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Compromise Merit Review—A Proposal for Both Sides of the Debate

Gregory Gorder

COMPROMISE MERIT REVIEW—A PROPOSAL FOR BOTH SIDES OF THE DEBATE

As is the case with many facets of modern life, government is involved in regulating the primary securities markets.[1] Both federal and state laws require registration of initial securities offerings.[2] Federal registration is procedural in nature, requiring full disclosure.[3] State registration, on the other hand, usually includes "merit review" of proposed securities offerings;[4] state administrators typically may deny registration of a security if the offering would not be fair, just, and equitable[5] or would be unreasonable in certain respects.[6] This Comment analyzes the advantages and disadvantages of merit review, specifically the discretionary power reposed in the state administrator, and proposes a change to the current system.

Merit review has advantages and disadvantages, and comment on it has

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1. L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 3, 8, 30–31 (1983); Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements?*, 1976 WIS. L. REV. 79, 83. The primary securities market is the market in which an issuing company (issuer) first offers its securities to the public (initial offering). This Comment addresses regulation of the primary market, as opposed to the secondary market (in which stockholders offer their shares to other members of the public).

2. State registration began in Kansas in 1911 and spread rapidly. In the wake of the stock market crash in 1929, Congress passed the Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (1982), followed by the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78kk (1982). The history of securities regulation is recounted elsewhere. *See, e.g.*, L. LOSS, *supra* note 1, at 8–16, 29–38; J. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS 5–14 (1971); G. ROBINSON & K. EPPLER, GOING PUBLIC, § 118 (rev. 2d ed. 1978); 11C H. SOWARDS & N. HIRSCH, BUSINESS ORGANIZATIONS, § 1.01 (1984); Bateman, *State Securities Registration: An Unresolved Dilemma and a Suggestion for the Federal Securities Code*, 27 SW. L.J. 759, 764–68 (1973); Goodkind, *supra* note 1, at 82–83.

3. The Securities Act of 1933 governs federal registration of securities offerings. Section 5 makes it unlawful to offer or sell unregistered securities. 15 U.S.C. § 77e(a) (1982). Registration requires filing a registration statement with the Securities Exchange Commission (SEC). *Id.* § 77f. The registration statement may not be materially misleading through either commission or omission. *See id.* §§ 77h(d), 77j(b), 77k, 77l. SEC staff members review the registration statement, usually specifying any dissatisfaction with the statement in a "deficiency letter" to the issuer. When the level of disclosure in the registration statement satisfies the staff, registration of the offering becomes "effective" and the issuer may then offer and sell the securities.

4. Most state securities acts contain a section like § 5 of the Securities Act of 1933 that makes offering or selling unregistered securities unlawful. The difference between the federal and most state registration provisions is that the SEC can only deny registration effectiveness for inadequate disclosure, whereas most state administrators have much more discretion. State administrators review the substantive terms of the offering to determine the merit of the offering, rather than just the disclosure of those terms, hence it is called "merit review." *See infra* Part I; UNIF. SEC. ACT § 304(d) commissioner's note, 7A U.L.A. 567, 612 (master ed. 1978) (uniform act not primarily disclosure act); L. LOSS, COMMENTARY ON THE UNIFORM SECURITIES ACT 83–85 (1976) (grounds for action under § 306(a) include fraud, full disclosure, and other violations); J. MOFSKY, *supra* note 2, at 4 n.7.

5. *See* Tyler, *More About Blue Sky*, 39 WASH. & LEE L. REV. 899, 902–03 (1982).

6. *See infra* notes 19, 20 and accompanying text.

been extensive[7] and long-lasting.[8] An unanswered question remains, however; that is, whether state registration would benefit by a compromise between the two extremes of no merit review and unrestricted merit review, especially in light of our two systems of registration.[9]

This Comment examines the compromise question in four parts. Part I describes the typical state registration process and the arguments of commentators, pro and con, concerning merit review. Part II develops a theoretical framework for securities registration by which the limits of registration can be understood and the value of different approaches analyzed. Part III examines the strengths and weaknesses of merit review in light of Part II. Finally, Part IV proposes a change to current state registration that maintains the strengths inherent in the overall federal-state registration system while minimizing its weaknesses.

I. BACKGROUND

When registering securities under typical state securities regulations,[10] issuers must supply the securities administrator with information about their company and its security.[11] Under merit review, the administrator

7. For some of the more illuminating commentary, see L. LOSS, *supra* note 1; J. MOFSKY, *supra* note 2; Bateman, *supra* note 2; Goodkind, *supra* note 1.

8. Merit review has been unpopular in many circles since its inception. Legislatures in many states amended merit review laws shortly after enactment to exempt from registration the clients of the major underwriter and brokerage houses. J. MOFSKY, *supra* note 2, at 12. Recent changes have been taking place in the state securities area. *States Stop Playing Detective for Investors*, BUS WK., July 16, 1984, 131, 131–32. Illinois, a "tough" regulatory state, has wholly discarded the discretionary merit review for all but fraud, 15 SEC. REG. & L. REP (BNA) 1354 (1983), and Iowa has done the same, at least for intrastate offerings. *See also id.* at 1833; Tyler, *supra* note 5, at 940–41. State securities codes contain numerous exemptions. These exemptions have been described as "a patchwork quilt . . . which reflects political convenience rather than sound economic analysis or systematic application of the principles of federalism." Sargent, Book Review, 39 BUS. LAW 359, 364 (1983).

9. The two systems are the federal disclosure system and the state systems. This Comment does not purport to evaluate the disclosure review of the federal system, except tangentially. Instead, it proceeds on the assumption that disclosure review will remain a part of the overall process of registration.

10. "Typical," here, is equivalent to the UNIF SEC ACT, 7A U.L.A. 567 (master ed. 1978) [hereinafter cited as Uniform Act]. Thirty-six states, the District of Columbia, and Puerto Rico have adopted the Uniform Act, usually with some modification. The states that have not adopted the Act are Arizona, California, Florida, Georgia, Illinois, Louisiana, Maine, New York, North Dakota, Ohio, Rhode Island, South Dakota, Texas, and Vermont.

11. Uniform Act §§ 302(b), 303(b), 304(b) (1978) (some states have dropped the notification category); *see also* H. SOWARDS & N. HIRSCH, *supra* note 2, § 7.01(1)(a)–(d); Mofsky & Tollison, *Demerit in Merit Regulation*, 60 MARQ L. REV. 367, 368 (1977) (citing Form U-1, 1 BLUE SKY L. REP (CCH) 4473 (1969)). The information required in a registration statement is typically detailed and complex, describing the business, the management, and the security at great length. *See* Uniform Act §§ 303(b), 304(b) (1978).

reviews that information,[12] focusing on the substantive terms of the proposed offering.[13] Based on that review, and regardless of the level of disclosure, the administrator may demand that the issuer change the terms of the offering. Unless and until the issuer complies with that demand, the administrator may deny registration.[14]

Nearly all states allow the securities administrator much discretion in deciding to deny registration.[15] Some states allow the administrator to deny registration if the offering would not be fair, just, and equitable.[16] Modern statutes,[17] however, are slightly more limited.[18] Under these statutes, securities administrators may deny registration either because the offering would "work or tend to work a fraud" on the investing public[19] or because the offering would entail unreasonable commissions, profits, or participation by the issuer or the underwriters.[20]

Most states have promulgated standards for denial that set forth particular areas for administrative review. These areas include "underwriting commissions and offering expenses, cheap stock, options and warrants, offering price, shareholder voting rights, debt and interest coverage, and promoters' investment."[21] The rules in these areas usually specify ranges of variation within which the offering is considered presumptively reasonable.[22] The reasonableness of the numerous offerings

12. Most state securities statutes contain disclosure requirements, but they are designed to provide state administrators with data to make qualitative decisions regarding the fairness and reasonableness of the proposed offering. Administrators do not usually investigate beyond the submitted information. If the offering does not meet certain statutory and administrative standards of quality, most jurisdictions provide their state administrators with the means to prevent or stop the offering. J. MOFSKY, *supra* note 2, at 19; *see also* L. LOSS, *supra* note 1, at 11–12; J. MOFSKY, *supra* note 2, at 59; H. SOWARDS & N. HIRSCH, *supra* note 2, § 7.05; *see, e.g.*, Uniform Act § 306.

13. *See infra* text accompanying notes 15–20.

14. Uniform Act § 306(a). With disclosure review, on the other hand, administrators focus on whether the registration statement is misleading in any material respect or whether it omits any material information. They may demand that the issuer change the level of disclosure but may not affect the terms of the offering. Once the information contained in the registration statement is complete, accurate, and not misleading, the administrators must approve the registration statement, regardless of their opinion of the terms of the offering. *See also infra* note 63.

15. Bateman, *supra* note 2, at 759–60 n.4; *see also* Goodkind, *supra* note 1, at 85, 123. Two important exceptions are New York and Illinois, states with large investor communities. New York registers only intrastate offerings and effectiveness is automatic without any administrator review. Illinois recently amended its registration statute and now only reviews registration statements for fraud. 15 SEC. REG. & L. REP. (BNA) 1354 (1983); *see also States Stop Playing Detective for Investors*, BUS. WK., July 16, 1984, at 131–32.

16. Tyler, *supra* note 5, at 902–03.

17. Thirty-six states have adopted the Uniform Act since its drafting in 1956. *See supra* note 10.

18. J. MOFSKY, *supra* note 2, at 15; *see also* Goodkind, *supra* note 1, at 91–93, 108–09.

19. Uniform Act § 306(a)(E).

20. *Id.* § 306(a)(F).

21. These seven are the most common subjects of substantive regulation. Goodkind, *supra* note 2, at 87.

22. *See, e.g.*, WASH. ADMIN. CODE ch. 460-16A (1983) (Washington blue sky regulations). The

that fall outside the presumptively reasonable range,[23] however, are left "subject to administrative discretion."[24]

Commentators on merit review have put forth strong arguments favoring and opposing the system. Some commentators have said that merit review discriminates against new businesses,[25] it impinges investors' freedom of choice[26] without providing a significant level of protection in return,[27] its administrators are sometimes irrational and overbearing,[28] its application is too flexible and unpredictable,[29] and it grants too much power to administrators without a realistic avenue of review.[30] On the other hand, some commentators have said that merit review is a vital protection for investors,[31] a protection that is lacking under the federal securities system,[32] it prevents abuses by unscrupulous promotors rather than just disclosing those abuses in documents that no one reads,[33] and the flexibility and discretion granted under the system are necessary to give realistic protection to investors.[34] Even though some have recognized the

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Blue Sky Law Reporter (CCH) lists each state's securities regulations, as well as their securities statutes.

23. The presumptively reasonable standards for most states are fairly conservative, especially for young businesses whose founders are attempting to retain control of their corporations while raising sufficient capital to grow. Underwriters also demand higher commissions in offerings for young corporations because of the greater risks associated with them. J. MOFSKY, *supra* note 2, at 33–34 (cheap stock and warrant rules based on wrong assumptions); *see also* Jarrell, *The Economic Effects of Federal Regulation of the Market for New Securities Issues*, 24 J.L. & ECON 613, 668 (1981) (impact of registration on relatively risky new issues).

24. Often, the presumptively reasonable standards, instead of being guidelines for administrative review, become rigid ceilings and no offerings that exceed the standards are allowed. *See* Bloomenthal, *Blue Sky Regulation and the Theory of Overkill*, 15 WAYNE L. REV 1447, 1462–78 (1969) (application of various standards shows rigidity although none intended).

25. J. MOFSKY, *supra* note 2; Bateman, *supra* note 2, at 778; *see* Mofsky & Tollison, *supra* note 11, at 369.

26. Bateman, *supra* note 2, at 761, 777–78; Tyler, *supra* note 5, at 935.

27. Bateman, *supra* note 2, at 777–78; Bloomenthal, *supra* note 24, at 1481; Tyler, *supra* note 5, at 908.

28. *See, e.g.*, Goodkind, *supra* note 1, at 86 & n.45; *see also* Bateman, *supra* note 2, at 774; Bloomenthal, *supra* note 24, at 1479; Tyler, *supra* note 5, at 934.

29. Bateman, *supra* note 2, at 774, 776–79; *see also* Bloomenthal, *supra* note 24, at 1479; Goodkind, *supra* note 1, at 86 & n.45, 98; Tyler, *supra* note 5, at 906–07.

30. Bateman, *supra* note 2, at 778.

31. H. SOWARDS & N. HIRSCH, *supra* note 2, § 1.02 (citing State Commissioner of Securities v. Hawaii Market Center, Inc., 52 Hawaii 642, 485 P.2d 105 (1971)); Bateman, *supra* note 2, at 770, 772; Hueni, *Application of Merit Requirements in State Securities Regulation*, 15 WAYNE L. REV 1417, 1445 (1969).

32. Goodkind, *supra* note 1, at 106; Mofsky & Tollison, *supra* note 11, at 367 (citing Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM ECON REV. 132 (1973)). *But see* Bateman, *supra* note 2, at 783–84; Wheeler, *Securities Law Practice in the 1980s—An Appraisal*, 9 SEC REG L.J. 3, 21 (1981) (disclosure is low cost regulatory option).

33. Hueni, *supra* note 31, at 1417–18.

34. Tyler, *supra* note 5, at 926.

system's advantages and disadvantages, commentators nearly always advocate all or nothing; rarely does a commentator propose a compromise that accomodates both sides.

II. THEORY OF SECURITIES REGISTRATION

Society has two opposing goals in securities registration. The first is to encourage investment in securities because participation in the securities markets is crucial to business innovation and expansion. The second goal is to protect investors who participate in these markets. These goals are expansive and might apply in any situation where an activity that benefits society also involves a risk to its members. Neither goal can be perfectly achieved in the presence of the other; therefore, the situation calls for balance and compromise. The crucial issue is where to strike the balance.

A. *Protecting Investors*

Of the two aspects of securities, risk and reward, it is the former that is the target of investor protection. The general concept of risk is probably familiar to all; but, in order to identify the limits of protection through securities registration, it is necessary to understand the basic elements and nature of investment risk.

There are two major categories of investment risk in the primary securities market: "external risk" and "transactional risk."[35] External risk is that which is commonly thought of as the risk of business investment. Examples include the risk that hula hoops will go out of style imediately after one buys hula hoop stock, the risk that the economy will enter a recession or the stock market will turn bearish, the risk that the management of a company will be inept, and the risk that the company whose stock was purchased will finish second in the race to develop commercial uses for genetic engineering. External risk arises after the point of investment from the fluid factors that affect securities—the performances of the economy, the stock market, the consumer, or the management of the company.[36]

35. The categorization of risk is the author's own for analyzing the limits of investor protection that can be provided by securities registration. For other categorizations of risk, see F. REILLY. INVESTMENT ANALYSIS 16–18 (1979) (business risk, financial risk, and liquidity risk); L. SCHALL & C. HALEY, *supra* note 21, at 129–31 (personal, general economic, inflation, and operating risk).

36. External risk is forward-looking and impossible to accurately predict. Administrators, therefore, are in the same, if not worse, position to predict which securities issues have too much external risk than are the investors whom the administrators are trying to protect. Thus, it is the author's view that external risk is an inappropriate factor for securities administrators to review. Discussion of that view is, however, beyond the scope of this Comment.

Transactional risk, on the other hand, is the risk specifically associated with the investment transaction itself. Transactional risk includes both the "fraud risk"[37] and the "structural risk" of the transaction. For the investor in the primary market, the risk of fraud is the possibility that the issuer is being less than candid with the investor. The basis for fraud risk is the information the investor receives about the transaction; fraud occurs when material information is omitted or misstated. Structural risk differs from both external risk and fraud risk.[38] Structural risk arises from the terms of the investment transaction—the risk that is allocated to the investor by virtue of the investment agreement.[39] Unlike fraud risk, it is not a function of the information the investor receives.[40] Structural risk is the major focus of modern merit review.[41]

Society can protect investors from investment risk by different methods. The government reduces many external risks by general pro-business programs.[42] In the context of securities registration, however, protection takes two forms. The first form is disclosure. Disclosure, if complete, accurate, available, and understandable, eliminates fraud risk.[43] Although it does not eliminate external or structural risk,[44] disclosure allows

37. "Fraud," as used in the securities context, is much broader than the common law concept. *See, e.g.*, Uniform Act § 306(a)(E) commissioner's note. It includes all instances of misstatement or omission by the issuer. Goodkind, *supra* note 1, at 79 n.2; *cf.* 17 C.F.R. § 240.10b-5 (1984) (Rule 10b-5) (basis for Uniform Act § 101).

38. If investment risk as a whole is the risk that the investor will lose some amount of his investment, then external risk is that which is caused by events, fraud risk is that which is caused by information or a lack of it, and structural risk is that which is caused by the investment agreement itself. Structural risk is thus a derivative of external risk. For example, if the investment agreement gives public investors a priority in liquidation over the inside investors, then there is less structural risk than if the situation is reversed. Of course, the priority is meaningless unless an external event, liquidation, occurs.

39. In most cases, structural risk relates to external events. Thus, a liquidation preference relates to the external event of liquidation, but the structural risk that arises from the fact of the preference is separate from the event and can be considered separately. Some structural risk, like that arising from voting rights or the lack thereof, relates less to external events than does other structural risk, such as the price of the security or a liquidation preference.

40. Structural risk arises whether or not investors know of, read, or rely upon information supplied by the issuer.

41. Those states that have substantially adopted the Uniform Act concentrate their review on the terms of the offering such as underwriting commissions, voting rights, cheap stock, and options and warrants. *See supra* text accompanying notes 20–21. Some of the older merit review statutes direct administrator attention to external risk. *See* Bloomenthal, *supra* note 24, at 1450.

42. Every time the government takes an action that boosts the economy, it is reducing external risk for investors. Each investor whose company would have failed or been less profitable in the absence of the economic stimulation has had the external risk of that investment reduced by the government.

43. This conclusion follows from the meaning of "fraud" in the securities context. Fraud is materially misinforming or underinforming the investor. If disclosure by the issuer is complete, accurate, and understandable, then by definition the investor cannot be defrauded.

44. External and structural risk are independent of the level of disclosure. This is because the

investors to be aware of those risks and choose securities with risk characteristics that are appropriate for them.[45]

The second form of investor protection in securities registration is preclusion. Preclusion protects the investor by eliminating securities from investor consideration.[46] Preclusion protection occurs any time the government prevents a proposed securities offering from coming to market. It occurs in merit review when the administrator denies registration because the issuer refuses to change the terms of the offering to comply with the administrator's merit demands or refuses to comply with the administrator's disclosure demands. Preclusion eliminates all investment risk connected with a security, but it also eliminates any potential for reward that the security may have represented.[47]

Both forms of investor protection have drawbacks. Disclosure, even complete, accurate, and understandable disclosure, will not protect investors who pay no attention to the information. Preclusion, in contrast, protects investors without any action on their part. It does this, however, by substituting administrators' centralized decisions for the individualized decisions of all market investors, thus eliminating one major advantage of the securities markets.[48] Both disclosure and preclusion give over-broad protection—disclosure in the sense that even information that is complete, accurate, and understandable may be unnecessary, unwanted, or duplicative for some investors,[49] and preclusion in the sense that external

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events that give rise to the potential for economic loss, whether external to the transaction or part of the structure of the transaction, occur and exist regardless of the investor's knowledge or ignorance.

45. Awareness and choice are crucial elements of disclosure protection. Because disclosure does not reduce either structural or external risk, *see supra* note 44, the investor must take an active role to gain the benefit of disclosure protection. Disclosure, however, allows the investor to take that active role: to become aware of external and structural risk and to make a choice among different possibilities. *See* Bateman, *supra* note 2, at 781. *But see* Hueni, *supra* note 31, at 1417–18 (present disclosure prospectuses are difficult for investors to understand and use properly).

46. This protection comes from a party outside the usual transaction relationship—the government. "Preclusion" is used in a generic sense. It includes all occasions when the government prevents the investment transaction from occurring. Its protection is paternalistic in that the investor cannot ignore or circumvent the preclusion; it is also, in contrast to disclosure protection, automatic in that the investor need not take an active role in the protection.

47. *See* Bateman, *supra* note 2, at 761 (importance of diversified financial medium); Tyler, *supra* note 5, at 934 & n.165.

48. When many individual investors make investment decisions independently, some decisions will be correct and some incorrect. With the correct decisions, companies with needed products or services will receive financing and be able to develop and prosper; those companies that are destined to fail, on the other hand, will fail—taking their investors' money with them. When a centralized securities administrator's decisionmaking precludes many independent decisions, however, the economic development of the country is retarded each time the administrator, who is as fallible as anyone else, makes an incorrect decision.

49. This phenomenon is often referred to as the "perfect market." It occurs when information is received, disseminated, and reflected in a stock's price so quickly that the information required by the government is useless by the time it reaches investors. A corollary of the perfect market theory is that

or structural risk that is appropriate for some investors may be eliminated because it is inappropriate for others.[50]

B. *Encouraging Investment*

Society's second goal in securities regulation is to encourage investment. Investment provides a benefit to society by making the excess resources of investors available to businesses and entrepreneurs, who then may apply these resources to support innovation and expansion. Also, when the uncertainties of innovation or expansion are too great for the entrepreneur to shoulder alone, the securities vehicle for investment allows the entrepreneur to shift that uncertainty to a greater population.[51]

C. *Ideal Securities Registration*

The ideal securities registration would perform two functions: it would eliminate fraud risk, and it would tend to match the risk of each security purchased with the investor's ability to bear risk.[52] Society gains nothing from fraud; its elimination facilitates the goal of encouraging investment by reducing a risk for which there is no real reward[53] and advances the

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investors cannot react quickly enough to avoid movement of a stock price by buying or selling on public information. There is some question, however, whether the perfect market hypothesis applies to securities with relatively small markets because of the smaller numbers of investors and analysts watching the corporation full-time. Thus, whether the perfect market hypothesis applies to the primary market may depend largely on the number of potential investors.

50. Investors have differing abilities to bear risk. Although no investor wants to bear a loss on his or her investment, some are better able, financially and psychologically, to assume greater risk. Unless preclusion protection is individually tailored for each investor, some investors will be unable to assume as much risk as they would prefer. *See* Bateman, *supra* note 2, at 761; Bloomenthal, *supra* note 24, at 1490. *But see* Tyler, *supra* note 5, at 935; *cf.* Soraghan, *Private Offerings: Determining "Access," "Investment Sophistication," and "Ability to Bear Economic Risk,"* 8 SEC REG L.J. 3, 28–34 (1980) (discussing the difficulties of statutory definitions of ability to bear risk).

51. Thirty million individuals owned shares of publicly held corporations in 1980. In addition, approximately 133 million persons had an indirect stake in the market through their pension plans, life insurance, and other intermediaries. L. LOSS, *supra* note 1, at 4–5; *see also* Bateman, *supra* note 2, at 760–61.

52. These functions are ideal because, in a perfect environment, they provide the balance between protecting the investor and encouraging investment. *Cf.* Tyler, *supra* note 5, at 931 (must evaluate balance).

53. Hueni argues that all types of merit protection also encourage investment. Hueni, *supra* note 31, at 1444–45. This is true to the extent that investors are risk averse and protection reduces risk. *See* Mofsky & Tollison, *supra* note 11, at 375; Tyler, *supra* note 5, at 930–31. To the extent that the protection creates additional costs or precludes the possibility of reward, however, protection does not encourage investment. Mofsky & Tollison, *supra* note 11, at 367–69; *cf.* Jarrell, *supra* note 23, at 667–68 (discussing the economic costs of federal registration procedures). Eliminating fraud from the information that the investor desires is ideal because its preclusive effect is limited to those offerings in which the investor would be misinformed and its cost falls only upon the misinforming issuer.

goal of protecting the investor by eliminating one of the transactional investment risks.

The ideal securities registration would also promote matching the external and structural risk of an investment with the investor's ability to bear risk.[54] The securities markets act to shift the risk of economic expansion among the investing members of society. No investor, however, should assume more risk than he or she is willing and able to bear. Thus, the limit to economic expansion through the securities mechanism should be the aggregate risk that the investing public is willing and able to accept. The ideal system would accomodate each investor's choice. Those securities whose external or structural risk makes them undesirable for the "average" investor would still be available for purchase by investors with high risk-bearing abilities.

III. STRENGTHS AND WEAKNESSES OF MERIT REVIEW

Merit review has both strengths and weaknesses. Its strengths are at least partially responsible for its enduring the decades since its inception. Conversely, the continued criticism of the system,[55] the federal government's adoption of a different system of securities registration,[56] and the many exemptions to the system's coverage[57] reflect merit review's weaknesses. An examination of merit review along the theoretical lines developed in Part II will identify why it should be retained and where improvements may be made.

Merit review protects investors primarily through preclusion.[58] Preclusion, like disclosure, can protect[59] investors from both external[60] and

54. This matching principle provides a benchmark for measuring the protection provided by securities registration. Investors have different abilities to bear risk. A registration system can fail in two ways. If the investor purchases a security with more risk than the investor is willing and able to bear, then the registration system is skewed too much in favor of the issuer; not enough investor protection is provided. When, however, the investor is precluded from purchasing a high risk security, even though the investor is willing and able to accept the risk that the security represents, the system is weighted too much in favor of protection, and economic expansion and innovation will be retarded.

55. *See, e.g.*, J. MOFSKY, *supra* note 2; Bateman, *supra* note 2; Bloomenthal, *supra* note 24; Goodkind, *supra* note 1; Mofsky & Tollison, *supra* note 11; Tyler, *supra* note 5.

56. Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (1982); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78kk (1982); *see also* L. LOSS, *supra* note 1, at 29–38.

57. *See* Bateman, *supra* note 2, at 777–78.

58. Merit review can also protect through the *threat* of preclusion. When standards are not objective and clearly delineated, however, the issuer is less able to conform its behavior to the expectations of the administrator.

59. Disclosure can protect investors from external and structural risks by making them aware that the risk exists, but cannot prevent its existence. *See infra* text accompanying note 63.

60. Modern merit review statutes, as exemplified by the Uniform Act, are not intended to allow the administrator to protect the investor from external risk. The combination, however, of states that

transactional risk.[61] Preclusion, however, is stronger than disclosure because it works without any action by the investor. Used carefully, this strength benefits society because many investors are unwilling or unable to gain the full benefits from a disclosure system.[62] Thus, the ability to protect investors without their active participation in the system is an important strength of merit review. In this respect, merit review protects all investors, not just those able to understand registration statements.

Another important strength of merit review is the greater control it gives administrators over issuers. Under the disclosure approach, administrators can control issuers to prevent fraud risk but not to prevent structural or external risk.[63] Once those risks are fully disclosed, the administrators' power over issuers ends. Merit review, through its preclusion approach to protection, however, gives administrators the power to control issuers even in the areas of structural and external risk. With preclusion power, administrators can prevent unacceptable structural and external risks, regardless of how they are disclosed. This power can provide investors with important protections greater than those that are possible under a disclosure system alone.

As important as its strengths are, merit review has serious weaknesses as well. Its major weaknesses arise because of administrators' discretion.[64] The first weakness that administrative discretion creates is uncertainty. Preclusion protection itself does not create the uncertainty; rather, it is the inability to predict which offerings will be precluded that produces the uncertainty.[65] The securities markets are volatile, and an

altered the Uniform Act when adopting it and administrators who liberally interpret the power granted them under the modern statutes leaves external risk a target for protection in many merit review states. Bloomenthal, *supra* note 24, at 1462–78; Goodkind, *supra* note 1, at 105–06; Tyler, *supra* note 5, at 902–04.

61. *See supra* text accompanying notes 46–50.

62. Hueni, *supra* note 31, at 1417–18.

63. "Disclosure approach" refers to the situation in which the administrator's power ends when the issuer meets investors' information needs. Often, however, the administrator with disclosure power will concurrently have a great deal of preclusive power either because the administrator is attacking external or structural risk under a disclosure pretense or because the issuer refuses to comply with the administrator's disclosure demands. *See* H. SOWARDS & N. HIRSCH, *supra* note 2, § 7.01 n.2. When the administrator is attacking external or structural risk under a disclosure pretense, the administrator actually takes a disguised merit review approach. When, however, the issuer refuses to comply with the administrator's legitimate disclosure demands, the approach is still one of disclosure even though the result is preclusion. If preclusion is the result of an administrator's disclosure demands, then external and structural risk may be actually prevented.

64. *See* Tyler, *supra* note 5, at 906–07. This Comment does not address whether the preclusion protection from external risk that is included in many states' merit review systems also represents a major weakness.

65. Bateman, *supra* note 2, at 778–79. Preclusion protection can be entirely predictable without reducing the level of protection. *Cf.* Goodkind, *supra* note 1, at 87 (although state securities regulation varies widely there are recurring standards).

issuer's primary concern is getting the offering registered and sold while the market is rising.[66] This is a major concern no matter how risky the offering because the condition of the market directly impacts the price and salability of the offering and, therefore, its value to the issuer.[67]

The second weakness of the discretionary approach to merit review is the resulting neglect of other forms of investor protection.[68] Most state securities administrators operate with a limited budget.[69] Because their power is discretionary and subject to limited review, conscientious administrators must devote a significant amount of time to preclusion decisions. This time is an important resource that administrators could apply to protect investors in other ways.[70] For example, administrators could devote the resources currently allocated to discretionary, non-fraud, preclusion to fraud preclusion, disclosure, or non-registration protections.

The third weakness of discretionary preclusion is that administrators often do not articulate the standards by which they judge offerings.[71] This creates difficulties in knowing, evaluating, and changing those standards. Even when administrators have promulgated standards, they often phrase the standards in terms of "presumptive reasonableness."[72] The discretion left to administrators to overrule the presumption or to find "reasonableness" beyond the presumptive level leaves investors, issuers, and lawyers unable to know why a security passed or failed.[73] Moreover, legislators, when called to evaluate administrators' actions, have no means to compare their state's registration policies with those in other states. Finally, discretionary preclusion prevents people, other than administrators, from instituting change; with no easy way of knowing the standards being applied, one cannot advocate their change.

66. The risk that is passed to the underwriter in a firmly underwritten offering is the same risk that the issuer suffers up to then. It should not be surprising, therefore, that issuers have the same desires to sell in a favorable market that underwriters have. *See* H. BLOOMENTHAL. SECURITIES LAW HANDBOOK 87–89 (1984) (underwriters' desire to be at risk for only short time); L. LOSS. *supra* note 1, at 86 (underwriters' contracting practices protect them from volatile market).

67. When an offering is firmly underwritten, L. LOSS. *supra* note 1, at 83–90, it is the underwriter, not the issuer, who bears the risk that the market will fall during an offering. For most young companies, however, a firm underwriting is not available and the company bears the risk. *See id.* at 90.

68. Sargent, *supra* note 8, at 363 n.23 (while growing trend toward fraud enforcement, most states still concentrate on evaluating registration documents) (citing *Empirical Research Project, Blue Sky Laws and State Takeover Statutes: New Importance for an Old Battleground,* 7 J. CORP. L. 689, 800 (1982)); *see also* Bloomenthal, *supra* note 24, at 1479 ("blue sky laws seldom touch the fraudulent promotion").

69. *See* Bateman, *supra* note 2, at 776; Tyler, *supra* note 5, at 908, 934.

70. Bloomenthal, *supra* note 24, at 1481.

71. Goodkind, *supra* note 1, at 85.

72. *See, e.g.,* WASH. ADMIN. CODE ch. 460-16A (1983); *see also* Tyler, *supra* note 5, at 906 (informal rules and guidelines developed under securities laws enhance administrator discretion).

73. Bateman, *supra* note 2, at 774; Bloomenthal, *supra* note 24, at 1479.

The final weakness of discretionary merit review is that it lacks realistic checks on administrators' power.[74] The judicial limits on administrative discretion concerning non-fraud preclusion are nearly nonexistent.[75] Although nearly every state's securities statute allows judicial review of registration decisions,[76] that review as a limitation on administrators' power is illusory. Courts defer to administrators' experience and discretionary powers.[77] Furthermore, issuers and underwriters are unwilling to challenge administrators' decisions because such challenges are too expensive and time-consuming, and may lead to adverse publicity concerning the issuer.[78] Instead of challenging administrators' decisions, issuers merely bypass the states that deny registration,[79] regardless of the quality of administrators' decisions.

The problems identified above do not suggest that current state registration systems are inimical to investor protection. Indeed preclusion is always the ultimate protection; it eliminates all the risk from a security by eliminating the security. The real problem is in the manner of preclusion. The current systems of registration give non-fraud preclusion protection in a way that is neither efficient nor subject to the normal restraints of administrative governance. Protection should not be the first and last goal of securities registration. Other social interests, such as judicial redress for administrative errors, responsive and representative government, and efficient and effective methods of financing business innovation and expansion, deserve weight as well.

IV. PROPOSAL FOR CHANGE

The problems identified above are mainly due to the discretion granted to state securities administrators, allowing them to deny registration of securities offerings for "unfair, unjust, or inequitable" structural or external risk[80] or "unreasonable" structural risk.[81] Administrators have promulgated standards,[82] but these standards have done little to limit the

74. Bateman, *supra* note 2, at 778.

75. H. SOWARDS & N. HIRSCH, *supra* note 2, § 7.06 (citing Hayden Plan Co. v. Friedlander, 97 Cal. App. 12, 275 P. 253 (1929)).

76. Of the jurisdictions that have adopted the Uniform Act, two, the District of Columbia and New Jersey, omitted § 411 (Judicial Review of Orders) and one, Oklahoma, materially changed that section. 7A U.L.A. 685–86 (master ed. 1978).

77. H. SOWARDS & N. HIRSCH, *supra* note 2, § 6.06.

78. Goodkind, *supra* note 1, at 80 n.5; *see also* Bloomenthal, *supra* note 24, at 1484–85 & n.214; Mofsky & Tollison, *supra* note 11, at 376.

79. *See* Mofsky & Tollison, *supra* note 11, at 376.

80. *See* Tyler, *supra* note 5, at 902–03.

81. *See supra* text accompanying notes 20–24.

82. *See generally supra* note 21.

discretion that produces merit review's weaknesses.[83] The dilemma can be solved without abandoning the merit philosophy. The solution is to reject administrative discretion in the non-fraud situation and move instead to a system of objective standards.

Under a non-discretionary, objective system, issuers and underwriters could structure offerings with a greater certainty as to the result, even in the face of a lack of uniformity among the states.[84] This would increase the efficiency of the capital markets and perhaps decrease the staggering costs of public financing.[85] Uncertainty is an unnecessary cost because it provides no greater protection to investors.[86] If administrators exercise preclusion power consistently and regularly according to established standards, the investor receives better protection than if the preclusions are discretionary because the investor can place greater reliance on an offering's registration.[87]

A non-discretionary registration system would also free administrative resources for other areas of investor protection.[88] Without the subjective balancing of one structural risk against the other, an exercise of dubious value, administrators could process registration applications more quickly. Scholars and legislators could scrutinize objective standards to better assess their value. Finally, non-discretionary, objective standards

83. *See supra* text accompanying notes 22–24.

84. Many authors have deplored the lack of uniformity among state blue sky laws. *See, e.g.*, Bateman, *supra* note 2, at 759–60, 769, 774; Bloomenthal, *supra* note 24, at 1448–49; Goodkind, *supra* note 1, at 85. *But see* Tyler, *supra* note 5, at 902, 923–26. Lack of uniformity would still be a problem with diverse objective standards, but these standards would drastically reduce the magnitude of the problem. Instead of dealing with the discretionary whims of the state securities administrators, issuers and underwriters would be able to observe and plan for each state's securities requirements.

85. *See* Mofsky & Tollison, *supra* note 11, at 367–68; Tyler, *supra* note 5, at 932.

86. Arguably, discretion gives greater protection from new and unforeseeable structral risk by allowing administrators to preclude that offering. Tyler, *supra* note 5, at 926. This argument confuses speedy adaptation with discretion. There may indeed be a benefit in having preclusion protection readily adaptable to new risk; that benefit, however, can be enjoyed without the uncertainty and unpredictability inherent in discretionary preclusion. *See* Hueni, *supra* note 31, at 1419–20 (standards that are fair, reasonable and consistently applied protect investors and make a better securities market).

87. Commentators often overlook this point. *See, e.g.*, Hueni, *supra* note 31, at 1417–18. The fact of review by administrators, even if the review is random, allows the investor to rely on the level of protection given. *Cf.* Mofsky & Tollison, *supra* note 11, at 374; Tyler, *supra* note 5, at 930–31. Since investors cannot know the level of protection provided by a discretionary review, their reliance on such a review must be less than under a non-discretionary review system. *See* Bateman, *supra* note 2, at 774; Bloomenthal, *supra* note 24, at 1479; Goodkind, *supra* note 1, at 86 & n.45.

88. Examples of other protections that legislatures or administrators could institute include: increasing disclosure protection through an administrative classification of securities; increasing fraud preclusion protection through greater investigation by administrators into the issuer at the registration stage; increasing post-registration fraud policing and prosecutions; and other non-registration protections.

would help ensure registration's evolution to match evolutions in market ethics and investor sophistication.

The disadvantages of a non-discretionary system are the reduction of administrative flexibility and the difficulty of setting appropriate standards. These disadvantages are more apparent than real, however. Objective standards would not seriously hamper administrative flexibility to deal with newly devised structural risks if administrators were responsible for proposing or promulgating the standards. Structural risks do not directly cause financial loss to the investor, but merely represent an increased potential exposure to loss. Thus, concern over the few securities with newly devised structural risks that issuers might register before administrators could promulgate applicable objective standards should not override the value of the objective system. Loss of flexibility to distinguish between differently situated issuers should not be overemphasized either. If administrators are making rational distinctions under the present system, those distinctions can and should be made under an objective system.

The difficulty of setting standards for an objective system of securities is also not an acceptable reason to reject the system. One purpose of changing from a subjective to an objective system is to encourage participation in setting the system's standards and scrutiny of those standards thereafter.[89] To start the process, however, most administrators need do no more than make public the standards that they have been using informally or make non-discretionary the standards that were previously discretionary.[90] If the previous standards are too restrictive for a non-discretionary, objective system, then the solution is to ease the standards or tailor them more closely to specific situations.

In sum, legislators and administrators can improve the present investor protections in the areas of external and structural risk by instituting a registration process in which administrators must promulgate and follow objective standards. The change would alleviate many of the more objectionable qualities of the current merit review system without significantly impinging on investor protection.

Gregory Gorder

89. *See supra* text accompanying notes 71–73.

90. The author makes no suggestion for specific objective standards. One of the advantages of state registration systems is to allow experimentation with different approaches. The ideal standards, however, would promote the matching principle discussed *supra* in Part II. This requires that the standards not be so restrictive that they preclude risks that could well be borne by that segment of investors with greater risk bearing abilities.