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BLUE-SKY MERIT REGULATION: BENEFIT TO INVESTORS OR BURDEN ON COMMERCE?

*Roberta S. Karmel**

INTRODUCTION

All fifty states, the District of Columbia, and Puerto Rico have a securities regulation statute, called a blue-sky statute. Some are merit regulation statutes, and some are not. Merit regulation gives a state, through its blue-sky commissioner, the authority to prevent an issuer from selling its securities in that state when the offering or the issuer's capital structure is substantively unfair or presents excessive risk to the investor.¹ State blue-sky regulation of securities offerings have co-existed with federal securities regulation without much question or examination for over fifty years. In some cases, federal and state regulatory interests have been harmonized and coordinated so that investors enjoy greater protection without an undue burden being placed on capital formation. Nevertheless, there has been regulatory duplication that is confusing and costly to investors.

Despite increasing coordination between federal and state regulators, and a widespread political shift favoring deregulation, the dual regulatory system with its state-imposed merit regulation component has changed little since 1933. However, federal securities regulation and the securities markets have changed considerably. Moreover, some of the traditional concerns of blue-sky commissioners relating to fair and equitable capital structures have emerged as matters of national concern, generally in the context of battles for corporate control of large

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¹ *Report on State Merit Regulation of Securities Offerings by the Ad Hoc Subcommittee on Merit Regulation of the State Regulation of Securities Committee*, 41 BUS. LAW. 785, 787 (1986) [hereinafter *ABA Report*].

public companies. Many commentators, therefore, have begun to take a critical look at merit regulation and question its effect on capital formation.²

Merit regulation clearly imposes burdens on capital formation.³ The question is whether the costs added to the underwriting process by blue-sky compliance outweigh whatever benefits blue-sky laws provide to investors or the securities markets.⁴ The serious, ongoing philosophical and political debate about the value of state merit regulation, which dates back to the early twentieth century,⁵ suggests that while some degree of regulation as to the fairness of securities offerings is perceived to be in the public interest, the continuation of individual state standards for determining the worthiness of an offering should generally give way to a uniform federal standard promulgated by the Securities and Exchange Commission (SEC) or by securities self-regulatory organizations (SROs).

The internationalization of the securities markets and the need for United States' interests to compete effectively in those markets is another reason for the development of a uniform national standard at this time. Such a standard should be in accord with the basic principle of federal securities regulation "to protect the public with the least possible interference to honest business."⁶ While this is usually accomplished by selecting dis-

² See, e.g., 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); Dumont, *The Case for States to Abolish "Merit Review" of New Offerings*, N.Y.L.J., Nov. 20, 1985, at 1, col. 3; Mofsky & Tollison, *Demerit in Merit Regulation*, 60 MARQ. L. REV. 367 (1977). These and other critics have generated articles in defense of merit regulation. See, e.g., Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements?*, 1976 WIS. L. REV. 79 (1976); Warren, *Reflections on Dual Regulation of Securities: A Case Against Preemption*, 25 B.C.L. REV. 495 (1984). See also 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 (1985); Makens, *Who Speaks for the Investor? An Evaluation of the Assault on Merit Regulation*, 13 U. BALT. L. REV. 435 (1984).

³ See ABA Report, *supra* note 1, at 845-47.

⁴ One obvious burden imposed by merit regulation is the significant legal fees for counsel who perform the blue sky survey provided to the underwriters. Filing fees, printing costs, and other expenses also are high. A less obvious but very real cost is the delay and uncertainty that is imposed on the underwriting process. In addition to such monetary costs, merit regulation constrains the freedom of issuers, underwriters, and investors to contract to allocate the risks and rewards of business enterprise.

⁵ L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 29-38 (1983).

⁶ President Roosevelt's message to Congress recommending the passage of the So-

closure rather than substantive standard setting as a regulatory method, it is unlikely that a national standard can be developed without some attention by the SEC to qualitative governance standards.

A uniform federal regulatory standard can be achieved either by federal-state cooperation or by federal preemption. Cooperation is politically preferable and has been suggested by Congress in the 1980 amendments to the Securities Act of 1933 (Securities Act).⁷ Nevertheless, in view of the continuing commitment of many states to merit regulation, stronger action may be necessary to achieve a uniform standard. In addition, the SEC must accept responsibility, either directly or with the assistance of SROs, for formulating such national standards as may be necessary and appropriate to maintain investor confidence in the public securities markets if state merit regulation is abolished.

This article argues that state merit regulation is a burden on interstate commerce and stands as an obstacle to the achievement of the SEC's statutory goals of facilitating capital formation and the establishment of a national market system (NMS).⁸ Further, the basic philosophical conflict between federal and state regulation will become increasingly troublesome as the SEC grapples with the problems of regulating the market for corporate control of large public companies and participating in the regulation of international capital markets.

I. THE DUAL REGULATORY SYSTEM

The federal-state-SRO system of securities regulation does not have a well articulated allocation of responsibilities and priorities. It involves conflicting philosophies and considerable overlap and duplication. Although Congress may not have intended that the federal securities laws eliminate state blue-sky regulation, it is not clear that Congress "had any systematic understanding of what the relations of state and federal securities

curities Act, *reprinted in* LEGISLATIVE HISTORY OF THE FEDERAL SECURITIES LAWS, at 20 (1983).

⁷ See 15 U.S.C. § 77s(c) (1982).

⁸ For a further discussion of these SEC mandates, see R. KARMEL, REGULATION BY PROSECUTION: THE SECURITIES & EXCHANGE COMMISSION VERSUS CORPORATE AMERICA 101-38, 295-339 (1982).

regulation should be, how regulatory responsibilities should be allocated, or how federal disclosure regulation and state merit regulation should be accommodated to each other."⁹

A. *Constitutional and Statutory Framework*

Blue-sky merit regulation may be invalidated under either the supremacy or commerce clauses of the United States Constitution. Such invalidity can result from (1) the preemption of state blue-sky law under the supremacy clause or (2) a determination that blue-sky statutes constitute an undue burden on interstate commerce which contravenes the commerce clause.

In deciding whether the supremacy clause of the Constitution requires that federal law preempt a state statute, the courts look to the intent of Congress. Preemption may be compelled whether Congress' command is explicitly stated in the language of a statute or implicitly contained in its structure and purpose. An analysis of the relevant statutes demonstrates that in general, Congress did not intend to preempt state blue-sky laws when it enacted the Securities Act and the Securities Exchange Act of 1934 (Exchange Act).

Section 18 of the Securities Act provides: "Nothing in this Subchapter shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person."¹⁰ The legislative history of this provision is sparse. However, it is known that the initial securities act bill, which passed the House, set forth a clause prohibiting the sale of securities in interstate commerce into any state if such sale would have violated the blue-sky laws of that state.¹¹ The stated purpose of this prohibition was "to assure the states that the [Securities Act] was not an attempt to supplant their laws, but an attempt to supplement their laws and assist them in enforcing their laws in cases where they have no control."¹² This clause was later deleted by Senate amend-

⁹ *ABA Report*, *supra* note 1, at 793.

¹⁰ 15 U.S.C. § 77r (1982).

¹¹ H.R. REP. No. 85, 73rd Cong., 1st Sess. 25 (1933).

¹² *Securities Act Hearings on H.R. 4314*, 73rd Cong., 1st Sess. 117 (Statement of Ollie M. Butler).

ment.¹³ The present version of section 18 of the Securities Act replaced it, and has never been altered.

Section 28(a) of the Exchange Act is similar to section 18 of the Securities Act. It provides:

Nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder.¹⁴

Section 19(c)(3)(C) of the Securities Act provides that “[n]othing in this subchapter shall be construed as authorizing preemption of State law.”¹⁵ This provision was added to the Securities Act by the Small Business Investment Incentive Act of 1980,¹⁶ and would appear to be limited to the 1980 amendments.¹⁷

Although the foregoing provisions indicate a congressional intent not to preempt state blue-sky law generally,¹⁸ such savings clauses do not necessarily prevent the Supreme Court from declaring state securities laws unconstitutional. Absent an express statutory preemption, federal law will preempt state law where a direct conflict exists between particular provisions of state law and federal law, making compliance with both laws a

¹³ See H.R. REP. No. 152, 73rd Cong., 1st Sess. 27 (1933).

¹⁴ 15 U.S.C. § 78bb(a) (1982).

¹⁵ 15 U.S.C. § 77s(c)(3)(C) (1982).

¹⁶ Pub. L. No. 96-477, 94 Stat. 2292 (codified at 15 U.S.C. § 77s(c)(3)(C) (1982)). The Small Business Investment Incentive Act of 1980 was enacted to encourage greater uniformity and simplicity of federal and state securities regulation. S. REP. No. 958, 96th Cong., 2d Sess. 42-43 (1980).

¹⁷ Professor Warren, who sets forth a thorough and eloquent argument against preemption, see Warren, *supra* note 2, explains that this savings clause was included in a statute requiring federal and state cooperation to achieve greater uniformity in securities regulation, in the face of industry clamor for preemption of state regulation and the use of the threat of preemption by at least one SEC Commissioner to achieve the goal of uniformity. *Id.* at 499-500, 523-24. While this general congressional reaffirmation of a dual regulatory system was perhaps necessary to prevent the SEC from using section 19(c) of the Securities Act to support generalized rule-making to preempt state securities law, I do not believe that it prevents limited, implied repeal of blue-sky merit regulations that conflict with the federal securities laws. *Cf. Shaw v. Delta Air Lines Inc.*, 463 U.S. 85 (1983) (ERISA preempts state law insofar as state law prohibits practices that are lawful under federal law; complete preemption would frustrate goals of joint federal-state enforcement of federal law).

¹⁸ See Smith, *State “Blue Sky” Laws and the Federal Securities Acts*, 34 MICH. L. REV. 1135, 1160 (1936).

“physical impossibility,”¹⁹ or where an area of law is so pervasively regulated by a complex federal statutory scheme that state regulation “stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.”²⁰

In addition to being invalidated due to federal preemption, state legislation can be declared invalid under the commerce clause. Legislation will be invalidated under the commerce clause if it imposes a burden on interstate commerce that is excessive in relation to the local interests served.²¹ In many instances, state blue-sky regulations impose burdens on interstate commerce. While these burdens are somewhat justifiable because a state may have a legitimate interest in capital investment or financial services within its borders, regulation that effectively impedes the interstate capital markets is invalid.²²

B. Case Law

The constitutionality of state blue-sky laws was first tested in three Supreme Court cases decided in 1917, sixteen years before the first federal securities law was enacted.²³ While a variety of constitutional arguments were raised in these cases, the cases particularly focused upon the possible limitations imposed by the fourteenth amendment on the power of a state to prevent fraudulent securities issuances. Only one of the opinions, however, specifically discussed the contention that the blue-sky laws burdened interstate commerce. In *Hall v. Geiger-Jones Co.*,²⁴ the Court upheld the blue-sky statute under review on the ground that the statute was only applicable to dispositions of securities *within* the state and, thus, could not burden interstate commerce. The Court found that

¹⁹ *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142-43 (1963).

²⁰ *Ray v. Atlantic Richfield Co.*, 435 U.S. 151, 158 (1978) (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)); *Jones v. Rath Packing Co.*, 430 U.S. 519, 525-26 (1977).

²¹ *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970).

²² *Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869 (1985) (Alabama domestic preference tax statute violative of equal protection clause); *Lewis v. BT Inv. Managers*, 447 U.S. 27 (1980); *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318 (1977). New Chief Justice Rehnquist may have a higher tolerance for balkanized economic regulation than any other member of the Court. See Fein, *Rehnquist Proven to be Big Booster for Business*, *Legal Times*, July 28, 1986, at 12, 13.

²³ See *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917); *Caldwell v. Sioux Falls Stock Yards Co.*, 242 U.S. 559 (1917); *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568 (1917).

²⁴ 242 U.S. 539 (1917).

[u]pon their transportation into the State there is no impediment — no regulation of them or interference with them after they get there. There is the exaction only that he who disposes of them there shall be licensed to do so and this only that they may not appear in false character and impose an appearance of a value which they may not possess — and this certainly is only an indirect burden upon them as objects of interstate commerce, if they may be regarded as such.²⁵

This reasoning clearly suggests that in-state corporations that participate in purely local financing ventures are subject to blue-sky merit regulation and that blue-sky merit regulation limited to intrastate issuances is valid. It remains an open question, however, whether this reasoning would insulate blue-sky merit regulation that has the effect of compelling an out-of-state corporation, which has registered an offering with the SEC and made the full disclosure required by federal law, to change its capitalization in order to syndicate a securities offering nationally.

It was not until the 1982 case of *Edgar v. MITE Corp.*²⁶ that the Supreme Court held a state securities regulatory statute — the Illinois takeover law — inconsistent with the United States Constitution. The Court explained that its traditional rationale for upholding state blue-sky laws against commerce clause invalidity “was that they only regulated transactions occurring within the regulating States”²⁷ The Court stated, however, that the Illinois regulatory scheme went beyond regulating intrastate transactions.

The rationale of allowing blue-sky merit regulation due to its local nature may have made sense prior to the adoption of the federal securities laws and the development of a mature national securities marketplace. Further, it may continue to be utilized to enable the states to engage in certain types of truly intra-state blue-sky regulation. However, *MITE* suggests that blue-sky merit regulation may be vulnerable to constitutional attack if it denies an out-of-state issuer (which registers securities

²⁵ *Id.* at 557-58.

²⁶ 457 U.S. 624 (1982). There were six separate opinions issued in this case, and a majority found only that the state law imposed an indirect burden on interstate commerce. A plurality of Justices found direct burdens on commerce, and another plurality found preemption of the state law by the Williams Act, which in 1968 amended the Exchange Act by regulating tender offers.

²⁷ *Id.* at 641 (citing *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917)).

with the SEC in order to effectuate a nationwide offering) access to the capital market in the state because of perceived deficiencies in that issuer's capitalization. In other words, if the local interests served by merit regulation are balanced against the national interest in the efficient allocation of economic resources in connection with the capital formation process, there may not be a sufficiently significant difference between the Illinois takeover law declared invalid in *MITE* and blue-sky statutes that enable a state commissioner to block an offering that is not deemed fair and equitable.

While the *MITE* Court expressly distinguished the Illinois takeover law from general state blue-sky laws, the viability of this distinction is problematic. In most instances, the reasoning that the Court used to strike down the Illinois takeover statute can be applied to blue-sky merit regulation in general, thus making the constitutionality of such statutes questionable, and reducing the viability of the Court's distinction between the two types of statutes.

A plurality of Justices in *MITE* felt that the policy of neutrality between tender offerors and targets articulated in the Williams Act was offended by the pro-target tilt of the Illinois takeover law. Similarly, perhaps a majority of the Court could be persuaded that the policy of free access to the capital markets, conditioned only on the full disclosure requirements of the federal securities laws, is offended by, and therefore preempts, state law that presumes to pass on the merits of an offering and denies access to the capital markets to an issuer that does not meet a fair and equitable offering test. Alternatively, the Court could find that the burden placed on commerce by state merit regulation outweighs the benefits of local investor protection.

Two post-*MITE* cases raised questions of the constitutionality of blue-sky merit regulation, but neither case squarely decided the issue. In *North Star International v. Arizona Corp. Commission*,²⁸ the Ninth Circuit upheld the application of Arizona's merit review of an intrastate offering. Although the appellant advanced the argument that Arizona's merit review was in fundamental conflict with the disclosure provisions of the Securities Act, the court never reached the merits of this issue due to

²⁸ 720 F.2d 578 (9th Cir. 1983).

deficiencies in the complaint.

*Carney v. Hanson Oil Co.*²⁹ involved a suit for rescission by a purchaser of oil and gas interests which were not registered under a Missouri blue-sky statute. The defense included challenges to the state statute on preemption, equal protection and commerce clause grounds. The Missouri Supreme Court held that there was no conflict between the Missouri statute and the federal securities laws and that the state law did not unduly burden interstate commerce. However, this case involved no effort to comply with state law, and it was not clear that there was federal law compliance.

In summary, since the federal securities laws were passed, no case has reached the United States Supreme Court that squarely raised the question of whether state merit regulation conflicts with the free access to the capital markets provided by federal law to any issuer that makes the required full disclosure about its financial affairs, and whether, therefore, state merit regulation statutes should be deemed to be preempted. Neither has there been a case that considered whether such regulation, especially in the context of international securities markets, is an excessive burden on commerce in relation to the local interests protected. Nevertheless, a sound legal basis exists for constitutional challenges to state merit regulation, and if the SEC should begin to exercise plenary rule-making authority to achieve a national uniform standard in certain areas of security regulation, such constitutional challenges may be successful.

C. *The Role of the SROs*

Complicating the usual difficulties of a dual regulatory system is the unique role of the SROs in securities regulation. Individual stock exchanges and the National Association of Securities Dealers, Inc. (NASD) are industry membership organizations which operate under the aegis of the Exchange Act. In addition to requiring their members to comport with high standards of commercial conduct in their dealings with customers and one another, the exchanges have enforced various corporate governance mechanisms on public companies through their listing agreements. For this reason, they are called self reg-

²⁹ 690 S.W.2d 404 (Mo. 1985).

ulatory organizations. In part because of the New York Stock Exchange's (NYSE) requirements for listing, which give investors protection over and above the federal securities laws, most states have a "blue chip" exemption from the coverage of blue-sky laws for exchange listed securities.³⁰ However, marketplace and legal developments have generated competition for listings between the NYSE, other exchanges, and the over-the-counter NASDAQ market; this competition may undermine the ability of the NYSE to maintain higher listing standards than other marketplaces.³¹ As a result, the merit regulation states are taking a critical look at the "blue chip" exemption.

Since 1975, the SEC has had both more power and more responsibility concerning SRO rule-making than previously was the case. Accordingly, despite the selection of disclosure over substantive regulation in the Securities Act, the SEC could well exercise merit regulation under the authority given to it by Congress to establish a national market system (NMS).³²

In the amendments to the Exchange Act, which laid the foundation for the NMS, two significant new powers were given to the SEC: the power to approve, disapprove, abrogate, add to or delete from rules of SROs;³³ and the power to "designate the securities . . . qualified for trading in the national market system" (qualified securities).³⁴ The SEC's authority to regulate the rules of SROs is limited to actions in "furtherance of the purposes" of the Exchange Act.³⁵ Further, any amendments to any SRO rules that are mandated by the SEC remain rules of the

³⁰ *ABA Report, supra* note 1, at 833-35. Fifteen states have such an exemption: Georgia, Illinois, Kansas, Kentucky, Minnesota, Montana, Nebraska, New Hampshire, New Mexico, North Dakota, Oklahoma, Tennessee, Texas, Washington, and Wyoming.

³¹ See generally Karmel, *The SEC's Power to Regulate Stockholder Voting Rights*, N.Y.L.J., Aug. 21, 1986, at 1, col. 1.

³² In 1975 Congress laid the foundation for the establishment of the NMS in amendments to the Exchange Act. Without mandating specific components of the NMS or even defining the term, Congress vested the SEC with broad flexible authority to design, implement and regulate the NMS. Pub. L. No. 94-29, 89 Stat. 97 (codified in scattered sections of 15 U.S.C.). The goal in establishing the NMS was "to assure that the country maintains a strong, effective and efficient capital raising and capital allocating system in the years ahead." S. REP. No. 75, 94th Cong., 1st Sess. 3 (1975) [hereinafter *SENATE REPORT*].

³³ Securities Exchange Act §§ 19(b)-(c), 15 U.S.C. §§ 78s(b)-(c) (1982).

³⁴ Securities Exchange Act § 11A(a)(2), 15 U.S.C. § 78k-1(a)(2) (1982).

³⁵ Securities Exchange Act § 19(c), 15 U.S.C. § 78s(c) (1982).

SRO and do not become SEC rules.³⁶ The SEC's authority to establish criteria for "qualified securities" is not limited on the face of the statute, except implicitly by the objectives of the NMS. One of these principles is that whether a security is qualified to be included in the NMS should depend primarily on its trading characteristics rather than where it happens to be traded. The Senate Report, for example, noted that "many securities do not have the characteristics — e.g., trading, volume, price, and number of stockholders — which would justify auction-type trading."³⁷ Also, one of the statutory findings added to the Exchange Act of 1975 is that it is "in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure . . . fair competition . . . among exchange markets, and between exchange markets and markets other than exchange markets."³⁸

In giving the SEC authority to define "qualified securities", it would appear that Congress intended that the SEC could equalize listing standards of competing marketplaces. To the extent that such traditional standards are qualitative and relate to some matters that are covered by state merit statutes, the SEC may have an untapped capacity to establish national merit standards. However, due to the general principle that the federal securities laws were not intended to federalize state corporate law,³⁹ some commentators have questioned whether the SEC can validly exercise this untapped capacity to establish national merit standards.⁴⁰ In answer to this, it should be noted that the SEC has frequently and successfully established national standards regarding certain aspects of corporate finance that go beyond state corporation law.⁴¹

³⁶ Securities Exchange Act § 19(c)(4)(C), 15 U.S.C. § 78s(c)(4)(C) (1982).

³⁷ SENATE REPORT, *supra* note 32, at 16.

³⁸ Securities Exchange Act § 11A(a)(1)(C)(ii), 15 U.S.C. 78A(k)(1)(C)(ii) (1982).

³⁹ *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977).

⁴⁰ Compare Dent, *Dual Class Capitalization: A Reply to Professor Seligman*, 54 GEO. WASH. L. REV. 725 (1986), with Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 637 (1986).

⁴¹ SEC STAFF REPORT ON CORPORATE ACCOUNTABILITY, SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 642-47 (Comm. Print 1980).

II. CONFLICTS BETWEEN MERIT REGULATION AND FEDERAL REGULATION

Because of the "blue chip" exemption, merit regulation applies primarily to initial public offerings of equity securities. While merit regulation is not necessarily antithetical to disclosure regulation, a merit regulator does have the capacity to directly intervene to require changes in the internal structure of a securities issuer, the relations among insiders and outsiders, and the terms of the offering.⁴² The merit regulator acts as a negotiator in getting a better deal for investors. Although this role is justified as necessary to prevent overreaching and to bolster investor confidence,⁴³ it is a form of price and profit regulation, which can be criticized as a paternalistic interference with market forces which inhibits capital formation by discriminating against start-up firms and new technologies.⁴⁴ The purpose of this article is not to repeat the claims of defenders and detractors of merit regulation, but to suggest points of conflict between federal securities regulation and state law. Annexed as Table I is a chart setting forth the states that have the kinds of merit restrictions discussed below.

A. Price and Profit Regulation

1. Offering-Price Restrictions

Twenty-one states regulate the price at which a new unseasoned issuer can offer its stock to the public.⁴⁵ These restrictions are set forth in a variety of ways, such as setting the offering price as a multiple of the company's book value,⁴⁶ or comparing the multiple of the offering price to earnings to that of similar public companies.⁴⁷ Closely related to offering-price restrictions

⁴² ABA Report, *supra* note 1, at 823.

⁴³ *Id.* at 829.

⁴⁴ Brandi, *supra* note 2, at 698; Campbell, *supra* note 2, at 565; Dumont, *supra* note 2, at 4.

⁴⁵ H. SOWARDS AND N. HIRSCH, BUSINESS ORGANIZATIONS — BLUE SKY REGULATION § 7A.02[2] (1986 & Supp. Nov. 1986). See Table I of this article.

⁴⁶ *E.g.*, FLORIDA SECURITIES RULE 3E-700.15(2)(a), 1A BLUE SKY L. REP. (CCH) ¶ 17,485, at 13,433.

⁴⁷ *E.g.*, ALASKA ADMIN. CODE tit. 3, § 3AAC 08.140(b)(3), 1 BLUE SKY L. REP. (CCH) ¶ 8427 at 4422; CALIF. ADMIN. CODE, Rule 260.140.50(b), 1 BLUE SKY L. REP. (CCH) ¶ 11,901, at 7669; MO. REV. STAT. § 30-52.050(2)(c), 2 BLUE SKY L. REP. (CCH) ¶ 35,455, at 30,528.

are restrictions against excessive dilution, which prohibit a large disparity⁴⁸ between the price of the stock purchased by insiders or promoters and the price of the stock sold to the public.⁴⁹

The SEC focused on this type of dilution in the value of the common stock being sold to public investors at a fairly early date. However, the SEC determined that as long as full disclosure of these facts was made to investors, it was not within the prerogative of the Commission to prevent a financial product from coming to the marketplace.⁵⁰ Yet the state merit regulations regarding dissolution do just that. However, neither the SEC nor any court has gone so far as to say that the congressional determination not to impede capital formation by requiring securities offerings to pass a fair and equitable test was an affirmative federal policy.

2. Limits on the Compensation of Promoters and Underwriters

Merit regulation frequently limits the entrepreneurial profit that insiders, underwriters, and other promoters can make. This may be accomplished by restricting the sale of stock to insiders within a three year (or other) period prior to the public offering at a price lower than the public offering price;⁵¹ requiring that

⁴⁸ Generally the disparity between the public price of stock and the price at which insiders or promoters can buy the stock must be limited to 33 ⅓ %. *ABA Report, supra* note 1, at 811. This may contribute to the questionable underpricing of new issues by underwriters. *See Brandi, supra* note 2, at 697.

⁴⁹ *E.g.*, ALABAMA SECURITIES RULE § 830-X-4.08, 1 *Blue Sky L. Rep. (CCH)* ¶ 7448, at 3415-16; FLORIDA SECURITIES RULE 3E-700.15(2)(b), 1A *BLUE SKY L. REP. (CCH)* ¶ 17,485, at 13,433.

⁵⁰ *See In re Universal Camera Corp.*, 19 S.E.C. 648 (1945). In this case the Commission stated:

In contrast to some of the State officials and commissions, operating under state "Blue Sky" laws that authorize them to pass upon the merits of securities registered with them, it is not this Commission's function under the Securities Act to approve or disapprove securities and the statute specifically makes it unlawful to represent that the Commission has passed upon the merits of any security, or given approval to it.

Id. at 656 (footnotes omitted).

⁵¹ *E.g.*, ARKANSAS SECURITIES RULE 11.02, 1 *BLUE SKY L. REP. (CCH)* ¶ 10,472, at 6427-28; IOWA SECURITIES RULE § 510-50.37(502), 1A *BLUE SKY L. REP. (CCH)* ¶ 25,437, at 20,416-17; OKLA. SEC. COMM. ADMIN. Rule R-305(g), 2 *BLUE SKY L. REP. (CCH)* ¶ 46,408B, at 41,518-19; TEX. ADMIN. CODE tit. 7, § 113.3(3) and (5), 3 *BLUE SKY L. REP. (CCH)* ¶ 55,583, at 49,520-21. *See NASAA Statement of Policy, Cheap Stock*, NASAA Reports (CCH) ¶ 802, at 601 (Adopted Apr. 23, 1983).

promoters invest a minimum proportion of the company's total equity capital;⁵² or limiting options and warrants available to promoters to a "reasonable amount."⁵³ If an issuer does not meet applicable standards, it must restructure its capitalization in order to tap the capital market in a merit state.

The rationale for such limitations are rarely articulated beyond a reference to the prevention of fraud and overreaching.⁵⁴ Yet, such profit regulation necessarily must rest on a theory of fiduciary duty. At the federal level, limitations on the use of cheap stock, options, and warrants as a means of compensating underwriters are established by the NASD pursuant to its Rules of Fair Practice.

The NASD reviews offerings to determine whether these underwriting agreements are fair and reasonable in the same fashion as a merit regulator reviews offerings. Generally, the NASD will examine the size of the offering; the type of underwriting commitment; the type of securities being offered; the existence of restrictions, or lack of them, on stock, warrants, options, or convertible securities received in connection with the offering by the underwriters or related persons; the amount of such stock, warrants, options, or convertible securities; the nature and amount of overall compensation received by the underwriter; the underwriter's relationship to the issuer; and evidence of arm's length bargaining and conflicts of interest. All the circumstances surrounding the offering during the twelve-month period prior to filing the registration statement are examined. Normally, any purchases made within six months are considered part of the underwriter's compensation. The transferability or assignment of the stock, options, or warrants is restricted by the NASD for a minimum period of one year from the effective date of the registration statement. A limitation also exists on the amount of stock, warrants, or options that can be received by an

⁵² *E.g.*, ALASKA ADMIN. CODE, tit. 3, § 3 AAC 08.170(a) (Feb. 1972), 1 BLUE SKY L. REP. (CCH) ¶ 8430, at 4425; ARIZONA SECURITIES Rule 14-4-107, 1 BLUE SKY L. REP. (CCH) ¶ 9517, at 5407-3; ARKANSAS Rule 12.04, 1 BLUE SKY L. REP. (CCH) ¶ 10,484, at 6431-32. See NASAA *Statement of Policy, Promoters' Investment*, NASAA Reports (CCH) ¶ 3202, at 1801 (Proposed).

⁵³ CALIF. ADMIN. CODE tit. 10, Rule 260.140.21, 1 BLUE SKY L. REP. (CCH) ¶ 11,872, at 7466-67. See NASAA *Statement of Policy, Options and Warrants*, NASAA Reports (CCH) ¶ 2810, at 1601 (Adopted Sept. 17, 1980).

⁵⁴ See, *e.g.*, H. SOWARDS AND N. HIRSCH, *supra* note 45, at § 7A.03.

underwriter in connection with an offering. In a firm commitment underwriting, the maximum amount cannot exceed ten percent of the total number of shares being offered to the public. In a best efforts underwriting, the underwriter usually cannot receive more than one share for every ten shares actually sold. If a purchase or receipt of securities is found to be excessive, the securities must be returned to the issuing company at their original cost or the distribution will be considered unreasonable and unfair. Where a potential conflict of interest or lack of arm's length bargaining exists, a change in the underwriter may be required.⁵⁵

Some state merit standards are more rigorous than the NASD's standards; some are less rigorous. However, the disparity in standards is due to historical accident. If some price regulation of promoters and underwriters compensation is necessary and appropriate for the protection of investors — and the persistence of both national and state regulations to this effect would indicate this may be the case — a uniform national standard could and should be established. A rule-making proceeding by the SEC to develop a rule under the Exchange Act to address this problem could serve to focus the debate between opponents and proponents of merit regulation so that whatever features of merit regulation appear to be essential to capital formation can be made a part of a uniform standard.

The basic conflict between the full disclosure philosophy of the federal securities laws and the philosophy of substantive review of the fairness of an offering of state merit statutes may not have been so apparent in a period when the SEC was engaged in consumer-oriented investor protection. However, the policies of the current SEC, which have encouraged greater efficiency in the capital-raising process — through such deregulatory measures as integrated disclosure and shelf registration — may more obviously come into conflict with the substantive blue-sky review of offerings. Further, the shift in SEC policy is at least in part a response to the institutionalization of the securities markets.⁵⁶

⁵⁵ Review of Corporate Financing, Interpretations of the Board of Governors Relating to Section 1 of Article III of the Rules of Fair Practice, NASD Manual (CCH) ¶ 21,51.02, at 2019.

⁵⁶ See generally Karmel, *Assessment of Shelf Registration: How Much Diligence is Due Investors?*, 3 YALE J. ON REG. 401 (1986).

Because state regulation has not similarly adapted to changes in the investor population which call into question the consumer protection aspects of merit regulation, conflicts between federal and state law have become more apparent.

In view of the improvements in corporate disclosure and accounting and auditing standards which fifty years of federal securities regulation has accomplished, and the vastly improved communications systems utilized by today's investors, it is questionable whether there is any continuing policy justification for permitting a state blue-sky administrator to stop any securities offering that has been registered with the SEC from going forward in a particular state. This is a barrier to capital formation that does not appear justified by whatever additional investor protection may be provided.⁵⁷ Further, the parochial interest of a single state in protecting its residents from purchasing shares in an interstate offering subject to the full disclosure requirements of the Securities Act would not seem to outweigh the concomitant burden on commerce.

B. *Internationalization*

One of the reasons that the Commission should make a greater effort to work either for the abolition of state merit regulation or to incorporate any needed features of such regulation into a national standard is that the securities markets are now international. The only open question is the extent to which United States corporations, investment banks, and investors will participate in those markets. Because of the recognized present and future importance of multinational securities offerings, the SEC has issued a concept release requesting comments on the implementation of a framework to accommodate multinational securities offerings.⁵⁸ SEC action to facilitate multinational securities offerings is a worthwhile and needed endeavor. However, implementation of the ideas set forth in the SEC's release requesting comment on this subject could be impeded by the continued existence of blue-sky merit regulation.

⁵⁷ Merit regulation does not protect investors against frauds perpetrated by those who flout the law. Improved state enforcement action against confidence men would be a better mechanism for separating dishonest from honest businessmen.

⁵⁸ Securities Act Rel. No. 33-6568 (Feb. 28, 1985), *reprinted in* 17 *Sec. Reg. & L. Rep.* (BNA) No. 10 (Mar. 8, 1985).

Some commentators have recommended a shift to a system of comity, in which compliance with foreign securities disclosure and accounting standards will be recognized and accepted for the registration of foreign securities offerings in the United States, at least as to issuers of those countries that have disclosure and accounting standards comparable to those of the United States.⁵⁹ Others have suggested the drafting of common prospectus-disclosure requirements.⁶⁰ The ability of individual state blue-sky commissioners to insist upon different standards would render a determination by the SEC to adopt either type of program meaningless.⁶¹ Furthermore, the necessity for complying with blue-sky laws by foreign issuers who are unfamiliar with United States law may be even more costly and burdensome than it is to corporations in the United States. It is easy to take the position that if a foreign issuer wishes to tap the capital markets in the United States, it has to do so according to our rules. However, such a position is myopic and self defeating. It merely prevents United States investors from buying such securities through investment bankers in the United States and encourages the further development of an off-shore international marketplace subject to little, if any, regulation by the United States.

C. *Blue Chip Exemptions*

Most state securities laws currently provide an exemption from their securities registration requirements to issuers that list on a national securities exchange. Some states also provide an exemption for certain over-the-counter securities.⁶² Controversy over these exemptions has been caused by two different developments.

On the one hand, the NASD has been urging that the states adopt broader exemptions so that securities listed on NASDAQ

⁵⁹ See *Division of Corporation Finance, Summary of Comments on Concept Release Facilitation of Multinational Securities Offerings*, Jan. 10, 1986.

⁶⁰ *Id.*

⁶¹ Massachusetts and the NASAA submitted comments cautioning that a reciprocal approach could lead to both merit and disclosure review of foreign offerings by the states. *Id.* at 52-53. See also Letter from Michael Unger to John Wheeler, Aug. 16, 1985, NASAA Reports (CCH) ¶ 9303, at 9210.

⁶² See note 30 *supra*.

and/or securities designated as "NMS securities"⁶³ become exempt from blue-sky registration requirements. On the other hand, the NYSE has decided to revise its listing requirements, which presently prohibit dual class capitalizations that result in non-voting or restricted voting stock.⁶⁴ While the SEC has not yet approved such a change, the pendency of this probable rule change has caused some blue-sky regulators to consider elimination of the blue chip exemption in view of merit standards addressed to voting rights.

Blue-sky provisions dealing with shareholder voting rights generally are promulgated under a fair and equitable standard. Such restrictions are intended to keep promoters from obtaining public financing without relinquishing some company control to the public.⁶⁵ The states that have rules mandating such rights seek to provide equity between classes of stock, although preferential rights to either dividends or distributions on liquidation may provide the necessary justification for unequal voting rights. Annexed as Table II is a chart setting forth the states that have merit restrictions relating to voting rights.

A North American Securities Administrators Association (NASAA) Statement of Policy on Non-Voting Stock states that unless preferential treatment as to dividends and liquidation is provided with respect to the publicly offered security or the differentiation is otherwise justified, the offering or proposed offering of equity securities of an issuer having more than one class of equity security authorized or outstanding shall be considered unfair and inequitable to public investors if the class of equity securities offered to the public (a) has no voting rights or (b) has less than equal voting rights, in proportion to the number of shares of each class outstanding, on all matters, including the election of members to the board of directors of the issuer.⁶⁶ This type of merit review has been adopted in Alaska, Indiana,

⁶³ See 17 C.F.R. § 240.11Aa-2-1 (1986) (defining "national market system securities").

⁶⁴ See Karmel, *supra* note 31, at 1, and Dent, *supra* note 40; Seligman, *supra* note 40. See also Karmel, *Is One Share, One Vote Archaic?*, N.Y.L.J., Feb. 26, 1985, at 1, col. 1.

⁶⁵ Brandi, *supra* note 2, at 700; H. SOWARDS AND N. HIRSCH, *supra* note 45, at § 7A.03[h][ii].

⁶⁶ NASAA Statement of Policy, Non-Voting Stock, NASAA Reports (CCH) ¶ 2401, at 1401 (Adopted Sept. 17, 1980).

Missouri, and Nebraska.⁶⁷

In January 1986, the NASAA Committee on State Registration Exemptions issued a Report and Recommendation on the issues of an NMS exemption, an exchange exemption, and other matters.⁶⁸ This report subsequently was approved by NASAA at its spring meeting.⁶⁹ In the context of current controversies over possible changes in listing standards relating to voting rights and any expansion of the blue chip exemption, the NASAA Committee Report recommended that instead of a blue chip exemption specifying, for example, NYSE securities, the blue-sky commissioner should designate the criteria for any blue chip exemption in a rule. Thus, state administrators would have the power to certify appropriate blue chip standards, rather than delegating their ability to set criteria to an SRO. Further, the proposed model rule would require exempt issuers, among other

⁶⁷ ALASKA ADMIN. CODE tit. 3, § 3AAC 08.210, 1 BLUE SKY L. REP. (CCH) ¶ 8434, at 4428; INDIANA ADMIN. CODE § 710IAC, 1-12-4, 1A BLUE SKY L. REP. (CCH) ¶ 24,590, at 19,463; MO. CODE REGS., tit. 15 § 30-52.110, 2 BLUE SKY L. REP. (CCH) ¶ 35,461, at 30,532; NEB. SECURITIES RULES, tit. 48, Ch. 8, 2 BLUE SKY L. REP. (CCH) ¶ 37,408, at 32,505-06.

The Minnesota regulations, MINN. R. 2875.3080, 1A BLUE SKY L. REP. (CCH) ¶ 33,501, at 28,436, go one step further to say there will be no registration of securities with unequal voting rights unless the Commissioner, in his discretion, deems such substitutes satisfactory. Similarly, Texas and Wyoming permit the Commissioner to determine that the preferential treatment justifies unequal voting rights. TEX. ADMIN. CODE tit. 7, § 113.3(6), 3 BLUE SKY L. REP. (CCH) ¶ 55,583, at 49,521; WYO. SECURITIES RULE § 3(j), 3 BLUE SKY L. REP. (CCH) ¶ 66,433, at 57,507. Two alternatives to the stringent voting rights requirement are provided in TENN. CODE ANN. 0780-4-3.06(4)(i), 3 BLUE SKY L. REP. (CCH) ¶ 54,426, at 48,513. In addition to preferential treatment as to dividends and liquidation, it allows unequal voting rights if a public market exists for the issuer's securities.

Another slight modification to the NASAA statement exists in the WIS. ADMIN. CODE, § SEC 3.07(1), 3 BLUE SKY L. REP. (CCH) ¶ 64,527, at 56,520-21. Whereas the NASAA statement provides that the offering shall be deemed unfair and inequitable if voting rights are unequal and preferential treatment is absent, the Wisconsin statute states that the offering may be deemed unfair and inequitable if common stock has no voting rights. Less than equal voting rights may be justified by preferential treatment.

Other merit statutes classify equity securities into preferred and common stock categories. See, e.g., CAL. ADMIN. CODE, tit. 10 § 260.140.1, 1 BLUE SKY L. REP. (CCH) ¶ 11,852, at 7,664; LA. REV. STAT. ANN. § C-08 (West 1973), 1A BLUE SKY L. REP. (CCH) ¶ 28,498 at 23, 428-29; MINN. R. Parts 2875.3080, 2875.3510 (1983), 1A BLUE SKY L. REP. (CCH) ¶¶ 33,501, at 28,436, 33,508, at 28,437; WASH. ADMIN. CODE §§ 460-16A-035, 460-16A-040, 3 BLUE SKY L. REP. (CCH) ¶ 61,547, at 54,503, and ¶ 61,548, at 54,503-53,504.

⁶⁸ NASAA Committee Report on State Registration Exemptions, reprinted in 18 Sec. Reg. & L. Rep. (BNA) No. 6, at 206 (Feb. 7, 1986).

⁶⁹ NASAA Agrees to Propose Amendments to '56 Uniform Act at Spring Meeting, reprinted in 18 Sec. Reg. & L. Rep. (BNA) No. 12, at 399 (Mar. 21, 1986).

things, to have at least two independent directors, an audit committee composed solely of independent directors, and no class of nonvoting common stock. If two classes of voting stock are outstanding, the class with the lesser voting rights would be required to have the right to elect at least twenty-five percent of the directors of the issuer. Further, the voting disparity between the classes could be no greater than 10 to 1. Voting rights for preferred stockholders also are specified in the proposal.

Some commentators believe that the trend toward issuance of non-voting common stock could have a deleterious effect in the long term on capital formation. First, it could impair investor confidence in the securities markets and more generally in business corporations. Second, it could eliminate an important accountability mechanism, which enables large public corporations to avoid further government regulation.⁷⁰ Yet, because the stock exchanges and the over-the-counter market are competing marketplaces, it is not realistic to expect one exchange faced with the possibility of widespread delistings to uphold ideal standards. Further, the trends in the direction of non-voting stock are a reaction to perceived abuses in the so-called market for corporate control.

This makes it likely that the SEC ultimately will be forced to intervene in imposing a national standard with regard to voting rights on publicly traded corporations. The SEC cannot credibly maintain that the states should maintain and even expand the blue chip exemption if it is not ready to afford shareholders and investors some basic protections with regard to corporate governance. The alternative is greatly increased merit review of securities offerings, which would be a big step in the wrong direction.

CONCLUSION

The balance between SEC, SRO, and state regulatory requirements for securities issuances has always been complex and tenuous. This article has addressed only some of the emerging controversies that threaten to upset the existing balance and require the development of a new relationship between the SEC,

⁷⁰ See, e.g., Seligman, *The One Share, One Vote Controversy*, Report prepared for Investor Responsibility Research Center Inc., Jan. 1986, at 19-22.

the SROs, and the states in order to establish necessary and appropriate investor protection standards in connection with securities flotations. As so often is the case, the marketplace is moving much faster than the regulators in establishing a new order.

TABLE I. PRICE & PROFIT REGULATION

(a) Offering Price Restrictions	(b) Dilution Restrictions	(c) Cheap Stock Restrictions	(d) Promoters' Equity Investment Requirement	(e) Options & Warrants Restrictions
Alaska Arkansas California Florida Hawaii Indiana Kansas Kentucky Louisiana Massachusetts Mississippi Nebraska New Mexico North Carolina North Dakota Tennessee Texas Utah West Virginia Wisconsin Wyoming	Alabama Alaska Hawaii* Kansas* Kentucky Louisiana Massachusetts* Mississippi Utah Wyoming	Alaska Arizona Arkansas California Hawaii Idaho Indiana Iowa Kansas Kentucky Louisiana Massachusetts Minnesota Missouri Montana Nebraska New Mexico North Dakota Tennessee Washington West Virginia Wisconsin Wyoming	Alabama Alaska Arizona Arkansas Florida Kentucky Louisiana Minnesota Mississippi Missouri Nebraska Nevada New Mexico Oklahoma Tennessee Texas Utah Washington West Virginia Wisconsin Wyoming	Alabama Alaska Arizona Arkansas California Connecticut Delaware Florida Hawaii Idaho Indiana Kansas Louisiana Massachusetts Michigan Minnesota Mississippi Missouri Montana Nebraska New Jersey New Mexico North Dakota Oklahoma Pennsylvania South Carolina Tennessee Texas Vermont Washington Wisconsin Wyoming
Iowa's Offering Price Restriction Was Rescinded August 21, 1985.	* This Provision Applies To Promotional Securities.	Michigan's Cheap Stock Restriction Was Rescinded December 27, 1983.	Iowa's Requirement Was Rescinded August 21, 1985. Michigan's Requirement Rescinded December 27, 1983.	Iowa's Restriction Was Rescinded August 21, 1985.

TABLE II. RIGHTS & PROTECTIVE COVENANTS

<u>(a) Voting Rights Restrictions</u>	<u>(b) Capitalization & Capital Structure Restrictions</u>
Alaska	Alabama
Arkansas	California
California	
Florida	
Indiana	
Kansas	
Louisiana	
Minnesota	
Missouri	
Nebraska	
North Dakota	
Tennessee	
Texas	
Washington	
Wisconsin	
Wyoming	
<u>Iowa's Restriction Was Rescinded August 21, 1985.</u>	

