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STATE DISCLOSURE REGULATION AND THE ALLOCATION OF REGULATORY RESPONSIBILITIES

MARK A. SARGENT*

State regulation of securities disclosure is a misunderstood and underappreciated phenomenon. Little discussion of the topic can be found in the academic literature,[1] and the current debate over state securities regulation has focused almost entirely on the state securities administrators' authority to review the substantive merits of registered offerings.[2] By these measures, state disclosure regulation appears to be neither important nor controversial. A closer look at the way state securities regulation really works, however, will show that state regulation of securities disclosure is in fact very important. This article provides that closer look at the realities of state disclosure regulation. Before beginning, however, it makes sense to ask why this regulatory technique is so poorly understood.

Two sources of confusion have impeded development of a fuller understanding of state disclosure regulation. The first source

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1. There is, for example, virtually no discussion of the topic in the major treatises on state securities regulation, or "blue sky" law. *See* J. LONG, BLUE SKY LAW (1985); H. MARSH, JR. & R. VOLK, PRACTICE UNDER THE CALIFORNIA SECURITIES LAW (1986); C. MOSCOW & H. MAKENS, MICHIGAN SECURITIES REGULATION (1983); H. SOWARDS & N. HIRSCH, BLUE SKY REGULATION (3 vols. 1982). There is also little discussion of the topic in one of the better-known practitioner's guides, P. FASS & D. WITTNER, BLUE SKY PRACTICE FOR PUBLIC AND PRIVATE LIMITED OFFERINGS (1986).

2. For citations to some of the literature of this debate, see Ad Hoc Subcommittee on Merit Regulation of the State Regulation of Securities Committee, *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW 785, 785 nn. 1&2 (1986) [hereinafter *Report on State Merit Regulation*]. *See also* Jennings, Childers & Kudla, *Federalism to an Advantage: The Demise of State Blue Sky Laws Under the Uniform Securities Act*, 19 AKRON L. REV. 395 (1986); Sargent, *The Challenge to Merit Regulation* (pts. 1 & 2), 12 SEC. REG. L.J. 276 (1984), 12 SEC. REG. L.J. 367 (1985) [hereinafter Sargent, *Challenge*]; Walker & Hadaway, *Merit Standards Revisited: An Empirical Analysis of the Efficacy of Texas Merit Standards*, 7 J. CORP. L. 651 (1982); Comment, *What to Do with Merit Review*, 65 NEB. L. REV. 413 (1986) [hereinafter Comment, *What to Do*]; Comment, *Compromise Merit Review—A Proposal for Both Sides of the Debate*, 60 WASH. L. REV. 141 (1984). For discussion of the definition of merit regulation, see *infra* text accompanying notes 61-63, and *Report on State Merit Regulation, supra*, at 795, 823-30.

is an excessively abstract, absolutist distinction between merit and disclosure regulation. The conventional wisdom tends to define the two regulatory techniques as fundamentally antithetical, with merit regulation the states' exclusive preserve and disclosure regulation the province of the Securities and Exchange Commission (SEC).[3] One of the goals of this article is to show that, in state law, disclosure and merit regulation are not clearly antithetical, but rather function together in a complex and symbiotic interrelationship.

The second source of confusion is the relative inaccessibility of information about how state disclosure regulation works. One cannot explain, let alone evaluate, state disclosure regulation by examining statutes, rules and regulations, statements of policy, or case law. There are no state equivalents to the SEC's massive compendium of rules and regulations governing disclosure.[4] This law is being made in the oral and written comments provided by state administrators on registration statements filed in their jurisdictions, in the negotiations between the administrators and the attorneys responsible for those registration statements,[5] and in the prospectuses reflecting the outcomes of those negotiations. Accurate information about state disclosure regulation thus cannot be obtained through a trip to the law library, no matter how diligent the researcher. This difficulty has impeded the development of a clear picture of this phenomenon. The difficulty may be overcome, however, by turning to those persons actually involved in the blue sky process. The description of state disclosure regulation contained in this article is

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3. *See, e.g., Empirical Research Project, Blue Sky Laws and State Takeover Statutes: New Importance for an Old Battleground,* 7 J. CORP. L. 689, 706 (1982) (drawing unqualified antithesis between state merit regulation and federal disclosure regulation) [hereinafter *ERP*]; Comment, *What to Do, supra* note 2, at 414-15 (similarly relying on overstated distinction between disclosure and merit regulation); Dumont, *The Case for States to Abolish 'Merit Review' of New Offerings,* N.Y.L.J., Nov. 20, 1985, at 4, col. 3 (emphasizing in absolute terms philosophical differences between federal and state regulation).

4. There are, of course, published requirements for the contents of registration statements. *See, e.g.,* UNIF. SEC. ACT § 304(b), 7A U.L.A. 608-12 (1978) (describing contents of registration statement filed with application for registration by qualification). These can be quite detailed. *See, e.g.,* North American Securities Administrators Association, Statement of Policy on Registration of Oil and Gas Program § X, NASAA Reports (CCH) ¶ 2610 (Sept. 22, 1976) (outlining prospectus and disclosure requirements). The SEC's disclosure rules under the Securities Act of 1933, 15 U.S.C. §§ 77a-77mm (1982), however, are far more detailed. *See* Regulation C, 17 C.F.R. §§ 230.400-.494 (1986); Regulation S-K, 17 C.F.R. § 229.10-.802 (1986).

5. For discussion of the role of these negotiations in the state registration process, see Bartell, *Blue Sky Registration,* in 2 SECURITIES LAW TECHNIQUES §§ 24.01, 24.03, 24.04 (A. Sommer, Jr. ed. 1987); Gray, *Blue Sky Practice—A Morass?,* 15 WAYNE L. REV. 1519, 1525-31 (1969); Ptacek, *Blue Sky Considerations in Structuring a Public Offering,* 21 DRAKE L. REV. 225, 235-36 (1972); *Report on State Merit Regulation, supra* note 2, at 801-02.

derived in large part from interviews with state administrators and blue sky practitioners intimately familiar with these problems.[6] It also may be overcome by turning to the tangible results of the state disclosure review process—the prospectuses drafted or redrafted to reflect the states' disclosure requirements.[7] Taken together, these sources permit a detailed description of the different varieties of state disclosure regulation.

Part I sets the stage for this description by providing a brief overview of the joint state-federal regulatory system. Part II focuses directly on the theoretical distinction between merit and disclosure regulation and suggests some substantial qualifications. Part III examines with specificity the different varieties of state disclosure regulation, with particular emphasis on examples of the functional interdependence of merit and disclosure review. Finally, Part IV critically evaluates the role of state disclosure regulation in the allocation of regulatory responsibilities between the states and the SEC.

I. AN OVERVIEW OF THE REGULATORY CONTEXT

An analysis of disclosure regulation under *federal* securities law would require consideration of a bewildering array of requirements under the Securities Exchange Act of 1934[8] (the 1934 Act) with respect to periodic reporting,[9] proxy solicitations,[10] tender offers,[11]

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6. Note, however, that the description of state disclosure review practices contained in this article, *infra* text accompanying notes 96-134, does not purport to be based on scientific surveying and sampling techniques. These practices also will not be "supported" by whatever "authority" might be contained in footnote references to telephone conversations or correspondence with state securities administrators and blue sky practitioners, most of whom are understandably reluctant to see their opinions memorialized in print. This description is based largely on extensive discussions with practitioners actively engaged in the blue sky process, with state securities administrators in several jurisdictions, and with the chairs of the Disclosure Standards Committee of the North American Securities Administrators Association (NASAA) and the Subcommittee on Disclosure Standards of the American Bar Association State Regulation of Securities Committee. Needless to say, these persons bear no responsibility for the analysis and conclusions set forth in this article.

7. Once again, surveying and sampling techniques used in connection with the review of these prospectuses do not purport to be scientific. The review focused simply on prospectuses judged by the author to be typical examples of the disclosure documents used in state-registered public offerings of corporate equity securities and limited partnership interests, as well as a variety of comment letters submitted by state administrators on specific offerings.

8. 15 U.S.C. §§ 78a-78kk (1982).

9. 15 U.S.C. § 78m (1982); 17 C.F.R. §§ 240.12b-1 to .12b-37(1986).

10. 15 U.S.C. §§ 78n(a)-(c), (g) (1982); 17 C.F.R. §§ 240.14a-1 to .14c-7 (1986).

11. 15 U.S.C. §§ 78n(d)-(f) (1982); 17 C.F.R. §§ 240.14d-1(a) to .14d-101 (1982).

and insider trading,[12] as well as the requirements imposed by the Securities Act of 1933[13] (the 1933 Act) on both registered and exempt offerings of securities. In contrast, analysis of state disclosure regulation requires consideration of a much narrower range of issues. The state securities acts, the great majority of which are modeled on the Uniform Securities Act,[14] contain no equivalents to the 1934 Act's periodic reporting, proxy, and insider trading provisions, and the states' brief foray into tender offer regulation was aborted after the Supreme Court's 1982 decision in *Edgar v. MITE Corp.*[15] State securities regulation is almost entirely concerned with the offering of securities for sale—the territory covered by the 1933

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12. 15 U.S.C. § 78p (1982); 17 C.F.R. §§ 240.16a-1 to .16a-11 (1986).

13. 15 U.S.C. §§ 77a-77mm (1982).

14. UNIF. SEC. ACT § 416, 7A U.L.A. 696 (1978). This act was approved by the National Conference of Commissioners on Uniform State Laws in 1956, with amendments approved in 1958. The Uniform Securities Act is conveniently reprinted at 1 Blue Sky L. Rep. (CCH) ¶¶ 5501-5573 (1986), and in L. LOSS, COMMENTARY ON THE UNIFORM SECURITIES ACT (1976) [hereinafter L. LOSS, COMMENTARY].

Thirty-nine jurisdictions have adopted the Uniform Securities Act, although many have done so with very substantial revisions. For example, the drafters of the Maryland Securities Act, MD. CORPS. & ASS'NS CODE ANN. §§ 11-101 to -805 (1985), deleted all of the Uniform Securities Act provisions relating to merit regulation of securities offerings and investment adviser registration. *See* COMMITTEE TO STUDY THE ADMINISTRATION OF THE BLUE SKY LAW OF MARYLAND, REPORT TO THE LEGISLATIVE COUNCIL AND THE GENERAL ASSEMBLY OF 1962, at 4, 6 (1961); Miller, *A Prospectus on the Maryland Securities Act*, 23 MD. L. REV. 289, 292 (1963); Sargent, *State Limited and Private Offering Exemptions: The Maryland Experience in a National Perspective*, 13 U. BALT. L. REV. 496, 511-13 (1984) [hereinafter Sargent, *State Exemptions*].

Two of the above-mentioned thirty-nine jurisdictions have adopted versions of a revised Uniform Securities Act approved by the National Conference of Commissioners on Uniform State Laws in 1985, *reprinted in* UNIF. SEC. ACT (1985), 1 Blue Sky L. Rep. (CCH) ¶¶ 5601-5707 (1986). This version of the Act, however, has not yet been approved by the American Bar Association, and the chances of its widespread enactment are slight. *See* Sargent, *Some Thoughts on the Revised Uniform Securities Act*, 14 SEC. REG. L.J. 62, 71-75 (1986) [hereinafter Sargent, *Some Thoughts*]. For discussion of the great difficulties encountered in the revision process, see Hensley, *The Development of a Revised Uniform Securities Act*, 40 BUS. LAW. 721 (1985); Braisted, *RUSA Draft: Regulation of Securities by States*, Nat'l L.J., Mar. 25, 1985, at 15, col. 4. For an overview of the provisions of the revised act by one of the reporters for the project, see Titus, *Uniform Securities Act (1985)*, 19 REV. SEC. & COMMODITIES REG. 81 (1986).

In view of the dubious status of the revised act, this article will refer only to the 1956-58 version of the Uniform Securities Act.

15. 457 U.S. 624 (1982) (holding that Illinois takeover statute violated the Commerce Clause). For discussion of *MITE's* impact on the first-generation takeover statutes, see Warren, *Developments in State Takeover Regulation: MITE and Its Aftermath*, 40 BUS. LAW. 671 (1985). This decision severely limited, if not destroyed, the states' ability to regulate the tender offer phase of the takeover process. *But see* L.P. Acquisition Co. v. Tyson, 772 F.2d 201 (6th Cir. 1985) (affirming the constitutionality of the application of the Michigan first-generation statute to tender offers for securities not registered under the Securities Exchange Act of 1934); Cardiff Acquisitions, Inc. v. Hatch, 751 F.2d 906

Act—and with the licensing and supervision of securities professionals such as broker-dealers and investment advisers.[16] Discussion of state disclosure regulation, therefore, is largely a matter of analyzing the affirmative disclosure obligations imposed by state securities administrators on registered public offerings of securities.[17] That analysis should begin with an overview of the state registration process and its legal framework.

Every state securities act, like the 1933 Act,[18] requires every sale of securities in the state to be either registered or exempt from registration.[19] The state provisions differ from section 5 in that they apply only to offers or sales *in the state*,[20] but with respect to those transactions the basic requirement is the same: the offeror or seller

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(8th Cir. 1984) (affirming the constitutionality of a first-generation Minnesota statute that had been substantially revised in light of *MITE*).

The virtual demise of these statutes led some jurisdictions to enact so-called second-generation takeover statutes. These statutes, however, do not form part of the states' securities laws, and they do not create any role for the state securities administrators. Rather, they represent revisions of the state corporate laws to establish structural requirements for or impediments to takeovers of corporations organized under those laws. For discussion of these second-generation statutes and their differences from the first-generation models, see ALI-ABA, NEW DIRECTIONS IN STATE TAKEOVER REGULATION, THE SECOND GENERATION STATUTES (1986); Profusek & Gompf, *State Takeover Legislation After MITE: Standing Pat, Blue Sky, or Corporation Law Concepts?*, 7 CORP. L. REV. 3 (1984); Sargent, *Do the Second-Generation State Takeover Statutes Violate the Commerce Clause? A Preliminary Inquiry*, in TENDER OFFERS, DEVELOPMENTS AND COMMENTARIES 75 (M. Steinberg ed. 1985); Steinberg, *The Pennsylvania Anti-Takeover Legislation*, 12 SEC. REG. L.J. 184 (1984). The constitutionality of one form of second-generation state takeover regulation was recently affirmed by the Supreme Court in CTS Corp. v. Dynamics Corp. of Am., 107 S. Ct. 1637 (1987).

16. See, for example, the registration and supervisory provisions of the Uniform Securities Act for broker-dealers, agents, and investment advisers. UNIF. SEC. ACT §§ 201-204.

17. This is not to say that the states play an insignificant part in the regulation of disclosures in exempt transactions. Some states impose disclosure conditions additional to or different from those required under the applicable federal exemption. *See* Hainsfurther, *Summary of Blue Sky Exemptions Corresponding to Regulation D*, 38 SW. L.J. 989, 1002, 1008-09 (1984) (discussing Mississippi and Pennsylvania disclosure requirements for certain exempt transactions); Sargent, *State Exemptions, supra* note 14, at 554-56 (discussing Maryland disclosure requirements for certain exempt transactions). State disclosure requirements for exempt transactions thus can be important with respect to some transactions in some states, but in the aggregate, they are less important than the affirmative disclosure obligations imposed upon public offerings as a condition of registration. This article, therefore, will concentrate on the latter topic.

18. 15 U.S.C. § 77e (1982).

19. *See, e.g.*, UNIF. SEC. ACT § 301 (providing that "[i]t is unlawful for any person to offer or sell any security in this state unless (1) it is registered under this act or (2) the security or transaction is exempted under section 402)." *But see* D.C. CODE ANN. §§ 2-601 to -619 (1981) (requiring registration only of broker-dealers).

20. For discussion of this jurisdictional prerequisite, see J. LONG, *supra* note 1, at 3-2 to -118; L. LOSS & E. COWETT, BLUE SKY LAW 186-217 (1958); Long, *The Conflict of Laws*

of securities must either register the securities or find some exemption from registration.

Most transactions are in fact exempt from state registration,[21] just as most transactions are exempt from federal registration, and the grounds for exemption at the two levels are often similar. The federal and state exemptions, however, are by no means co-extensive. For example, many offerings subject to registration at the federal level are exempt from registration at the state level. This category includes offerings by issuers listed on a national stock exchange or, in a few states, on the National Association of Securities Dealers Automated Quotations National Market System (NASDAQ/NMS), or by issuers that meet specified "blue chip" criteria.[22] Conversely, some offerings exempted from federal registration pursuant to regulation D[23] or some other federal exemption[24] may not be able to qualify for a coordinating state exemption in every jurisdiction in which the offering is made, and thus may be subject to "registration by qualification" in one or more states.[25]

Provisions of the Uniform Securities Act, Or When Does a Transaction "Take Place in This State?"—Part 1, 31 OKLA. L. REV. 781 (1978).

21. For an overview of the state exemptions, see J. LONG, *supra* note 1, at 4-2 to 5-149. For a detailed discussion of their status and use in a fairly typical Uniform Securities Act jurisdiction, see Hansell & Neumann, *The Iowa Uniform Securities Act Exemptions, Part I: The Securities Exemptions*, 2 J. CORP. L. 437 (1977); *The Iowa Uniform Securities Act Exemptions, Part II: The Transaction Exemptions*, 3 J. CORP. L. 437 (1978). For a similar survey in a non-Uniform Securities Act jurisdiction, see Lipsman, *Exemptions Under the Texas Securities Act: A Logical Framework for the Practicing Attorney*, 22 HOUS. L. REV. 725 (1985). For discussion of problems of policy and practice with the state exemptions, see Sargent, *State Exemptions*, *supra* note 14, at 498-511.

22. For a survey of these exemptions and the current debate over them, see Warren, *The Status of the Marketplace Exemption from State Securities Registration*, 41 BUS. LAW. 1511 (1986) [hereinafter Warren, *Marketplace Exemption*].

"National Market System Securities" are defined at 17 C.F.R. § 240.11Aa2-1 (1986), pursuant to § 11A(a)(2) of the Securities Exchange Act of 1934, 15 U.S.C. § 78*l*A (1982).

23. 17 C.F.R. §§ 230.501-.506 (1986).

24. An example is the statutory exemption for nonpublic offerings under § 4(2) of the Securities Act of 1933, 15 U.S.C. § 77d(2) (1982).

25. "Registration by qualification" is the Uniform Securities Act registration device used for offerings not registered with the SEC and not eligible for "registration by notification," a short-form registration device available to issuers that meet specified earnings and stability criteria. UNIF. SEC. ACT §§ 302, 303.

The movement to develop uniform state exemptions corresponding to regulation D, 17 C.F.R. §§ 230.501-.506 (1986), has generated significant controversy, but has also resulted in NASAA's adoption of a "Uniform Limited Offering Exemption" (ULOE). The ULOE is published at NASAA Reports (CCH) ¶ 6201 (Jan. 17, 1984). While the ULOE has provided a framework for greater uniformity, it has not been adopted in every state, and there is still substantial variation among the versions of ULOE that have been adopted in others. For overviews of the patterns of adoption, see Hainsfurther,

There is a substantial area of state-federal overlap, however, with respect to initial public offerings by corporations and limited partnerships. These are the offerings usually subject to both state and federal registration. Many are likely to receive a relatively detailed review from the SEC, and many are likely to be looked at carefully by some of the state administrators.[26]

The procedural mechanism for simultaneous state and federal registration is relatively simple. A public offering submitted for federal registration ordinarily will also be submitted for "registration by coordination" in every state in which the offering is to be sold.[27] Registration by coordination ties state effectiveness to federal effectiveness, permitting simultaneous effectiveness at both levels while allowing the state administrator time to review the offering during the federal waiting period.[28]

If the state administrator objects to the offering on one or more of the statutory grounds for denial of registration, he or she may issue a stop order denying effectiveness to the offering.[29] As in the

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supra note 17, at 991-1021; Halloran & Linderman, *Coordinating State Securities Laws with Regulation D and Federal Integration Policy: State Limited Offering Exemptions and Integration Standards*, in PRACTISING LAW INSTITUTE, BLUE SKY LAWS, STATE REGULATION OF SECURITIES 1985, at 447 (1985); MacEwan, *Blue Sky Regulation of Reg D Offerings*, 18 REV. SEC. & COMMODITIES REG. 103 (1985). For discussion of the difficulties experienced in one state with accommodating the state and federal exemptive schemes, see Honig, *Massachusetts Securities Regulation: In Search of the Fulcrum*, 13 U. BALT. L. REV. 469, 479-95 (1984).

26. *Report on State Merit Regulation*, *supra* note 2, at 796-801.

27. The term "registration by coordination" is used in Uniform Securities Act jurisdictions. *See* UNIF. SEC. ACT § 303. Similar terminology is used in non-Uniform Act jurisdictions. *See, e.g.*, CAL. CORP. CODE § 25111 (West Supp. 1987) ("qualification by coordination").

28. UNIF. SEC. ACT § 303(c) describes the conditions for coordination of the timing of state and federal effectiveness. For discussion of the practical importance of this registration device, see L. LOSS, COMMENTARY, *supra* note 14, at 51-55; Sargent, *Some Thoughts*, *supra* note 14, at 73.

29. The grounds for denial of effectiveness are set out in UNIF. SEC. ACT § 306. Section 306(a)(2)(F) defines specific "merit" grounds for denial of effectiveness by permitting the administrator to issue a stop order if "the offering has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, or promoters' profits or participation, or unreasonable amounts or kinds of options." The drafters specifically excluded from the Act, however, a general requirement that the offering be "fair, just, and equitable" as a condition of effectiveness. *See* L. LOSS, COMMENTARY, *supra* note 14, at 83-84. Some Uniform Securities Act jurisdictions, however, have added language granting the administrator authority to deny effectiveness on "fair, just, and equitable" grounds. *See, e.g.*, WIS. STAT. ANN. § 551.28(1)(e) (West 1986). There is also some dispute over whether UNIF. SEC. ACT § 306(a)(2)(F), which permits denial of effectiveness on the ground that "the offering has worked or tended to work a fraud upon purchasers or would so operate," constitutes a general grant of merit authority similar to a "fair, just, and equitable" standard. For

federal scheme, however, issuance of a stop order is rare;[30] if the problems with the offering are insurmountable, the issuer ordinarily will withdraw the application for registration[31] and "sell around" that state or those states in which the offering has not "cleared."[32] The inability to clear in one or more states is rarely fatal to the success of a nationwide public offering,[33] although a projected inability to clear in several highly regulatory jurisdictions with large numbers of investors such as California or Texas may send the issuer and underwriter back to the drawing board.

While there is always some potential for compliance problems at the state level, the nature and intensity of the review received in the state varies substantially.[34] It varies, first of all, with the charac-

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negative responses to this suggestion, see *Report on State Merit Regulation*, *supra* note 2, at 808 n.136; Honig, *supra* note 25, at 474-76. *But see ERP*, *supra* note 3, at 809 (three states claim that their "work-a-fraud" standard constitutes a "fair and equitable" test).

The administrator's authority to deny effectiveness on the grounds of inadequate disclosure is derived from UNIF. SEC. ACT § 306(a)(2)(A), which allows denial if the registration statement "is incomplete in any material respect or contains any statement which was, in light of the circumstances under which it was made, false or misleading with respect to any material fact."

30. According to Professor Loss, the "heavy artillery" of § 8(d) of the Securities Act of 1933, 15 U.S.C. § 77h(d) (1982), which authorizes the issuance of stop orders, "is reserved for flagrant cases." L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 128 (1983) [hereinafter L. LOSS, FUNDAMENTALS]. The same is true in state registration. Bartell, *supra* note 5, at § 24.04(11) ("stop orders are rarely used").

31. Bartell, *supra* note 5, at § 24.03(4)(b); Shapiro & Sachs, *Blue Sky Law and Practice: An Overview*, 4 U. BALT. L. REV. 1, 13 (1974).

32. P. FASS & D. WITTNER, *supra* note 1, at 2-5. An alternative to "selling around" a recalcitrant state is to withdraw the application for registration by coordination, which the administrator would deny in order to prevent automatic state effectiveness upon federal effectiveness, UNIF. SEC. ACT § 303(c), and to submit an application for registration by qualification. A registration by qualification becomes effective only when the administrator so orders. UNIF. SEC. ACT § 304(c). The switch from coordination to qualification would allow counsel and the administrator time to resolve the problem without the time pressure created by coordinated state-federal effectiveness. P. FASS & D. WITTNER, *supra* note 1, at 2-5; Liebolt, *State Securities Registration Requirements: Forms, Procedures, Requirements*, in PRACTISING LAW INSTITUTE, BLUE SKY LAWS, STATE REGULATION OF SECURITIES 1985, at 376 (1985). For discussion of the term "cleared" with respect to federal registration, see Comment, *State Securities Regulation: Merit Review of Foreign Equity Offerings*, 25 VA. J. INT'L L. 939, 939-40 n.5 (1985).

33. *See* Makens, *Who Speaks for the Investor? An Evaluation of the Assault on Merit Regulation*, 13 U. BALT. L. REV. 435, 459 (1984) (expressing doubt about the claim that merit regulation "kills" offerings); *but see* J. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS 35 (1971) (stating that restrictions "may force some promoters to give up a plan for a public offering").

34. *Report on State Merit Regulation*, *supra* note 2, at 789-90, 836-38. For a survey of perceptions of the relative stringency of the various state regulatory systems, see Brandi, *Securities Practitioners and Blue Sky Laws: A Survey of Comments and a Ranking of States by Stringency of Regulation*, 10 J. CORP. L. 689, 703-07 (1985).

teristics of the offering. Low-priced, speculative offerings, usually described as "penny stock" offerings, are likely to be scrutinized carefully.[35] Consequently, many such offerings are never submitted for registration in heavily regulatory states. Other types of offerings, furthermore, may receive an intensive review if the underwriter is not well-established, the issuer or its principals have a disciplinary record, or the offering is of a type that has been presenting enforcement problems.[36]

The type of review received will also vary from state to state. A primary basis for variation will be the nature and extent of the individual states' review authority. In the so-called "free" states such as Colorado and Nevada, there is a blanket exemption for SEC-registered offerings, so such offerings will not be reviewed at all in those jurisdictions.[37] In so-called "disclosure-only" jurisdictions, such as Illinois, Maryland, and Connecticut, the administrator may review only the adequacy and accuracy of the disclosure, and may not deny effectiveness to the offering on merit grounds.[38] As a practical matter, the level of review applied in these jurisdictions is highly varied. Many registrations by coordination are hardly reviewed. In contrast, registration statements for offerings exempted from federal registration but registered in the state by qualification tend to be scrutinized closely.[39] The most intensive scrutiny, however, is likely to be received from state administrators possessing the authority to review both the substantive merits of the offering and the adequacy and accuracy of the disclosures.[40] As will be explained in detail below,[41] the review received in those states is likely to be a complex

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35. For discussions of the states' concerns with such offerings, see NASAA Investor Alert, Penny Stock Frauds, NASAA Reports (CCH) ¶ 8206 (Aug. 1984); Leefeldt, *Blank Check Offerings Lure Investors*, Wall St. J., June 16, 1986, at 15, col. 1; *States Stop Playing Detective for Investors*, BUS. WEEK, July 16, 1984, at 131.

36. A current example of an offering likely to attract intensive scrutiny is a so-called "blind-pool" or "blank-check" offering by an issuer without any assets that will use the proceeds of the offering to acquire a privately-held business. The blind-pool offering, in short, allows the private company to go public without government scrutiny. See Leefeldt, *supra* note 35, at 15, col. 1.

37. *See* COLO. REV. STAT. § 11-51-113(2)(n) (Supp. 1986); NEV. REV. STAT. § 90.075 (1986).

38. For discussion of Illinois' shift from a merit jurisdiction to a disclosure-only jurisdiction, see Sosin & Fein, *The Landmark 1983 Amendments to the Illinois Securities Law*, 72 ILL. B.J. 196 (1983). For discussion of Maryland's status as a disclosure-only jurisdiction, see authorities cited *supra* note 14. On Connecticut's status, see *ERP*, *supra* note 3, at 804, 810.

39. *See supra* notes 25, 32.

40. *See supra* note 29 for discussion of the statutory bases of merit review authority.

41. *See infra* text accompanying notes 96-134.

amalgam of merit and disclosure reviews.

A second basis for state-to-state variation is the extent of state administrative resources. The great majority of states possess the statutory authority to engage in both merit and disclosure review, but as a practical matter only a few states possess the ability to regulate public offerings.[42] Many states simply lack the personnel and the financial resources to carry out rigorous, independent reviews. At any one time, only ten to fifteen states are likely to comment extensively on the registration application and require compliance with specific disclosure or merit standards.[43] The roster of heavily regulatory states, furthermore, changes frequently, since legislative developments,[44] funding shifts, and turnover at both supervisory and staff levels can rapidly alter the way a state office behaves.[45]

In short, only a relatively small number of states are likely to engage in serious regulation of public offerings. Their ability to regulate will depend upon both the extent of their statutory authority and their administrative resources. Their inclination to review will depend largely upon the nature of the offering. But once several states decide to review an offering, the level of scrutiny is likely to be as intense as that received from the SEC. The review will also be independent of the SEC's,[46] primarily because of some states' obligation to evaluate the offering in light of their merit standards. It is vital to recognize, however, that the review received in the heavily regulatory states will not be purely a "merit review."[47] Administrators in these jurisdictions will employ a complex regulatory methodology in which merit and disclosure techniques are inextricably intertwined. To understand that methodology, it is necessary to ex-

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42. For surveys listing the states that consider themselves merit jurisdictions, see *ERP*, *supra* note 3, at 803-11. For a comparative analysis of the resources of the state securities administrations and the uses to which those resources are put, see *id.* at 786-800.

43. *See* Bartell, *supra* note 5, at § 24.07(7); *Report on State Merit Regulation*, *supra* note 2, at 790 n.25.

44. For discussion of the impact of legislative change in Illinois and other jurisdictions, see Sargent, *Challenge*, *supra* note 2 at 367-77.

45. For discussion of the impact of personnel changes in one state, see Honig, *supra* note 25, at 471.

46. This is not to say that state examiners will not consult with SEC examiners or that they will ignore SEC requirements. The contrary is ordinarily true. The state examiner is, however, fully capable of conducting an independent review that may lead to special state disclosure requirements.

47. *See infra* text accompanying notes 96-134; *see also* Makens, *supra* note 33, at 441 ("when a merit administrator provides comments on an offering, the comments are more likely to relate to the adequacy of disclosure than to merit issues").

amine more closely the basic concepts of "merit" and "disclosure" regulation.

II. "IT MUST NOT BE THOUGHT, HOWEVER, THAT DISCLOSURE AND MERIT ARE TWO GODS THAT SIT ON SEPARATE BUT EQUAL THRONES."[48]—LOUIS LOSS

A. *Defining the Difference*

With this evocative phrase, Professor Loss drew on his unique experience as both principal draftsman of the Uniform Securities Act[49] and principal commentator on the federal securities laws[50] to suggest that an absolute distinction between disclosure and merit regulation is misleading, a theme we are about to explore in much greater detail. He also insisted, however, that "there *is* a difference" between disclosure and merit regulation,[51] a point that cannot be denied.

The system of disclosure regulation employed by the SEC is an inheritance of the Progressive faith in the value of disclosure as a remedy to social and economic wrongs.[52] This faith was expressed not only in the late nineteenth and early twentieth century tradition of muckraking,[53] but also in the evolution of the investigative hearing as a technique of exposing abuses,[54] and, most importantly, in

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48. L. LOSS, FUNDAMENTALS, *supra* note 30, at 36.

49. UNIF. SEC. ACT, Official Prefatory Note, *reprinted in* 1 Blue Sky L. Rep. (CCH) ¶ 5500A. For discussion of Professor Loss' critical role in the drafting of the Uniform Securities Act, see Blair-Smith, *More on the Project for a Uniform Securities Act*, 11 BUS. LAW. 111 (1956).

50. For discussion of Professor Loss' role in the development of federal securities regulation, see Macey, *Book Review*, 93 YALE L.J. 1173, 1173-74 (1984).

51. L. LOSS, FUNDAMENTALS, *supra* note 30, at 36.

52. For extensive discussions of Progressive ideology, see D. AARON, MEN OF GOOD HOPE (1951); R. HOFSTADTER, THE AGE OF REFORM, FROM BRYAN TO F.D.R. (1955); M. WHITE, SOCIAL THOUGHT IN AMERICA: THE REVOLT AGAINST FORMALISM (1949); R. WIEBE, THE SEARCH FOR ORDER 1877-1920 (1967). For a critical analysis of Progressive financial and economic reform programs as essentially conservative efforts to protect business interests, restrain competition and preserve economic inequality, see G. KOLKO, THE AGE OF CONSERVATISM (1963); RAILROADS AND REGULATION, 1877-1916 (1965); MAIN CURRENTS IN MODERN AMERICAN HISTORY (1976).

53. For discussion of the muckraking tradition, see R. HOFSTADTER, *supra* note 52, at 186-95.

54. One such investigation was the 1912 Pujo Committee Hearings, which exposed the so-called "money trust" and other abuses in the financial markets. *See* C. COWING, POPULISTS, PLUNGERS AND PROGRESSIVES 52-56 (1965). The Committee's findings were popularized by Louis D. Brandeis in his famous work, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT (1914). These proceedings had a New Deal echo in the dramatic 1933 hearings conducted by Ferdinand Pecora with respect to the activities of the Insull public utility interests, the National City Company, and J.P. Morgan and Company. *See*

the development of legislation designed to mandate disclosure of material information to the public.[55] The faith in disclosure was expressed most succinctly in Louis Brandeis' oft-quoted phrase: "[S]unlight is said to be the best of disinfectants; electric light the most efficient policeman."[56] The 1933 Act and much of the federal securities legislation reflected this optimistic assessment of the value of full disclosure.[57]

Progressive disclosure legislation, nevertheless, was in many ways quite modest in its ambitions and its effects. Government's role would be confined to setting standards for disclosure; it would not be a guarantor of quality or fairness, and it would not mandate the substantive terms of private economic relations. This distinction is part of the SEC's legacy. That agency's primary function, at least under the 1933 and 1934 Acts, is to maintain a system of "truth in securities."[58] The 1933 Act, its attendant rules and regula-

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J. SELIGMAN, THE TRANSFORMATION OF WALL STREET, A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 20-38 (1982) [hereinafter J. SELIGMAN, TRANSFORMATION].

55. For discussion of the importance of government-mandated disclosure in Progressive economic reform programs, see V. CAROSSO, INVESTMENT BANKING IN AMERICA 353-54 (1970); C. COWING, *supra* note 54, at 227-35.

56. BRANDEIS, *supra* note 54, at 92; *see also id.* at 92-108 (explaining "what publicity can do"). On Brandeis' role in the development of early twentieth-century regulation, see T. MCCRAW, PROPHETS OF REGULATION, 80-142 (1984).

57. This legislation also reflects a political compromise with the forces that opposed adoption of federal securities regulation. The chances of enactment of disclosure-based legislation were far greater than enactment of merit-based legislation on the model of the state blue sky laws. *See* M. PARRISH, SECURITIES REGULATION AND THE NEW DEAL 57 (1970); J. SELIGMAN, TRANSFORMATION, *supra* note 54, at 56-57. The compromise implicit in the adoption of a disclosure-based system was harshly criticized by William O. Douglas, then a professor at Yale Law School, who doubted that most investors had "the time, money, or intelligence to assimilate the mass of information in the registration statement," and who described the Securities Act of 1933 as a "nineteenth-century piece of legislation" that did not "perfect a plan for control of our present forms of organization." Douglas, *Protecting the Investor*, 23 YALE L.J. 521, 528-30 (1933).

Note, however, that the drafters of this legislation were influenced as much by Felix Frankfurter's ideas about the importance to modern industrial society of independent administrative agencies staffed by experts as by the "simpler slogans of Louis Brandeis." J. SELIGMAN, TRANSFORMATION, *supra* note 54, at 58. Perhaps the classic statement of this perspective was written by James Landis, Frankfurter's protege, one of the drafters of the Securities Act of 1933 and an SEC Commissioner. J. LANDIS, THE ADMINISTRATIVE PROCESS (1938). On Landis' contribution to federal securities regulation, see T. MCCRAW, *supra* note 56, at 153-209. The Frankfurter-Landis model of the behavior of administrative agencies has been strongly criticized. For a survey of the literature, see Gifford, *The New Deal Regulatory Model: A History of Criticism and Refinements*, 68 MINN. L. REV. 299, 312-19 (1983).

58. Certain aspects of federal securities regulation, however, clearly constitute more than mandatory disclosure systems. The Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79a to 79z-6 (1982), for example, brought about a fundamental reorgani-

tions, and the SEC registration process can be understood as an engine designed to extract information from the issuer and the underwriter. Theoretically, therefore, the SEC will not, indeed cannot, deny registration to an offering that appears to be egregiously unfair to the public investor, or that presents an extraordinary amount of risk, so long as all information material to the offering has been disclosed. As will be argued below,[59] this basic point needs some qualification, but its essence remains true.

The establishment of a disclosure-based federal securities regulatory system in 1933 can be described as a rejection of the first indigenous tradition of American securities regulation, the merit-based system prevalent in the midwestern states, in favor of a disclosure-based system derived from a British model and from the broader tradition of Progressive disclosure legislation.[60] Merit regulation in 1933, as well as merit regulation in 1987, contemplated a far greater degree of intervention into private economic decision-making than did the form of disclosure regulation adopted in the 1933 Act.

In essence, merit regulation is a paternalistic system of securities regulation permitting the administrator to deny effectiveness to a registration statement if the terms of the offering, the structure of the issuer, or any associated transactions do not (i) ensure a fair relationship between promoters and public investors, and (ii) provide public investors with a reasonable relation between risk and return.[61] State administrators have used merit-based securities acts to erect a baroque, ever-changing network of standards and require-

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zation of the financial structure of that industry. *See* R. DEBEDTS, THE NEW DEAL'S SEC 112-43 (1964); E. HAWLEY, THE NEW DEAL AND THE PROBLEM OF MONOPOLY 325-37 (1966); M. PARRISH, *supra* note 57, at 145-78; J. SELIGMAN, TRANSFORMATION, *supra* note 54, at 127-38. The Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -64 (1982), furthermore, contains a number of substantive regulatory provisions that go far beyond the mere requirement of full disclosure of material information. *See* L. LOSS, FUNDAMENTALS, *supra* note 30, at 59. The Act, nonetheless, stops far short of imposing a full-scale fairness standard for investment company transactions. *See* J. SELIGMAN, TRANSFORMATION, *supra* note 54, at 230-31.

For discussion of other ways in which federal securities regulation may be said to serve goals beyond "truth in securities," see *infra* text accompanying notes 83-92.

59. *See infra* text accompanying notes 83-84.

60. L. LOSS, FUNDAMENTALS, *supra* note 30, at 35-36; M. PARRISH, *supra* note 57, at 57; J. SELIGMAN, TRANSFORMATION, *supra* note 54, at 56-57.

61. This definition is derived from *Report on State Merit Regulation*, *supra* note 2, at 829. In the interests of full disclosure, it should be stated that the present writer was the principal author of that report and hence of this definition. *Id.* at 785. For discussion of the different definitions of merit regulation, and of the difficulty in arriving at a consensus definition, see *id.* at 795.

ments that manage to cover both fundamental questions of corporate governance[62] and such minutiae as the amount of real estate brokerage commissions that may be paid for the resale of property acquired by a real estate limited partnership.[63]

State merit regulation, like federal disclosure regulation, drew upon late nineteenth and early twentieth century Progressive reform impulses.[64] Many of the central characteristics of that ideology were present in the merit-based blue sky statutes: a sense of victimization of the public by financial interests,[65] a suspicion of Wall Street,[66] and a trust in the expertise of government administrators.[67] Merit regulation, however, represents a more extreme version of those impulses than does federal disclosure regulation, and it was certainly perceived as more threatening by at least some business interests.[68] Merit statutes, after all, grant state administrators vast

62. *See infra* text accompanying notes 112-117.

63. NASAA Statement of Policy, Real Estate Programs § IV.F, NASAA Reports (CCH) ¶ 3604 (Nov. 20, 1986).

64. For discussion of the blue sky movement that led to the enactment of the first state securities statutes in the period immediately before and during World War I, see V. CAROSSO, *supra* note 55, at 156-64; C. COWING, *supra* note 54, at 67-74; M. PARRISH, *supra* note 57, at 5-20. For discussion of the origin of the term "blue sky law," see L. LOSS & E. COWETT, *supra* note 20, at 7 n.22. For a discussion of late nineteenth-century antecedents to this legislation, see Nash, *Government and Business: A Case Study of State Regulation of Corporate Securities*, 38 BUS. HIST. REV. 144 (1964).

65. This sense of victimization is clearly expressed in the literature of the blue sky movement. *See, e.g.*, Brach, *The Blue Sky Law*, 3 MARQ. L. REV. 142, 147 (1918-19) ("The purpose of the . . . Blue Sky Law was . . . to protect the innocent investors from being . . . defrauded by the wily, crafty salesman of spurious stock."); Dolley, *The Kansas "Blue Sky Law,"* 75 CENT. L.J. 221 (1912) ("At the time this law went into effect there were between four and six millions of dollars annually being taken from Kansas . . . .").

66. Suspicion of Wall Street seems to have been common in the agrarian states of the Midwest, but the most direct focus of resentment in the blue sky movement seems to have been itinerant confidence men peddling spurious oil and mining company shares. C. COWING, *supra* note 54, at 73. It is fair to say, however, that the blue sky movement was also part of a larger reform movement preoccupied with perceived abuses by the "money trust" and investment bankers, evils frequently personified by Wall Street. For discussion of the ideology of this broadly-based movement, see C. COWING, *supra* note 53, at 25-74.

67. A classic expression of this aspect of Progressive ideology is C. MCCARTHY, THE WISCONSIN IDEA (1912). McCarthy's description of the Wisconsin blue sky law is particularly evocative: "The [blue sky] commission is given the authority to determine in a scientific way whether certain issues are or are not reasonable . . . ." *Id.* at 72. J.N. Dolley of Kansas, the first blue sky commissioner, emphasized the role of experts in the administration of the state securities law: "Whenever we get an application from a company we get what information we desire and then it is submitted to one of our various state institutions or departments, who are experts in that line, and we receive their advice and opinion regarding the matter." Dolley, *supra* note 65, at 222.

68. For discussion of the assault by financial interests, particularly the Investment Bankers Association, on the early blue sky statutes and other attempts at financial re-

discretion to determine which investment opportunities may be presented to the residents of a state and which may not.[69] Regardless of how one feels about the merits of merit regulation, it must be acknowledged that it permits a type of intervention into private economic decisionmaking different from that permitted under the federal securities laws.

The basic difference between merit and disclosure regulation can be illustrated through a comparison of disclosure and merit approaches to the common problem of dilution. SEC regulation S-K,[70] which sets out the standard instructions for completing registration statements under the 1933 Act, treats the dilution resulting from the difference between the public offering price and the price previously paid by insiders entirely as a matter of disclosure:

> Where common equity securities are being registered and there is substantial disparity between the public offering price and the effective cash cost to officers, directors, promoters and affiliated persons of common equity acquired by them in transactions during the past five years, or which they have the right to acquire . . . there shall be included [in the prospectus] a comparison of the public contribution under the proposed public offering and the effective cash contribution of such persons.[71]

The dilutive effect on the public investors' equity of the disproportion between the public offering price and the price paid by insiders in previous transactions is thus obviously of substantial concern to the SEC,[72] but it is treated only as a matter for disclosure.

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form, see V. CAROSSO, *supra* note 55, at 165-92. The Securities Industry Association, the successor to the Investment Bankers Association, has maintained this tradition of opposing state merit regulation. *See Myriad of Approaches to Uniformity of State Regulation Urged at Hearing,* 15 Sec. Reg. & L. Rep. (BNA) 1737-38 (1983); *NASAA Adopts ULOE, Endorses Uniformity, Focuses on Threats to Merit Regulation,* 15 Sec. Reg. & L. Rep. (BNA) 1833-34. *See also* 18 Sec. Reg. & L. Rep. (BNA) 320 (1986).

69. In the words of one commentator, merit statutes "embrace the concept that the state has an interest in protecting its citizens from bad investments." Long, *State Securities Regulation: An Overview,* 32 OKLA. L. REV. 541, 548 (1979).

70. 17 C.F.R. § 229.10-.801 (1986).

71. 17 C.F.R. § 229.506 (1986). Item 506 provides further that:

> In such cases . . . the following shall be disclosed:
>
> (a) The net tangible book value per share before and after the distribution;
>
> (b) The amount of the increase in such net tangible book value per share attributable to the cash payments made by purchasers of the shares being offered; and
>
> (c) The amount of the immediate dilution from the public offering price which will be absorbed by such purchasers.

72. An important early manifestation of the SEC's concern with disclosure of price differential and dilution is In the Matter of Universal Camera Corp., 19 S.E.C. 648

This problem is handled very differently in merit jurisdictions. First of all, a merit administrator may be able to deny registration to an offering on fairness grounds if the amount of dilution of the public investors' equity is too high. A Wyoming regulation, for example, provides that in a "fair, just and equitable" offering of common stock, the offering price of the securities offered to the public shall not "result in excessive dilution . . . in the hands of the public."[73] The regulation does not specify how much dilution will be considered excessive, but the intent is clear. If there is too much dilution of the public investors' equity, registration in the state can be denied.

A disproportion between the public offering price and the promoters' price also may result in the promoters' stock being characterized as "cheap stock."[74] If the stock is so characterized, effectiveness may be tied to a reduction of the offering price or of the amount of cheap stock to be outstanding after the offering. A Missouri regulation demonstrates why this may be the case.[75]

The regulation begins by defining cheap stock as

> [s]ecurities sold or issued to promoters or underwriters for a consideration substantially different from the public offering price within two years before the filing of the [Missouri] registration statement, and securities sold or issued to any persons for a consideration other than cash within two . . . years of the filing of the registration statement, or to be sold or issued to such persons . . . .[76]

After defining cheap stock, the regulation goes on to state that "[r]egistration of equity securities . . . where cheap stock has been or will be issued may be looked upon with disfavor as substantially unfair, unjust, inequitable or oppressive . . . ."[77] With this general principle stated, the regulation then provides an escape hatch by declaring that "[c]heap stock is presumed to be justified"[78] if the fol-

(1945). For discussion of the importance of this case to the SEC's current disclosure policies, see T. HAZEN, THE LAW OF SECURITIES REGULATION 73-75 (1985).

73. Reg. Wyo. Sec. Div., ch. V, § 3(f), *reprinted in* 3 Blue Sky L. Rep. (CCH) ¶ 66,433, at 57,505-06 (Apr. 1987).

74. For a critical discussion of state cheap stock requirements, see *Report on State Merit Regulation*, *supra* note 2, at 839-43; *cf.* Tyler, *More About Blue Sky*, 39 WASH. & LEE L. REV. 899, 912-13 (1982) (defending state cheap stock limitations).

75. MO. CODE REGS. § 30-52.070, *reprinted in* 2 Blue Sky L. Rep. (CCH) ¶ 35,457 (Feb. 1987).

76. MO. CODE REGS. § 30-52.070(1), *reprinted in* 2 Blue Sky L. Rep. (CCH) ¶ 35,457 (Feb. 1987).

77. *Id.*

78. *Id.*

lowing conditions (*inter alia*) are met.

> The number of shares of cheap stock does not exceed fifty per cent . . . of the shares (including shares issuable upon conversion) to be outstanding at the completion of the public offering which is the subject of the application . . . [and] [t]he price paid per share for the shares of cheap stock is at least fifty per cent . . . of the public offering price per share.[79]

In order for the public offering to be registered in Missouri, therefore, it may be necessary to make a downward adjustment of the public offering price or the amount of stock being offered.

The merit administrator may wish not only to limit the amount of cheap stock, but also to require the remaining amount of cheap stock to be escrowed for a period of years, with the stock to be cancelled at the end of that period unless the corporation's earnings or the stock's market price reach specified levels.[80] The Texas provision defines the administrator's escrow authority in general terms:

> In circumstances in which there is substantial disparity between the consideration paid or to be paid for such securities by promoters and the public offering price, the Commissioner may require as a condition to the registration of securities an escrow of all or part of the securities issued to such promoters under an agreement providing for the impoundment of such securities for a reasonable period of time, subject to such conditions as the Commissioner may require which may include, in the discretion of the Commissioner, cancellation of the securities if the conditions for release from escrow are not attained.[81]

This Texas regulation, like the Wyoming and Missouri regulations just quoted, shows that the necessity to comply with merit requirements can lead to substantial changes in the fundamental terms of the offering.

This comparison of the state and federal approaches to dilution and cheap stock, furthermore, proves the point that there is in fact a

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79. MO. CODE REGS. § 30-52.070(1)(B), (C), *reprinted in* 2 Blue Sky L. Rep. (CCH) ¶ 35,457, at 30,530 (Feb. 1987).

80. For examples of such "earn-out" provisions, see NASAA g Statement of Policy, Cheap Stock § III, NASAA Reports (CCH) ¶ 804 (Apr. 23, 1987). This statement of policy has been intensely controversial and is in the process of revision. *See Report on State Merit Regulation*, *supra* note 2, at 839-43.

81. TEX. ADMIN. CODE tit. 7, § 113.3(5), *reprinted in* 3 Blue Sky L. Rep. (CCH) ¶ 55,574, at 49,519 (Dec. 1986).

real difference between disclosure and merit regulation.[82] In brief, the primary goal of merit regulation is to affect directly economic behavior, and not just the disclosure of information about that behavior.

B. Points of Connection

The epigram quoted at the beginning of this section suggests, however, that the differences may not be as profound as the foregoing discussion may indicate, and that there are significant points of connection. This may be demonstrated, first of all, by reexamining the goals of federal disclosure regulation.

The avowed goal is timely disclosure of the information investors need to make informed decisions about purchasing securities, granting proxies, or tendering shares. By mandating such disclosure, the law attempts to redress the informational imbalance between promoters and investors. The assumptions implicit in this goal, of course, are not without question and have indeed been harshly criticized.[83] The effects of the federal mandatory disclosure system, however, cannot be defined (or criticized) solely in terms of the goal of producing informed individual investors. The federal disclosure system also has a substantive or normative impact on economic behavior.

For example, one of the effects of required compliance with a mandatory disclosure system is the creation of incentives to forego, rescind, or restructure transactions or relationships that cannot stand the light of day. As part of the "house cleaning" needed before any company goes public,[84] unproductive, inequitable, or simply embarrassing self-dealing transactions between insiders and the company may be eliminated. Similarly, compensation policies may be revised and stock option programs rationalized and made more equitable. The management team may be improved through the addition of new board members whose names will strengthen the prospectus. Admittedly, these effects are largely marginal, but they are nevertheless real, and they show that disclosure regulation

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82. Professor Loss draws a similar comparison between federal disclosure and state merit approaches to the issuance of options. L. LOSS, FUNDAMENTALS, *supra* note 30, at 36-37.

83. *See* authorities cited *infra* note 147.

84. For practitioners' descriptions of this "house-cleaning" process, see Simons, *Pre-Offering Planning*, in PRACTISING LAW INSTITUTE, HOW TO PREPARE AN INITIAL PUBLIC OFFERING 59-64 (1986); A. Sachs, *Complex Capital Structures, IPO Housekeeping and Blue Sky Issues* 2-17 (unpublished manuscript on file with the *Maryland Law Review*).

can influence the way economic entities behave as well as what they disclose.

The goal of altering behavior has perhaps been more clear-cut, and certainly more self-conscious, under the 1934 Act. In the late 1970s the SEC used its control over proxy solicitation as a means of encouraging reform of corporate governance.[85] Nothing in the federal securities laws gave the SEC direct jurisdiction over the composition or functioning of boards of directors or any other corporate governance mechanisms, but as a result of its own experience with questionable payments cases[86] and the general agitation over corporate social responsibility,[87] the SEC began to explore ways in which it could influence substantive change in corporate governance.

The SEC's efforts in this area did not have a decisive effect on corporate governance, since expression of its most serious concerns seldom proceeded beyond the level of public hearings and hortatory statements.[88] The SEC did, however, use its control over the proxy disclosure mechanism to require more detailed disclosures concerning the independence of boards of directors, thereby creating incentives for the use of independent directors.[89] Similarly, the agency's

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85. For a generally favorable discussion of the impact of this and other SEC programs and policies on corporate governance, see M. STEINBERG, CORPORATE INTERNAL AFFAIRS 13-72 (1983) [hereinafter M. STEINBERG, INTERNAL AFFAIRS]. For generally critical discussion, see R. KARMEL, REGULATION BY PROSECUTION, THE SECURITIES AND EXCHANGE COMMISSION VERSUS CORPORATE AMERICA 139-86 (1982); Kripke, *The SEC, Corporate Governance, and the Real Issues*, 36 BUS. LAW. 173 (1981); Wolfson, *A Critique of the Securities and Exchange Commission*, 30 EMORY L.J. 119 (1981). For an argument that the SEC's corporate governance initiatives were insufficiently responsive to the need for fundamental reform, see J. SELIGMAN, TRANSFORMATION, *supra* note 54, at 534-51.

86. *See generally* SECURITIES AND EXCHANGE COMMISSION, REPORT ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES, SUBMITTED TO THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 94th Cong., 2d Sess. (Comm. Print 1976). For discussion of the SEC's experience in this area, see M. STEINBERG, INTERNAL AFFAIRS, *supra* note 85, at 55-59, 105-08.

87. There is an enormous literature on the legal structures of corporate social responsibility, whether that responsibility is defined in terms of accountability to shareholders, other corporate constituencies, or society at large. *See, e.g.*, R. NADER, M. GREEN & J. SELIGMAN, TAMING THE GIANT CORPORATION (1976); C. STONE, WHERE THE LAW ENDS (1975); Coffee, *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099 (1977); Goldschmid, *The Greening of the Boardroom: Reflections on Corporate Responsibility*, 10 COLUM. J.L. & SOC. PROBS. 15 (1973). For discussion of the SEC's response to this movement, see Seligman, *The Securities and Exchange Commission and Corporate Democracy*, 3 U. DAYTON L. REV. 1 (1978).

88. For discussion of the hortatory character of the SEC's activities during this period, see J. SELIGMAN, TRANSFORMATION, *supra* note 54, at 548-51; M. STEINBERG, INTERNAL AFFAIRS, *supra* note 85, at 18-28.

89. *See generally* Rules on Shareholder Communications, Exchange Act Release No. 15,384, [1978-1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,766 (Dec. 6, 1978)

use of its enforcement powers to force disclosure of questionable payments created strong incentives for the abandonment of that practice.[90] The SEC also responded to the concern for corporate social responsibility by institutionalizing and to some extent liberalizing the process by which shareholders could force corporate management to include their shareholder proposals—usually relating to social or political concerns—in management proxy statements.[91] In short, the SEC's corporate governance initiatives demonstrated how control over corporate disclosure could be used to affect corporate behavior.[92] The SEC stopped short of exerting all of the disclosure system's potential leverage, and the post-1980 Commission has shown no inclination to resume the corporate governance initiative in its most obvious form, but the essential point should be clear: the SEC's disclosure-based regulatory system has been used to effect substantive change in private economic relationships and prospectively to influence corporate behavior.

Disclosure regulation as practiced by the SEC, therefore, cannot be described as purely antithetical to merit regulation. The normative goals and effects of this mandatory disclosure system show that merit and disclosure, to some extent, occupy relative positions on a single regulatory continuum. The functional relationship of

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(requiring full disclosure of relationships between individual directors and the corporation). Note that the SEC also influenced the composition of corporate boards through enforcement actions that resulted in the restructuring of corporate boards to include a majority of nonmanagement directors and to establish independent audit committees. M. STEINBERG, INTERNAL AFFAIRS, *supra* note 85, at 31.

90. *See* J. SELIGMAN, TRANSFORMATION, *supra* note 54, at 539-44.

91. For discussion of the background to these developments and a defense of the use of the SEC's proxy rules to facilitate dissemination of shareholder proposals of a social or political character, see Schwartz, *Towards New Corporate Goals: Co-existence with Society*, 60 GEO. L. J. 57 (1971); Schwartz, *The Public-Interest Proxy Contest: Reflections on Campaign GM*, 69 MICH. L. REV. 421 (1971); Schwartz, *Proxy Power and Social Goals—How Campaign GM Succeeded*, 45 ST. JOHN'S L. REV. 764 (1971). For critiques of these rules, see Dent, *SEC Rule 14a-8: A Study in Regulatory Failure*, 30 N.Y.L. SCH. L. REV. 1 (1985); Liebler, *A Proposal to Rescind the Shareholder Proposal Rule*, 18 GA. L. REV. 425 (1984). The SEC's current shareholder proposal rule is 17 C.F.R. § 240.14a-8 (1986).

92. Something like this point has been noticed by other commentators. *See* M. STEINBERG, INTERNAL AFFAIRS, *supra* note 85, at 29 ("the Commission's disclosure polices . . . have not only had an effect of deterring unlawful or questionable conduct but have played a positive role in influencing the establishment of improved standards of conduct"); R. STEVENSON, CORPORATIONS AND INFORMATION—SECRECY, ACCESS AND DISCLOSURE 81-82 (1980) ("Today the disclosure requirements of the securities laws are used, in a variety of ways, for the explicit purpose of influencing a wide range of corporate behavior . . . ."); Weiss, *Disclosure and Corporate Accountability*, 34 BUS. LAW. 575 (1979) ("one of the central themes of the system by which large corporations are governed [is] that corporate decision-making be regulated through mandatory disclosure requirements rather than direct government intervention").

disclosure and merit regulation in state regulatory systems demonstrates this point even more clearly.

Disclosure regulation is used in connection with a merit review in at least three different ways. First, the administrator may require structuring or restructuring of the terms of the offerings or associated transactions to ensure compliance with a specific merit standard, and then mandate specific explanation in the prospectus of the steps taken to bring the offering into compliance. Compliance with merit regulation, thus, may generate material information that will have to be disclosed.[93] Second, an administrator may waive compliance with either a specific or a general merit standard on the condition that full disclosure of the facts and circumstances constituting the noncompliance is provided. In other words, the result of the negotiations between the administrator and counsel may be a disclosure solution to a merit problem.[94] Third, a state administrator may simply engage in a full-scale disclosure review, with or without particular reference to merit concerns, resulting in disclosure requirements additional to SEC requirements.[95]

Each of these three varieties of state disclosure regulation will receive more detailed consideration in Part III. Let it suffice to say for now, however, that the state administrators' use of these techniques shows that in state securities regulation, merit and disclosure reviews are used together in a highly complementary fashion.

III. THE VARIETIES OF STATE DISCLOSURE REGULATION

A. *Disclosure of Material Information Generated by Merit Compliance*

The most traditional, and perhaps least controversial, state disclosure obligations are those generated by compliance with merit requirements. In essence, the substantive structuring or restructuring of economic relationships in response to merit standards may create material information that needs to be disclosed. Examples in point are the disclosures incident to compliance with cheap stock restrictions.

The existence of cheap stock and the promoters' commitment to place all or some of their stock in escrow subject to "earn out" or other requirements ordinarily will be regarded as items of material information. It will usually be disclosed by including in the prospectus an undertaking or warranty expressing the promoters' agree-

93. *See infra* text accompanying notes 96-111.
94. *See infra* text accompanying notes 112-124.
95. *See infra* text accompanying notes 125-134.

ment to the escrow arrangement and describing the arrangement. This document thus serves as both a legally binding commitment and a disclosure of that commitment. Furthermore, some additional discussion will be required in the narrative portions of the prospectus when there are substantial amounts of cheap stock, or when the administrator has some concern about the escrow arrangement.[96]

Another example of the relationship between disclosure and merit requirements can be found in the treatment of the so-called "democracy" provisions of the Statements of Policy (or "guidelines") promulgated by the North American Securities Administrators Association (NASAA) for real estate, oil and gas, and equipment programs.[97] The guidelines are detailed sets of standards and requirements adopted by NASAA and implemented by some of its members either formally as state rules or on an informal basis.[98] Most of the standards and requirements are "merit" in character, in the sense that they expressly prohibit or limit specified types of economic relationships, with the main goal of controlling the many ways in which the program promoter or sponsor can hedge or eliminate its risk while leaving the public investor subject

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96. For example, a risk-factor or "certain factors" section of the prospectus might include language to this effect:

> Mr. [CEO] also has agreed to escrow a total of 1,000,000 shares of Common Stock of [Issuer] representing 50% of the ownership in [Issuer]. Such shares are subject to release only if the market price of the Common Stock reaches and maintains certain minimum levels in the future or if [Issuer] achieves certain levels of cumulative pretax earnings. Any shares not released will revert back to [Issuer].

97. NASAA Statement of Policy, Real Estate Programs § VII, NASAA Reports (CCH) ¶ 3607 (Nov. 20, 1986); NASAA Statement of Policy, Registration of Oil and Gas Programs § VIII, NASAA Reports (CCH) ¶ 2608 (July 1, 1984); NASAA Statement of Policy, Equipment Programs § VI, NASAA Reports (CCH) ¶ 1606 (Nov. 20, 1986).

NASAA is an organization comprised of securities regulators from sixty-five jurisdictions located in the United States, Puerto Rico, Canada, and Mexico. NASAA is not itself a regulatory entity. NASAA Reports (CCH) ¶ 1 (1986).

98. For surveys of the state-to-state implementation of the real estate and oil and gas guidelines, see Subcommittee on Real Estate Programs, ABA State Regulation of Securities Committee, Survey on State Implementation and Application of the Current NASAA Real Estate Guidelines (Apr. 1, 1986); Subcommittee on Oil and Gas Programs, ABA State Regulation of Securities Committee, Survey on State Implementation and Application of the NASAA Statement of Policy for Registration of Oil and Gas Programs (Apr. 1, 1986). For discussion of the three sets of guidelines, see Gruber, Johnson & Walker, *The Equipment Guidelines and Proposed Amendments*, 41 BUS. LAW. 1545 (1986); Lanctot & Harris, *Recent Developments in State Regulation of Public Real Estate Securities Offerings*, 41 BUS. LAW. 1533 (1986); Strahota, *Oil & Gas Program Offerings*, 17 REV. SEC. REG. 811 (1984).

to the risks of the enterprise.[99] The guidelines thus include comprehensive limitations on promoter compensation,[100] affiliate transactions,[101] "promotional interests,"[102] and a wide variety of other practices. They also contain requirements, such as the democracy provisions, that attack more indirectly the sponsor's perceived tendency toward opportunistic behavior.

The democracy provisions are intended to give the participants a voice in the governance of the program. Accordingly, they require that each participant be granted access to the list of participants and to the program's books and records,[103] and that participants holding more than ten percent of the outstanding interests be allowed to call meetings of the program.[104] The participants also must have the authority to amend the limited partnership agreement (if the program is a limited partnership), dissolve the program, replace the sponsor, and approve the sale of all or substantially all of the program's assets.[105] Programs that wish to qualify their securities offerings in jurisdictions applying the NASAA guidelines thus must provide their participants at least these governance rights, none of which are mandated by federal law.

The program prospectus must disclose the adjustments in their governance structure made in response to these state merit requirements. This disclosure is made primarily in the limited partnership agreement, the document that gives legal effect to these arrangements. Some discussion of the participant's governance rights, furthermore, ordinarily will be found in the narrative section of the prospectus. Substantive compliance with the democracy provisions of the NASAA guidelines, like compliance with state cheap stock re-

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99. *See Report on State Merit Regulation*, *supra* note 2, at 825; Makens, *supra* note 33, at 444-45.

100. *E.g.*, NASAA Statement of Policy, Registration of Oil and Gas Programs § V, NASAA Reports (CCH) ¶ 2605 (July 1, 1984) ("Fees, compensation and expenses")

101. *E.g.*, NASAA Statement of Policy, Equipment Programs § V, NASAA Reports (CCH) ¶ 1605 (Nov. 20, 1986) ("Conflicts of interest and investment restrictions").

102. *E.g.*, NASAA Statement of Policy, Real Estate Programs § IV.E, NASAA Reports (CCH) ¶ 3604 (Nov. 20, 1986). A "promotional interest" is an equity interest in the program received by the sponsor in consideration for its promotional services. The Statement of Policy permits such an interest provided that the amount or percentage of the interest is "reasonable," and sets out a complex formula for determining when the interest is "presumptively reasonable." *Id.*

103. *E.g.*, NASAA Statement of Policy, Registration of Oil and Gas Programs § VIII.C, NASAA Reports (CCH) ¶ 2608 (July 1, 1984).

104. *E.g.*, NASAA Statement of Policy, Real Estate Programs § VII.A, NASAA Reports (CCH) ¶ 3607 (Nov. 20, 1986).

105. *E.g.*, NASAA Statement of Policy, Equipment Programs § VI.B, NASAA Reports (CCH) ¶ 1606 (Nov. 20, 1986).

strictions, thus is a means of generating material information that must be fully disclosed.

A final example of the affirmative obligation to disclose material information generated by merit compliance can be found in a Minnesota regulation governing insider loans.[106] This regulation begins in a pure disclosure mode by requiring detailed disclosure in the prospectus of all loans by the issuer to officers, directors, employees, and principal shareholders outstanding as of one year prior to the application for registration.[107] The regulation then imposes a substantive requirement: the issuer must agree that all such loans will be repaid within one year from the date of registration.[108] That substantive requirement, however, is coupled with a disclosure requirement, since the commitment to repay the loan must be disclosed in the prospectus.[109] Finally, the regulation concludes with a requirement for disclosure of a substantive undertaking, by mandating that the prospectus contain language to the effect that:

> [t]he company has agreed with certain state regulatory authorities that so long as the company's securities are registered in such states, or one year from the date of this (prospectus) . . . whichever is longer, the company will not make loans to its officers, directors, employees or principal shareholders, except for loans made in the ordinary course of business . . . .[110]

The Minnesota regulation, therefore, demands that the issuer undertake not to make loans to insiders for at least a year, and then mandates specific disclosure of that information—information the administrator has, by rule, deemed material.[111]

The affirmative disclosure obligations created by the alteration of economic relationships in response to merit standards are neither new nor particularly controversial. They are an inevitable by-product of a system that requires both disclosure of all material information and compliance with substantive standards of fairness. They demonstrate, in a relatively simple way, the interdependent relationship of the two regulatory techniques. A more complex aspect of

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106. MINN. R. 2875.3060, *reprinted in* 1A Blue Sky L. Rep. (CCH) ¶ 33,499 (June 1984).

107. *Id.* Subpart 1.

108. *Id.* Subpart 2.

109. *Id.*

110. *Id.* Subpart 3.

111. For a similar mixture of merit and disclosure techniques in the regulation of insider loans, see Ohio Commissioner of Securities, *Insider Loans Policy*, 2 Blue Sky L. Rep. (CCH) ¶ 45,709 (May 1986).

that relationship, however, is reflected in the development of disclosure solutions to merit problems.

B. *Disclosure Solutions to Merit Problems*

In some instances, a state administrator may have specific merit concerns with the fairness of an offering, but will choose to address the problem through specific disclosure rather than requiring alteration of the substantive terms of the offering or associated transactions. This can be described as a disclosure solution to a merit problem, because the state's objection to a particular aspect of the offering flows from its preoccupation with fairness to the investor, but resolution of the problem is achieved through specifically mandated disclosure rather than through mandatory restructuring of the offer, the issuer, or associated transactions. Cases in which this occurs are thus distinguishable from those described in the previous section, when *both* compliance with some substantive standard and disclosure of that fact are required. The line between "merit" and "disclosure" is less distinct in these cases, as a recent policy statement by the Ohio Commissioner of Securities on "blank check" preferred stock shows.[112]

This policy statement defines the status under Ohio securities law of that popular form of shark repellent:

> A proposed public offering of securities to be made by an issuer which has or proposes to have preferred stock issued or issuable with rights, preferences, and privileges to be determined by the Board of Directors without further action by stockholders is presumed to be grossly unfair unless the final offering circular prominently discloses within the description of such preferred stock that "the Board of Directors without shareholder approval can issue preferred stock with voting and conversion rights which could adversely affect the voting power of the common shareholders."[113]

The blending of merit and disclosure concepts in this policy statement is remarkably explicit. The policy statement's reference to the "grossly unfair" character of blank-check preferred stock reflects this merit jurisdiction's traditional concern with substantive fairness,[114] but the statement does not require redemption of the stock

112. Ohio Commissioner of Securities, *Blank-check preferred policy*, 2 Blue Sky L. Rep. (CCH) ¶ 45,708 (May 1986).

113. *Id.* at 40,603.

114. *See* OHIO REV. CODE ANN. § 1707.13 (Anderson 1985) (stating fairness standard

as a condition of registration, as might be expected. It merely provides that the offering will be deemed "grossly unfair" unless the disclosure document clearly explains what the board may do with such stock. In essence, the Ohio Commissioner stopped short of applying the full weight of his merit authority, which would have permitted denial of registration to the offering, and remained content with requiring specific disclosure of the magnifying impact of the "blank check" preferred stock on the board's authority.[115] In short, the policy statement propounds a disclosure solution to a merit problem.

This approach to blank-check preferred stock and other forms of shark repellent has become popular in other jurisdictions, which tend to apply an Ohio-type disclosure requirement, even without adoption of an express rule or policy statement.[116] The reliance on a disclosure solution to this particular merit problem perhaps demonstrates an understandable, and highly politic, reluctance on the part of some states to challenge directly the broad movement among public issuers toward the adoption of this and other types of shark repellents.[117] Any attempt to influence these sensitive areas of corporate governance and control through the imposition of merit requirements would at least generate significant controversy, if not political or legal challenge, as the fate of the first-generation state takeover statutes shows.[118] States using the Ohio approach to shark repellents, therefore, are attempting to vindicate their merit

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for suspension or revocation of securities registration). *See also* Commissioner's Letter, OHIO SEC. BULL., Oct. 1986, at 2, 3 (describing the Division of Securities' concern with risky offerings).

115. The Ohio Commissioner of Securities has adopted a similar statement of policy with respect to public offerings by issuers with classes of stock possessing unequal voting rights, another common form of shark repellent. Ohio Commissioner of Securities, *Subordinate voting rights policy*, 2 Blue Sky L. Rep. (CCH) ¶ 45,707 (May 1986).

116. It is not necessary to identify the individual states that tend to apply this requirement. As of this writing, it is fair to say that most active merit jurisdictions will at least comment on the issue. They may differ, however, in the type of disclosure they will require with respect to the preferred stock. Some may require a simple statement to the effect that "the issuance of such stock may adversely affect the rights of the common shareholders." Others may require a more detailed explanation of the effect.

117. For analysis of the practical and policy implications of the various forms of shark repellent, see Finkelstein, *Antitakeover Protection Against Two-Tier and Partial Tender Offers: The Validity of Fair Price, Mandatory Bid, and Flip-Over Provisions under Delaware Law*, 11 SEC. REG. L.J. 291 (1984); Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775 (1982); Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred*, 97 HARV. L. REV. 1964 (1984).

118. For a discussion of the devastating impact of constitutional challenges on the first-generation state takeover statutes, see authorities cited *supra* note 15.

concerns, to the greatest extent possible, by imposing specific disclosure requirements.

The use of disclosure solutions to merit problems is not confined to the highly political and sensitive area of corporate governance and shark repellents. Disclosure solutions are often used in the ordinary negotiations among administrators and counsel over more mundane aspects of corporate initial public offerings and limited partnership programs. These negotiations are a process of give-and-take, and as part of that process, the administrator may choose to waive strict compliance with some specific merit standard on the condition that specific disclosure of the facts associated with the merit problem is made. Insider loans are a case in point. The administrator may have the authority, as under the Minnesota regulations described above,[119] to require repayment of the outstanding loans as a condition of registration. If the administrator can be persuaded, however, that the terms of the loans were reasonable, that their repayment would cause undue hardship, or that their effect on the issuer's financial position is not substantial, the administrator may forebear from demanding repayment, and may be satisfied by detailed disclosure of the loan.

Disclosure solutions of this kind are particularly important under the NASAA guidelines for limited partnership programs, which contain very specific limitations, usually expressed in quantitative terms, on many different aspects of the transactions.[120] The real estate guidelines, for example, set out a complex formula for determining the precise percentage of capital contributions that must be invested in properties rather than paid to the sponsor as front-end fees.[121] Similarly, there are specific quantitative limitations on the promotional interests that may be allowed to the sponsor and on property management and other fees that may be paid to the sponsor or its affiliates.[122] Administrators tend to enforce these limitations strictly, but they can sometimes be persuaded to waive strict compliance if they are satisfied that the terms of the offering, in the aggregate, are fair and if the issuer will disclose its noncompliance with the guideline's specific limitations.

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119. *See supra* text accompanying notes 106-11.

120. *See supra* notes 100-102.

121. NASAA Statement of Policy, Real Estate Programs § IV.C, NASAA Reports (CCH) ¶ 3604 (Dec. 1986). For discussion of the regulatory premises of the compensation sections of the real estate guidelines, see Makens, *supra* note 33, at 443-47.

122. NASAA Statement of Policy, Real Estate Programs §§ IV.D-I, NASAA Reports (CCH) ¶ 3604 (Dec. 1986).

It is virtually impossible to determine how frequently blue sky negotiations produce this result, or whether reliance on such disclosure solutions is increasing. It is probably fair to say, however, that the political and philosophical difficulties of dealing with the recent proliferation of shark repellents have caused at least some states to rely more heavily on disclosure as a means of addressing their merit concerns with governance issues. It is also possible that the threat of political assaults on merit regulation, such as those in Iowa, Illinois, Louisiana, and Texas,[123] has led some administrators to search for practical solutions that fall short of merit regulation in its full rigor and glory.[124]

In any event, the use of disclosure solutions to merit problems is perhaps the best illustration of the non-antithetical relationship of merit and disclosure regulation. It should also be recognized, however, that state administrators also engage in disclosure regulation for its own sake, without particular reference to merit concerns.

C. *Disclosure for Disclosure's Sake*

While merit regulation has long been state securities regulation's most distinctive characteristic, it has also long had a disclosure component. State administrators possess the statutory authority to deny effectiveness to a registration statement if it contains omissions or misrepresentations of material fact,[125] and many state laws require the delivery of a prospectus to all purchasers within the state.[126] The state administrators are particularly concerned with the level of disclosure in state-registered offerings not registered with the SEC. They often impose detailed disclosure requirements on such offerings, as is demonstrated by the many pages of detailed requirements for non-SEC-registered offerings contained in the NASAA oil and gas guidelines.[127] With respect to SEC-registered offerings, state administrators will to some extent be satisfied by the issuer's compliance with SEC disclosure require-

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123. For discussion of these political developments, see Sargent, *Challenge*, *supra* note 2.

124. For discussion of some other examples of such solutions, see *Report on State Merit Regulation*, *supra* note 2, at 801-04.

125. *See* UNIF. SEC. ACT § 306(a)(2)(A).

126. *See, e.g.*, IOWA ADMIN. CODE r. 510-50.27(502), *reprinted in* 1A Blue Sky L. Rep. (CCH) ¶ 25,427 (Aug. 1983); MD. CORPS. & ASS'NS CODE ANN. §§ 11-502(c), -504(d) (1985); WIS. ADMIN. CODE § SEC 3.23, *reprinted in* 3 Blue Sky L. Rep. (CCH) ¶ 64,543 (Dec. 1985).

127. NASAA Statement of Policy, Registration of Oil and Gas Programs § X.C, NASAA Reports (CCH) ¶ 2610 (July 1, 1984).

ments, but they are fully prepared to conduct an independent disclosure review.

The NASAA real estate guidelines, for example, provide that "[t]he prospectus shall meet the requirements of Guide 5 . . . of the Securities and Exchange Commission,"[128] which prescribes the contents of the prospectus to be used in connection with federal registration of real estate limited partnership programs.[129] The guidelines go on to state, however, that "[t]he administrator may require additional disclosure if, in the administrator's opinion, specific facts concerning the offering require it."[130]

The real estate guidelines also impose specific requirements for the disclosure of forecasts.[131] The guideline provisions relating to forecasts prohibit their use in connection with nonspecified property or "blind pool" programs, define categories of "material information" required to be included in the forecast, and prescribe the method of presentation.[132] In short, the real estate guidelines, as well as those developed for other types of programs,[133] are examples of an indigenous state tradition of disclosure regulation.

This regulatory tradition is not unique to limited partnership program offerings. Some states will engage in an independent disclosure review of corporate equity offerings and will provide a full set of disclosure comments. These comments can range over a broad variety of issues, from those with direct merit implications such as insider loans or cheap stock, to matters such as the status of pending litigation, the use of proceeds, the potential impact of reorganization in Delaware, or the qualifications of management. Pursuant to this disclosure review, the administrators may require disclosures additional to or different from those required by the SEC. They may, in particular, require more extensive disclosure and highlighting of risk factors for the benefit of the "average" investor. The administrator may, for example, require language stating simply that "these are speculative securities." The key characteristic of this form of disclosure regulation, however, is that

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128. NASAA Statement of Policy, Real Estate Programs § VIII.B, NASAA Reports (CCH) ¶ 3608 at 2032 (Nov. 20, 1986).

129. SEC Guide 5, Preparation of Registration Statements Relating to Interests In Real Estate Limited Partnerships, 1 Fed. Sec. L. Rep. (CCH) ¶ 3829 (Sept. 1982).

130. NASAA Statement of Policy, Real Estate Programs § VIII.B, NASAA Reports (CCH) ¶ 3608 (Nov. 20, 1986).

131. *Id.* § VIII.C.

132. *Id.* at 2033.

133. *See* NASAA Statement of Policy, Equipment Programs § VII.B, NASAA Reports (CCH) ¶ 1607 (Nov. 20, 1986).

the administrators are pursuing disclosure for disclosure's sake, and not purely in connection with the pursuit of their specific, traditional merit concerns.

As will be explained below, compliance with multistate disclosure reviews can be difficult and costly, especially if the net result is amendment of the prospectus or the preparation of several single-state supplements (usually in the form of special inserts or "stickers"). The states' interest in this type of "pure" disclosure regulation, furthermore, seems to be growing, perhaps in response to the administrators' perception that the SEC is devoting fewer resources to the review of registration statements.[134]

Be that as it may, it is fair to say that state disclosure regulation in general has become an important aspect of state securities regulation. It has also become a complex phenomenon, since the lines of distinction among the three varieties of state disclosure regulation can sometimes waver, and all three varieties are used simultaneously in connection with most offerings. For example, a state review of a corporate initial public offering may lead to: (i) a mandatory cheap-stock escrow arrangement that will have to be explained in the prospectus (disclosure of material information generated by merit compliance); (ii) a decision by the administrator to allow questionable loans to the chief executive officer to remain outstanding, provided that a detailed discussion of the loan is contained in the prospectus (a disclosure solution to a merit problem); and (iii) revision of the prospectus to set forth a more comprehensive discussion of risk factors (disclosure for disclosure's sake). The results of this review, therefore, reflect the impact of a multileveled system of disclosure regulation rendered more complex by its interaction with both state merit concerns and federal disclosure requirements. It is from the perspective of this interaction that the state system of disclosure regulation should be evaluated.

IV. A CRITICAL EVALUATION

State securities regulation, in general, has always been controversial. It has been challenged in the courts on constitutional

134. *See, e.g.*, Commissioner's Letter, OHIO SEC. BULL., Oct. 1986, at 2 ("Popular conception has it that the SEC is a powerful and dynamic watchdog of the securities markets and guardian of the public interest; however, in 1985 the SEC reviewed only 60% of first time offerings and only 25% of repeat offerings."); D. Bell, Remarks at 1986 Annual Meeting of NASAA 12 (unpublished transcript on file with the *Maryland Law Review*) ("Further[,] the diminishing SEC role is adding more incentive for expanding state regulation.").

grounds,[135] attacked in the state legislatures,[136] and vehemently criticized in the academic literature.[137] Most of the controversy has centered around merit regulation, for obvious reasons. The vast amount of discretion lodged in the merit administrator, the inherent subjectivity of the "fair, just, and equitable" standard, the elusive quality of specific merit standards, the disproportionate influence of individual state requirements on national public offerings, and the highly paternalistic character of the regulatory technique have all helped generate confusion, frustration, and resentment.[138] State disclosure regulation per se has never generated that kind of emotional response, or anything like the amount of controversy.

There is no mystery in this difference. To a large extent the failure to distinguish state disclosure regulation from merit regulation for purposes of criticism reflects the peculiar character of state securities regulation—a complex, functional intertwining of merit and disclosure techniques in a single regulatory system. Criticism of "merit regulation," therefore, should also be regarded as criticism of the disclosure component of that regulatory system. The failure also reflects the basic fact that the imposition of affirmative disclosure obligations is usually less obtrusive than the imposition of substantive requirements on the offering. These explanations, however, should not obscure the need for critical evaluation of state disclosure regulation. State disclosure regulation is problematic from both practical and policy perspectives, and it is likely to become more problematic as the state administrators' interest in this form of regulation grows.

A. *The Practical Problem*

The practical problem with state disclosure regulation is a consequence of the stresses inherent in an overlapping state-federal regulatory system. In a national or multistate public offering there is invariably a single prospectus, drafted largely if not entirely in

135. For discussion of the constitutional status of state securities regulation, see Warren, *Reflections on Dual Regulation of Securities: A Case Against Preemption*, 25 B.C.L. REV. 495, 501-14 (1984).

136. *See generally* Sargent, *Challenge*, *supra* note 2.

137. *See* Bateman, *State Securities Registration: An Unresolved Dilemma and a Suggestion for the Federal Securities Code*, 27 SW. L.J. 759 (1973); Bloomenthal, *Blue Sky Regulation and the Theory of Overkill*, 15 WAYNE L. REV. 1447 (1969); Campbell, *An Open Attack on the Nonsense of Blue Sky Regulation*, 10 J. CORP. L. 553 (1985); Mofsky & Tollison, *Demerit in Merit Regulation*, 60 MARQ. L. REV. 367 (1977).

138. For analysis of these issues, see *Report on State Merit Regulation*, *supra* note 2, at 832-45.

accordance with the SEC's specific disclosure rules and with a vivid awareness of potential liability under section 11 of the 1933 Act.[139] Drafting the prospectus is ordinarily a team effort, requiring significant contributions from issuer's and underwriter's counsel, accountants and other experts, and issuer management, all of whom approach the task with a desire to establish their own due diligence, while producing a document that will survive an SEC review.[140] The result is a document that has been thoroughly negotiated after many weeks of effort and that reflects the parties' considered judgment of which information is material and which is not.

Submission of this document to the SEC, of course, usually results in some revision and amendment, at least in the case of initial public offerings. This can create delays and additional expense, but the process has been institutionalized through a letter of comment process in which problems are resolved through negotiation.[141] Revision of the prospectus to reflect the concerns expressed in the single federal review process thus is workable so long as the process is administered on the basis of nonarbitrary standards and requirements. Difficulties arise, however, when that single document is subjected to multiple disclosure reviews in several jurisdictions. By their very nature, multiple disclosure reviews can make the registration process more difficult and expensive.

In order to satisfy the differing requirements of several state examiners, this carefully balanced disclosure document may have to be partially rewritten or festooned with single-state "stickers," each setting out the different language required to be delivered to investors in individual states. In some cases, furthermore, the disclosures required by an individual state may be regarded as so burdensome

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139. 15 U.S.C. § 77k (1982).

140. For practitioners' discussions of the roles of the different participants in the complex process of drafting an SEC registration statement, see Sonsini, *Preparing the Registration Statement*, in 1 SECURITIES LAW TECHNIQUES § 19.01 (A. Sommer, Jr. ed. 1987); Schneider, Manko & Kant, *Going Public: Practice, Procedure, and Consequences*, 27 VILL. L. REV. 1 (1981); Wheat & Blackstone, *Guideposts for a First Public Offering*, 15 BUS. LAW. 539 (1960). For discussion of the concept of "due diligence" as a defense to § 11 liability and its practical implications for the drafting of registration statements, see H. BLOOMENTHAL, C. HARVEY & S. WING, 1986 GOING PUBLIC HANDBOOK, GOING PUBLIC, THE INTEGRATED DISCLOSURE SYSTEM AND EXEMPT FINANCING 7-1 to -24; L. LOSS, FUNDAMENTALS, *supra* note 30, at 1029-46 (1983); M. STEINBERG, SECURITIES REGULATION 323-410 (1986); SODERQUIST, *Due Diligence Examinations*, PRAC. LAW., March 1, 1978, at 33.

141. For a set of materials exemplifying the SEC examiner's comments on a registration statement, together with letters of response to those comments, see VENTURE CAPITAL AND PUBLIC OFFERING NEGOTIATION (M. Halloran ed. 1984). For discussion of the SEC negotiation process, see Rowe, The Process of Becoming "Effective," in 2 SECURITIES LAW TECHNIQUES § 22.01 to -.11 (A. Sommer, Jr. ed. 1987).

that the application for registration will be voluntarily withdrawn, with the result that the underwriter will not offer the securities in that state.

These problems cannot be described as deal-killers.[142] There is no evidence that enforcement of state affirmative disclosure obligations causes entire national offerings to collapse, even though they may cause offerings to be withdrawn from individual states. Furthermore, the tinkering with the language of the prospectus probably will not produce additional exposure to section 11 liability, so long as counsel is careful to fit the state-mandated disclosures into the overall context of the document.[143] What state disclosure regulation does produce, however, is additional compliance costs, usually in the form of legal fees, printing fees, and, in serious cases, costs of delay.[144] In a more fundamental sense, the necessity to comply with state disclosure requirements generates opportunity costs for all of those involved in the process, including counsel, issuer management, accountants, and others, whose time and resources could be used more productively. Of course, the costs associated with compliance with state disclosure requirements cannot really be disentangled from those incurred in connection with a merit review, but state disclosure regulation can nevertheless be described as a complicating and cost-generating factor. If state disclosure regulation can fairly be described as a cost-generator, it must be asked whether the imposition of these costs on the capital formation process is justifiable as a matter of policy.

142. For statement of a practitioner's opinion to the effect that state disclosure requirements are usually workable and that actual conflict with SEC requirements is rare, see Bartell, *supra* note 5, at § 24.04. Other practitioners report far more difficulty with state disclosure compliance.

143. Some practitioners, however, hesitate to comply with state requests for single-state stickers or supplements, on the theory that an inadvertent and all-too-possible failure to deliver a stickered prospectus to every resident investor constitutes a failure to meet the state prospectus delivery requirement, thereby creating potential liability for a registration violation.

144. There is much debate over the amount and significance of the costs generated by compliance with state requirements in general and merit requirements in particular. *Compare* Tyler, *supra* note 74, at 931-34 *with* Campbell, *supra* note 137, at 577-79. While these costs are difficult to quantify, the aggregate cost of filing fees, additional printing expenses, attorneys' and underwriters' fees, and the expenses generated by delays incident to state compliance cannot be regarded as trivial, especially when combined with the opportunity costs incurred by the many people involved in the blue sky registration process. These costs, furthermore, must be combined with the costs of maintaining the state securities agencies themselves.

B. *State Disclosure Regulation as a Problem in the Allocation of Regulatory Responsibilities*

More specifically, it must be asked whether state disclosure regulation plays a positive role in the allocation of regulatory responsibilities between the states and the SEC. This question is difficult to answer, largely because it has to be answered in the context of the more fundamental question of whether the SEC's mandatory disclosure system is in any sense justifiable or desirable. The debate over this question is long-standing and heated, and its basic terms are currently undergoing revision.

Professor John Coffee has argued that academic discussion of the SEC's disclosure-based system has had three distinct phases.[145] The first, or "motherhood," phase placed the SEC virtually beyond criticism: "to criticize the SEC was tantamount to favoring fraud."[146] In the second phase, a group of revisionists used both empirical analysis and economic theory to argue that the federal mandatory disclosure system produced few benefits and substantial costs.[147] The revisionists' claims were sharply criticized by com-

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145. Coffee, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984).

146. *Id.* at 717.

147. *Id.* The first major revisionists were Professors Stigler, Benston, and Manne. Professor Stigler used empirical analysis to argue that corporate disclosures compelled by the SEC's mandatory disclosure system were unnecessary. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. L. 117 (1964). Benston used a more comprehensive quantitative study to assert that there was little evidence of fraud in corporate financial statements before 1933 and that corporate voluntary disclosures prior to that date provided investors with sufficient material information for sound investment decisions. *See, e.g.*, *The Value of the SEC's Accounting Disclosure Requirements*, 44 ACCT. REV. 515 (1969); *The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements*, in ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 23 (H. Manne ed. 1969); *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973); *Required Periodic Disclosure Under the Securities Acts and the Proposed Federal Securities Code*, 33 U. MIAMI L. REV. 1471 (1979); *The Costs and Benefits of Government Required Disclosure*, in CORPORATIONS AT THE CROSSROADS: GOVERNANCE AND REFORM (D. DeMott ed. 1980). For an excellent summary and critique of Professors Stigler's and Benston's arguments, see Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 10-45 (1983) [hereinafter Seligman, *Historical Need*].

Professor Manne's critique of the SEC's mandatory disclosure system focused on the federal prohibitions against insider trading, arguing that insider trading can be a means of aligning the interests of corporate managers and public shareholders. *See* H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966); H. MANNE & E. SOLOMON, WALL STREET IN TRANSITION: THE EMERGING SYSTEM AND ITS IMPACT ON THE ECONOMY (1974).

Other revisionists have relied on agency theory and the theory of the firm to argue that a mandatory corporate disclosure system is not needed because corporate managers possess sufficient incentives to disclose voluntarily all or virtually all material informa-

mentators who questioned their underlying assumptions, their empirical methodology, and most importantly, their findings with respect to historical levels of fraud.[148] This debate between the revisionists and their opponents focused primarily on the traditional formulations of the goals of the SEC's mandatory disclosure system: protection of the individual investor, control of fraud, and promotion of investor confidence in the securities markets.[149] In the third, emerging phase of the debate, a "post-revisionist" position is beginning to crystallize, in which the SEC's mandatory disclosure system is defended and the revisionists are taken to task for their overstated claims, but with the defense relying upon novel arguments drawn from the type of economic analysis used more critically by the revisionists.[150]

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tion to investors. H. KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE (1979); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Ross, *The Economics of Information and the Disclosure Regulation Debate*, in ISSUES IN FINANCIAL REGULATION (F. Edwards ed. 1979).

148. Among the major academic critiques of Professor Stigler's work are Friend & Herman, *Professor Stigler on Securities Regulation: A Further Comment*, 38 J. BUS. L. 106 (1965); Friend & Herman, *The SEC Through a Glass Darkly*, 37 J. BUS. L. 382 (1964); Friend & Westerfeld, *Required Disclosure and the Stock Market*, 65 AM. ECON. REV. 467 (1975). *See also* Professor Seligman's thorough refutation of Professor Benston's claims. Seligman, *Historical Need*, *supra* note 147, at 18-45. He argues compellingly against the revisionist position on the basis of new research into historical levels of securities fraud prior to the enactment of federal securities legislation.

Professor Manne's arguments against the prohibition on insider trading have been criticized by those who share many of his assumptions about the economics of securities regulation. *See* Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309; Haft, *The Effect of Insider Trading Rules on the Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051 (1982); Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117 (1982).

The SEC responded negatively to the revisionists' claims after an intensive review of its disclosure policies by a special advisory committee. *See* HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, 95TH CONG., 1ST SESS., REPORT OF THE ADVISORY COMMITTEE ON CORPORATE DISCLOSURE TO THE SECURITIES AND EXCHANGE COMMISSION (Comm. Print 1977).

149. Consider the series of arguments put forward in Professor Seligman's summary and critique of the revisionist arguments. Seligman, *Historical Need*, *supra* note 147, at 10-45.

150. The two principal statements of the emerging post-revisionist position are Coffee, *supra* note 145, and Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984). These authors disagree over some major points, but they share reliance on the efficient capital market theory, skepticism over the value of quantitative studies, and at least some belief in the value of a mandatory disclosure system in contemporary market structures. Coffee, *supra* note 145, at 719-20; Easterbrook & Fischel, *supra*, at 696-707, 709-13. The crux of their common position is a belief that private incentives for the production of information are inadequate. Coffee, *supra* note 145, at 737-47; Easterbrook & Fischel, *supra*, at 685-87. For a discussion of their differences, see Coffee, *supra* note 145, at 720-22.

It is too early to identify a canonical version of the post-revisionist position, but its crux seems to be a preoccupation with the effects of a mandatory disclosure system on the efficiency of the market,[151] rather than the traditional considerations of investor protection, fraud deterrence, and investor confidence.[152] In the post-revisionist view, a mandatory disclosure system makes sense if it improves the allocative efficiency of the capital market by generating greater amounts of and more accurate information, thereby reducing the cost of information search,[153] facilitating investment on a portfolio basis,[154] and reinforcing the disciplinary effect of the market on corporate managers.[155] From this perspective, furthermore, a mandatory disclosure system should function not to facilitate individual investor review of issuer disclosures, but rather to help securities intermediaries perform more efficiently.[156]

These arguments use as their central organizing principle the Efficient Capital Market Hypothesis,[157] but reflect serious reservations about the extent to which the hypothesis can be used to justify

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151. *See infra* note 157.

152. Easterbrook and Fischel specifically repudiate the traditional arguments in favor of a mandatory disclosure system. Easterbrook & Fischel, *supra* note 150, at 692-96. Coffee is also critical of these arguments, but chooses to emphasize the positive alternative of an efficiency-based justification for a mandatory disclosure system. Coffee, *supra* note 145, at 722-37, 751-53.

153. Coffee, *supra* note 145, at 723-37. Professors Gordon and Kornhauser have defined allocative efficiency in the capital markets in the following terms:

> [C]apital markets provide and allocate investment funds. Investment funds are used to produce "new capital," production facilities that will provide goods and services to be consumed in future periods . . . . To make a "good" *investment* decision, the investor must know how much value the new capital will produce in the future. That is, she must know the real returns of the (real) investment—namely, gross revenues less costs of production. We shall call a capital market that induces . . . "good" (real) investment decisions, "allocatively efficient."

Gordon & Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. Rev. 761, 767 (1985) (emphasis in original).

154. Coffee, *supra* note 145, at 747-51.

155. *Id.* at 722, 738-43.

156. *Id.* at 725-34.

157. As Professors Gilson and Kraakman have pointed out, the Efficient Capital Market Hypothesis "is now the context in which serious discussion of the regulation of financial markets takes place." Gilson & Kraakman, *The Mechanism of Market Efficiency*, 70 VA. L. REV. 549, 550 (1984). The classic definition of market efficiency is that "prices at any time 'fully reflect' all available information." Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970). For a discussion of the complex theoretical questions associated with the application of this definition to securities markets, see Gilson & Kraakman, *supra*, at 554-65. These writers attempt to develop a cogent theoretical account of the processes by which information is reflected in securities' prices. *Id.* at 552-54, 642-43. For a generally positive evaluation of their conclusions, see Levmore, *Efficient Markets and Puzzling Intermediaries*, 70 VA. L. REV. 645 (1984).

deregulation.[158] There seems to be a common belief that some kind of mandatory disclosure system is desirable and that wholesale deregulation is unnecessary.[159] This belief is tempered by a recognition that the SEC's existing rules are by no means optimal and that some reform is needed. The nature of the post-revisionist reform program, however, is not clear.

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158. For sharp criticism of unqualified reliance on the Efficient Capital Market Hypothesis as a basis for deregulation and other changes in legal policy, see Coffee, *supra* note 145, at 719 n.10 ("distinctions should be drawn in terms of the degree to which the ECMH is used as a justification for deregulation—particularly since very little evidence exists with respect to any market other than the New York Stock Exchange."); Gordon & Kornhauser, *supra* note 153, at 796-837 ("In our world, which may be only 'close' to the best of all possible worlds, the insights provided by theories of financial markets require patient cultivation before legal policy flowers."); Wang, *Some Arguments That the Stock Market is Not Efficient*, 19 U.C. DAVIS L. REV. 341, 394-402 (1986) ("Many legal commentators have assumed that the stock market is efficient. These commentators should recognize that the validity of this hypothesis is questionable.").

The Efficient Capital Market Hypothesis has been used as a basis for criticism and reformulation of legal policy in several areas. For example, it furnishes a key premise for the fraud on the market theory, under which the necessity to demonstrate reliance in rule 10b-5 actions (17 C.F.R. § 240.10b-5 (1986)) is eliminated. *See* Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C.L. REV. 435, 437-38 (1984); Pickholz & Horahan, *The SEC's Version of the Efficient Market Theory and Its Impact on Securities Law Liabilities*, 39 WASH. & LEE L. REV. 943, 956 (1982); Note, *The Fraud on the Market Theory: Efficient Markets and the Defenses to an Implied Rule 10b-5 Action*, 70 IOWA L. REV. 975, 975-93 (1985). It also has been used as an element in the definition of materiality. *See* Dennis, *Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix*, 25 WM. & MARY L. REV. 373, 381-86 (1984). Similarly, the hypothesis has played a role in critiques of the federal prohibition on insider trading. *See* Barry, *The Economics of Outside Information and Rule 10b-5*, 129 U. PA. L. REV. 1307, 1330-42 (1981); Heller, *Chiarella, SEC Rule 14e-3 and Dirks: Fairness versus Economic Theory*, 37 BUS. LAW. 517, 520-26 (1982); Lorie, *Insider Trading: Rule 10b-5, Disclosure, and Corporate Privacy: A Comment*, 9 J. LEGAL STUD. 819, 821-22 (1980). It has also been a principal element of the debate over whether the stock market exception to the appraisal remedy results in gross undervaluation of the shares. *See* J. SELIGMAN, THE SEC AND THE FUTURE OF FINANCE 312-15 (1985); Fischel, *The Appraisal Remedy in Corporate Law*, 1983 AM. B. FOUND. RES. J. 875, 884-85. The hypothesis' most dramatic impact, however, has been in the development of the SEC's integrated disclosure and shelf registration systems, both of which are based, in part, on presumptions about the efficiency of the capital markets. On the integrated disclosure system, see Proposed Comprehensive Revision to the System for Registration of Securities Offerings, Exchange Act Release No. 6235, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,649, at 83,484 (Sept. 2, 1980); Fox, *Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis*, 70 VA. L. REV. 1005, 1008 (1984); Gilson & Kraakman, *supra* note 157, at 550 & n.4. On shelf registration, see Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135, 136, 177-80 (1984); Gordon & Kornhauser, *supra* note 153, at 818-23.

159. *See* Coffee, *supra* note 145, at 753 ("the federal securities laws ain't necessarily broke, so let's be careful about fixing them"). Easterbrook and Fischel's position is more grudging. *See* Easterbrook & Fischel, *supra* note 150, at 715 ("We cannot say that the existing securities laws are beneficial, but we also are not confident that their probable replacements would be better.").

If a mandatory disclosure system is essential to the efficient operation of the markets, the central question becomes one of defining the *type* of system that will work best. This obviously raises serious questions about the nature, timing, and form of disclosures under the 1933 and 1934 Act, questions that must be answered if the efficiency-based justifications for a mandatory disclosure system are to be taken seriously. It also raises, however, serious questions about whether multiple-state disclosure reviews, single-state "stickers" and supplements, disclosures designed for the "average" investor, and independently evolving state conceptions of materiality should be part of an optimal mandatory disclosure system for public offerings of securities.

To state the question in these terms is almost to answer it. The structure of the question itself emphasizes the tendency toward duplication of efforts, inconsistency of standards, and parochial variations in the language and form of disclosure, all of which are the virtually unavoidable consequences of a system built upon overlapping jurisdictions and independent regulatory traditions. If one of the major goals of disclosure regulation should be the production of a collective fund of information that may be used (particularly by securities intermediaries) to reduce the costs of searching for information and to direct resources to more productive uses,[160] would the goal not be better achieved by imposing uniform disclosure requirements, developing a single standard of materiality, and collecting information in a single agency?

On closer examination, the answer is perhaps not self-evident. Even if it is assumed that the most effective disclosure system is one that collects and disseminates information through a single agency, it cannot be assumed that the SEC has or will have the practical ability to perform that function.[161] Administration of a mandatory disclosure system is labor-intensive, even in the truncated form that the

160. *See generally* Coffee, *supra* note 145, at 723-37.

161. For discussion of the SEC's recent difficulties in coping with its administrative responsibilities, see *Inundated Agency, Busy SEC Must Let Many Cases, Filings Go Uninvestigated,* Wall St. J., Dec. 16, 1985, at 1, col. 1. For a graphic description of the SEC's declining regulatory resources in the context of booming securities markets, see Morgenson, *The Leaky Umbrella That Is the SEC*, MONEY, Nov. 1985, at 226, 228.

The SEC's proposed fiscal 1988 budget, however, included a request for the largest funding increase in fifty years. Much of the new funding is earmarked for a stepped-up insider trading enforcement program, but substantial new resources would also be dedicated to the Division of Corporate Finance. *SEC Stepping Up Enforcement Efforts, Seeks Big Funding Increase for FY 1988*, 19 Sec. Reg. & L. Rep. (BNA) 192-93 (Feb. 6, 1987). As of this writing, the fate of this request is unknown.

SEC currently administers.[162] Some sharing of the regulatory responsibilities may be an effective means of accomplishing the task, particularly with respect to smaller issues offered and traded in relatively inefficient markets. Such sharing will, of course, generate the problems described above, but those problems can perhaps be justified as reasonable costs.

Furthermore, this is an area in which the states may be able to play a useful role in regulatory innovation. The states' importance as "little laboratories of democracy" (to use a hackneyed phrase) has been vastly overstated, since state legislatures have often functioned as soft targets for interest groups rather than as disinterested arbiters of the public good,[163] but the state securities regulators as a group have often performed a useful innovative function. Their underlying concern with fairness, for example, has made them particularly sensitive to governance issues, leading them to require particularly detailed disclosure with respect to affiliate transactions,[164] the participatory rights of limited partners,[165] and, most recently, shark repellents such as rights plans, poison pills, and blank-

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162. The SEC does not thoroughly review every registration statement it receives. For discussion of the different levels of SEC review, including "cursory" and "summary" review, see R. JENNINGS & H. MARSH, SECURITIES REGULATION: CASES AND MATERIALS 177-79 (5th ed. 1982). The adoption of the integrated disclosure system, furthermore, significantly reduced the level of scrutiny to be applied to subsequent offerings by many already public issuers. *See* Adoption of Integrated Disclosure Systems, Exchange Act Release No. 6383, [Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,328 (Mar. 3, 1982).

163. *See* Anderson, *The Meaning of Federalism: Interpreting the Securities Exchange Act of 1934*, 70 VA. L. REV. 813, 853 (1984):

> When one examines the state "interests" at stake in the judicial choice between application of federal and state rules in the corporate and securities area, the "interests" appear to be either those of particular interest groups whose lobbying is more effective at one governmental level than another or the very general interests of the states in preserving some bodies of substantive law that are not substantially federalized.

There is an element of truth in Professor Anderson's argument, as is demonstrated by the history of state takeover legislation. *See* Wilner & Landy, *The Tender Trap: State Takeover Statutes and Their Constitutionality*, 45 FORDHAM L. REV. 1, 18 (1976) (arguing that the main advocates of state takeover legislation "are often present management concerned more about their own jobs than about the state's economic welfare.") The attempt to defend these statutes from Commerce Clause challenges has foundered on the difficulty of articulating a legitimate state interest apart from that of special interest groups, but Professor Anderson probably goes too far when she claims that "the traditional judicial notion of federalism as involving some demarcation or balancing between discrete state and federal interests that can be defined and evaluated appears false in the context of corporate and securities law." Anderson, *supra*, at 853. For a detailed rebuttal, see Kitch, *A Federal Vision of the Securities Laws*, 70 VA. L. REV. 857 (1984).

164. *See supra* text accompanying notes 106-111.

165. *See supra* text accompanying notes 97-105.

check preferred stock.[166] The states have in particular taken the lead in regulating public limited partnerships, their merit standards serving as a basis for the development of industry standards.[167]

An optimal mandatory disclosure system, therefore, may have room for the state administrators. The SEC may not be able to carry the burden alone, so perhaps it should share the regulatory responsibilities with the states. The system may benefit, furthermore, from the regulatory innovations that the state administrators seem able to provide. The current allocation of responsibilities for disclosure regulation between the states and the SEC thus may not be as counterproductive as it may seem. This observation does not lead to the conclusion, however, that all is well with the current system. The costs associated with the current allocation of responsibilities could be reduced.

C. *Suggestions for Reform*

The task of finding ways to reduce the costs of integrating state disclosure regulation into an optimal mandatory disclosure system is complicated by the presence of merit regulation, to which state disclosure regulation is inseparably bound in most jurisdictions. The problem of allocating disclosure responsibilities is in fact a subset of the larger problem of allocation of regulatory responsibilities between the SEC and the states. No detailed solution to that problem can be proposed without detailed consideration of the goals, functioning, and effects of merit regulatory systems, a task beyond the scope of this article,[168] but at least one suggestion can be made that applies equally to the disclosure and merit aspects of state securities regulation.

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166. *See supra* text accompanying notes 112-124.

167. *See* Makens, *supra* note 33, at 446 ("many of the standards developed by these [real estate] guidelines have become industry standards applied by the promoters regardless of the extent or kind of regulation to be applied to a particular offering"); Makens, *A State Regulatory Perspective on the Report of the Advisory Committee on Corporate Disclosure to the SEC*, 26 UCLA L. REV. 147, 151 (1978) ("The early tax shelter offerings were so excessive in front-end promoter's compensation that they would have been an embarrassment to Jesse James. It was merit regulation at the state level, not disclosure or market factors, which ended the excesses . . . ."). The substantial influence of state administrators on the development of new securities products is described in Edelman, *Publicly Traded Limited Partnership: An Emerging Financial Alternative to the Public Corporation*, 39 BUS. LAW. 709, 714 (J. Slater ed. 1984), in which counsel for some of the early publicly traded limited partnerships explained that "we spent almost twelve months of intimate waltzing with the securities commissioners of California and Texas each of whom wanted to rewrite the several hundred page prospectus virtually from scratch."

168. For an attempt to address this problem, see *Report on State Merit Regulation*, *supra* note 2, at 847-52.

The goal of sharing regulatory responsibilities while minimizing the costs of sharing can be met by reducing, when possible, regulatory overlap and duplication of efforts. State law already achieves this goal in a partial, inexact manner, by exempting offerings by issuers listed on a national exchange and, in some states, offerings by so-called "blue-chip" issuers or by issuers listed on the NASDAQ/NMS.[169] These exemptions, in effect, constitute a division of responsibilities between the states, which may not review offerings by such issuers, and the SEC, which may. Much more thought needs to be given to this approach, however, since there is no consensus over its theoretical justification, as the current dispute over the NASDAQ/NMS exemption demonstrates.[170] Instead of relying on these state exemptions, most of which reflect either political compromise[171] or confused notions about "quality" or "seasoned" issuers,[172] policymakers should focus on differences in markets and seek to identify those markets in which regulation under the state securities laws would produce net benefits. Those markets might include the particularly inefficient ones in which the chances of market failure are high, restraints on the perverse incentives of managers are low, and the expenditure of SEC resources is not cost-effective. Examples of such markets might be those for limited partnership syndications, smaller corporate equity offerings such as those filed on form S-18,[173] and, of course, intrastate offerings. Different means of defining those offerings should be explored, either by reference to offering price, the firmly underwritten character of the offering, or other characteristics.[174] This approach

169. These exemptions are discussed in detail in Warren, *Marketplace Exemption*, *supra* note 22, at 1511-23.

170. *See* NASAA Registration Exemption Committee, Report and Recommendations Regarding State Registration Exemptions (Jan. 22, 1986), 18 Sec. Reg. & L. Rep. (BNA) 206 (Feb. 7, 1986) (recommending major revision of exchange exemptions); D. Bell, *supra* note 134, at 8-10 (criticizing both current exchange exemptions and proposed NASDAQ/NMS exemptions); Commissioner's Letter, OHIO SEC. BULL., Oct. 1986, at 2-3 (stating opposition to proposed Ohio NASDAQ/NMS exemption).

171. On the origins of the exchange exemption in a political compromise with the Investment Bankers Association in the early years of the blue sky movement, see M. PARRISH, *supra* note 57, at 21-30.

172. For discussion of some of these notions, see Warren, *Marketplace Exemption*, *supra* note 22, at 1514-15.

173. SEC Form S-18, *reprinted in* 2 Fed. Sec. L. Rep. (CCH) ¶ 7301 (June 4, 1982). Form S-18 is an abbreviated registration form available to offerings of $7.5 million or less. Form S-18 may be filed in the SEC Regional Office for the region in which the registrant's principal operations are or will be conducted. *See* SEC Form S-18, General Instructions I, II.

174. Some states have already begun to experiment with such definitions by establishing safe harbors from merit review for offerings that meet one or more of those criteria.

would also lead, however, to a somewhat diminished overall role for the states in the regulation of initial public offerings, and to a much smaller role for the states in areas in which the SEC has a strong presence, such as the regulation of investment company offerings.

The first step toward development of an optimal state-federal mandatory disclosure system, therefore, is a market-oriented redefinition of the role of state securities regulation in both its merit and disclosure aspects. There is some indication that this rethinking of the basic structural relationship between federal and state securities regulation is beginning to take place.[175] The pace of such change, however, is likely to be slow and incremental, so some attention should be paid to the possibility of improvement within the constraints of the present system.

The key to improvement is improved coordination between the SEC and the state administrators. This coordination could take place at two levels. First, administrators in individual states and SEC staff members should make a greater effort to communicate with each other about their different disclosure concerns. This already happens to some extent in individual states, but it could hap-

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See Sargent, *Challenge*, *supra* note 2, at 371-77 (analyzing Michigan safe-harbor rule for certain firmly underwritten offerings); *Report on State Merit Regulation*, *supra* note 2, at 801-04 (analyzing similar exemptions in Washington and West Virginia).

175. *See* authorities cited *supra* note 174. *See also* Wisconsin Office of the Commissioner of Securities & Marquette University College of Business Administration, Merit Review: In the Public Interest? An Empirical and Qualitative Analysis of Merit Regulation of Common Stock Offerings in Wisconsin (1986-87). The study described in this report analyzed 1,439 initial public offerings made during the 1978-1984 period. *Id.* at 9. The report recommended on the basis of this study "that initial public offerings be exempt from merit review if the issues are firmly underwritten and the issuer has common equity of at least $500,000." *Id.* at 4. In support of this recommendation, the report asserted that "when sufficient supply and demand conditions are present, the market will fairly price and evaluate the new issue. In such instances, government regulation is not necessary." *Id.* For a summary of the report, see *Wisconsin Merit Review Study Group Suggests Broader, Simplified Exemptions*, 19 Sec. Reg. & L. Rep. (BNA) 65 (Jan. 9, 1987).

In Texas the State Securities Board has proposed a rule under which an offering registered under the 1933 Act will be deemed fair, just, and equitable if it is firmly underwritten, the public offering price is not less than $5 per share, and the aggregate gross proceeds to the issuer are at least $2,000,000. TEX. ADMIN. CODE tit. 7, § 113.3(14) (proposed), *reprinted in* 3 Blue Sky L. Rep. (CCH) ¶ 55,583, at 49,521 (June 1987).

The Wisconsin and Texas administrators thus have demonstrated a willingness to experiment with redefining the appropriate sphere for their regulatory efforts. The immediate focus of these proposals, of course, is merit regulation, but they should be regarded in the broader perspective as experiments in the reallocation of regulatory responsibilities, since the net effect of the proposed rules would be to assign to the SEC primary responsibility for a broader class of offerings. This could have a substantial impact on disclosure regulation in Texas and Wisconsin as well as on merit regulation.

pen more frequently and more uniformly. Improved communication could have the immediate, positive effect of reducing conflicting or inconsistent disclosure requirements, and could have the long-term effect of creating common experience with disclosure regulation as well as a common fund of disclosure standards. Most importantly, it will help in the evolution of a common conception of materiality, particularly if the development and application of such a common conception is regarded as an appropriate goal by both sides.

Second, greater coordination is needed at the institutional level between the SEC and NASAA. This coordination could take several forms. For example, it could include greater NASAA participation in the SEC's formulation of disclosure policy. Such participation could broaden the SEC's sensitivity to the states' disclosure concerns, particularly those that emerge from their merit concerns. It could also give NASAA and its members something of a proprietorial interest in standards that it helped develop. SEC-NASAA coordination also could take the form of joint examiner training programs, in which both state and federal personnel could be helped to develop a common vocabulary, a common understanding of the goals and limitations of a mandatory disclosure system, and an appreciation of the need for cooperative efforts. The prerequisite to greater coordination between the SEC and NASAA, though, should be the recognition of the need for such coordination.[176] Section 19(c) of the 1933 Act[177] has already established a

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176. There is some indication that the SEC and NASAA have begun to recognize the need, in general, for greater cooperation. *See* SEC-NASAA Conference on Federal State Securities Regulation 48-49, Summary Report (Apr. 1984) [hereinafter Summary Report]:

> To reduce tensions arising primarily from the subject of preemption, NASAA and the SEC must work to improve their communications. Problems can be avoided, duplicative regulation reduced, and time and money savings effected if both groups will maintain a regular dialogue. NASAA and the SEC need to study specifically targeted information, but also free and open information sharing, including information on areas of economic impact, management and administrative systems, training and statutory implementation.

177. Section 19(c) of the 1933 Act, 15 U.S.C. § 77s (1982), was enacted by Congress in 1980 as part of the Small Business Investment Incentive Act, Pub. L. No. 96-477, 94 Stat. 2275 (current version at 15 U.S.C. § 775) (Oct. 21, 1980). Section 19(c) authorizes the SEC to cooperate with NASAA in effectuating greater federal/state regulation by promoting: (1) maximum effectiveness of regulation; (2) maximum uniformity in federal and state regulatory standards; (3) minimum interference with capital formation; and (4) substantial reduction in the costs of raising investment capital and the costs of government administration. To these ends, § 19(c) calls upon the SEC to meet regularly with NASAA and others, with such conferences to provide a framework for cooperation among all parties. *See* Summary Report, *supra* note 176, at 1-2 n.2.

framework for the development of a more cooperative approach to state-federal securities regulation; this framework needs merely to be used as effectively in this area as it has been in others.[178]

The possible implementation of these modest reform proposals, however, must not be regarded as a panacea. The more fundamental problem of defining and implementing a rational and systematic allocation of regulatory responsibilities between the states and the SEC remains unresolved, and until it is resolved, state disclosure regulation will remain problematic.

178. The SEC and NASAA have already made some progress in developing a cooperative approach to private and limited offering exemptions and to investment company regulation. *See* Summary Report, *supra* note 176, at 5-8. For discussion of the need for greater cooperation with respect to investment company regulation, see Sargent, *State Regulation of Investment Companies—Sources of the Current Controversy*, 13 SEC. REG. L.J. 167 (1985).