STATE REGISTRATION OF SECURITIES: AN ANACHRONISM NO LONGER VIABLE

CHARLES H.B. BRAISTED

In 1956, Louis Loss and Edward Cowett characterized the field of blue sky laws as a "statutory and administrative morass."[1] In 1969, Milton Gray, participating in a symposium, observed that although state authorities and the practicing blue sky law bar had taken a number of steps to ameliorate the situation, "the practice of blue sky law today seems still entangled in a morass, hopefully of a somewhat thinner consistency."[2] "The long-standing debate over state blue sky merit regulation of securities offerings recently has assumed a new intensity and practical significance."[3] While the debate no longer retains the intensity it had in 1956, 1969 or 1986, the morass remains.

A number of articles and treatises give a detailed recitation of the history of blue sky laws, the reasoning behind the different approaches taken by federal and state legislators, and the arguments for and against each.[4] There is no need to rehash the arguments here, pro or con. A cursory review of certain developments of the last fifteen years might be in order, however.

The Revised Uniform Securities Act of 1985 ("RUSA") raised the debate over state security registration to a higher and more urgent pitch. While RUSA did not eliminate states from the security registration process, it did lay out the groundwork for legislative activity that solved some of the more pressing problems of the day. RUSA included an exemption from securities registration for those securities authorized for trading on NASDAQ's national market system,[5] thus giving that exchange parity with the American and New York stock exchanges. Even though the states did not widely adopt RUSA, almost all passed the NASDAQ exemption into law between 1985 and 1990. Thus much of the pressure on the states over the application of "merit" standards to new security offerings dissipated.

At about the same time, the market for initial public offerings began to explode. The states, through their trade association, the North American Securities Administrators Association ("NASAA"), then began pressuring

1. LOUIS LOSS & EDWARD M. COWETT, BLUE SKY LAW 44 (1958).
2. Milton H. Gray, *Blue Sky Practice—A Morass?*, 15 WAYNE L. REV. 1519, 1519 (1968).
3. AD HOC SUBCOMMITTEE ON MERIT REGULATIONS OF THE STATE REGULATION OF SECURITIES COMMITTEE, *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785 (1986).
4. *See id*. at 785 n.1.
5. *See* Uniform Securities Act § 401(8), 7B U.R.L. 185 (Supp.1985).

the National Association of Securities Dealers ("NASD") to (i) raise its listing standards, (ii) apply those listing standards more strictly, and (iii) police more rigorously its own corporate governance provisions. Once again, the pressure on the capital-raising process increased. In 1996, Congress passed the National Securities Markets Improvement Act ("NSMIA"),[6] preempting the states in certain areas.

Between 1985 and 1995, an annual cry for help could usually be heard emanating from the SEC-sponsored Government Business Forum For Small Business Capital Formation (the "Forum"). The Forum participants, including regulators, bankers, investors, accountants, entrepreneurs, lawyers, legislators, and representatives from a variety of governmental agencies, would gather to discuss ways to aid in the process of raising capital for small business ventures. Almost without fail, the Forum's reports requested relief from the blue sky laws. The relief requested usually included a plea for a streamlined, inexpensive, non-merit based method of registering securities, an exemption from registration for a broader range of transactions, or both.

The debate has begun once again in the aftermath of NSMIA—did Congress go far enough? At least one commentator has stated that NSMIA was a "failure" because it made only slight adjustments to the security registration process and did not deal effectively with the problems facing startups and smaller entrepreneurs.[7] To be sure, NSMIA mandated uniformity in Rule 506 transactions, codified into federal law existing state exemptions for listed stocks, and provided relief from substantive state regulation of investment company securities. These changes were indeed only slight adjustments. The most significant substantive change made by NSMIA was the division of responsibility for the regulation of investment advisers. Moreover, NSMIA was the first successful attempt at federal preemption of the state securities laws, a welcome first step.

The question of whether a role remains in our financial markets for continued state registration of securities must be reexamined in light of changes in the marketplace. Several factors merit consideration. When the states first enacted the blue sky laws, individual investors were not generally involved in the public securities markets outside of the northeast. No federal laws governed the sale of securities. American capital markets were in their infancy, and the public generally was neither well-informed nor particularly experienced in the matter of securities investments. The population was

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6. PUB. L. NO. 104-290, 110 Stat. 3416 (codified in scattered sections of 15 U.S.C. (Supp. II 1996)).

7. Rutheford B. Campbell, Jr., *Blue Sky Laws and the Recent Congressional Preemption Failure*, 22 J. CORP. L. 175, 209 (1997).

generally agrarian and only modestly educated.[8] In contrast, today's investing public is generally literate, educated, inundated daily with investment and financial periodicals, exposed to financial analysts on radio and television,[9] and can access financial news and analyses on their home computers. Moreover, changes in the funding of retirement plans and the establishment of IRAs and 401(k) plans have forced individual investors either to learn how to handle investments on their own or to seek professional advice. The SEC's program to make prospectuses more readable and understandable has added to the maturity and sophistication of today's investing public.

Several attempts have been made to determine empirically whether merit regulation effectively deters fraud.[10] The Wisconsin study compared[11] the performance of securities registered in Wisconsin with the performance of securities denied registration there. Based on a small sample during a three year period (1968-1971), the study concluded that issues denied registration performed less well on average than those registered, notwithstanding evidence that, on a price per share basis, those denied registration outperformed those registered after one year, not falling behind until after three years.[12]

In a study conducted by Ernest Walker and Beverly Hadaway,[13] the results were inconclusive for similar reasons, although the study itself concluded that the data collected supported the Texas merit standards. Like the Wisconsin study, the Walker/Hadaway study revealed that, on average, the group of issuers that was denied registration outperformed, on a price per share basis, the group that achieved registration for the first year of the study, performed about the same in the second year, and fell behind in the third year.[14]

Professors Mofsky and Tollison sharply criticized the methodology of the Wisconsin study and its *a priori* acceptance that blue sky regulation does not

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8. *See* Hal M. Bateman, *State Securities Registration: An Unresolved Dilemma and a Suggestion for the Federal Securities Code*, 27 SW. L.J. 759, 766 (1973).

9. *See id*. at 764.

10. *See* Conrad G. Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements?*, 1976 WIS. L. REV. 79. *See also* Ernest W. Walker & Beverly Bailey Hadaway, *Merit Standards Revisited: An Empirical Analysis of the Efficacy of Texas merit Standards*, 7 J. CORP. L. 651 (1982). A third study was conducted by Professors David Brophy and Joseph Verga of the University of Michigan Graduate School of Business. Copies of this report can be obtained from professor Brophy or the Business Law Section of the ABA.

11. *See* Goodkind, *supra* note 108, at 107-23.

12. *See id.* at 111-12.

13. *See Walker & Hadaway, supra* note 8.

14. *See id.* at 674.

generate unintended costs for consumers and society.[15] However, Professors Mofsky and Tollison failed to recognize the possibility that denial of the registration and consequent denial of access to the capital markets may have contributed ultimately to the poorer performance. Their critique of the Wisconsin study raised questions about the different time horizons held by different investors, noting that some investors trade for short-term gain and others for long-term gain.[16] Their comments about the Wisconsin study apply equally to the Walker/Hadaway study. None of the studies reported offer reliable data from which one may determine that state security registration effectively protects the public from fraud. To the contrary, the studies may lead one to conclude that worthwhile stock issues were denied access to the capital markets.[17]

After ninety years of state security registration, there still has been no credible showing that state security registration effectively protects the public investor from fraudulent schemes or creates any public benefit other than to provide revenue for the states. While the arguments for and against merit regulation have not changed appreciably, there are new factors to consider. The development of the Internet and the advent of online trading and e-commerce, generally, have turned the markets inside out.

The time has come, I believe, for the states to "think the unthinkable," to scrap merit regulation completely and adopt instead a disclosure standard for those remaining instances in which registration is still required.

Merit regulation simply does not work well. Far from being apodictic, the studies referred to above are inconclusive at best. At worst, the studies show that merit regulation, by denying access to capital, may be a contributing factor in hastening the demise of a fledgling enterprise. As a practical matter, most of the merit policies can be handled through disclosure, thus allowing the marketplace to make the decision.

Inconsistency and uneven application of merit standards have always been, and will continue to be, a problem. Coordinated Equity Review, NASAA's attempt to have all the states on the same page at the same time may help, but it is too little too late. For the kinds of offerings that have been left to state regulation, an issuer will not likely volunteer to use the coordinated equity review process. Before 1985, the inconsistency across the

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15. James S. Mofsky & Robert D. Tollison, *Demerit in Merit Regulation*, 60 MARQ. L. REV. 367, 370 (1977).

16. *Id.* at 372.

17. *See* The Brophy/Verga study, *supra* note 10. The sample used in the Brophy/Verga study included data from six states. The findings further support the position that issues denied registration generally outperformed those approved, on a price per share basis.

states made "blue skying" an initial public offering fun, i.e., taking an "Apple Computer" and getting it approved in Texas, banned in Massachusetts and, faced with certain denial, avoiding such states as Illinois, Michigan, Missouri, and Wisconsin altogether. The challenge was to review the offering documents before filing, catalog the potential problems, and then bet on which states would approve and which states would deny. More than a few investors became irate when they could not participate in the Apple Computer offering because their state regulator had already made the investment decision.

Professor Bateman, in reviewing the history of the Securities Act of 1933, observed that the first bills introduced in Congress were patterned after the state model and incorporated the merit standard philosophy.[18] In the end, Congress rejected that approach in favor of the English disclosure philosophy, based on the belief that a federal qualification statute with merit standards would be unworkable and unreasonable, and that, in any event, it was not the best approach to security registration. Congress chose the disclosure philosophy as the best protection for public investors because it allowed each investor to make his or her own investment decision based on full information, without imposing an unreasonable restraint on legitimate business finance. Finally, the disclosure philosophy was considered essential to avoid the risk of implicit approval by the federal government of the merits of any securities offered for sale to the public, because all securities involve some degree of risk.[19]

Defenders of the blue sky laws have relied upon U.S. Supreme Court decisions finding the laws to be a proper exercise of the police power of the state. However, times have changed appreciably since 1917, and perhaps the issue ought to be reexamined in light of today's financial marketplace. In 1917, the state laws were the only laws available, and recourse to the state laws was the only way for the courts to provide relief to aggrieved parties. As Bateman noted in 1973, millions of literate, educated investors consume countless investment periodicals and are furnished with a wide variety of investment services by the brokerage community. The flow of relevant investment information compelled by the federal securities laws has had a significant impact, and today's investor is better informed than his pre-World War I counterpart. It is also abundantly clear that securities distribution systems and the securities markets generally are inescapably national and interstate in nature.[20]

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17. *Bateman*, *supra* note 6, at 768.
19. *Id.*
20. *See id*. at 764.

I believe it is time to emulate Solomon and split the state regulatory scheme, retaining the licensing and enforcement at the state level, but eliminating state security registration. The state licensing functions relating to brokers, dealers, and advisers are certainly a defensible exercise of the police power. Similarly, enforcement of the fraud provisions of the state securities laws appears equally defensible. However, the security registration provisions, surely conflict with principles of interstate commerce and should either be eliminated entirely or, at the very least, made to conform to the federal model.