1984

Who Speaks for the Investor? An Evaluation of the Assault on Merit Regulation

Hugh H. Makens
Warner Norcross & Judd LLP

Follow this and additional works at: http://scholarworks.law.ubalt.edu/ublr

Part of the Securities Law Commons

Recommended Citation
Available at: http://scholarworks.law.ubalt.edu/ublr/vol13/iss3/2

This Article is brought to you for free and open access by ScholarWorks@University of Baltimore School of Law. It has been accepted for inclusion in University of Baltimore Law Review by an authorized administrator of ScholarWorks@University of Baltimore School of Law. For more information, please contact snolan@ubalt.edu.
WHO SPEAKS FOR THE INVESTOR?
AN EVALUATION OF THE ASSAULT ON MERIT REGULATION

Hugh H. Makens†

Merit regulation is under attack from critics who allege that it unnecessarily delays or inhibits capital formation. The author draws on his experience as both a state and federal securities regulator and as a private securities practitioner to examine the scope of merit regulation, analyze the criticisms, explain why the quantitative studies of the regulatory system have failed to prove its value, and recommend changes that would lead to a more effective administration of merit standards.

I. INTRODUCTION

An issuer desiring to make a public offering of securities must consider both federal and state statutes regulating the sale of securities. Although the federal laws, administered by the Securities and Exchange Commission (SEC), are the most familiar form of regulation, state securities laws regulate both federally registered offerings and offerings exempt from federal registration. Many state securities acts, sometimes referred to as blue sky laws, attempt to protect investors by requiring some issuers to demonstrate to state securities administrators the fairness of an investment opportunity before an offer or sale to the


2. The phrase "blue sky law" refers to the state statutes' purpose of protecting the investor from promoters who would sell stock in the blue sky itself. See Hall v. Gieger-Jones Co., 242 U.S. 539, 550 (1917) ("speculative schemes which have no more basis than so many feet of blue sky").
public can occur.3

The basic distinction between the standards applied in federal and state securities registration is that the SEC is chiefly concerned with the full and timely disclosure of all material information, while many state laws, in addition to requiring disclosure, require that the offering meet certain standards of fairness. This fairness requirement, referred to as merit regulation, reflects very basic assumptions about the need to protect investors both from excessive investment risk and from self-serving behavior by promoters and other insiders.4

This two-tier system of regulation has been criticized as serving no purpose other than to inhibit capital formation.5 Other commentators have responded by emphasizing the state’s responsibility to protect all investors within its jurisdiction, particularly unsophisticated investors.6 The issue at the forefront of this debate is whether the benefits of merit regulation as a measure of investor protection outweigh the costs associated with the requirements of merit regulation.7 This issue has become perhaps the most controversial subject in the field of securities regulation, as several states have recently considered the modification, restriction, or elimination of merit regulation in their jurisdictions.8

The debate, unfortunately, is grounded more on opinion than on fact. A complete analysis of the costs and benefits of merit regulation has yet to be made. This analysis is missing in part because the empirical data needed for a comprehensive study are so difficult to obtain.9 The principal problem, however, is the lack of an appreciation of the many intangible, non-quantifiable benefits of merit regulation. Consequently, past law review articles and books on merit regulation have had difficulty assessing its value.10

---

3. For a discussion on the historical origins of blue sky laws, see L. Loss & E. Cowett, BLUE SKY LAW 5-13 (1958).
4. For a thorough description and defense of these assumptions, see Tyler, More About Blue Sky, 39 WASH. & LEE L. REV. 899 (1982).
7. See Mofsky & Tollison, Demerit in Merit Regulation, 60 MARQ. L. REV. 367, 370-71 (1977) (criticizing quantitative analysis of merit regulation’s benefits for failure to analyze cost factor).
9. See infra notes 99-116 and accompanying text.
10. It is impossible to write about merit regulation without some bias. Mine arises from experience as a member of the SEC enforcement division, as Director of the Michigan Corporation and Securities Bureau, as President of NASAA, and as a private practitioner. Although I believe there are substantial flaws in the state securities regulatory system, I advocate retaining the present structure until it is shown that it is an ineffective means of investor protection in light of its impact on
This article fills some of the gaps in the present debate by explaining how merit regulation works, why it generates so much hostility, who it benefits, and how it can be improved. The central argument of this article is that under many circumstances merit regulation is a uniquely effective means of protecting the public investor that can be made even more effective through greater cooperation among the state administrators, the SEC, the securities bar, and the securities industry.

Section II of this article defines the scope of merit regulation, with reference both to its range of application and its philosophical premises. Section III examines the current assaults in both the theoretical literature and the state legislatures on merit regulation's value as a system of investor protection. This section identifies some of the practical problems that lay behind the challenges to merit regulation. These challenges have led to several attempts to quantify the benefits allegedly provided by merit regulation. Section IV examines why these quantitative studies actually prove very little about merit regulation and merely reflect the need for a new approach to the problem. Section V outlines a new approach by explaining why some form of merit regulation is needed, and explores how that need can be met through a greater cooperative effort among all of the parties affected by state securities regulation.

II. THE SCOPE OF MERIT REGULATION

A. An Overview of the Merit Concept and Registration Process

Although blue sky legislation varies from state to state, nearly all jurisdictions require the registration of securities. In addition, since a majority of states have modeled their securities law on the Uniform Securities Act (Uniform Act), most state securities acts are quite similar, especially with respect to the procedural aspects of the registration process. Not all state securities acts, however, permit the administration the securities market. Although critics of this article will be able to argue that its conclusions are unsupported by either empirical data or historical documentary evidence, my conclusions and impressions are firmly based on my experience in the field.

11. The only jurisdiction that does not require some form of securities registration is the District of Columbia. See 1 BLUE SKY L. REP. (CCH) ¶¶ 504-506 (Nov. 1980).


14. The typical state law provides for three types of registration: (1) registration by
tor to review the merits of an offering. Administrators without merit authority are empowered to review registration statements only from a disclosure and antifraud perspective. This distinction between merit and non-merit review standards is reflected in the Uniform Act, which defines several grounds for the denial of registration to a securities offering, only one of which, section 306(a)(2)(F), incorporates merit standards. Furthermore, registration problems may arise in a merit jurisdiction for reasons unrelated to the state's merit standards.

When a state applies merit regulation in its registration process, it is attempting to channel investment capital into offerings that will give investors a better chance to earn a return on their investment. The exclusive goal of merit regulation, therefore, is a very specific form of investor protection. Recently, with the shift in emphasis to a more deregulatory environment, a trend has developed toward the realization that an administrator may have a dual obligation, involving both investor protection and consideration of the overall economic climate for business in determining the manner of application of the securities laws.

The specific merit standard contained in the Uniform Act demonstrates how this goal is sought to be achieved. Section 306(a)(2)(F) authorizes the state administrator to deny registration if "the offering has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, or promot-

---

notification (a type of short-form registration in offerings whose issuers meet duration and earnings tests); (2) registration by coordination (for offerings pursuant to a registration statement under the 1933 Act); and (3) registration by qualification (for all other offerings). See id. §§ 302-04, 7A U.L.A. at 599-612.


19. For example, a filing may not be in reviewable condition because of inadequate preparation or counsel's ignorance of the securities laws. Furthermore, an offering may encounter difficulty in a merit state because of disclosure problems or because the transaction has fraudulent aspects.
ers' profits or participation, or unreasonable amounts or kinds of options."20 Other states go beyond such listings of specific merit criteria, and apply provisions authorizing the administrator to deny registration if the offering is not "fair, just and equitable."21 In essence, a blue sky statute may contain both a provision identifying specific merit concerns and a provision authorizing a broad consideration of fairness.22

To an issuer who makes a securities offering, specific merit concerns present a composite of substantive standards that must be met to offer securities in a particular state. The attorney attempting to comply with these standards for the first time, however, may be puzzled to learn that they often cover topics not specifically referenced in the state's equivalent of section 306(a)(2)(F). For example, a state may impose very specific criteria relating to the competence of the issuer's management, the organization of the offering, sale through qualified persons, the use of the proceeds of the offering, limitations on the ability of the promoter to "cash-out" of an enterprise without the investor having a similar opportunity, and adequacy of the business plan in the prospectus.23 The brief merit criteria referenced in the statute, therefore, merely represent a portion of the requisite merit standards. Indeed, most merit states will either by rule or informal policy apply much more specific merit standards.

Perhaps the most familiar aspect of the merit regulation is its regulation of corporate offerings, particularly equity offerings. Most merit states have specific rules relating to these offerings.24 There are some

---

22. For a discussion of the adoption of a specific rather than a general merit review standard in the Uniform Act, see L. LOSS, COMMENTARY ON THE UNIFORM SECURITIES ACT 83-85 (1976).
23. An example of a detailed set of merit standards is the NASAA Statement of Policy Regarding Real Estate Programs. This document provides a detailed set of guidelines for state administrators who review these offerings in terms of these and other merit concerns. NASAA is the major organization of the securities agencies of the 50 states, the District of Columbia, the Canadian provinces, and Mexico. It has adopted and proposed guidelines and statements of policy for a broad variety of merit concerns. The NASAA real estate guidelines are applied by many merit jurisdictions through formal rules or on the basis of informal administrative policy. For the text of these guidelines, as effective January 1, 1984, see 1 BLUE SKY L. REP. (CCH) ¶¶ 5352-5379 (Apr. 28, 1984).

For a discussion on state implementation of the NASAA real estate guidelines, see Subcommittee on Real Estate Programs, ABA State Regulation of Securities Committee, Survey of State Implementation and Application of the Current NASAA Real Estate Guidelines (Apr. 1, 1984) (copy on file at the University of Baltimore Law Review office). See infra notes 43-64 and accompanying text.
national guidelines for merit review of various aspects of corporate equity offerings, but the different state rules or policies cover similar issues and are applied in generally the same manner. These merit standards have received fairly extensive treatment in the secondary literature and need not be summarized in detail here.

Merit regulation has a significant impact primarily on public corporations in which insiders retain significant ownership or voting control. The effect of merit regulation on the problems created by the separation of ownership and control is seen most vividly in the restrictions on officer and director compensation. The states restrict this compensation by objecting to excessive warrants and options, cheap stock, and loans to insiders. Some forms of compensation are curtailed to ensure promoter commitment to the project, provide for an orderly secondary market, and increase the amount of capital actually going to the project. Anyone familiar with securities offerings would identify these as basic objectives that underwriters, investment advisors, and attorneys should seek to achieve in structuring an offering for an issuing entity. Much of the quarrel with these objectives thus relates not to the propriety of the objectives but rather to the specific limitations imposed in their name.

Issuers whose offerings do not fit within merit constraints must either modify the terms of the offering or face denial of the application for registration. The customary procedure, however, is for the administrator to negotiate with the registrant, a process that results in either registration or voluntary withdrawal of the application.

Most registrations, whether of corporate equity offerings or other types of offerings, are prepared with a recognition of potential blue sky problems, and appropriate advance planning has been applied to the

25. See, e.g., NASAA Statement of Policy, Cheap Stock, 1 BLUE SKY L. REP. (CCH) ¶¶ 5311-5314 (Apr. 23, 1983) (cheap stock is stock sold to a specified class of promoters or other insiders at a price less than that at which the stock is offered to the public).


27. See supra note 25.

28. See supra note 26, at 90-95; Tyler, supra note 4, at 910-15.


30. Denial of an application seldom occurs since a registrant will ordinarily withdraw an application once it becomes apparent that the administrator's merit (or other) concerns cannot be satisfied. See Bartell, Merit Regulation and Clearing Strategy, in STATE REGULATION OF CAPITAL FORMATION AND SECURITIES TRANSACTIONS 315, 333 (D. Goldwasser & H. Makens eds. 1983).
filing documents. Nonetheless, there still may be a confrontation with the administrator over the fairness of the offering. When this happens, the administrator has moved from the role of defender of certain basic and non-controversial standards to that of negotiator of the economic terms of the transaction on behalf of the investor. If the underwriter has done an in-depth due diligence review, and if counsel has carefully examined the potential blue sky implications of the terms of the offerings, this will ordinarily not create a problem, because counsel should be prepared to justify the apparently unfair provision to the administrator.

The administrator assumes the role of investor’s advocate because the investor is not in a position to negotiate the terms of an offering on his own behalf and because the underwriter is often unable to negotiate favorable terms for the investor without risk of losing the underwriting. The administrator may initially assume, often correctly, that the lead underwriter will provide only a minimum level of due diligence and fairness negotiation. Through application of the merit standards, the administrator seeks to establish a level of minimum fairness to the investor. These standards attempt to ensure that sufficient funds are placed into a project to permit the success of the enterprise, to prevent self-dealing that would strip the enterprise of vital capital resources, and to provide the investor with a means of self-help if the transaction fails because of managerial wrong-doing.

The administrator’s merit review, however, usually accompanies a review of the quality of the registrant’s disclosure. In fact, 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. Because many states will review most offerings, the state administrators are often able to identify internal inconsistencies, missing information, and similar problems. Many of these disclosure comments relate to merit concerns. Specifically, the administrator may probe extensively for hidden compensation, conflicts and background information relating to the issuer or its affiliates, and may require specific disclosure with respect to these typical merit concerns. Since the examination at the SEC does not always identify and resolve these problems, it is fair to say that the states fulfill an important role in the

33. See id. at 324-33 (useful guide to this planning).
34. See id. at 327-29.
35. See infra text following note 135.
36. See infra text accompanying notes 138-41.
37. Id. This problem is compounded when the lead underwriter is an affiliate of the issuer.
38. See, e.g., NASAA Statement of Policy, Real Estate Programs, Section VII, 1 BLUE SKY L. REP. (CCH) ¶ 5358 (Apr. 28, 1984) (requiring real estate program to provide participants with voting rights, access to records, rights to call meetings, and certain consent powers).
Identification of these problems by an administrator in the course of a merit review may prove beneficial to the issuer as well as to the investor. Removal of either the appearance or the reality of overreaching, self-dealing, or conflict of interest often works to the advantage of the issuer by preventing future dispute and litigation.\textsuperscript{40} Similarly, a merit requirement of a system of communication with investors is likely to foster stable investor relations.\textsuperscript{41} Restraints on the dumping of cheap stock in the market are likely to keep the market for that security and other securities more reputable and hence more attractive to investors. The industry and the issuer, as well as the investor, benefit by these restraints. They should be self-imposed by the issuer, its counsel, or the underwriter, but when they are not, they should be imposed by law.

Perhaps the most important aspect of merit regulation is the securities industry’s voluntary compliance with published rules and guidelines. Insofar as the premises underlying merit standards are valid, many companies include these protections without reference to the guidelines or rules because it is in their self-interest to do so. In contrast, other issuers will comply with merit standards only because they realize that without compliance they will face substantial problems in meeting blue sky requirements. The net result, however, is that many of the merit standards become industry standards, honed in a competitive environment over time. The development of an industry standard has a dramatic effect on all offerings, public and private. In the real estate field, for example, the controversial offerings of the early 1970’s, as modified in response to merit concerns, have become the models for most of today’s offerings.\textsuperscript{42} The ripple effect of merit regulation thus goes far beyond culling out the fraudulent or weak offerings. This vital

\textsuperscript{40}This intangible effect is virtually impossible to measure, but it should be considered one of the benefits of merit regulation. Unfortunately, both supporters and critics of merit regulation tend to ignore it, at least in their published works.

\textsuperscript{41}See, e.g., NASAA Statement of Policy, Real Estate Programs, Section VII.C, 1 \textsc{Blue Sky L. Rep.} (CCH) ¶ 5358 (Apr. 28, 1984); NASAA Statement of Policy, Oil and Gas, Section VIII.B, 1 \textsc{Blue Sky L. Rep.} (CCH) ¶ 5229 (Sept. 22, 1976) [hereinafter cited as NASAA Oil and Gas].

\textsuperscript{42}This is not to suggest, however, that the real estate syndication industry has been entirely satisfied with state merit regulation of real estate programs. See Securities Industries Association, \textit{SEC-NASAA Hearings on Federal-State Securities Regulation}, Washington, D.C. (Sept. 12, 1983) (statement of Alan J. Parisse) (urging more effective and cooperative regulation) (copy on file at the University of Baltimore Law Review office).
element of merit regulation has been ignored by all of the commentators.

B. A Case Study of How Merit Regulation Works: The NASAA Real Estate Guidelines

Although each merit state has enacted regulations expressing the merit standards to be applied by the blue sky administrator, these individual standards have not developed in a vacuum. Instead, the sources of state merit regulation are usually the guidelines and statements of policy developed by voluntary associations of state administrators. In the past, three separate organizations developed these policy guidelines and statements; today, only the North American Securities Administrators Association (NASAA) remains active in this area. NASAA is an association composed of the securities administrators of the fifty states, the District of Columbia, Puerto Rico, the Canadian Provinces, and Mexico. In addition to providing a forum for joint action, its purposes are the development of uniform laws and policies and the coordination of enforcement activities. Although NASAA guidelines and statements of policy do not bind its members, they provide a recommended direction for states to follow. The current NASAA real estate guidelines are a good example of how merit standards can be used to promote uniform standards for investor protection in a specific type of offering.

The NASAA guidelines require sponsors of real estate programs to have at least two years of experience in real estate development. This requirement is designed to prevent inexperienced people from using public funds to learn the business of real estate development. This standard reflects the customary practice of most experienced securities attorneys, who would rarely consider taking an issue public with unseasoned promoters. These attorneys would instead recommend that the

43. The organizations consisted of NASAA, the Central States Administrators Council (CSAC), and the Midwest Securities Commissioners Association (MSCA). Today CSAC functions primarily as an enforcement forum, and not as a source of merit guidelines or policy statements. MSCA was merged into NASAA in 1979, but some of its former members constitute the core of NASAA's merit regulation committee. Makens, Administration and Relationship with other Agencies, in MICHIGAN SECURITIES REGULATION 15, 22-23 (C. Moscow & H. Makens eds. 1983).

44. NASAA's major efforts in this direction have included the development of standardized forms, see 1 BLUE SKY L. REP. (CCH) ¶¶ 5111-5121 (Jan. 1984), statements of policy, see id. ¶¶ 5151-5385 (Apr. 1984), and the Uniform Limited Offering Exemption (ULOE), see id. ¶ 5294 (Oct. 1983).

45. Although these guidelines are technically designated a "Statement of Policy," they are usually referred to as guidelines. Consequently the two terms will be used interchangeably in this article. See Hildebrandt, Regulation of Real Estate Securities, in BLUE SKY LAWS: STATE REGULATION OF SECURITIES 295-304 (J. Halprin & H. Makens eds. 1984) (refers throughout to NASAA real estate "guidelines").

46. NASAA Statement of Policy, Real Estate Programs, Section II.A, 1 BLUE SKY L. REP. (CCH) ¶ 5353 (Sept. 21, 1983).
client consider either a private offering with a limited number of inves-
tors or a joint venture with experienced partners. Similarly, most reputa-
table brokerage firms would not consider handling a real estate offering
with inexperienced promoters. Nonetheless, to the extent some attor-
neys and brokerage firms do not exercise the self-restraint necessary to
prevent these clients from promoting real estate offerings, the guide-
lines provide a necessary degree of investor protection.

The guidelines also require real estate sponsors to meet certain net
worth requirements. The basic requirement that a sponsor be able to
meet the financial obligations of a public program is certainly a reason-
able method to ensure the general partner's financial commitment to
the project.

The real estate guidelines also establish suitability standards for
investors. These standards vary with the nature of the programs. For
example, a program with a tax shelter orientation will customarily re-
quire investors to have a substantial net worth and be in a tax bracket
that will allow them to take advantage of the tax benefits provided by
the program. As a practical matter, since many real estate syndica-
tions have a significant tax orientation, the net worth test applied by the
Internal Revenue Code with respect to the safe harbor for partner-
ships have become the industry standard, and they comport with the
NASAA guidelines. In contrast, the net worth and income suitability
standards applied to real estate programs designed to produce income
for the investor rather than to provide a tax shelter are substantially
lower.

In addition to requiring the investor to meet suitability standards,
the guidelines require the investor to make a certain minimum invest-
ment. The concept of minimum investment has been debated both
within and without NASAA for several years. The minimum invest-
ment requirement perhaps can be best justified as a means of creating
an incentive for the investor to read the prospectus carefully or to
spend the amount needed for competent professional advice. The crit-
ics assail the concept as assuring a minimum loss.

The heart of merit regulation through the real estate guidelines is
the requirement that "[t]he total amount of consideration of all kinds
which may be paid directly or indirectly to the sponsor or its affiliates
shall be reasonable, considering all aspects of the syndication program
and the investors." The guidelines also indicate the type of consider-

47. NASAA Statement of Policy, Real Estate Programs, Section II.B, 1 BLUE SKY L.
REP. (CCH) ¶ 5353 (Apr. 28, 1984) [hereinafter cited as NASAA Real Estate].
48. Id. at Section III, ¶ 5354.
49. Id. at Section III.A.
51. NASAA Real Estate, supra note 47, Section III.B.4, ¶ 5354.
52. Id. at Section III.D., ¶ 5354.
53. Id. at Section IV.A.1., ¶ 5355.
ation that is customarily received in these real estate programs, and to require that a substantial portion of the program's capital contributions be applied toward the investment in properties. Except in very highly leveraged programs (a type not normally made available through public offerings), it is reasonable to require that a substantial portion of the proceeds collected from investors be devoted to the actual purchase and development of the properties rather than in payment of fees to promoters. While definition of the appropriate percentage is certainly subject to debate, the concept that an investor's money is much more likely to yield a return if it is used to purchase property rather than to pay promoters seems unquestionable. There are perhaps some situations in which this requirement does not make absolute sense, such as when a promoter has obtained the property at an exceptionally good price or has negotiated unusually favorable financing, but these situations are relatively uncommon, especially in public programs. In my experience, most national programs meet or significantly exceed the guidelines' requirements for the use of proceeds.

The equity interests in the program retained by the promoters are also closely regulated by the guidelines. The guidelines require the receipt of benefits from these promotional interests to be deferred until investors have received a certain return on their capital contributions. Real estate brokerage commissions on resale of the property are also limited. The guidelines permit payment of a property management fee, capped at different percentages for residential properties and for industrial and commercial properties.

The discussion above is only a brief explanation of the NASAA guidelines for real estate programs and is intended to illustrate the goals of merit regulation of these programs. It is important to emphasize, however, that the merit standards imposed by these guidelines were not arbitrarily selected or developed without careful attention to the realities of the industry and the marketplace. NASAA guidelines are traditionally developed through a committee designated for the purpose of studying a particular subject for guidelines. The committee prepares guidelines for public comment and subsequently presents them to the NASAA membership for vote on adoption. The standards for promoter compensation, for example, were based on exten-

54. Id. at Section IV.A.1.a.-h.
55. Id. at Section IV.C.1.-2.
56. Id. at Section IV.E.
57. Id. at Section IV.F.
58. Id. at Section IV.G.
59. For more detailed discussion, see Hildebrandt, supra note 45, at 304-11; Sargent & Pollitt, Introduction to State Securities Regulation (Blue Sky Law), ALI-ABA, Effect of Securities Regulation on Real Estate Transactions 179 (1983).
60. Beyond this basic sequence, however, NASAA has not followed any definite procedure for the drafting adoption of guidelines and statements of policy, and this has contributed substantially to the level of controversy that has surrounded some of the NASAA pronouncements.
sive testimony about the level of compensation ordinarily paid in the industry to promoters providing similar services. In addition, this area, perhaps more than any other, experiences extensive negotiation between administrators and sponsors about the application of the guidelines to particular transactions, and the requirements are frequently modified to meet the needs of individual programs.

Most aspects of the NASAA guidelines do not burden the affected class of issuers. For example, with respect to real estate programs, the NASAA guidelines have served not only as a basis for merit regulation but also as the basis for SEC review. In addition, the guidelines were first implemented at the time of the initial development of the real estate syndication industry. As a result, many of the standards established by these guidelines have become industry standards applied by the promoters regardless of the extent or kind of regulation to be applied to a particular offering. The development of these standards certainly has not hindered the dynamic growth of the real estate syndication industry, and probably has helped to ensure the stability and public confidence in this form of investment. The real estate guidelines have also promoted compliance with the SEC disclosure policies because they have had the effect of forcing a great number of private real estate offerings to change drastically the nature and extent of disclosure, as well as the structure of offering and the promoter compensation structure. The prospectuses used in private real estate offerings of the early 1970's bear little resemblance to their counterparts today. Both the level of disclosure and the economics of these programs have been dramatically affected by merit regulation to the advantage of the investor.

This type of regulation also works to the benefit of the industry. To the extent that the real estate syndication industry could have been

61. This author was a member of the NASAA Committee that drafted the first real estate guidelines in 1976.


63. See Kuklin, Corporate and Real Estate Relationships—"Through the Looking Glass," ALI-ABA, Effect of Securities Regulation on Real Estate Transactions 17 (1983) (discussing the interrelation of securities law and real estate transactions in the syndicated offerings developed in the past fifteen years): see also Makens, supra note 39, at 151 ("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. . . .").

64. This is perhaps the inevitable result of the fact that syndicators simply had to comply with the merit requirements of administrators in major states such as California, Illinois, Michigan, and Texas. For a description of how the same phenomenon is occurring in the context of another securities product (publicly traded limited partnerships), see Publicly Traded Limited Partnership: An Emerging Financial Alternative to the Public Corporation, 39 BUS. LAW. 709, 714 (1984).
labeled as one in which promoter self-dealing is common, it would have lost stature as a legitimate investment vehicle. This problem has been largely avoided in national real estate programs. My belief is that the industry's phenomenal growth has benefited from merit regulation.

This does not mean that all the guidelines promoted by NASAA represent the proper level of merit regulation needed in each state. At times, NASAA guidelines have been inappropriate and too heavily weighted in favor of what is perceived by administrators as investor protection. A current example of this problem is the handling of limitations on the amount of cheap or lower priced stock that promoters may retain in connection with new offerings.65

Many states require this so-called "cheap stock" to be placed in escrow.66 In 1983, NASAA adopted "cheap stock guidelines"67 that represent an excessive use of merit authority. These guidelines require cancellation of the stock unless the issuer achieves certain earnings within specified periods, regardless of the performance of the market or industry in which the issuer operates or of any other external considerations.68 NASAA is currently planning to revise these guidelines in the near future.69 Although not without some flaws, the existing real estate guidelines offer a model of how effective guidelines can be developed in a manner consistent with NASAA's goal of investor protection.

III. THE ASSAULT ON MERIT REGULATION

In some states, merit regulation today is under siege. It was substantially eliminated in Illinois, one of the leading merit jurisdictions, by legislative action in 1983.70 A similar attempt to eliminate merit regulation in Texas was narrowly defeated,71 but significant reductions in its scope resulted from legislative changes in Wisconsin72 and Iowa73 during 1983. Comparable changes have been considered and apparently rejected in at least two other states, Arizona and Missouri.74

65. For discussion of the issues associated with merit regulation of cheap stock, see Bloomenthal, Blue Sky Regulation and the Theory of Overkill, 15 WAYNE L. REV. 1447, 1464-67 (1969); Goodkind, supra note 26, at 90-93; Hueni, supra note 6, at 1423-28; Tyler, supra note 4, at 912-13.

66. See, e.g., MO. REV. STAT. § 409.305(1)(1) (1978); 64 PA. ADMIN. CODE § 207.071, reprinted in 2 BLUE SKY L. REP. (CCH) ¶ 48,468 (Jan. 1982); WIS. ADMIN. CODE § SEC 3.04, reprinted in 3 BLUE SKY L. REP. (CCH) ¶ 64,524 (Dec. 1983).


68. Id.

69. These revised guidelines will be drafted by NASAA's Cheap Stock Committee, chaired by R.G. Tucker, Chief Deputy, Montana Securities Division.

70. For discussion of the change in Illinois, see Sosin & Fein, supra note 5, at 196.

71. The proposed changes in the Texas law are discussed in Bromberg, Texas Securities Act, TEX. B.J., Jan. 1983, at 36.


73. On the Iowa developments, see 15 SEC. REG. & L. REP. (BNA) 963 (May 20, 1983).

74. See Sargent, supra note 8, at 284-85.
Some states have acted administratively to narrow their own authority, such as Michigan. These efforts are the result of substantial uncertainty and skepticism about the premises and efficiency of the merit regulatory system. The depth of this uncertainty and skepticism is suggested by the variety of criticisms leveled at merit regulation.

For example, it has been argued that market forces should govern the sale of securities, and that as long as "full disclosure" is provided, no further regulation is necessary or appropriate, particularly the paternalistic regulation implicit in the use of merit standards. Some contends that inexperienced or untrained securities examiners and administrators lack the expertise needed for intelligent evaluation of most offerings. It has been argued that the efficient working of the market will provide adequate investor protection, and that merit regulation is unnecessary. Similarly, it has been said that the best allocation of scarce state securities regulatory resources is fighting fraud through enforcement, not fighting reams of prospectuses used in offerings in which little if any fraud may be involved. The net effect of these arguments may lead to the suggestion that the federal disclosure system provides adequate protection in public offerings and that state review is redundant, except perhaps in the case of wholly intrastate offerings.

Particular aspects of merit regulation are arguably not only ineffective in providing investor protection, but that the merit process goes beyond establishing "fairness" and attempts to negotiate the final terms of an economic relationship on behalf of one of the parties to the extreme detriment of the other without a legislative mandate to do so. Similarly, it may be asserted that application of merit standards undercuts the clear legislative intent expressed in the state corporation laws. Most vehement, perhaps, are the practitioners' complaints that some administrators regulate in an irrational manner by attempting to exclude entire categories of offerings, by applying personal standards

76. See Bateman, supra note 5, at 781-82.
77. See Tyler, supra note 4, at 934-35.
78. See Mofsky & Tollison, supra note 7, at 367-69.
79. See Bloomenthal, supra note 65, at 1481-85.
80. Id. at 1492-93.
81. General corporation statutes tend to have a broadly enabling character, allowing a basic separation of ownership and control. See generally Werner, Corporation Law in Search of its Future, 81 Colum. L. Rev. 1611 (1981). To the extent that the blue sky laws represent an attempt to impose greater restraints on the possibility of managerial misconduct and self-dealing behavior associated with that separation, they are somewhat inconsistent with the intent of the state corporation laws.
82. See L. Loss & E.Cowett, supra note 3, at 76-77 (because of their substantial experience with abusive practices in certain types of highly speculative offerings, some administrators may tend to treat all offerings of that type with a negative attitude).
inconsistent with those imposed by other administrators, or by ignoring the requirements of the state administrative procedure acts.

One commentator has suggested that merit regulators are ineffective in protecting investors because the perpetrators of flagrant types of fraud simply ignore the registration requirements, and that the devotion of state resources to enforcement would produce a greater degree of investor protection. The same commentator has recommended that the appropriate focus of efforts to protect public investors is the general corporation statute, not the blue sky law, and that the public policy concerns of merit regulation would be best served by reform of those statutes. As if these criticisms are not enough, it has further been alleged that merit regulation has an adverse effect upon local employment opportunities.

These criticisms have been debated elsewhere, and do not require reconsideration here. What is needed is some discussion of the very practical reasons for the unpopularity of merit regulation. It is perhaps fair to state that the current assault on merit regulation has been generated by a sense of frustration with the formulation and application of merit policy. This general sense of frustration has several specific sources.

Possibly the most important source is the inherent difficulty associated with a regulatory system based on substantive standards of fairness. Fairness is a will-o’-the-wisp, difficult to describe, and impossible to define. Certain aspects of fairness appear clear to the extent they are stated as statutory requirements, rules, guidelines, or forms, but even these pronouncements are subject to interpretation, and not all merit policies are stated in these written sources. As with the SEC and other

83. See Tyler, supra note 4, at 923-26.
84. There has been very little written on the applicability of state administrative law to blue sky law. For an introduction to the problem, see DeYonker, Administrative Enforcement Proceedings, in MICHIGAN SECURITIES REGULATION 221 (C. Moscow & H. Makens eds. 1983).
85. Bloomenthal, supra note 65, at 1481.
86. Id. at 1484.
87. See Statement of Jack Bailey, Iowa Development Commission, 15 SEC. REG. L. REP. (BNA) 1882 (Oct. 7, 1983). The decision to locate in a state is based on fundamentals such as the availability of human and material resources, cost of building, leasing, or owning facilities, transportation, state tax or workers’ benefits structure, attractiveness of the community, and the generation of ideas that give rise to the business opportunity. Financing is an element to consider, but the blue sky laws have never been a decisive factor in my experience or those of the attorneys whom I have queried. This argument has been raised in states where merit regulation has been under recent attack as the basis for excluding certain “high tech” companies from developing in those states. A far more likely scenario is that those states do not have an existing industrial base or a strong program of research in their universities that are the bases for development of that type of company, and these factors, combined with the elements for a location decision, determine where high tech companies spring forth.
88. See, e.g., Hueni, supra note 6; Tyler, supra note 4.
89. For another version of this argument, see Sargent, supra note 8, at 279-80.
regulatory agencies, policy is defined, interpreted, and debated in a variety of contexts, including speeches by administrators, agency releases, administrative proceedings and litigation, professional articles, and by practitioners themselves.\textsuperscript{90} Merit regulation also falls short of absolute definition because it must respond to the facts of each particular offering. In addition, new forms of compensation, new products, new industries, new types of securities, and new approaches to regulation at the federal level all preclude development of a truly and perennially complete set of merit requirements. Written regulation invariably lags behind changes in an industry, regardless of the type of change. For it to be otherwise, administrators would need a crystal ball or would have to be willing and able to stifle business change and development.

It is thus difficult to state all merit requirements as administrative rules. Merit regulation is the imposition of arbitrary fairness standards to a securities offering. All regulation is arbitrary to some extent, but merit regulation is more so since it is often applied at the sole discretion of a single individual on an ad hoc basis. This inherent problem has produced much frustration among securities practitioners and has helped generate the current assault upon merit regulation. This problem has been exacerbated by the failure of some states to attempt any meaningful merit rulemaking.\textsuperscript{91} Whether an administrator's excuses are an overburdened staff or other priorities, the failure to express established policy in some written form is costly to issuers in these states and to those involved in interstate offerings seeking to comply with the tremendous diversity of state laws.

Another source of frustration is what administrators refer to as the "smell" test.\textsuperscript{92} If something about the offering strikes the administrator as illogical or improper, the administrator typically will make a much closer inspection of the offering. These expanded inquiries frequently are made with good cause because experienced administrators are quick to spot disclosures that appear to disguise more than they reveal or to camouflage problems with omissions. Discovery of underlying problems will then lead to rigorous application of the specific merit requirements. The administrator's decision to inspect more closely a particular offering, however, may appear arbitrary to the persons involved in that offering.

\textsuperscript{90} For discussion on the research tools useful for reaching these different sources of blue sky law, see Sargent & Greenberg, Research in Securities Regulation: Access to the Sources of the Law, 75 L. Libr. J. 98, 105-09, 119-20 (1982).

\textsuperscript{91} A review of the Blue Sky Law Reporter (CCH) will show that a fair number of merit states have failed to adopt detailed merit regulations. See Blue Sky L. Rep. (CCH) (4 vols.). Experienced blue sky practitioners will report, however, that these states might apply one or more sets of very detailed NASAA guidelines on a purely informal basis.

\textsuperscript{92} See L. Loss & E. Cowett, supra note 3, at 77 ("[A] midwestern administrator replied that he looked on uranium issues with a 'jaundiced eye' and tended to disapprove them 'unless they are of such a nature that we might be tempted to invest our own money in them").
Perhaps the most troublesome aspect of merit regulation to many practitioners is the demonstration of prejudice by the administrator with respect to certain types of offerings. Blanket disapproval of a particular industry or method of doing business is rarely justified and tends to bring the entire merit regulatory system into disrepute. Merit regulation is not intended to provide this type of power and its exercise in this manner is a gross abuse of discretion.

The problems with imprecise standards, the smell test, and administrator prejudice are compounded by the "echo effect." The echo effect can often be observed during a national offering, and it can cause an issuer problems with clearance. It works quite simply. First, one state will make a somewhat unusual merit comment. That comment is then circulated in an informal network among state administrators. Just as the issuer resolves the comment with the first administrator, an echo of the comment is heard in some other state. Since that second state may have a different approach to the problem than the first state, the issuer may find itself negotiating a different solution to the same problem.

These problems are also compounded by uncertainty over whether a given state is a "merit" state or whether a merit state will choose to exercise its merit powers in a particular case. The phrase merit regulation is bandied about as though it had a very solid and identifiable form. It is far more amorphous than that. Some states possessing merit powers will apply them only occasionally, either ignoring all but a few offerings or relying almost exclusively on clearance in the "tough" states as a basis for signoff on an offering. Frequently counsel hears, "Have you cleared X state?" If he has, prompt clearance is often forthcoming in the second state. The rigorous merit states number no more than a dozen at any time, and the composition of the group may vary according to whether the administrator is young, inexperienced, or tempered by experience. This variation in administration seems unfair to issuers, but the variation is usually little worse than that incident to drawing a difficult branch chief or examiner at the SEC or the difference between bringing a complaint to the Justice Department or the Federal Trade Commission (FTC) during the Carter or Reagan admin-

93. See Bloomenthal, supra note 65, at 1492; see also NASAA Uniform Limited Offering Exemption, 1 BLUE SKY L. REP. (CCH) ¶ 5294 n.l (Sept. 21, 1983) (expressing NASAA's suspicion of tax shelter offerings).

94. For discussion of this question in Massachusetts, see Honig, Massachusetts Securities Regulation: In Search of the Fulcrum, 13 U. BALTIMORE L. REV. 469, 474-76 (1984).

95. Those states as of this writing are probably Arizona, California, Massachusetts, Minnesota, Ohio, Oklahoma, Pennsylvania, Texas, and Wisconsin. On the phenomenon of leaders and followers, see Gray, Blue Sky Practice—A Morass?, 15 WAYNE L. REV. 1519, 1529-30 (1969).

96. See id. at 1522 (discussing variations in experience and attitude among state administrators).
While all of the problems discussed above have generated resentment of merit regulation, there are perhaps three principal causes for the present challenges to merit regulation. The first is an administrator's rigid adherence to specific standards or policies when the offering, taken as a whole, is beneficial to investors. A real estate program that meets the guidelines, but has a marginal general partner, will in some states clear more easily than one with a financially strong and highly reputable general partner who has designed his program out of compliance with one relatively unimportant aspect of the guidelines. The offering with the marginal general partner is probably far more risky to the investor than the offering with the substantial general partner, but that distinction makes little difference to those administrators who rigidly adhere to the letter of the guidelines without regard to the overall merit of the offering. The administrator who permits an offering to clear without strict compliance with the guidelines may be embarrassed if the program fails, but he should be willing to take that risk, recognizing that the possible reward to investors and business in general outweighs the potential threat to the investor. Widespread adoption of this balanced attitude would also help dispel the impression that merit regulators do not understand the transactions they are trying to regulate. A refusal to follow this approach, however, produces understandable resentment.

The second principal cause derives from the personal behavior of a few administrators and their staffs. The perception that attorneys and their clients have of state regulation is largely shaped by the manner in which they are treated by staff examiners. Attorneys who deal with examiners should do so in a professional manner. It is reasonable to expect that the same professional courtesy will be extended by the examiners and the rest of the staff. In my experience and that of other securities practitioners, inexperienced or overly aggressive examiners have sometimes failed to act in a professional manner. When that happens, and particularly when it happens on a regular basis, the reputation of that examining state is damaged nationally because the examiner deals with so many attorneys. The examiner who insults an attorney, questions his integrity, refuses to return telephone calls, or is overly aggressive on the telephone brings discredit to the entire NASAA organization and to each of the many administrators and examiners who conduct themselves in a professional manner. It is extraordinary to hear of this problem at the SEC, and NASAA should be able to make the same boast. This negative perception, brought about by the conduct of a few, is fueling the fires for reasons unrelated to the

97. For a survey of the legislative results of the challenges, see Sargent, supra note 8, at 282-85.
underlying value of merit regulation. 98

The third principal cause is a tendency toward strained state interpretations of the law in a manner contrary to published NASAA guidelines. This behavior may place a single state at odds with the rest of the country, producing unnecessary delays in clearance, as well as undermining NASAA's efforts to produce uniformity. The non-uniform actions of a leading merit jurisdiction can have a disproportionate impact on many states and generate even more resentment of merit regulation.

Although the resentment created by these problems is understandable, they do not justify elimination of merit regulation. These problems indicate the need for greater discipline, professionalism, and coordination among NASAA members. The possible solutions to these problems are complex and will be considered in greater detail below. Progress will require vastly improved training of new state administrators and examiners, development of better communications systems among the states, improvement in the drafting and the interpretation of written merit standards expressed in NASAA guidelines or through state rules, growth in the administrators' awareness of the public opinion of their regulatory systems, expansion of the administrative policy-making procedure to include local professionals and other citizens, and removal of those administrators or staff members who refuse to operate within the norms of the system. Only progress in these directions will alleviate the practical problems that have produced so much hostility and misunderstanding.

IV. THE QUANTITATIVE STUDIES OF MERIT REGULATION: ONLY PART OF THE PICTURE

Despite the theoretical debate over merit standards, all recent efforts to determine the value of merit regulation through quantitative analysis have been notably unsuccessful. 99 The authors of these studies have been like the four blind men who were taken to different parts of the elephant and asked to describe what the elephant looked like. One


99. The studies to be discussed in this article are: Goodkind, supra note 26, at 107-23; Kudla & Jennings, An Evaluation of the Efficacy of Merit Review by Arizona's Securities Division (June 30, 1983) (unpublished manuscript) (copy on file at the University of Baltimore Law Review office); Walker & Hadaway, Merit Standards Revisited: An Empirical Analysis of the Efficiency of Texas Merit Standards, 7 J. CORP. L. 651 (1982). In addition, the FTC in early 1984 solicited comments on a proposed FTC sponsored quantitative analysis of merit regulation. See Comment Letter from Robert J. Millstone, ABA State Regulation of Securities Committee, to Don Arbuckle, FTC Office of Information and Regulatory Affairs (Mar. 13, 1984) (copy on file at the University of Baltimore Law Review office) [hereinafter cited as ABA-FTC Comment Letter].
described the trunk, another the tail, another a foot, and the last a side, but none understood or described an entire elephant. The merit regulation studies in question compared only the performance of issuers whose offerings have cleared a state against those whose offerings were denied. This approach is fundamentally flawed because it does not measure the major effect of merit regulation: voluntary compliance with merit standards. The studies tell us nothing about how widespread this type of voluntary compliance may be or how it is affected by changes in merit policy. Similarly, this approach does not measure a major effect of merit regulation until months or years after the completion of the offering, when investors seek to use the safeguards against mismanagement, fraud, or incompetence mandated by merit regulation. Furthermore, this approach cannot gauge the impact of merit standards that subsequently become adopted as industry standards. By missing all of these vital issues, the existing quantitative studies prove very little.

The oldest published quantitative study of merit regulation is Goodkind's 1976 analysis of the operation of Wisconsin merit standards. The principal feature of Goodkind's article is the analysis of seven principal factors that are applied in determining the fairness of corporate offerings. His explanation of the underlying rationales, an exposition of the advantages and disadvantages of the merit approach, is excellent. Goodkind's quantitative analysis is a statistical comparison of the performance of corporate issuers whose offerings were registered or withdrawn in Wisconsin over the four year period 1968-1971. Goodkind used three indices of performance to compare the two classes of issuers: price, book value, and dividend distribution. Although noting several qualifications to his conclusions, Goodkind's net determination was that the Wisconsin merit standards resulted in the exclusion from Wisconsin markets of offerings presenting a risk of severe investment loss. His study thus established a prima facie case for the alleged inconstancy of the Wisconsin standards.

100. See, e.g., NASAA Oil and Gas, supra note 41, at Section VIII; NASAA Real Estate, supra note 47, at Sections VII, IX.A, ¶¶ 5358, 5359A.
102. Withdrawal may be caused by adverse comments from the administrator, but it also may be triggered by successful completion of sales of the securities in other states while waiting to resolve conflicts in the states from which withdrawal is eventually made. Withdrawal may also occur because of conditions totally unrelated to blue sky regulation, including a change in market conditions, the occurrence of adverse events affecting the issuer, underwriting difficulties, or national events unrelated directly to the field of securities or the issuer. Measurement of the blue sky law impact on companies that have withdrawn issues from states is difficult, unless one is able to isolate those issuers who have successfully marketed their securities, but failed to register in certain states. Even then obtaining information as to the underlying cause of nonregistration is exceptionally difficult.
103. Goodkind, supra note 26, at 108. Goodkind also gathered data on business failures, finding that 23.5% of the non-clearing issuers were failures (defined as a loss of more than 75% of the market value of their stock) after three years. Id. at 121.
for maintaining those registration standards in place.\textsuperscript{104}

Goodkind's study has been criticized both for its methodology\textsuperscript{105} and its failure to quantify the costs of merit regulation.\textsuperscript{106} The principal limitation of the research is its evaluation of only a single aspect of merit regulation: merit review of corporate equity offerings. His conclusions are most helpful with respect to that aspect of the regulatory scheme, but are of limited usefulness to an evaluation of the overall impact of merit regulation.

A 1982 study of the efficacy of Texas merit standards by Walker and Hadaway\textsuperscript{107} had a similarly narrow focus. The Texas study compared corporate issuers that withdrew their application for registration of common stock with a selected set of companies whose stock was cleared for sale in Texas between 1975-1980.\textsuperscript{108} By limiting their review to corporate offerings, Walker and Hadaway focused on only a small percentage of the offerings filed in and subject to merit review by the Texas Securities Board. Although this study concluded that merit review as a whole is producing its intended result of "equiponderating the positions of the new and existing investors,"\textsuperscript{109} it is impossible to reach a general policy determination on the basis of this evidence without a review of the performance of partnership as well as corporate issues. In short, the Texas study provides additional information on

\textsuperscript{104.} Id. at 111-12. Goodkind concluded that:

Those [rules] limiting offering price, options and warrants, and underwriting commissions and expenses proved especially effective, as did those requiring earnings sufficient to cover interest and dividend obligations, and requiring a minimum promoters' investment. In addition, the data indicate that the Commissioner's discretionary authority has been quite effectively utilized for the protection of Wisconsin investors, and support the rule dealing with cheap stock. . . .

For those who have attacked the rules as unnecessary restrictions on free enterprise and unwarranted limitations on promoters' profits, the results provide a convincing rebuttal.

\textsuperscript{105.} Id. at 123. Goodkind qualified this conclusion, however, by emphasizing that:

[T]he aggregate results produced by the study concealed tremendous internal variations. Hidden by the averages set forth herein are many issuers whose performance was exceptionally good despite their inability to obtain registration in Wisconsin, and some registrants which failed miserably. The range for both groups is large enough to suggest that the present rules, even though empirically justifiable, leave room for improvement.

\textsuperscript{106.} Mofsky & Tollison, supranote 7, at 376 ("The Wisconsin study is so methodologically flawed that it yields no useful information on the very interesting problem it posed"). Mofsky & Tollison's conclusion does not do credit to the study that was the pioneering constructive effort to evaluate merit regulation.

\textsuperscript{107.} Walker & Hadaway, supranote 99.

\textsuperscript{108.} Id. at 659-62.

\textsuperscript{109.} Id. at 680.
one narrow facet of merit regulation, but contributes only a limited amount to the understanding of the overall picture.

The more recent attempts at quantitative analysis have contributed virtually nothing to an appreciation of the effectiveness of merit regulation. An uncompleted study of the effects of state merit regulation by the FTC, begun in 1984, had the same narrow focus as the Wisconsin and Texas studies—corporate equity offerings—and therefore could not provide a meaningful evaluation of the overall value of merit regulation.110 The FTC proposal was criticized extensively by both NASAA and the ABA's State Regulation of Securities Committee of the Section of Corporation, Banking, and Business Law for this and other problems with the study design.111

A 1983 study by Kudla and Jennings of the Arizona registration process112 appears to be an unsuccessful attempt to provide support for a presumption113 that merit regulation should be abolished. The authors attempted to compare the performance of issuers of registered and withdrawn offerings,114 but it is difficult to attach any significance to their conclusions since they received a very poor response to their questionnaire.115 Especially questionable is the authors' conclusion that the merit system discriminates against small issuers and thereby

110. The FTC described its project in "Supporting Statement for a Survey to Assess State Registrations of Common Stock Securities Issued in 1976 and 1979" (unpublished manuscript) (copy on file at the University of Baltimore Law Review office).

111. See Comment Letter from Michael J. Unger, NASAA President, to Don Arbuckle, FTC Office of Information and Regulatory Affairs, Feb. 13, 1984 (copy on file at the University of Baltimore Law Review office). The ABA's criticisms were set forth in the ABA-FTC Comment Letter, supra note 99. That letter concluded that the:

FTC's proposed survey is not an appropriate mechanism for eliciting meaningful analysis of state merit regulation of securities. Problems resulting from the narrow scope of the survey, design of questions, inadequate access to securities law expertise and limited data source will restrict the usefulness of the data produced and make it difficult to extrapolate.

Id. at 4.

112. See Kudla & Jennings, supra note 99.

113. See Letter of Marianne Jennings and Ron Kudla to Governor Bruce Babbit of Arizona (June 30, 1983) (copy on file at the University of Baltimore Law Review office).

114. Kudla & Jennings, supra note 99, at 14-18. Highly speculative or otherwise questionable offerings from a merit perspective may be registered in some states despite adverse comment from the administrator, based on a combination of emphasized or expanded disclosure of the adverse information and an increase in the suitability requirements for investors. These offerings are lumped in the studies into the list of offerings that have cleared a state, and are used to show that merit regulation was not effective in particular instances, when in fact the merit regulatory screen was applied to limit the investors to those who desire to make a speculative investment and could afford to gamble with their investment funds.

115. The authors report that 350 survey questionnaires were mailed to issuers whose performance was to be studied. Only 64 were returned with the requested data; 89 were returned without data; and 197 did not respond. Id. at Exhibit 3.
acts as a barrier to the free enterprise system, because their conclusion rests on the fact that the approved companies typically had larger total assets than withdrawn issuers.\textsuperscript{116} In short, the authors' conclusions are unsupported by meaningful quantitative data, and thus cannot be considered a serious evaluation of the efficiency of the merit process.

V. A NEW APPROACH TO MERIT REGULATION

A. The Need for Merit Regulation

This article has argued that both the advocates and opponents of merit regulation have failed to provide the analysis and data needed for a policy decision about the efficacy of merit regulation. Today, however, some state legislatures\textsuperscript{117} are reevaluating the merit system and are doing so on the basis of emotional arguments about how well the system does or does not work. Something more is needed. In particular, some very basic data about the actual operation of merit regulation is needed. No one knows what percentage of offerings receive merit comments on initial review or what response is made to those comments.\textsuperscript{118} The extent to which those comments are implemented, explained, or turned into the basis for denial or withdrawal is unknown. More importantly, perhaps, it is uncertain which of the comments are of significant benefit to investors and which represent the mere triumph of form over substance and consequently induce frustration, skepticism, and resentment. All of these data will be needed if one is to answer fully the fundamental question of social policy: Who needs merit regulation? In the absence of these data, however, certain basic observations can be made.

The opponents of merit regulation can marshal philosophical arguments and provide specific examples of the failure of merit review as to particular issues, but they have not yet produced any strong basis for the claim that the merit system produces more social costs than social benefits. No regulatory system works perfectly, and the suggestion that a few failures destroy the value of the system is as ridiculous as suggesting that merit regulation is justified by the existence of a few frauds. An evaluation of merit regulation cannot be made on the basis

\textsuperscript{116} Id. at 17. The authors found that approved companies had a greater average asset figure ($76,878,550) than withdrawing companies ($28,788,706). On the basis of these figures, which merely suggest that larger and more seasoned issuers have an easier time complying with merit regulation than new issuers, the authors leap to the conclusion that "the merit review process discriminates against small issuers. The effect of the merit review is to impede economic progress and business development by preventing small, capital-short businesses from raising capital in the marketplace. The merit standards thus can create barriers to a free enterprise system." \textit{Id.}

\textsuperscript{117} See Sargent, supra note 8, at 282-85.

\textsuperscript{118} It may not be possible to distinguish systematically between "merit" and "disclosure" comments, since the latter are often based on the need for fuller discussion of aspects of the transaction that generate merit problems.
of isolated instances on either side of the equation. As demonstrated above, the existing quantitative studies have failed to make a conclusive or even meaningful contribution to an understanding of merit regulation. Before another study is attempted, the nature of merit regulation as a whole must be understood, and its value must be defined in terms of relative costs and benefits.

Cost must be measured not only in economic terms but in human terms as well. It must reflect not only the additional burden of regulation but also the burden that the regulation relieves. If the result of merit regulation is that fewer failures occur or that investor confidence is higher so that investments are more attractive in the market, then one must counterbalance the loss of opportunity to go to market for a few firms, the modification of offering terms for others and the direct costs of compliance with the ease of capital formation that is provided for issues that possess meritorious characteristics, the reduction of enforcement problems, the improvement of competition, and the monetary benefit to investors.

The direct costs of merit regulation are obvious: filing fees, attorney's fees for blue sky work, and mailing expenses. In my experience, these costs represent a miniscule percentage of the money raised and are not in themselves a sufficient basis for challenging merit regulation or blue sky regulation in its entirety.119 If merit regulation has value, these limited costs are de minimis, and most of them would be present unless all aspects of the blue sky laws were preempted. In any event, the amount of time and money devoted to compliance with federal disclosure and accounting requirements far exceed these direct blue sky costs.120 Furthermore, the compliance costs associated with merit regulation are similar to those generated by other forms of regulation. Thus, these inherent regulatory costs must be accounted for and discounted when the costs specific to merit regulation are calculated.

The most significant cost of merit regulation is perhaps that of time.121 Clearance with multiple states may take several weeks because some states are faced with substantial backlogs. Because time is often of the essence for first-time corporate issuers and for real estate or other programs requiring the purchase of specific properties, these delays may be very costly. This factor is difficult to quantify but it is a pervasive concern of issuers and their counsel.

A second major cost is more elusive. This is the expense to busi-

119. For a discussion on the question of direct blue sky compliance costs, see Tyler, supra note 4, at 932 (arguing that though he could not locate data on these costs, they should be quantifiable); cf. J. MOFSKY, supra note 5, at 31-32 (state registration involves "considerable cost"); Bateman, supra note 5, at 773 (merit regulation "creates a pointless degree of confusion, paperwork and uncertainty").


121. See Bartell, supra note 32, at 325-26 (discussing methods to avoid blue sky delays).
ness created by the need to restructure an offering to comply with merit guidelines. This kind of forced restructuring happens frequently, but it is not clear whether or to what extent this possibility actually "kills" potential public offerings. Because it is difficult to quantify these costs, policy makers should exercise caution before concluding that this cost of merit regulation outweighs its benefits to society.

Against these costs must be weighed the benefits of merit regulation. The central benefit, of course, is investor protection. A simple reference to the concept of "investor protection" is misleading since there are multiple categories of investors who require differing amounts of protection. For example, the Uniform Act exempts from registration certain offerings made to institutional investors. Some states have special exemptions for sales to certain wealthy investors, or have implemented the accredited investor concept through the adoption of the ULOE. These exemptions and exclusions reflect a recognition that there are classes or persons whose need for protection varies substantially from that of the average investor. These investors are sophisticated, experienced, or able to hire professional advisers and advocates, and are therefore presumed capable of judging fairness. The federal and state regulatory schemes are moving toward allowing unlimited offers and sales to these persons in private offerings. Although a few years away from that ultimate conclusion, it appears to be a logical and likely extension of current regulatory philosophy. If the wealthy or sophisticated investor does not require the protection of regulatory review in connection with a private offering, he may not need it in connection with public offerings.

Many individual investors do not meet wealth and sophistication suitability criteria and, as a consequence, cannot use the exemptions that depend upon the character of the investor. They will still be able to avoid the effects of merit regulation, however, if they purchase securities that are themselves exempt. Some securities are exempted from registration because of various market or jurisdictional considerations.

124. NASAA Uniform Limited Offering Exemption, 1 Blue Sky L. Rep. (CCH) ¶ 5294 (Sept. 21, 1983) (accredited investors are persons deemed not to need the benefits of securities registration because they meet certain objective criteria indicative of sophistication and risk-bearing ability).
or because the securities are sufficiently regulated by other agencies.\textsuperscript{128} For example, the Uniform Act provides an exemption for securities listed on the New York and American Stock Exchanges, both of which are effective self-regulatory organizations.\textsuperscript{129} Similarly, government securities,\textsuperscript{130} securities issued by nonprofit entities,\textsuperscript{131} and commercial paper\textsuperscript{132} are excluded because of the nature of the underlying security or the existence of a special relationship affecting the purchase of these securities. Finally, securities issued by financial institutions,\textsuperscript{133} utilities,\textsuperscript{134} and common carriers\textsuperscript{135} are exempted because of the supervision of other government agencies that provide a level of merit regulation.

The need for merit regulation arises in the context of public offerings of non-exempt securities. Many individual investors are neither informed nor sophisticated about securities offered in that manner. Furthermore, these investors have no intrinsic negotiating power. They may collectively decide not to purchase a particular issue, but investors do very little else collectively because there is no mechanism through which they can share information to formulate decisions. If an investment fails, furthermore, they have almost no recourse because the cost of securities litigation is so great that it is useless for investors who have lost less than a very substantial amount or who are unable or unwilling to become part of a class action.

The people who sell securities may even be less experienced than the public investors, and often cannot or will not offer any guidance to them. The market itself provides little information helpful to these investors, particularly with respect to initial public offerings.\textsuperscript{136} The public investor lacks a practical means of acquiring prospectuses of competing offerings for purposes of comparison; indeed, it is unlikely that he would take the time to acquire them even if they were readily available. Furthermore, the public investor lacks the information and experience needed to compare different types of offerings. The typical level of information and sophistication applied to purchases of new se-

\textsuperscript{128} For analysis of the Uniform Act's treatment of exempt securities, see generally J. Long, 1984 BLUE SKY LAW HANDBOOK (1983) (surveying each of the Uniform Act's securities exemptions).

\textsuperscript{129} UNIF. SEC. ACT § 402(a)(8), 7A U.L.A. 639 (1978).

\textsuperscript{130} Id. § 402(a)(1)-(2), 7A U.L.A. at 638.

\textsuperscript{131} Id. § 402(a)(9), 7A U.L.A. at 639-40.

\textsuperscript{132} Id. § 402(a)(10), 7A U.L.A. at 640.

\textsuperscript{133} Id. § 402(a)(3)-(6), 7A U.L.A. at 638-39.

\textsuperscript{134} Id. § 402(a)(7), 7A U.L.A. at 639.

\textsuperscript{135} Id.

\textsuperscript{136} It cannot be argued seriously that the market operates efficiently with respect to initial public offerings. See Makens, supra note 39, at 153; Walker & Hadaway, supra note 99, at 658-59. For a discussion on the limitations of the efficient market hypothesis, see generally U.S. DEP'T OF COMMERCE, EVALUATING THE IMPACT OF SECURITIES REGULATION OF VENTURE CAPITAL MARKETS 26-28 (1980) (efficient market hypothesis is a useful means of asserting the effects of securities regulation only if inherent testing problems are recognized).
curities is thus surprisingly low. The public investor is most likely to act on the basis of advice from a registered representative, a newspaper story about the company or its product, or advice from an acquaintance with similar investment interests and a similar lack of information. The reputation of the brokerage firm or the particular registered representative is often far more important to this kind of investor than any available information about the security itself. Brokerage firms thus should be advocates of investor protection, but they often fail to fulfill this role. In fact, the Securities Industry Association has recently taken a position against merit regulation, reflecting its primary concern with the impact of blue sky regulation on the ability of its members to bring products to market.

The need for merit regulation would be substantially diminished if underwriters consistently exercised strong due diligence in conjunction with bringing new products to market. Indeed, if adequate due diligence were performed by underwriters then arguably only a small percentage of primary offerings would need to be reviewed by the states for fairness. It is my impression, however, that the competitive economics of the securities business prevents many underwriters from engaging in the type of due diligence review that would make merit regulation unnecessary. To obtain underwritings, the underwriter frequently must be willing to settle for less than a full measure of investor's rights. Some underwriters apparently consider those rights unimportant. In addition, an underwriter seeking to convince an issuer that it should be allowed to handle a public offering has only limited ability to compel alteration of the compensation taken by the issuer's promoters or insiders. Only if the issuer operates in a non-competitive market for its product can the underwriter impose a substantial level of control over compensation and conflicts.

As a result of these pressures, the underwriter's due diligence effort ranges from excellent to inadequate and is, on occasion, completely absent. This problem is exacerbated by the lack of specific standards for due diligence. Proposals for government definition of these stan-


138. For a study of both the practical and legal aspects of the “due diligence” concept in connection with securities offerings, see NAT'L ASSOC. OF SEC. DEALERS, SPECIAL REPORT, DUE DILIGENCE SEMINARS (July 1981).

139. No administrative agency, either state or federal, has defined specific standards of due diligence. Accordingly, the level of due diligence applied by underwriters, accountants, and attorneys to a particular offering is determined largely by their willingness to adhere to the unwritten standards generally applied in the industry. The level of due diligence thus varies widely, and may reach very low levels indeed, especially when smaller, less well-established regional underwriters are in-
dards have been opposed by the underwriters and the brokerage community on the ground that specific standards would expose them to potential liability in civil litigation.\textsuperscript{140} As a regulator, I was continually amazed by the number of underwriters and brokerage firms that totally failed to explore in their sponsored offerings the nature and amount of promoter compensation, the potential conflicts of interest, and the level of disclosure about the intended use of the proceeds. If the prospectus roughly complies with the SEC's disclosure format, many underwriters feel quite comfortable, even though certain obvious facts may have indicated that additional inquiry should be made.\textsuperscript{141}

There are similar market pressures on brokerage firms. If the brokerage firm believes that the issue can be sold in the market, it is unlikely that it will take any steps to hold the price down for the benefit of investors. That is not the nature of the marketplace. Since brokerage firms lack an incentive to protect the investor,\textsuperscript{142} only the regulator can protect him against an overpriced or over-hyped issue.

It is perhaps fair to say that new issues are customarily sold to rather than bought by the public investor. This inherent market pressure, when viewed in light of the varieties of competing securities products, the lack of informed and critical analysis of new issues, the paucity of information that is provided by most registered representatives to their customers, and the inadequacy of many due diligence reviews, creates a substantial need for investor protection. Merit administrators fulfill the function of asking the questions and seeking the underlying information that should have been asked and sought by underwriters.\textsuperscript{143} That, however, is only part of the blue sky process. By applying merit standards, regulators perform the function that neither the market, the underwriter, nor the brokerage firm can perform on a consistent basis: ensuring fair treatment of the public investor. By performing these interrelated functions of eliciting material involved in the transaction. For discussion of how regional underwriters, rather than national underwriters, tend to dominate the initial public offering market, see Tyler, \textit{supra} note 4, at 917-18. For a review on the role of underwriting forms in highly abusive penny stock offerings, see Barnes, \textit{Bad Pennies}, Venture, Nov. 1983, at 38, 44-46.

\textsuperscript{140} When Director of the Michigan Corporation and Securities Bureau, I informally suggested that the Bureau consider adopting by rule specific due diligence standards. The response from the industry was decidedly negative.

\textsuperscript{141} Merit regulation can perhaps be understood as in part a trade-off for the uncertainty about whether an appropriate level of due diligence will be applied. To the extent that an appropriate level of due diligence could be mandated by law, merit standards can and should be relaxed.

\textsuperscript{142} Brokerage firms may have an incentive to protect the investor to secure his repeat business, but certainly not all firms take this view at all times. \textit{See} Tyler, \textit{supra} note 4, at 919 (discussing the temptation to use hard-sell techniques in connection with high-risk initial public offerings).

\textsuperscript{143} To the extent that the administrator serves this function, the underwriter, as well as the public investor, is benefited.
disclosures and regulating the substantive fairness of the offering, the merit regulators try to speak for the investor.

Despite their efforts merit regulators are sometimes accused of attempting to enhance their own power, reputation, or budget at the expense of the industry and without any corresponding benefit to the investor.144 While this criticism is usually unfair and inaccurate, administrators are not without fault. The problem is sometimes one of inflexibility. In my experience as both an administrator and private practitioner, I have seen some well-intentioned administrators apply merit standards in a rigorously mechanical way without considering the overall character of the offering. As a consequence, issues will be delayed by questions about the offering that have little, if any, relevance to the investor.

The problem may also be one of perspective. The administrator's perspective on an offering may be skewed to the negative side since the majority of investors with whom they meet are those who have lost money or have been defrauded. As a result of this experience, virtually all administrators would agree that it is better to prevent the loss from occurring than it is to attempt to recoup the loss later. Accordingly, some administrators evince a strong pro-investor bias. Taken to an extreme, this bias can lead to an "overkill" application of merit standards.145 These criticisms are valid, and deserve to be taken seriously both by NASAA and the individual merit administrators. In my opinion, however, most administrators recognize their inherent bias in favor of protecting the investor and attempt to maintain a realistic view of the needs of capital formation and the limits of their regulatory responsibilities.

This article has contended that the central benefit of merit regulation is the administrator's attempt to speak on the investor's behalf. In this role, the administrator attempts to provide what the marketplace and the SEC cannot provide. The merit administrator's good faith attempt to play this role should be preserved. It is obvious that much can be done to improve this system through the joint efforts of NASAA, the SEC, the bar, and the securities industry.

B. Recommendations

1. Recommendations for NASAA

The current level of public criticism of merit regulation indicates substantial problems with the merit regulatory system. Some of the problems are mechanical. For example, it is inefficient to require that

145. See Bloomenthal, supra note 65, at 1493.
the same document filed with the SEC also be filed in fifty states. This is more than a question of excess paperwork. Multistate filing means multistate merit review, with all the potential problems that entails. A more efficient means of allocating responsibility for merit review is needed. There has been some experimentation in this area. For a period of six months in 1977, four states offered issuers the opportunity to volunteer for a single regional review of offerings to be made in those states. 146 Issuers refused to use the system largely because their attorneys were reluctant to abandon the relative certainty of their existing relationships with each individual state examiner. 147 The current problem with multistate filings and multistate reviews is, in part, the result of reluctance on the part of the bar and the brokerage community to experiment with this system.

Another major problem has been the failure of the individual states to adopt a uniform limited offering exemption compatible with Regulation D. 148 The current amalgam of inconsistent and inadequate state private and limited offering exemptions generates confusion and compliance costs without a matching benefit to investors. 149 This problem has intensified the criticism of merit regulation by forcing transactions exempt on the federal level and exempt in some states into registration and merit review in other states. NASAA can help solve this problem by vigorously promoting a policy of uniformity among its members with respect to exempt transactions. 150

An especially troublesome problem is that created by unqualified or unprofessional examiners. Both NASAA and the individual states should give more attention to training and supervision. This would remove one of the major irritants in the present system.

Another important goal for NASAA should be detailed explanation of the policy decisions expressed in its merit guidelines. 151 If

146. Those states were Illinois, Michigan, Minnesota, and Wisconsin. See H. Sowards & N. Hirsch, Blue Sky Regulation § 7.01, at 7-3 n.4 (1977).
149. See Sargent, supra note 16, at 502-06.
150. NASAA has already taken strides in this direction. See NASAA Committee Develops ULOE Adoption Chart to Help Promote State Uniformity, 15 SEC. REG. & L. REP. (BNA) 2183 (Dec. 2, 1983).
151. A major flaw in NASAA's adoption procedure for guidelines has been its failure to provide detailed explanations of the reasons for the actions proposed in the guidelines. SEC releases are usually characterized by a preliminary policy statement. Unfortunately, NASAA guidelines have not contained this information, placing commentators at a substantial disadvantage in interpreting the position adopted by NASAA. In addition, once adopted the guidelines contain no explanation for the positions that have been assumed. Since many of the decisions are
NASAA can clearly explain the overall purpose of the guidelines and the specific purposes of their individual provisions, there will be less blind application of specific requirements. Examiners can be given more flexibility in clearing offerings, and counsel and underwriters would be able to draft and negotiate with a better appreciation of the guidelines’ valid concerns. If NASAA begins to provide this kind of careful, clear, and detailed explanation of its guidelines, a coherent philosophy of merit regulation will eventually develop.

NASAA also needs to take more positive steps toward developing uniformity in merit regulation. Many states tend to act in a vacuum when they develop their own merit rules or develop inconsistent interpretations of NASAA guidelines. These states tend to ignore the available means of sharing information. This situation should be remedied and it can only be accomplished through greater pressure by NASAA on its membership. NASAA should have as its goal “standards in securities regulation that are fair and reasonable and consistently applied . . . . [T]he requirements should not be so burdensome as to unduly impede or delay the marketing of those issues that are entitled to be sold publicly.”

If NASAA begins to provide this kind of careful, clear, and detailed explanation of its guidelines, a coherent philosophy of merit regulation will eventually develop.

Achievement of this goal would eliminate much of the hostility toward merit regulation.

2. Recommendations for the SEC

If merit regulation is a substantial impediment to capital formation, it is remarkable that the SEC has taken such a low profile in discussions on the topic. Despite the political reasons for hesitation, the time has come for increased SEC participation in this debate. The SEC can participate in at least three ways.

First, the SEC can provide some important data needed for further study of the problem. Only the SEC has the data needed to evaluate the changes made in filing documents as a result of merit regulation, because every public offering is registered with the SEC. Similarly, the data regarding the withdrawal from and the avoidance of rigorous merit states cannot be provided by any single state because none has all of the pertinent data. The SEC and NASAA should consider a joint attempt to produce and study these data to assess the impact of merit regulation on the offering process.

Second, the SEC and NASAA need to reconsider the current allocation of regulatory authority. The SEC has clung tenaciously to jurisdiction over small offerings where state regulation would provide adequate public protection. Conversely, the states have continued to

152. Hueni, supra note 6, at 1419-20.
regulate offerings in connection with which the market’s efficient absorption of publicly available information provides sufficient protection. 154 A question that has never received detailed consideration is to what extent can or should the SEC and NASAA members divide responsibility for regulation of the different levels of the securities markets.

Third, the SEC and NASAA need to examine the ways in which their different regulatory techniques can or should interact. In particular, a joint SEC-NASAA study of the principal areas of disagreement on disclosure and of the extent to which SEC-mandated disclosure can address state merit concerns is needed.

The SEC must recognize the reality and importance of state regulation and take a more active role in its reform. In so doing, it should be more attentive to the advice of the state administrators. If the SEC had been more receptive to the states’ suggestions during the drafting of Regulation D, 155 the fight for a uniform limited offering exemption would have been less bitter. 156 While the Regulation D drafting experience is not the best model for the SEC’s participation in the debate over merit regulation, more SEC participation is necessary. In fulfilling its statutory mandate under section 19(c) of the Securities Act of 1933 to explore with state administrators ways to reduce the cost of capital formation, 157 the SEC can and should turn its attention to how

---

154. This problem is reflected in the continuing debate over the extent to which the states should apply merit regulation to widely followed issuers not listed on the national exchanges. See authorities cited in Sargent, supra note 16.


156. NASAA participated to a limited extent with the SEC in the drafting of Regulation D. See Securities Act Release No. 6339, supra note 153, at 84,455; Securities Act Release No. 6389, supra note 153, at 84,909-84,910. As originally proposed, Regulation D contained provisions reflecting some of NASAA’s particular concerns, such as restrictions on remuneration for sales efforts (Securities Act Release No. 6339, supra note 153, at 84,464-84,465) and disqualification from eligibility for issuers subject to recent actions by state administrators. Id. at 84,468. These provisions were deleted from the final version of Regulation D. These changes, together with a perception that Regulation D in general represents a refusal to heed the state administrators’ warning of the need for continued investor protection in exempt transactions, produced considerable resentment in NASAA and have impeded the widespread adoption of a uniform limited offering exemption. See Memorandum of NASAA Enforcement Liaison Committee to NASAA Small Business Committee, Apr. 19, 1983, at 3 (copy on file at the University of Baltimore Law Review office).

157. Section 19(c) of the Securities Act of 1933 (current version at 15 U.S.C.A. § 77s(c) (West 1982)) provides:

(c)(1) The Commission is authorized to cooperate with any association composed of duly constituted representatives of State governments whose primary assignment is the regulation of the securities business
it can help improve the conception and functioning of merit regulation. The SEC's September 1983 joint hearings with NASAA on federal-state securities regulation were a step in the right direction, but more must be done.

VI. CONCLUSION

It is time to stop spouting generalities and filling the air with emotional outbursts. If there are problems with merit regulation, they should be documented and shared with NASAA so that attempts can be made to correct the situation. It is easy to be a critic. It involves little effort and often less thought. The critic without positive and realistic suggestions adds little to the improvement of the system and deserves little attention.

The securities industry, in particular, needs to reexamine its posi-

within those States, and which, in the judgment of the Commission, could assist in effectuating greater uniformity in Federal-State securities matters. The Commission shall, at its discretion, cooperate, coordinate, and share information with such an association for the purposes of carrying out the policies and projects set forth in paragraphs (2) and (3).

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

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

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

tion on merit regulation.\textsuperscript{159} Because of the brokerage firm’s intimate relationship with the investor, the firm is perhaps best able to determine when and how merit regulation benefits the investor. The securities industry can help identify the specific merit concerns that are of significance to the investor and define how due diligence standards are affected by merit regulation. It can help one understand how some aspects of merit regulation protect investors while others may unnecessarily impede capital formation.\textsuperscript{160} The objections of the securities industry to merit regulation will become meaningful only to the extent that these questions are addressed.

The securities bar also needs to do more. In fact, the bar may have contributed to the merit “problem” by failing to take the lead in developing better systems. The credibility of its criticisms has been diminished by its inability or refusal to provide specific data corroborating some of its complaints. This diminished credibility has reinforced some administrators’ perception that practitioners are merely hired guns with no concern for investors. This perception is inaccurate, but it is reinforced by those attorneys who posture and threaten in their dealings with administrators rather than present a sound case. If real progress is to be achieved, the bar must help to reduce the tension and mistrust currently associated with the merit regulatory system.

The bar should function as neither an opponent nor a supporter of merit regulation. Its role should be to contribute to a regulatory system that works effectively for both investors and for issuers. In the long run, a balanced approach will serve the best interest of both groups. The organized securities bar has recently taken a step in that direction. The ABA’s State Regulation of Securities Commission of the Corporation, Banking, and Business Law Section has designated a subcommittee to study the elements of merit regulation and to consider its functioning and effectiveness.\textsuperscript{161} NASAA has established a similar committee.\textsuperscript{162} The opportunity for informed dialogue is here and should not be lost.

\textsuperscript{159} See sources cited supra note 136 (comments of securities industry representatives); see also Myriad of Approaches to Uniformity of State Regulation Urged at Hearing, 15 SEC. REG. & L. REP. (BNA) 1737, 1738 (Sept. 16, 1983).

\textsuperscript{160} See SEC & NASAA REPORT, supra note 158, at 15 (discussing recommendation that merit regulation be evaluated in terms of specific effects).

\textsuperscript{161} See ABA Subcommittee to Study Merit Regulation, Attempt Neutral Review, 16 SEC. REG. & L. REP. (BNA) 650 (Apr. 13, 1984).

\textsuperscript{162} The NASAA committee charged with this study of merit regulation is the NASAA White Paper Project Committee, chaired by E.C. Mackey, Director, Michigan Corporations and Securities Bureau. Telephone interview with James L. Karpen, Committee Member and Director, Enforcement Division, Michigan Corporation and Securities Bureau (June 19, 1984).