULOE unlimited offers and sales also apply to accredited investors, 1 BLUE SKY L. REP. (CCH) ¶ 5294 (Sept. 21, 1983).

[95]The SEC definition of "accredited investor" is found in Regulation D and includes the following:

(a) Institutional investors (banks, employee benefit plans).
(b) Private business development companies;
(c) Tax exempt organizations with assets exceeding $5,000,000;
(d) Directors, executive officers and general partners of the issuer;
(e) Investors who purchase at least $150,000 of the securities (provided such purchase is not more than 20% of net worth);
(f) Natural persons with individual or joint net worth exceeding $10,000,000;
(g) Natural persons with income exceeding $200,000 in each of the past two years; and
(h) An entity in which all equity holders qualify for any classification under accredited investor.

See, 17 C.F.R. § 230.501 (a) (1)-(8) (1985).

The USA defines "financial or institutional investor" as including [but not limited to]:

(i) a depository institution;
(ii) an insurance company;
(iii) a separate account of an insurance company;
(iv) an investment company as defined in the Investment Company Act of 1940;
(v) an employee pension, profit-sharing or benefit plan if the plan has total assets in excess of $5,000,000; or if investment decisions are made by a plan fiduciary, as defined in the Employee Retirement Income Security Act of 1974, which is either a broker-dealer registered under the Securities Exchange Act of 1934, an investment adviser registered or exempt from registration under the Investment Advisers Act of 1940, a depository institution, or an insurance company; and
(vi) any other institutional buyer.

Uniform Securities Act § 103(5) (1985).

nization"[96] and "expedition."[97]

1. Section 305 — Registration by Filing

The most dramatic change in the new Act comes in Section 302 entitled Registration by Filing.[98] This section would permit issues which meet certain specific criteria[99] to become effective automatically at the state level once the

[96]Reporter's Memorandum, Uniform Securities Act, August 3, 1984 draft, p. 4.

[97]*Id.* at p. 5.

[98]There are actually two types of registration available at the state level — registration by filing and registration by qualification. Registration by filing is automatic registration that requires paperwork but involved no action on the part of the administrator. Registration by qualification is a term from § 304 of the Uniform Securities Act (1985). Registration by qualification is non-automatic registration requiring review of materials by the administrators. Registration by qualification is used in those states where there is no registration by coordination or in other states where there is no SEC simultaneous registration (*see supra*, notes 8 and 9 for a list of the coordination states).

[99]The criteria for registration by filing are as follows:

(a) . . .

(1) the issuer is organized under the laws of the United States or a state or, if the issuer is not organized under the laws of the United States or a state, it has appointed a duly authorized agent in the United States for service of process;

(2) the issuer has actively engaged in business operations in the United States for a period of at least 36 consecutive calendar months immediately before the filing of the federal registration statement;

(3) the issuer has registered a class of equity securities under Sections 12(b) or 12(g) of the Securities Exchange Act of 1934, which class of securities is held of record by 500 or more persons;

(4) the issuer has:

(i) (A) a total net worth of $4,000,000; or (B) a total net worth of $2,000,000 and net pre-tax income from operations before allowances for extraordinary items, for at least 2 of the 3 preceding fiscal years;

(ii) not less than 400,000 units of the class of security registered under Section 12 of the Securities Exchange Act of 1934 held by the public, excluding securities held by officers and directors of the issuer, underwriters and persons beneficially owning 10% or more of that class of security; and

(iii) outstanding warrants and options held by the underwriters and executive officers and directors of the issuer in an amount not exceeding 10% of the total number of shares to be outstanding after completion of the offering of the securities being registered;

(5) the issuer has been subject to the requirements of Section 12 of the Securities Exchange Act of 1934 and has filed all the material required to be filed under Sections 13 and 14 of that act for at least 36 calendar months immediately before the filing of the federal registration statement and the issuer has filed in a timely manner all reports required to be filed during the 12 calendar months immediately before the filing of the federal registration statement;

(6) for a period of at least 30 days during the 3 months preceding the offering of the securities registered there have been at least 4 market makers for the class of equity securities registered under Section 12 of the Securities Exchange Act of 1934;

(7) each of the underwriters participating in the offering of the security, and each broker-dealer who will offer the security in this State, is a member of, or is subject to the rules of fair practice of, a national association of securities dealers with respect to the offering and the underwriters have contracted to purchase the securities offered in a principal capacity;

(8) the aggregate commissions or discounts to be received by the underwriters will not exceed 10% of the aggregate price at which the securities being registered are offered to the public.

(9) neither the issuer nor any of its subsidiaries, since the end of the last fiscal year preceding the filing of the registration statement, have:

(i) failed to pay a dividend or sinking fund installment on preferred stock;

(ii) defaulted on indebtedness for borrowed money; or

(iii) defaulted on the rental on one or more long-term leases;

which defaults in the aggregate are material to the financial position of the issuer and its subsidiaries, taken as a whole; and

(10) in the case of an equity security, the price at which the security will be offered to the public is not less than $5 per share.

offering is declared effective by the SEC.

Naturally, this most dramatic change has generated the most dramatic comments. The reporter's memorandum reflects the drafting Committee's view that seasoned companies are being subjected to significant state review processes while the cost of such intense review is not justified by the need for protection of investors.[100] Although the merit review procedures remained in the Act, such inclusions are an option. The standards for merit review range from "work a fraud upon purchasers"[101] to "unfair, unjust or inequitable" prohibitions.[102]

The Sub Committee on the Uniform Securities Act of the American Bar Association issued a strong statement in favor of Section 302 when it was proposed (as section 305):[103]

> We view the inclusion of Section 30[2] as a significant forward step in coordinating and integrating federal and state securities regulation, and probably the single most important change to the Act. The SEC and various of its advisory committees have devoted substantial effort over

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(b) A registration statement under this section must contain the following information and be accompanied by the following documents in addition to the information specified in Section 305(c) and the consent to service of process required by Section 708:
 (1) a statement demonstrating eligibility for registration by filing;
 (2) the name, address, and form of organization of the issuer;
 (3) with respect to a person on whose behalf a part of the offering is to be made in a non-issuer distribution: name and address; the amount of securities of the issuer held by the person as of the date of the filing of the registration statement; and a statement of the reasons for making the offering;
 (4) a description of the security being registered; and
 (5) a copy of the latest prospectus filed with the registration statement under and satisfying the requirements of Section 10 of the Securities Act of 1933.

(c) If the information and documents required to be filed by subsection (b) have been on file with the [Administrator] for at least [5] business days, or any shorter period as the [Administrator], by rule or order, allows and the applicable registration fee has been paid before the effectiveness of the federal registration statement, a registration statement under this section automatically becomes effective concurrently with the effectiveness of the federal registration statement. If the federal registration statement becomes effective before the conditions in this subsection are satisfied and they are not waived, the registration statement becomes effective when the conditions are satisfied. The registrant shall promptly notify the [Administrator] by telephone or telegram of the date and time when the federal registration statement became effective and the content of the price amendment, if any, and shall file promptly a post effective amendment containing the information and documents in the price amendment. The [Administrator] shall promptly acknowledge receipt of notification and effectiveness of the registration statement as of the date and time the registration statement became effective with the Securities and Exchange Commission.

JSA, *supra* note 87, § 302 (originally proposed § 305).

[100]The reporter's memorandum stated:

> The preliminary deliberations of the Committee generated an initial consensus that there are a number of seasoned companies for which the costs of detailed securities review at the state level may not be justified vis-a-vis the additional benefits achieved by such review for the protection of investors.

Reporter's memorandum, *supra* note 96, at 5.

[101]Section 306(a)(2)(v).

[102]Alternate § 306(a)(2)(v).

[103]COMMENTS OF THE SUBCOMMITTEE ON THE UNIFORM SECURITIES ACT OF THE AMERICAN BAR ASSOCIATION STATE REGULATION OF SECURITIES COMMITTEE CONCERNING PROPOSED REVISION TO THE UNIFORM SECURITIES ACT, July 24, 1984. A copy is available through AKRON LAW REVIEW.

> the past several years to bring about a structure of federal securities regulation which focuses regulatory resources upon those issuers and offerings which present the greatest potential threat to investors. Section 30[2] carries that concept to its logical extension by providing a mechanism for state administrators to permit national offerings of seasoned companies to be processed routinely, thereby enabling scarce regulatory resources to be applied where they are most needed, in the close scrutiny of offerings by unseasoned companies and in the investigation and prosecution of violators.[104]

The subcommittee's view of Section 30[2] is further praised as a reflection of the "fact that today's sophisticated financial markets quickly absorb and adjust for information on public companies and that those markets change quickly, necessitating rapid consummation of major transactions by seasoned companies."[105] The new section is deemed "a necessary step in the long process to modernize our nation's securities registration system.[106]

NASAA submitted its comments on the then proposed Section 30[2].[107] Their major concern was Section 302, and their comments refer to the section as a "misguided attempt to carve out from appropriate review at the state level certain so-called 'seasoned' companies," and the proposal as "fatally flawed."[108] Their concerns are:

(1) an inadequate definition of "seasoned" companies;
(2) NASAA is currently preparing an additional exemption to cover issuers listed and reporting under the National Market System of the National Association of Securities Dealers (NASD)
(3) 30[2] makes the USA (along) with other sections too weak to be effective.[109]

NASAA also expressed a fear of "shell" companies using the procedure. "Shell" companies are those that do not meet the public reporting requirements of the Securities Exchange Act of 1934 but[110] will register to take advantage of section 302.[111]

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[104] *Id.* at 20.

[105] *Id.* at 21. The comments note that any potential efficiency the SEC might achieve is not realized if the same degree of efficiency is not present at the state level. *Id.*

[106] *Id.* at 21. The opinion concludes with a "strong recommendation" for adoption. *Id.* at 23-4.

[107] Open Letter to the Members of the National Conference of Commissioners on Uniform State Laws from the North American Securities Administrators Association, Inc. (NASAA) regarding the revised draft of the Uniform Securities Act to be given a First Reading in July 1984. A copy is available from AKRON LAW REVIEW.

[108] *Id.* at 2.

[109] *Id.* at 2-3. The letter refuses support by a unanimous vote of NASAA's members. *Id.* at 3.

[110] 15 U.S.C. §§ 78a to 78lll (1983).

[111] However, Section 302 does have the additional requirement that the issuer "has been actively engaged in business operation" for at least three years preceding the offering. Furthermore, § 302(a)(3) and (4)(i)(A)-(B) require the issuer to have a registered class of securities held of record by 500 persons and provisions regarding net assets. The ABA subcommittee feels these additional requirements eliminate the worry about shell companies.

NASAA expressed further concern that Section 302 would narrow the functions of state administrators.[112] The ABA's response was that these functions would not be narrowed but instead be focused on those offerings most in need of review.[113]

2. Sections 401-403 — Uniform Exemptions

Sections 402-403 of the Act are a significant indication of the intent of the USA to allow state administrators to bring their regulations and exemptions in line with federal standards.[114] The sections when proposed won praise from the ABA and no objections were voiced by the NASAA. Although the ULOE that resulted from the cooperation of NASAA, the ABA and the SEC was intended to result in uniformity, there was much discretion given to the states, and the result has been a "patch-work pattern" of state requirements.[115]

3. Part VI — Increasing State Enforcement Authority

Part VI of the USA expands the scope of the Act and the administrators' authority by adding administrative remedies such as cease and desist orders,[116] as well as civil[117] and criminal penalties.[118] In addition, the Act gives more teeth for enforcement to the private sector through the incorporation of damage formulas allowing ease of investor proof and recovery.[119] These expanded penalties are consistent with the reformers' stated policy of having the states act in those areas where their regulation is most effective, while removing the problems of inconsistent and, at times, arbitrary registration approval.[120]

IV. CONCLUSIONS AND RECOMMENDATIONS

In spite of opinions to the contrary,[121] there is both empirical and practical

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[112]Subcommittee Report, *supra* note 103, at 23.

[113]*Id.* at 23. The ABA also noted opposition to NASAA's exemption for securities listed on exchanges. Their reasoning was that there are many seasoned, reporting companies which happen not to be listed on the national exchanges.

[114]Section 403(b) allows an administrator to promulgate by rule a "limited offering transactional exemption that will further the objectives of compatibility with the exemptions from securities registration authorized by the Securities Act of 1933 and uniformity amount the States."

[115]Subcommittee Report, *supra* note 103, at 32-3. For example, FLA. STAT. § 517.061(12)(Supp. 1986) provides an exemption with no offering price limitation, a 35-investor limitation (not counting accredited investors, relative and affiliates and no requirements on investment sophistication.

[116]Section 602(a)(ii). Licenses can also be revoked and brokers and dealers unsured. *Id.* at §§ 602-603.

[117]Section 603. The civil penalties are up to $2,500 for a single violation and $25,000 for multiple violations. *Id.* at § 603(a)(l)(ii).

[118]Section 604.

[119]Section 605 provides for penalties relating to the securities' value as well as interest, costs and attorney's fees. *Id.* at § 605(a).

[120]*See supra* notes 100 and 113.

[121]*See* Makens, *supra* note 23 in which the author noted: "It is time to stop spouting generalities and filling the air with emotional outbursts. If there are problems with merit regulation, they should be documented and shared with NASAA so that attempts can be made to correct the situation. It is easy to be a critic. It involves little effort and often less thought." *Id.* at 467. It should be noted that the same author severely

evidence that the state regulation of securities' registration may not be as effective as it is alleged to be, and instead may be an impediment to raising capital. Because the states and NASAA have been relatively unwilling to yield, the ABA, the SEC, Congress and other groups have sought methods of circumvention. The circumvention is coming by giving the federal government more authority while streamlining the states' role in securities registration. In short, if the state administrators do not take the appropriate steps to engage in meaningful and fair regulation, the authority will be changed or taken away. Federalism has proven to be an answer to sometimes arbitrary and always time-consuming state registration. NASAA's reaction to allowing streamlined registration for seasoned companies is an indication of the administrators' desire to retain registration approval authority regardless of need or efficacy.

If state regulators do not become more aware of the need for capital and the changed structure of the securities market, their regulatory grip could strangle capital ventures growth, unless and until federalism removes their authority.

Several groups need to become involved in the effort to achieve a coordinated and more effective system of regulation. NASAA will need to become more flexible in its approach to Uniform Acts. Compromise is necessary to achieve some form of continuity. Recognizing market realities would be helpful in updating existing state securities laws. The SEC could be more involved in encouraging cooperation and providing assurance of its role as a force for full disclosure in an efficient market. The ABA has taken a very positive position and answered objections to streamlining with articulate responses. However, all three groups have failed in their study efforts.

One of the reasons for so much debate over merit vs. disclosure and state vs. federal regulation is the lack of tangible evidence. A multistate study funded and staffed jointly by the organizations should be undertaken to discern the following:

(1) the differences in issuers and offerings in merit vs. non-merit states;
(2) the consistency of application of merit review standards by administrators;
(3) the costs of compliance in state registrations;
(4) the differences in performance of seasoned vs. unseasoned offerings;
(5) a quantification of the number of frauds investigated, uncovered and prosecuted in merit vs. non-merit states.

Before the pendulum swings to a federal system of full disclosure and the disappearance of what may be effective state regulation, some answers are

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criticized all three empirical studies of merit review that offered some tangible evidence of effectiveness and dismissed the studies as "narrowly focused," "unsuccessful," "questionable" and "unsupported." *Id.* at 455-57. Makens also makes several personal but undocumented evaluations of the ability of regulators to set aside prejudices and be fair. *Id.* at 450.

needed. To date, no one has provided an in-depth set of facts regarding where securities regulation stands and what it does. With appropriate evidence, the respective groups may be able to agree on a regulatory system with balance — one which provides protection for the investor without the destruction of capital sources for business.