An Open Attack on the Nonsense of Blue Sky Regulation

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The evolution of state securities laws (hereinafter "blue sky laws") in this country is a classic example of regulation that was, perhaps, initially justified and that was apparently promulgated with the best of motives, but which now is actually harmful to society. Today, blue sky laws are ineffective, philosophically unsound, and unnecessarily expensive, and they should be substantially eliminated. Because of the vested interests that have developed, however, it is unlikely that states will respond to this problem, and it will probably take action by the United States Congress to preempt the area. Such an action is appropriate and, indeed, is long overdue.

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1. The writer would not argue all state securities divisions should necessarily be eliminated. If states wish to invest resources in this area, however, they should be limited to the enforcement of federal antifraud standards. Any legislation in the area should provide states with this option. See infra text accompanying note 151.

2. The vested interests in this case are those of the bureaucrats who are employed by the various state securities divisions. It would, of course, be quite surprising if they were unwilling to fight for the status quo. Some have already defended their functions. See, e.g., Goodkind, Blue
The case for substantially eliminating state blue sky laws is based, fundamentally, on a cost-benefit analysis. This writer's research, as reflected in this Article, uncovered no meaningful benefit to society from state regulation of securities. In the areas of disclosure and broker-dealer governance, for example, blue sky laws merely duplicate the federal requirements and as a result add no additional protection for investors. Where merit regulation is concerned, however, the regulatory scheme is harmful to society, even without considering the actual dollar costs of such regulation. Although the writer does not attempt any precise quantification of these dollar costs to society, the article does contain some information and observations about the level of expenditures generated by the enforcement of and compliance with state blue sky laws. The inference from this information leads one to the conclusion that blue sky laws exact a considerable tribute from society. For these reasons, the Article recommends that the blue sky laws be essentially eliminated.

B. Historical Overview

At the birth of our republic, there were, of course, no blue sky laws. At that time, and for the next few decades, the capital requirements of business generally were small, and there was little pressure to resort to public financing for such enterprises. As the industrial revolution proceeded, however, and especially as the construction of railroads was undertaken, the need for large amounts of capital increased, leading promoters to begin looking to the public for financing. Reports exist of massive meetings, sometimes conducted by prominent figures, at which persons attending were invited to invest in certain enterprises. Eventually, stocks were peddled to the public in more aggressive fashions, including door-to-door selling.

It is impossible to evaluate accurately the extent of the abuses that occurred in the sales of securities during this period. There is also little evidence that the state legislatures had any data measuring the breadth of these abuses, and
there certainly is no evidence that the legislatures had any understanding of the economic impact of blue sky legislation. Nonetheless, the legislatures, with no doubt the best of intentions, enacted blue sky laws, and they did so with a flourish. Within two years after Kansas enacted the first such law in 1911, twenty-three states followed, and today every state has some form of blue sky act.

Once the laws were in place, the next step was entirely predictable. Bureaucracies were established to administer and enforce the laws that had been enacted. Although many of these bureaucracies (hereinafter referred to as "divisions") were administering laws that were quite similar, each division began to take on its own personality based principally on the quality and attitudes of its leader (hereinafter referred to as the "commissioner"), its staff, the resources available to the division and, of course, the particular state’s law. For the last fifty years, therefore, issuers raising capital through the sale of securities have been required to comply with these state blue sky laws, as well as federal legislation governing securities.

Today some scholars realize that we have gone too far in this area, and, as a result, some debate about the value of state blue sky laws has erupted. This debate, however, which intensified in the late 1960’s, generally seems to have been limited to the value of merit regulation by the states. As one would expect, authors reach different conclusions on these matters.

9. Because Kansas is generally conceded to have been the first state to enact a modern blue sky law, information is available about the circumstances surrounding that legislative enactment. In assessing why the act was passed, commentators uniformly conclude that the "wave of prairie populism which had swept the Populist Party to power" was a significant factor in the passage of the legislation. See, e.g., Goodkind, supra note 2, at 82.

In discussing the economic impact of the enactment of blue sky laws, one should examine the initial implementation of the Kansas Act, since, if one is to believe the claims of Kansas’ Bank Commissioner, its implementation nearly throttled capital formation in the state. In his first report, the Commissioner stated that "[b]etween fourteen and fifteen hundred companies have been investigated by the Department since the enactment of this law, and of this number less than one hundred have been granted permits to sell their securities in Kansas." Quoted in L. Loss & E. COWETT, supra note 3, at 9. The Commissioner was quite proud of this and characterized it as "some wonderful results." Id.

10. Id. at 10.
11. Goodkind, supra note 2, at 83.
12. Even in the early days of blue sky laws, long before the Uniform Securities Act, states often based their blue sky laws on the laws of other states. Loss and Cowett report that six of the states adopting blue sky acts in the two years after Kansas "were either identical with the Kansas statute or modeled upon it." L. Loss & E. COWETT, supra note 3, at 10. Today, more than one half of the states have acts modeled on the Uniform Securities Act. Goodkind, supra note 2, at 83.
13. Certainly the personality of Commissioner Dolley, the Commissioner charged with the responsibility of enforcing the Kansas act when it was passed, impacted significantly on the situation in Kansas in those early years. See Goodkind, supra note 2, at 82-83; J. MOFSKY, supra note 4, at 17-20; L. Loss & E. COWETT, supra note 3, at 7-10.
C. Purposes of Blue Sky Laws

In order to appreciate the debate and to evaluate the soundness of these state laws, one must understand the four typical functions of blue sky laws:

1. They require an issuer of securities either to register those securities with the state or to qualify for an exemption from registration.17

2. They impose certain standards as a prerequisite to the right of an issuer to sell securities to the public.18 The application of these standards by a state is referred to as “merit regulation.”

3. They require registration and licensing of persons and firms performing broker-like functions within the particular state.20

4. They provide remedies for fraud in connection with securities transactions.22

None of the foregoing, however, justifies the existence of blue sky laws. The functions are either adequately regulated at the federal level or involve areas that should be free from any governmental intrusion. As a result, society receives no benefit for the substantial costs of blue sky regulation.

II. Registration Requirements

Blue sky laws require that securities offered or sold in a particular state either be registered with that state’s division or be exempt from the registration requirements.23 Although this is the same basic rule as the Securities Act of 1933 (“1933 Act”),24 there are some significant differences between state and federal registration and exemption requirements. For example, the exemptions from state registration differ somewhat from federal exemptions.25 More significantly, however, the very purpose for the state registration requirements apparently differs from the purpose of the registration requirements under federal law.

Under federal law, the purpose of registration is disclosure. As a result, section 5 of the 1933 Act requires that a prospectus be delivered to each investor.26

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17. See, e.g., Unif. Securities Act §§ 301-304, 7A U.L.A. 596-612 (1958). Since the Uniform Securities Act has been adopted in a majority of states, references to state blue sky laws will generally be made to that Act unless deviations by states are relevant for this paper.


19. For a good discussion of the various merit standards in the states, see Goodkind, supra note 2, at 87-107.


21. One issue that will not be treated in this paper is the extraterritorial application of a particular blue sky law. On the subject, see Friedman, Searching for a Blue Sky Remedy—A Forum Shopper’s Guide, 15 Wayne L. Rev. 1495 (1969).


23. Id. § 301, 7A U.L.A. 596 states: “It is unlawful for any person to offer or sell any security in this state unless (1) it is registered under this act or (2) the security or transaction is exempted under section 402.”


In order to insure that the prospectus conforms to the disclosure requirements of the 1933 Act, the registration statement is submitted to the Securities and Exchange Commission (the "SEC") for the staff's review.  

The purpose for registration under state blue sky laws differs from the pure disclosure philosophy of the 1933 Act. The Official Comment and the Draftsmen's Commentary to the relevant sections of the Uniform Securities Act make it clear that the primary purpose of the registration requirements is to provide the commissioner with sufficient information to determine whether the offering meets the substantive standards of the Uniform Securities Act. In other words, the primary purpose of state disclosure is to facilitate the application of the merit standards of the particular state.

It follows, therefore, that the Uniform Securities Act does not contain any prospectus delivery requirement. Instead, the registration statement is only submitted to the commissioner, and there is no requirement that the investor receive any information. Section 304(d) does provide, however, that the commissioner may, by rule or order, condition a registration by qualification on the delivery of a prospectus to each offeree, but the Official Comment indicates that such requirement should be limited to "unusual cases." The Official Comment goes on to state: "This Act, unlike the federal statute, is not primarily a disclosure act." The states, however, have not been content to limit the purpose of registration to the facilitation of merit review. Instead, most states have adopted laws or regulations requiring that a prospectus be delivered to investors in connection with any registered offering. As a result, the registration provisions now require significant disclosure to investors, as well as facilitate the application of the state's merit requirements.

A. Disclosure Requirements

Certain scholars have questioned whether government should mandate disc-

27. Although each registration is required to be submitted to the SEC, the staff no longer reviews each registration. Instead, the staff will review certain registration statements while assuming a "no-review" position in certain cases.

29. One author has referred to blue sky laws as "the first consumer protection statutes." Long, supra note 7, at 543.
34. See, e.g. ALA. CODE § 8-6-7(c) (1984); ALA. SEC. COMM'R, Rul. 6-4-2; ARK. STAT. ANN. § 67-1244(d) (1980); SEC. COMM'R RUL. § 10.2. CONN. GEN. STAT. § 36-487(d) (1983); CONN. AGENCIES REGS. § 36-500-18(d) (1979); DEL. CODE ANN. § 7306(d) (1974); IDAHO CODE § 30-1426 (1980); KY. REV. STAT. § 292.380(1) (1981).
closure in connection with the offer and sale of securities. Some have argued that the very premises underlying the disclosure philosophy are questionable. Others have argued that decisions about the level of disclosure that companies make should be market decisions and not governmental decisions. These latter critics contend that market pressures would force disclosure of sufficient information at a much cheaper cost to society.

For the purposes of this paper, however, it will be assumed that it is appropriate for a government to require the disclosure of material information in connection with the sale of securities. But, even assuming the appropriateness of mandated disclosure, the present state requirements regarding disclosure are indefensible. The reason is, quite simply, that the federal disclosure requirements are sufficient, and, as a result, there is no need to impose additional registration requirements at the state level.

If an issuer is required to file a registration statement under the 1933 Act, the prospectus delivery requirements under the 1933 Act necessitate the disclosure of a substantial amount of information to each investor. This required information includes balance sheets and income statements, usually audited and usually for a period of years, information about management, information about the industry

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35. H. Kripke, The SEC and Corporate Disclosure: Regulation in Search of Purpose (1979). Professor Kripke concludes:

The disclosure system was founded, without investigation or serious consideration, on erroneous premises, namely, that the written SEC documents would be the primary, if not the only source, of investor information, that they would be used and understood by lay investors and that they would be sufficient and adequate for the purpose.

The Commission has shown no creative ability to overcome these erroneous premises with a fresh start. It has been content to trumpet the virtues of disclosure, while showing no disposition (except the appointment of the Advisory Committee) to learn how disclosure is in fact used for securities decisions, and it has shown no creative interest in how it could best be used.

The Advisory Committee did several things of admitted utility, including the final shove to move the Commission toward projections. But in my opinion, its only recommendation for a break with the past was in urging the Commissioner to emphasize disclosures showing the amounts, timing, and certainty of cash flows. In this thinking, it had been preceded by the FASB.

Now we know that:

—Securities selection is a process of choice among alternatives, and the disclosure document on a single company does not provide all the information necessary for choice.

—Securities decisions are too complicated for laymen.

—Securities decisions are made by professionals who use broader information sets than those provided by SEC documents, including (1) better indications of improvement of wealth than those furnished by present-day accounting; (2) projections and other forward looking information, on which Commission policy is still tentative; (3) industrywide information.

—The SEC documents are usually filed after the information is otherwise available.

—The efficient market hypothesis raises a basic question whether efforts to use financial information to select individual securities can yield results superior to those obtained by buying and holding a diversified portfolio. On the practical plane astute investors are giving credence to the efficient market theories by moving toward diversification and placing the emphasis on selection of portfolios, not individual securities.

Id. at 284-85.


37. Id.
and the company, information about the terms of the underwriting and many other pieces of information concerning the company and related matters. 38

These requirements regarding what information must be disclosed in a federal registration statement and prospectus are the result of a long evolutionary process. This evolution has involved input from a number of talented, perceptive and experienced groups, including the SEC and its staff, the securities bar and the academic community. 39 Accordingly, both the amount and type of information required by federal regulations are sufficient to protect investors.

In addition, one cannot ignore the time and effort that go into completing a federal registration statement. Usually, hundreds of hours of professional time are required to complete a registration statement. 40 Also, the officers and employees of a company will spend many hours gathering and disclosing the information required in a registration statement. Finally, if the issue is underwritten, the underwriter and its counsel will spend a significant number of hours investigating the company and editing the registration statement.

While one may concede the adequacy of federal disclosure requirements when a federal registration statement is mandated, the adequacy of disclosure in offerings exempt from federal registration requirements may be less clear. Even in those situations, however, federal law requires the issuer to make significant disclosures about the company and the offering, and accordingly, additional state requirements are unnecessary.

There are six exemptions from registration under the 1933 Act that have general applicability to the sale of stock by issuers. There is the intrastate exemption under rule 147; 41 there are the three exemptions contained in Regulation D, which are rule 504, 42 rule 505 43 and rule 506; 44 and there is the exemption for nonpublic offerings in section 4(2). 45 Finally, there is the exemption contained in section 4(6), 46 the newest statutory exemption of general applicability. 47 Whichever of these exemptions is used, federal law requires that

39. Prior to the adoption of any rule change, the SEC proposes the particular new rule and requests public comment. Often, depending of course on the particular rule involved, the SEC receives numerous comments from the securities bar and others.
40. The time necessary to complete a registration statement can vary substantially. One important factor, of course, is the registration form that the issuer is required to use. Some of the new forms, such as Form S-3, can reduce substantially the cost and time necessary to complete the registration process. See, 2 FED. SEC. L. REP. (CCH) ¶ 7151-7155 (May 23, 1984) (the text of Form S-3).
41. 17 C.F.R. § 230.147 (1984). For an excellent article on rule 147, see Hicks, Intrastate Offering Under Rule 147, 72 MICH. L. REV. 463 (1974). There is also the possibility of an exemption from registration pursuant to the common law that has developed under § 3(a)(11) of the 1933 Act, 15 U.S.C. § 77c(a)(11) (1982). Because of the ambiguities in that exemption, it is rarely used by experienced counsel. See, 1 L. LOSS, SECURITIES REGULATION 591-605 (2d ed. 1961).
47. There are, of course, other exemption provisions under the 1933 Act. Those exemptions from registration, however, either involve special securities (such as government securities) or special transactions (such as recapitalizations) or are so confining as to be practically unavailable. The
the issuer disclose information about the deal to the purchasers of the securities. Sometimes this disclosure is a prerequisite to use of the exemption, such as is the usual case in rule 505, rule 506, and, probably, section 4(2). In other instances, such as the intrastate offering, rule 504 and section 4(6), disclosure is not a prerequisite for the availability of the exemption, but it is necessary in order to avoid a violation of the antifraud provisions under federal law. In either instance, the disclosure requirements are sufficient to protect investors, and no additional protection by the states is necessary.

Under rule 505, which is part of Regulation D, offers and sales of securities up to an amount of $5,000,000 are exempt from federal registration, provided certain conditions are met. These conditions include a limitation on the number of purchasers, a prohibition against general advertising, limitations on resales and, in most instances, a requirement that prescribed information be furnished to each purchaser of the securities. Normally, the issuer is required to supply each purchaser with the information contained in a Form S-18. If use of the Form S-18 is not available to the issuer, however, the issuer must supply the information prescribed by the applicable form.

Rule 506 provides for an exemption from registration without imposing any limitation on the dollar amount of securities that can be sold. Two requirements of rule 506 are most relevant to this discussion. First, each purchaser must be either sophisticated or an "accredited investor." The definition of an accredited investor includes persons who are wealthy and persons who are insiders. Second, disclosure requirements must be met before the exemption can be used. Each issuer is required to disclose the "same kind of information as would be required in part I of a registration statement filed under the Act."

The requirements for exemption status under section 4(2) have always been something of a mystery. Today, however, it seems that there is a general consensus with regard to two elements. First, the offerees and purchasers must be sophisticated. Second, each purchaser must be supplied with the same information that would be contained in a registration statement. The disclosures mandated


59. See, e.g., Schwartz, The Private Offering Exemption—Recent Developments, 37 Ohio St.
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by rule 505, rule 506, and section 4(2), therefore, are as extensive as the disclosures required in a registered offering. In addition, the exemptions usually impose additional requirements (such as sophisticated offerees or purchasers) designed to protect investors. In those instances, federal requirements are entirely adequate to protect investors, and it makes no sense for states to impose a separate disclosure scheme on top of the federal plan.

Disclosure is not, however, a prerequisite to the exemptions from registration available under rule 147, rule 504, or section 4(6). The essential requirements for complying with rule 147 are that the issuer be incorporated and doing business in the same state where the offerees and purchasers reside. For an exemption under rule 504, the offering cannot exceed $500,000, and there can be no general advertising. Under section 4(6), an issuer can sell up to $5,000,000 in securities to accredited investors, provided there is no advertising or general solicitation.

Each of the foregoing exemptions is, however, subject to the antifraud provisions under the 1933 Act and the Securities Exchange Act of 1934 ("1934 Act"), and those sections require that all material facts be disclosed or be available to each purchaser of securities. Thus, disclosure is still required. It is just that disclosure is not a prerequisite to use of the exemption, and there is no particular form that tells one specifically what must be disclosed. It has been this writer's experience that most issuers prepare and distribute an offering circular or memorandum in connection with exempt offerings, even in situations where disclosure is not a prerequisite to use of the exemption. Clients with which this writer has been involved over the years have invariably conceded the necessity for such a document, and only in unusual situations have such deals been completed without such an offering circular. Conversations with other members of the securities bar indicate similar experiences by those attorneys.

As to the quality of these documents, this writer has generally found the depth and breadth of such disclosure to be appropriate for the circumstances. At least, these documents appear as adequate as those prepared in situations where disclosure is a prerequisite to the availability of an exemption.

Moreover, the issuer's flexibility to fashion disclosure documents based on a materiality standard is an attractive feature. Excessive disclosure requirements can, of course, throttle capital formation. For example, it would be practically impossible for an issuer selling $50,000 in securities to prepare and disclose the


63. The most significant of these fraud provisions for the purposes of this paper are section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77l(2) (1982), and rule 10b-5 promulgated under the Securities Exchange Act of 1934, 17 C.F.R. § 240.10b-5 (1982).

64. An example of this is probably instructive. The firm in which this author was a partner and with which he is presently of counsel does a significant part of its practice in the horse business. Normally, for horse deals, disclosure documents that are based on Form S-1 or S-18 are 60 to 80 pages. The firm has also developed disclosure documents for smaller horse deals where disclosure is not a prerequisite to the availability of an exemption. These disclosure documents are about 20-30 pages.

As an aside, the consensus among the firm members is that the shorter document is actually a better disclosure document for the investor.
information prescribed by Form S-1. Costs, in light of the size of the offering, would make such disclosures impractical. On the other hand, an issuer selling $5,000,000 in securities probably could afford to pay for the disclosures required by Form S-1. By defining an issuer’s disclosure requirements in terms of materiality, an issuer is able to fashion a level of disclosure that is appropriate for the size of the deal. It is essential that this trade-off be permitted to occur, unless we are willing to foreclose all small offerings by issuers.

Even if one were convinced that the federal disclosure requirements are inadequate, however, it would still be inappropriate for each state to have its own scheme of disclosure. Inadequacies in disclosure requirements should be remedied at the national level, for a number of reasons. In the first place, there is no compelling need for local control in this matter. A company in Idaho should make essentially the same disclosures as a company in Ohio, since investors need the same basic information about companies, no matter where the investor or the company is located. On the other hand, there is a compelling reason for uniformity in the disclosure requirements. Without such uniformity, any issuer making a wide distribution of securities must comply with the disclosure requirements of many different jurisdictions, each of which may have “different standards, different definitions, different exemptions and different procedures.”

Although the only way one can truly appreciate the difficulty generated by a multistate offering is to participate in one, even the layman should appreciate the appalling complexity of a broad offering. This complexity, of course, adds to the risk that an issuer will inadvertently violate a state’s laws and increases significantly the cost associated with an offering.

Finally, one must recognize differences in resources and quality between the SEC and the divisions of the various states. The point here is not that the staffs of the states are necessarily poor. This writer’s experience has been, however, that the quality of the SEC staff is uniformly high, while one does not always get the same impression about the staffs of all states. This may, of course, merely reflect the lack of resources allocated to the states’ staffs by the state legislatures. For whatever reason, it seems apparent that the SEC is more capable of developing sensible disclosure norms than are the states. The SEC has the resources, experience and continuity to handle this task.

In summary, therefore, this writer would argue that the disclosure requirements under federal law are sufficient and that it is unnecessary for the states to impose any additional requirements. In the instance of an offering registered under federal law, the prospectus delivery requirements insure disclosure; when the offering is exempt from federal registration, the disclosure requirements of the particular federal exemption or the general antifraud provisions insure sufficient disclosure. Furthermore, to the extent that adjustments are needed in the disclosure standards, these adjustments should be made uniformly by the SEC.

65. This trade-off has been recognized by the Commission in Regulation D, which requires increased levels of disclosure as the size of the deal increases. 17 C.F.R. § 230.502(a) (1984).

66. “The mechanical problems involved in preparing an issue for a nationwide distribution under approximately forty different statutes with different standards, different definitions, different exemptions and different procedures—and somehow synchronizing effectiveness everywhere so that the issue may be offered on the same day throughout the country—are literally appalling.” Unif. SECURITIES ACT § 303(a) (1956) (Proposed Final Draft and Commentary, L. Loss & E. Cowett).
From the very inception of modern blue sky laws, certain commentators have stoutly defended merit regulation. In the early 1920's, commissioner Dolley went on record by loudly extolling the success of his application of merit standards in Kansas. More recently, some administrators from the states have written in law reviews attempting to demonstrate the efficacy of merit regulation. This writer is convinced, however, that in today's world merit regulation simply is not worth its cost to society.

Merit regulation generally empowers state securities commissioners to deny registration if the offering does not meet the substantive standards contained in the particular state's securities act. Although the standards applied by the various states involve, as one commentator observed, "a confusing array of substantive tests", the standards typically are designed to insure the fair treatment of investors by protecting investors from exploitation at the hands of promoters and underwriters.

A major portion of merit regulation, therefore, is designed to insure that the original owners of the company (i.e., those who own the company prior to the public offering) do not retain an unfairly large portion of the company after the proposed offering is completed. In this regard, a number of states will deny registration if the commissioner concludes that stock has previously been purchased by insiders at prices that are unfairly low.

Although states have developed various criteria to deal with the acquisition of "cheap stock" by promoters, a typical formula will result in the denial of registration if there is an "unreasonable" amount of cheap stock going to promoters. As one would imagine, states have differing tests for determining whether the prior sale to promoters was "cheap," whether the amount was "unreasonable" and whether the prior issuance was so distant that it was not to be considered a problem.

Some states apply merit criteria that focus on the price paid for stock by the new investors and, accordingly, will deny registration in the event the commissioner determines the price to the public is excessive or unfair.
of course, is merely a corollary to the limitation on cheap stock, since both are intended to insure a fair division of the company between the promoters and the new investors. Again, states apply different formulas to determine whether or not the new shareholders are paying too much for their stock. Some states will consider a price excessive if it is in excess of some predetermined multiple of the company's recent earnings. Other states determine the excessiveness by the dilution suffered by the new shareholders at the time of their investment.

Section 306(a)(2)(F) of the Uniform Securities Act authorizes the commissioner to deny registration if "the offering has been . . . made with . . . unreasonable amounts or kinds of options". To the extent that the promoters retain warrants or options to purchase equity of the company in the future, it will dilute the investment of the new shareholders. The premise here is that this dilution is unfair, because the new shareholders wind up with less of the company than is reasonable or, at least, less of the company than they anticipated. Although states have developed differing criteria for determining when warrants or options to the insiders will be deemed excessive, typically states will allow options and warrants for ten to twenty percent of the stock that will be outstanding at the completion of the offering.

The substantive standards of merit regulations are also designed to protect public investors from exploitation at the hands of underwriters. The Uniform Securities Act, for example, permits the commissioner to deny registration if he finds that "the offering . . . has unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation." As in the case of the merit standards aimed at promoters, these constraints on underwriters are designed to keep the underwriters from grabbing too much of the proceeds of the offering or too much of the company.

States vary as to the percentage of the offering price that underwriters can

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75. Iowa, for example, has a complicated formula that requires the issuer to file information "in justification" of any price that exceeds 25 times earnings. IOWA ADMIN. CODE, 510-50.35(502) (1983), 1A BLUE SKY L. REP. (CCH) ¶ 25,435 (1980); See also, e.g., Wis. ADMIN. CODE § 3.02 (1983).

76. E.g., 808 KY. ADMIN. REGS. 10:080 (1983), 1A BLUE SKY L. REP. (CCH) ¶ 27,498 (1980).


78. In addition to promoters, underwriters are also often prohibited from taking excessive options. See, e.g., UNIF. SECURITIES ACT § 306(a)(2)(F), 7 U.L.A. 621 (1958).

79. See, e.g., Wis. ADMIN. CODE § 3.30(4) SEC (1984) (10% limit); WASH. ADMIN. CODE R. 460-16A-100 (1975), (20% limit).

There are two other types of merit regulation that deserve brief mention. First, some states will deny registration of non-voting equity securities unless those securities are preferred securities. See, e.g., IND. ADMIN. CODE § 710:1-1-1, 1A BLUE SKY L. REP. (CCH) ¶ 24,444 (1980). Second, some states will deny registration to senior securities unless the issuer can demonstrate the capability of servicing the interest or dividend requirements of the senior securities. See, e.g., ARK. SEC. COMM'R. RUL. § 12.10, 1 BLUE SKY L. REP. (CCH) ¶ 10,490 (1980). This determination is made by the commissioner and his staff pursuant to various criteria developed by the states. Id.


81. It has been pointed out, however, that underwriters' fees are a good barometer of risk, which should also be judged and controlled by the merit process. The idea here is that high underwriting fees mean that the issue will be a hard sell for the underwriter, which, in turn, means that the offering must be a high risk deal. As one author has stated, "excessive commissions . . . are a good indicator of the presence of the kind of investment risks that blue sky laws theoretically are designed to reduce." Goodkind, supra note 2, at 89.
take as commissions. Typically, however, states limit underwriters to commissions of ten to eighteen percent. Also, states vary as to what items are included in the calculations of underwriters’ commissions, although any cheap stock or warrants and options granted to underwriters are generally included.

Proponents of merit regulation continue to argue its effectiveness, often bolstering their arguments with reports of their own experiences or actual statistical data. Writing in 1969, the Director of the Securities Bureau in Michigan reported that the “files in Michigan . . . are replete with cases where securities applications were withdrawn or never filed because of objections involving soundness or fairness and where the issuer subsequently met financial disaster.”

Two other articles reported more systematic studies of the experience in particular states. Those two studies reported that, based on certain criteria, companies that were granted registration under the state’s merit standards outperformed companies denied registration by the commissioner. One of those authors concluded that “the data . . . establishes a prima facie case for the utility of those registration standards in general.”

There seems to be no reason to doubt the conclusion that regulators can recognize deals that are risky and that, in such instances, investors will suffer no loss if the regulators deny permission to make the offering. This does not, however, resolve the more fundamental issue of whether society benefits from denying issuers access to public financing in such situations.

It is not difficult to identify the pernicious impact of merit regulation. To the extent that merit regulation is used to deny issuers the right to register their securities, that pernicious impact can be significant. Simply stated, merit regulation unnecessarily constrains the freedom of people to do business as they see fit, discourages entrepreneurial initiative and impedes the flow of capital to its most efficient use.

By denying registration under existing merit standards, a state government is refusing promoters, underwriters and investors the right to do business and allocate risks and rewards of an enterprise in a way that each has determined to be in its own best interest. This is exceedingly presumptuous and paternalistic on the part of regulators and represents a significant compromise in the right one has (or at least should have) to remain free from unnecessary governmental intrusion. One should be denied the right to conduct his affairs as he sees fit only if the benefits of such regulation outweigh the adverse consequences of the regulation, and that is not the case in the application of merit standards.

83. Some or all of the offering expenses are sometimes included in calculating the maximum amount allowed underwriters. See Goodkind, supra note 2, at 88-89.
84. Hueni, supra note 15, at 1445.
85. Walker & Hadaway, supra note 8; Goodkind, supra note 2, at 107 (describing a study of the experience in Wisconsin).
86. The criteria used to measure performance in the Walker & Hadaway study included the following: dividends per share as a percentage of offering price; book value per share (annualized) as a percentage of offering price; and price per share (annualized) as a percentage of offering price. Walker & Hadaway, supra note 8, at 660.
87. Goodkind, supra note 2, at 123. The other authors dodged this issue and merely “hypothesized that the efficacy depended on the relative performance of the approved and withdrawn groups.” Walker & Hadaway, supra note 8, at 679.
In addition, merit regulation is inconsistent with the very essence of a capitalistic system. If any capitalistic system is going to work, entrepreneurial initiative must be encouraged. Investors, promoters and underwriters must be encouraged to evaluate which enterprises society desires and allowed to divide the enterprises in a way that provides each with sufficient rewards to justify his participation.

Obviously one does not encourage a promoter to take the risk of forming and financing a new enterprise if regulators are permitted to limit the rewards a promoter can keep in the event the deal is successful. Just as obviously one does not encourage new enterprises by allowing regulators to limit the rewards underwriters can receive for their selling efforts. Capital formation and entrepreneurial initiative can be promoted only by allowing participants the possibility of rewards sufficient to justify their efforts.

Related to this is the question of who should control the flow and use of capital in this country. This author is convinced that the efficient use of capital requires that the market make this determination. When one decides to invest his capital, he has determined that the potential reward justifies the risk of the capital. This means, in an economic sense, that the investor believes (and is willing to risk his capital on the belief) that his capital will be used efficiently, since society, as a result of the utility derived from the enterprise, will reward the investor sufficiently to pay him for the use of his capital. Without a clear and significant reason, regulators should not be permitted to interfere with this process. Capital should be permitted to flow into those enterprises and uses that the market demands.

In discussing the possible benefits to society of merit regulation, it is essential that one avoid an overly emotional, knee-jerk analysis. One should be suspicious of attempts to justify merit regulation on the basis that it saves the unprotected and unsophisticated investor from squandering his life’s savings on some dishonest promoter’s fraudulent scheme. Professor Bloomenthal has convincingly argued that merit regulation is no serious impediment to the perpetration of fraud.\(^{88}\) Promoters with fraud on their minds can either neglect any attempt to comply with state securities laws or, alternatively, comply with those laws and then waste, mismanage or steal the proceeds of the offering.\(^{89}\) Obviously merit regulation cannot, and one would assume is not intended to, prevent such abuses. Rather, remedies in those situations must come from the disclosure and antifraud provisions of the applicable laws\(^{90}\) and from state fiduciary laws.

More to the point, however, it simply is not true that investors, without the benefit of merit regulations, are unprotected. Most obviously, these investors are protected by the disclosure and antifraud provisions of securities legislation. This should not be overlooked. An issuer must either register each offering with the SEC or find an exemption from the registration requirements. In addition, any material omission or misstatement made in connection with a sale of securities

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89. Id.
90. This author would argue that federal securities laws are the appropriate source of protection in this area.
is actionable under applicable antifraud standards. As has been discussed earlier, these provisions offer substantial protection to investors.

Finally, one must not overlook the protection afforded by the availability of alternative investments. Especially as the deregulation of the banking industry has continued, the competition for money among institutions has increased dramatically. Banks now have various types of accounts that pay a fair market rate for depositors' money. Also, each major brokerage firm has various investments that pay fair rates of return. Certainly, one would concede that the availability of these investments is well known, as local papers regularly run advertisements of banks and other institutions soliciting for these investments.

The point of all this is to dispel the notion that merit regulation protects helpless and hapless investors who, with purity and naiveté, invest in fraudulent schemes. People who invest in schemes that would not pass muster under merit regulations are people who are otherwise unhappy with the rates of return that are being paid by banks and similar institutions. Indeed, one could argue in these circumstances that the only effect of merit regulation is to protect investors from their own stupidity and greed. Society should not be asked to pay much for this.

III. REGULATION OF BROKERS AND DEALERS

State blue sky laws requiring registration of broker-dealers are subject to the same criticism as the state laws requiring registration of securities sold to the public, because state regulation of broker-dealers adds a superfluous layer of rules to an area that is already subject to extensive (some would say excessive) regulation at the federal level. The result is additional complexity and cost without any demonstrable increase in protection for the public.

In order to operate as a broker or a dealer under federal law, a firm must first register with the Securities and Exchange Commission. As part of this process, the firm is required to file an application on Form BD and to provide the Commission with certain additional documents and information. In addition, the 1934 Act requires, with certain exceptions, brokers and dealers to be members of a registered securities association, and at the present time, the National Association of Securities Dealers ("NASD") is the only existing

91. Usually state blue sky laws prohibit anyone from acting as a "broker-dealer," "agent" or "investment advisor" unless the person is registered as such. UNIF. SECURITIES ACT §§ 201(a) and (c), 7A U.L.A. 576 (1958).
94. Section 15(a) of the 1934 Act makes it "unlawful for any broker or dealer . . . [with certain exceptions] to effect any transactions in . . . any security [with certain exceptions] . . . unless such broker or dealer is registered." 15 U.S.C. § 78o(a)(1) (1982).
96. E.g., 17 C.F.R. §§ 240.15b-2(a) and (c) (1984).
registered securities association. The application process with the NASD also requires the firm to submit a Form BD and requires persons who are to be "principals" or "representatives" to file a Form U-4 and, usually, to take a qualification examination.

As a result of these applications, one seeking registration as a broker or dealer is evaluated, both with regard to competence and character. Under the standards applied by the Securities and Exchange Commission, registration as a broker or dealer is denied if the Commission finds such denial to be "in the public interest" and it finds that the firm "or any person associated with" the firm has committed certain acts or been involved in certain transactions or proceedings that are deemed unsavory. Similar standards are

99. "Principals" are defined as "Persons associated with a member (including sole proprietors, officers, partners, managers and directors) ... who are actively engaged in the management of the member's investment banking or securities business, including supervision, solicitation, conduct of business or the training of persons associated with a member for any of these functions." By-Laws of the National Association of Securities Dealers, Article I, Schedule C, § 1(1)(b), National Association of Securities Dealers Manual, ¶ 1102A (1980).

100. A "representative" is defined as a "person associated with a member, including assistant officers other than principals, who are engaged in the investment banking or securities business for the member including the functions of supervision, solicitation or conduct of business in securities or who are engaged in the training of persons associated with a member for any of these functions." By-Laws of the National Association of Securities Dealers, Article I, Schedule C, § 11(1)(b), National Association of Securities Dealers Manual, ¶ 1102A (1980).

101. By-Laws of the National Association of Securities Dealers, Article I, Schedule C § 2, (1980). For a good description of the application process with the NASD, see the NASD publication, How to Become a Member of the NASD (August, 1980).

102. 15 U.S.C. § 15(b)(1) (1982); 15 U.S.C. § 15(b)(4) (1982). The 1934 Act provides that the Commission may deny registration if it finds that such denial is in the public interest and that the applicant or any associated person:

(A) has willfully made or caused to be made in any application for registration or report required to be filed with the Commission under this title, or in any proceeding before the Commission with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein.

(B) has been convicted within ten years preceding the filing of any application for registration or at any time thereafter of any felony or misdemeanor which the Commission finds —

(i) involves the purchase or sale of any security, the taking of a false oath, the making of a false report, bribery, perjury, burglary, or conspiracy to commit any such offense;

(ii) arises out of the conduct of the business of a broker, dealer, municipal securities dealer, investment advisor, bank, insurance company, or fiduciary;

(iii) involves the larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds, or securities, or

(iv) involves the violation of section 152, 1341, 1342, or 1343 or chapter 25 or 47 of title 18, United States Code.

(C) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, dealer, or municipal securities dealer, or as an affiliated person or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security.

(D) has willfully violated any provision of the Securities Act of 1933, the Investment
applied for admission to the NASD. 103

Both the regulations promulgated under the 1934 Act and the Rules of Fair Practice of the NASD govern the conduct of brokers and dealers once they begin their business. Rules 17a-3, 17a-4 and 17a-5 104 under the 1934 Act, for example, establish recordkeeping and reporting requirements for brokers and dealers and require that brokers and dealers file periodic reports with the commissioner (including quarterly and annual financial statements). Rule 15c3-1 under the 1934 Act 105 establishes certain minimum net capital requirements and sets certain maximum indebtedness limitations for brokers and dealers. The Commission is also empowered to censure, suspend, or revoke the registration of any broker or dealer it finds guilty of misconduct. 106 Under the NASD Rules of Fair Practice, members are subject to rules governing their conduct, including participation in initial public offerings, 107 charges for services, 108 publication of quotations 109 and recordkeeping. 110

State blue sky laws essentially duplicate this federal regulation. Under the Uniform Securities Act, one is prohibited from transacting business in a particular

Advisors Act of 1940, the Investment Company Act of 1940, this title, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or is unable to comply with any such provision.

(E) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any person of any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, this title, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this subparagraph (E) no person shall be deemed to have failed reasonably to supervise any other person if —

(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

(F) is subject to an order of the Commission entered pursuant to paragraph (6) of this subsection (b) barring or suspending the right of such person to be associated with a broker or dealer.


state as a “broker-dealer” unless registered with the division. In order for a firm to register as a broker-dealer, an application is filed with the division, and the application usually is accompanied by other documents and information. In addition, the persons who are actually engaged in selling securities are required to register as agents, which normally requires the filing of an application on Form U-4 and requires that the agent pass an examination. While most states permit the NASD examination to suffice for registration as an agent, usually a second examination is required, which tests one’s knowledge of state blue sky laws.

The Uniform Securities Act authorizes the commissioner to deny an application to become a broker-dealer or an agent if such denial is “in the public interest” and the applicant either has been involved in certain types of unsavory conduct or is unable or unqualified to act as a broker-dealer or agent. Once

111. A “broker-dealer” is defined as “any person engaged in the business of effecting transactions in securities for the account of others or for his own account.” Unif. Securities Act § 401(c), 7A U.L.A. 626 (1958).

112. An “agent” is defined as “any individual other than a broker-dealer who represents a broker-dealer or issuer in effecting or attempting to effect purchases or sales of securities.” Unif. Securities Act § 401(b), 7A U.L.A. 625 (1958).

113. The Uniform Securities Act § 201(a) states: “It is unlawful for any person to transact business in this state as a broker-dealer or agent unless he is registered under this act.” Unif. Securities Act § 201(a), 7A U.L.A. 576 (1958).

114. Under the Uniform Securities Act § 202(a), the application is to contain “whatever information the [commissioner] by rule requires concerning such matters as.” A number of states have authorized the use of Form BD as the applicable form for registration. Unif. Securities Act § 202(a), 7A U.L.A. 577 (1958). See, e.g., 808 Ky. Admin. Reg. 10:010 (1983). Because of the strong push for uniformity, it is anticipated that nearly all states will use Form BD by the end of 1984.


117. In Kansas, for example, an applicant must take and pass “a written examination in the form and content prescribed or approved by the commissioner.” Kan. Admin. Reg. § 81-3-1(C) (1978).

118. In Kentucky, for example, one applying as an agent is required to pass the NASD examination and the Uniform Securities Agent State Law Examination Series 63. General Requirements for Filing as Agent of Broker-Dealer or Issuer, revised as of 8/19/82 (available from the Kentucky Division of Securities).


(a) The [Commissioner] may by order deny, suspend, or revoke any registration if [he] finds (1) that the order is in the public interest and (2) that the applicant or registrant, or in the case of a broker-dealer or investment advisor, any partner, officer, or director, any person occupying a similar status or performing similar functions, or any person directly or indirectly controlling the broker-dealer or investment adviser

(A) has filed an application for registration which as of its effective date, or as of any date after filing in the case of an order denying effectiveness, was incomplete in any material respect or contained any statement which was, in light of the circumstances under which it was made, false or misleading with respect to any material fact;

(B) has willfully violated or willfully failed to comply with any provision of this act or a predecessor act or any rule or order under this act or a predecessor act;

(C) has been convicted, within the past ten years, of any misdemeanor involving
the registration is complete, state laws and regulations normally subject broker-dealers to operational rules, such as minimum capital rules and recordkeeping and financial reporting rules. The state retains control over the broker-dealers and agents by its power to suspend or revoke the registration of agents or broker-dealers that engage in "dishonest or unethical practices" or that "willfully" violate or "willfully" fail "to comply with any provision of" the blue sky laws.

Although the foregoing is not intended to represent an in-depth comparison of the state and federal regulation of brokers and dealers, it does demonstrate the significant duplication between the two systems. Unfortunately, however, more than mere duplication is involved. Because each state has its own laws and regulations with regard to broker-dealers, an applicant is required to register in each state where it intends to conduct business. Thus, if an agent or a broker-

a security or any aspect of the securities business, or any felony;
(D) is permanently or temporarily enjoined by any court of competent jurisdiction from engaging in or continuing any conduct to practice involving any aspect of the securities business;
(E) is the subject to an order of the [Commissioner] denying, suspending, or revoking registration as a broker-dealer, agent, or investment adviser;
(F) is the subject of an order entered within the past five years by the securities administrator of any other state or by the Securities and Exchange Commissioner denying or revoking registration as a broker-dealer, agent, or investment adviser, or the substantial equivalent of those terms as defined in this act, or is the subject of an order of the Securities and Exchange Commission suspending or expelling him from a national securities exchange or national securities association registered under the Securities Exchange Act of 1934, or is the subject of a United States Post Office fraud order; but (i) the [Commissioner] may not institute a revocation or suspension proceeding under clause (F) more than one year from the date of the order relied on, and (ii) [he] may not enter an order under clause (F) on the basis of an order under another state act unless that order was based on facts which would currently constitute a ground for an order under this section;
(G) has engaged in dishonest or unethical practices in the securities business;
(H) is insolvent, either in the sense that his liabilities exceed his assets or in the sense that he cannot meet his obligations as they mature; but the [Commissioner] may not enter an order against a broker-dealer or investment adviser under this clause without a finding of insolvency as to the broker-dealer or investment adviser;
(I) is not qualified on the basis of such factors as training, experience, and knowledge of the securities business, except as otherwise provided in subsection (b);
(J) has failed reasonably to supervise his agents if he is a broker-dealer or his employees if he is an investment adviser; or
(K) has failed to pay the proper filing fee; but the [Commissioner] may enter only a denial order under this clause, and [he] shall vacate any such order when the deficiency has been corrected.

The [Commissioner] may not institute a suspension of revocation proceeding on the basis of a fact or transaction known to [him] when registration became effective unless the proceeding is instituted within the next thirty days.


122. The Uniform Securities Act provides the same bases for suspension or revocation of registration as are bases for denial of an application. See supra note 119. UNIF. SECURITIES ACT 204(a), 7A U.L.A. 581-89 (1958).
dealer intends to operate in ten states, it must meet the registration requirements in eleven jurisdictions (federal plus ten states).

Currently, the states are in the process of developing a uniform application process for registration as broker-dealers and agents, which, when fully operational, will eliminate the need to make applications on a state-by-state basis. Obviously, this is sensible and laudable, but it is an incomplete remedy. A company that wishes to register as a broker-dealer in twenty states will still have to underwrite the expense of searching the law (and traditions) of each state to determine if the application procedure requires any additional documentation or information and to insure compliance with the various operational rules that must be met.

In any event, even if all states had exactly the same rules and application procedures and if there were complete uniformity and cooperation among the states, there would still be two systems, the federal system and the state system, and there is no justification for that. What is needed is a single, sensible system of regulation.

The pernicious effect of duplicative regulation of the broker-dealer functions is not limited to application and operational situations, however. There are problems that can impact directly on the issuer’s ability to raise capital. An example will best demonstrate this problem.

Assume X Corporation forms a limited partnership to drill for natural gas and intends to sell the limited partnership units in transactions exempt from federal registration under rule 505.123 It is anticipated that sales will be made to thirty-five persons in ten different states. Mr. Adams, the president of X (the corporate general partner), will be in charge of selling the limited partnership units. The question arises whether Mr. Adams is required to register as a broker or a dealer.

Under the federal law, Mr. Adams usually will not be required to register as a broker or dealer with the SEC, if he receives no special commission for participating in the sales effort, was not hired specifically for the proposed offering and has and will continue to have substantial duties with the company unrelated to the sale of the units.124 In such an instance, the Commission takes the position that Adams is not “engaged in the business” of effecting securities transactions and is thus outside the definition of “broker” and “dealer”.125 This does not, however, end the inquiry for Adams, since he must now research

123. 17 C.F.R. § 230.505 (1984). This rule provides as exemption from registration for sales of securities made to 35 or less persons in an amount not to exceed $5 million.

124. For a good discussion of this question and a citation to relevant SEC rulings, see N. WOLFSON, R. PHILLIPS & T. RUSSO, REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS, 1-10 to 1-15 (1977). Those authors state that employees of an issuer engaged in a distribution of its own securities are required to register as a broker unless they:

(1) Do not receive commissions or other special compensation tied directly to the success of their sales effort;
(2) Do not have significant backgrounds in the securities business;
(3) Were not hired specifically to participate in the proposed offering;
(4) Have substantial duties other than effecting sales of securities; and
(5) Will remain with the issuer after conclusion of the proposed offering.

Id., at 1-12.

125. Under the 1934 Act, a “broker” is defined as “any person engaged in the business of
the same question ten more times (in each state in which he intends to make offers or sales). Unless the proposed activities of Adams fall outside the states' definitions of “broker-dealer”\(^2\) and “agent”\(^3\) Adams may be subjected to the registration requirements under the applicable state blue sky laws.

Typically, these are not easy decisions to make. One's research often reveals substantive and structural differences among the various states' laws,\(^4\) an absence


126. \textit{Unif. Securities Act} § 401(c), 7A U.L.A. 626 (1958), defines broker-dealer as follows:

“Broker-dealer” means any person engaged in the business of effecting transactions in securities for the account of others or for his own account. “Broker-dealer” does not include (1) an agent, (2) an issuer, (3) a bank, savings institution, or trust company, or (4) a person who has no place of business in this state if (A) he effects transactions in this state exclusively with or through (i) the issuers of the securities involved in the transactions, (ii) other broker-dealers, or (iii) banks, savings institutions, trust companies, insurance companies, investment companies as defined in the Investment Company Act of 1940, pension or profit-sharing trusts, or other financial institutions or institutional buyers, whether acting for themselves or as trustees, or (B) during any period of twelve consecutive months he does not direct more than fifteen offers to sell or buy into this state in any manner to persons other than those specified in clause (A), whether or not the offeror or any of the offerees is then present in this state.

127. \textit{Unif. Securities Act} § 401(b), 7A U.L.A. 625 (1958), defines “Agent” as follows:

“Agent” means any individual other than a broker-dealer who represents a broker-dealer or issuer in effecting or attempting to effect purchases or sales of securities. “Agent” does not include an individual who represents an issuer in (1) effecting transactions in a security exempted by clause (1), (2), (3), (10), or (11) of section 402(a), (2) effecting transactions exempted by section 402(b), or (3) effecting transactions with existing employees, partners, or directors of the issuer if no commission or other renumeration is paid or given directly or indirectly for soliciting any person in this state. A partner, officer, or director of a broker-dealer or issuer, or a person occupying a similar status or performing similar functions, is an agent only if he otherwise comes within the definition.

128. Not only does one find substantive differences among the states, but one also finds subtle (or not so subtle) structural differences, which add to the research time necessary to solve problems in this area. To demonstrate this, the author chose four states, Iowa, Kansas, Kentucky and Louisiana, and researched the question whether the activities of Mr. Adams, as described in the text, would require him to register as a “broker-dealer,” an “agent,” or otherwise.

In Iowa, the definition of broker-dealer includes “any person engaged in the business of effecting transactions in securities for the account of others or for such person's own account.” Excluded from this definition, however, are an “issuer,” an “agent” and a person “who has no place of business in this state” if that person “does not direct more than fifteen offers to sell or buy into state in any manner to persons” within any 12 month period. \textit{Iowa Code} § 502.102.4 (1983). The staff in Iowa takes the position that one in Adams' situation would be exempt from “broker-dealer” status, since he would fall within the “issuer” exemption.

The law in Iowa defines “agent” to include an “individual... who represents [an]... issuer in effecting... purchases or sales of securities” but excludes from that broad definition one who represents an issuer only in exempt transactions or in transactions involving certain exempt securities. \textit{Iowa Code} § 502.102.2 (1983). Thus, if the limited partnership units are sold only in transactions exempt from the registration requirements under Iowa law, Adams would not be required to register as an agent.

In Kansas the content and structure of the act is different, although the result may be about the same. Kansas law preliminarily defines “broker-dealer” the same as Iowa (i.e., “any person engaged in the business of purchasing, offering for sale or selling securities for the account of others or for such person's own account...”). \textit{Kan. Stat. Ann.} § 17-1252(c) (1981). Although
of sufficient administration or court guidance necessary to solve the questions with any meaningful degree of certainty and, occasionally at least, an ad-

the definition excepts from the definition of "broker-dealer" an "agent" and an "issuer," it does not have any exemption based upon the minimum number of transactions within a 12 month period, as was found in Iowa. Nonetheless, the Kansas staff takes the position that one like Adams would be excluded from the broker-dealer definition, again apparently because he is an "issuer."

The definition of "agent" in Kansas is similar to the Iowa definition, in that it includes an "individual . . . who represents [an] . . . issuer in effecting . . . sales of securities." The exception from the definition of agent is more narrow than the Iowa definition, however, since one effecting exempt transactions on behalf of an issuer is not excluded from the definition of "agent" under the Kansas provision. KAN. STAT. ANN. § 17-1252(b) (1981). Although such a person is an "agent" within the Kansas definition, he is not required to register with the Commissioner, if he limits his activities to sales of securities in exempt transactions, since a subsequent provision excludes such an agent from the requirements of registration. KAN. STAT. ANN. 17-1254 (1981). Thus, if the limited partnership units are sold only in transactions exempt under Kansas law, Adams, although he may be an agent, would not have to register. There are, however, differences between the exempt transactions securities in Iowa and Kansas. Compare IOWA CODE § 502.203 (1983) with KAN. STAT. ANN. § 17-1262 (1981).

Under Kentucky law, a "broker-dealer" is defined as one "engaged in the business of effecting transactions in securities for the account of others or for his own account," which is the same basic definition as found in Iowa and Kansas. The Kentucky statute excludes from the definition an "agent," an "issuer" and one "who has no place of business in this state if during any period of twelve consecutive months he does not direct more than fifteen offers to sell . . . into the state." KY. REV. STAT. § 292.310(3) (Supp. 1984). This latter exception differs from the Iowa statute and the Kansas statute. The staff of the Kentucky division would probably take the position that Adams was not a "broker-dealer," since he is not "engaged in the business" of buying or selling securities. The staff may take a different position, however, if Adams had been engaged in selling on behalf of other partnerships he had formed.

Kentucky defines "agent" similarly to the previous two states ("any individual . . . who represents [an] . . . issuer in effecting . . . purchases or sales of securities." KY. REV. STAT. § 292.310(2)) (Supp. 1984). The definition exempts one representing an issuer only with regard to exempt transactions or with regard to the sale of certain exempt securities. KY. REV. STAT. § 292.310(2) (Supp. 1984). Again, if the sales by Adams are completed in compliance with a transactional exemption under Kentucky law, Adams will be exempted from the definition of "agent." But, the transactional exemption in Kentucky differs from those in Iowa and Kansas. Compare KY. REV. STAT. § 292.410 (Supp. 1984) with KAN. STAT. ANN. 17-1262 (1981) and with IOWA CODE § 502.203 (1983).

In Louisiana, one finds a different structure, different definitions and, quite possibly, a different outcome. In Louisiana, the agent concept is embodied in the definition of "agent-salesman" but that definition does not include persons who sell on behalf of an issuer. LA. REV. STAT. ANN. § 51:701(6) (Supp. 1984). It would not, therefore, include Adams. The definition of "broker-dealer," however, is the troublesome category for Mr. Adams. That term is defined as a "person . . . who in this state engages either for all or part of his time . . . in the business of selling any securities issued by another person." LA. REV. STAT. ANN. § 51:701(4) (Supp. 1984). The definition contains no express exemption for an "issuer" and contains no exemption for one without a residence in the state who executes some minimum number of transactions in a twelve month period.

In determining whether someone like Adams would be required to register as a broker-dealer, the commissioner seems to apply standards somewhat similar to those applied by the SEC at the federal level. However, it is apparent that the commissioner views the decision more intuitively than does the SEC. The commissioner stated to this writer, in response to a telephone call on this matter, that the definition was like the statement that has been made about the definition of pornography: "I can't define it, but I know it when I see it." Normally, however, the commissioner indicated that a single offering by an issuer would not require the registration by someone like Adams.

Notwithstanding the foregoing expression by the commissioner, this writer previously received a different opinion from the commissioner regarding the sale of a limited partnership unit in Louisiana. See infra note 130.

129. For example, neither Iowa, Kansas, Kentucky nor Louisiana, which were the four states surveyed in the preceding footnote, has any administrative regulations further defining or clarifying the definitions of "broker-dealer" or "agent."
ministrative interpretation that one considers bizarre. Notwithstanding these difficulties, a decision must, of course, be made with regard to each state.

If it is determined that Adams is required to register as a broker-dealer or an agent in a particular state, that state probably must be excluded from the offering, since as a practical matter it is impossible for Adams to register. Not only are officers like Adams unwilling to endure the burden of making applications and taking examinations, but the time required to complete the process practically excludes this possibility.

The point of this discussion is to demonstrate that the pernicious impact of allowing states to regulate the broker function goes beyond the multiplicity of registration requirements and operational rules. The state regulations can retard capital formation by adding substantial expenses to an offering and, in some instances, excluding issues from particular states. Even if an issuer is able to complete its particular offering, however, the extra expense involved in resolving these issues represents a waste of society's resources. Society simply does not benefit by having an issuer resolve the broker-dealer question eleven times instead of one.

IV. ANTIFRAUD PROVISIONS

The antifraud provisions under state blue sky laws are essentially innocuous and, therefore, deserve little treatment in this paper. Notwithstanding, this writer would argue that, on balance, the state antifraud provisions should be preempted in favor of the federal antifraud provisions, since it would, at least to some degree, reduce the possibility of unnecessary regulation at the state level.

The antifraud provision of the Uniform Securities Act prohibits, "in connection with the offer, sale, or purchase of any security . . . ," the use of any

130. While this author was engaged in practice, he structured an offering of limited partnership interests under old Rule 146. The vice president of the corporate general partner was the person who had the necessary expertise for the partnership's business, and it was anticipated that he would be in charge of all partnership affairs. Also, he would sell the units, taking no commission for his efforts. In a particular state, one potential offeree was identified as the only person in that state to whom an offer would be made. The commissioner in that state took the position that if the sale were made by the vice president of the corporate general partner that he (the vice president) would have to register as a broker-dealer. As an alternative, the commissioner suggested that the sale could be effected through a person already registered in the state as a broker-dealer. When it was pointed out to the commissioner that paying a commission to such an outside broker-dealer may destroy the small offering exemptions of certain other states where offers were to be made, the commissioner replied that that was our problem and not his. He was right, of course. Frustrated and seeing, by that point, that we were not going to be able to make our one offering in that state, I asked how the commissioner handled the situation where a three person corporation in a small town sells 10 additional shares of stock to a local accountant who wants to invest. Would the president of the corporation, who sold those ten shares, be a "broker-dealer"? The commissioner stated that the division handled that "on a case-by-case basis." At that point, the conversation was terminated.

No offer was made in that state. The offering was completed. At this point, it appears that the limited partnership will be quite profitable for the investors.

131. See supra note 130 and accompanying text.

"device, scheme, or artifice to defraud," any "untrue statement of material fact," the failure "to state a material fact necessary . . . to make [other] . . . statements . . . not misleading" and "any act, practice, or course of business which operates . . . as a fraud or deceit . . . ." Obviously, this section is, as the Official Comment points out, substantially the same as rule 10b-5 under the 1934 Act. Also, of course, it overlaps with section 12(a) and Section 17(a) of the 1933 Act.

Although state antifraud rules duplicate the federal standards, little pernicious effect is caused by this duplication. There are two reasons for this lack of pernicious effect. First, the state antifraud rules are fundamentally the same as the federal antifraud rules, each requiring an issuer, in connection with the sale of securities, to disclose all material facts and to refrain from making material misstatements about the transactions and the company. As a result, compliance with federal standards normally insures that an issuer is in compliance with state standards, which means that the issuer is not subject to additional expense or difficulty because of the state provisions. Second, compliance with state antifraud provisions does not require any filing or administrative approval as a prerequisite to the completion of a proposed transaction. Again, therefore, compliance with state antifraud provisions does not subject the issuer to additional obstacles or expenses.

There is, of course, always the possibility that states could define their antifraud provisions differently from the federal provisions. While it is unlikely that such variations, even if they were to occur, would substantially increase the costs to issuers or impede capital formation, this possibility provides the basis for the argument in favor of pre-emption of the state antifraud provisions. For example, states could define materiality more broadly than the federal courts


136. This characterization is, of course, an oversimplification, since it is not clear, for example, how states might resolve more complicated issues such as those presented by Chiarella v. United States, 445 U.S. 222 (1980) and Dirks v. SEC, 103 S. Ct. 3255 (1983).


138. One area where this has happened is in the definition of a "security" under some state laws. Most state laws define a "security" substantially the same as the federal statute, and invariably included in the state definition is the term "investment contract." See, e.g., UNIF. SECURITIES ACT § 401(i), 7A U.L.A. 628 (1958). State courts, however, in defining the term "security" under blue sky laws, differ as to how closely they follow federal interpretations. Compare Rose v. Dobras, 624 P.2d 887, 889 (Ariz. 1981) ("[f]ederal interpretations are often looked to for guidance"), with State By Spannus v. Coin Wholesalers, Inc., 250 N.W.2d 583, 588 (Minn. 1976) (acknowledging that Minnesota's definition of a security is "broader and more flexible" than the federal definition).
have defined the concept.\footnote{139} If that were to happen, issuers would be faced with researching and evaluating the materiality standard in multiple jurisdictions, which would raise all the problems discussed previously in this paper.\footnote{140}

Although one must admit that the specter of inconsistent definitions and the fear of pernicious effects following therefrom are not particularly troubling at this point, there simply is no reason for the states to enact separate laws and regulations governing securities fraud. To the extent state regulation is the same as the federal rules, it is superfluous. Any variations between state and federal standards generate costs and burdens in excess of any benefit to society.

V. CONCLUSION

The costs of blue sky regulation, while sometimes difficult to identify and usually impossible to quantify, are not, by all evidence, insubstantial.\footnote{141} For example, it is obvious that the states annually spend millions of dollars promulgating, administering and enforcing blue sky laws. Each year, the North American Securities Administrators Association (NASAA) solicits information concerning the funding, expenditures and revenues of the states’ blue sky divisions. For the year 1983, this author received the NASAA information on thirty states, which reflected total expenditures of approximately $25.6 million for all thirty divisions.\footnote{142} The average expenditure of each reporting state, therefore, was approximately $853,124, which leads one to infer that total expenditures for all states may be as much as $40 million.\footnote{143}

\footnote{139} The Supreme Court has defined a fact as material if there is a “substantial likelihood that a reasonable shareholder would consider it important.” TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (emphasis added). Prior to that case, some courts had defined a fact as material if it involved a substantial likelihood that a “reasonable shareholder might consider it important.” See, e.g., TSC Industries, Inc. v. Northway Inc., 512 F.2d 324, 330 (1975), rev’d, 426 U.S. 438 (1976).

\footnote{140} A similar problem has occurred due to the fact that each state has its own definitions of a “security,” and at least some states have refused to follow the federal definition of a “security.” See supra note 138. As a result, if one is attempting to avoid regulation by structuring a particular deal outside the definition of a “security,” he is required to research the definition of a “security” under federal law and under the laws of each applicable state.

\footnote{141} In his book, CORPORATE FINANCIAL DISCLOSURE IN THE UK AND USA, Benston categorizes the costs that may be generated by the disclosure requirements of federal law as direct costs, indirect costs and opportunity costs. G. BENSTON, CORPORATE FINANCIAL DISCLOSURE IN THE UK AND THE USA (1976). Direct costs include, for example, the costs paid by an issuer to register with the SEC or to qualify for an exemption from such registration. Direct costs to the government include the costs associated with reviewing registration statements and otherwise enforcing securities laws. Id. at 154. Benston cites the reported difficulty of corporations in finding competent outside directors, due to the added risk and pressure that compliance with securities laws places on such directors, as an example of indirect expenses of securities regulation. Id. at 155. Finally, Benston points out that the added burden caused by regulation of securities at the federal level can result in delays in offerings and even in the failure to undertake or complete securities offerings. Benston labels the costs associated with such delays and incompletions as opportunity costs. Id.

\footnote{142} NASAA refused to supply complete information to this author. At first the officials of NASAA agreed to supply the information, but, after further reflection, they concluded that the information was “proprietary” and, therefore, that they could not release the information.

\footnote{143} This inference is based on the assumption of approximating 50 divisions that enforce blue sky laws. The information that this writer obtained for 1982 indicates smaller expenditures than the 1983 results reported in the text. For 1982, this writer obtained information on 25 states, which spent a total of approximately $14.8 million to support their blue sky divisions. This was
Blue sky laws also involve significant direct costs to the issuers of securities. For example, an issuer involved in a registered offering is required to "blue sky" the offering in each state in which selling activity is to occur. In 1983, approximately 5,000 registration statements became effective with the SEC.\textsuperscript{144} If one were to assume that each of these registration statements involved $10,000 in legal expenses for the blue sky work,\textsuperscript{145} total legal fees for all these offerings would be approximately $50,000,000.

Additionally, there are thousands of unregistered offerings each year, which may involve substantial legal expenditures in order to insure compliance with applicable blue sky laws. Regarding the number of such unregistered offerings, the SEC received filings \textsuperscript{146} indicating that there were approximately 11,000 Regulation D offerings during 1983.\textsuperscript{147} Since no such filings are required for intrastate offerings or offerings under section 4(2), there is no valid indication of the number of such offerings. Regarding the costs of "blue sky ing" these unregistered offerings, one should not assume that they are necessarily insubstantial.\textsuperscript{148} Although most unregistered offerings involve offers to a limited number of persons, which will tend to reduce the number of states involved in the unregistered offering, the problems, to some extent, are sometimes more complicated than those encountered in a registered offering.\textsuperscript{149}

In the area of broker-dealer regulation, compliance with the state regulations requires brokerage firms to spend substantial amounts of time and money. Not only are the firms and many of their employees required to register with the states, but firms also are required to monitor the laws of each jurisdiction regarding the conduct of their business in that state.\textsuperscript{150} Obviously, this burden

\begin{itemize}
\item an average of approximately $572,000 per state, which would indicate total expenditures (based on 50 divisions) of approximately $28 million.
\item The difference between the 1983 and 1982 numbers appears principally to be caused by the particular states included in the available information. For example, this writer did not have information on California for 1982. In 1983, California reported a budget of $7,264,000. Other large budgets for 1983 included Ohio, approximately $2.5 million, and Texas, approximately $1.9 million.
\item \textsuperscript{144} Telephone conversation with an employee of the Securities and Exchange Commission on March 22, 1984.
\item \textsuperscript{145} This writer's experience and conversations with other attorneys indicate that the legal expenses associated with a broadly distributed, registered offering may reach $25,000. Legal expenses can, of course, be significantly less, depending upon the breadth of the distribution, the skills of the law firm, the firm's hourly rate and other factors.
\item \textsuperscript{146} Form D must be filed with the Commission for each offering made under Regulation D. 17 C.F.R. § 230.503 (1984).
\item \textsuperscript{147} Telephone conversation with an employee of the Securities and Exchange Commission on June 21, 1984.
\item \textsuperscript{148} While in practice in 1980, this author was involved in an offering under old rule 146. He cleared that exempt offering in approximately 30 states. The legal fees for that blue sky work were approximately $8,000. This author is aware of a later deal under Regulation D that was cleared in nearly 50 states, where the legal expenses probably approached $20,000.
\item At the other end of the spectrum, deals completed under an intrastate exemption may not involve any significant legal expenses for blue sky work, because only one state is involved.
\item \textsuperscript{149} For example, in registered offerings an issuer may not be faced with any significant broker-dealer questions, since the deals are often sold by registered, professional brokers. Unregistered offerings, on the other hand, are usually sold without the aid of professional underwriters and thus raise questions of whether the persons involved in the sale campaign may fall within the definitions of "broker-dealer" or "agent." See supra text accompanying notes 124-32.
\item \textsuperscript{150} See supra text accompanying notes 92-132.
\end{itemize}
is greater on larger firms, which may have hundreds of agents and many offices throughout the country.  

This description of costs is not intended to be precise or to be exhaustive of the costs to society of blue sky regulation. It is, however, intended to suggest that millions of dollars are spent each year on a system of regulation that provides no significant protection to investors and retards capital formation. Only legislative inertia and bureaucratic entrenchment can explain this present state of affairs.

The remedy for this situation, however, does not require that states be excluded entirely from the regulation of securities. In fact, states could play a vital role in the enforcement of securities rules, if their role were limited so as to avoid the problems described in this Article. The most sensible solution would be to limit the state role to the enforcement of federal antifraud standards and to leave states free, to the extent they see fit, to invest resources to enforce these antifraud laws. State divisions, therefore, would no longer be in the business of registering issues or broker-dealers or enforcing merit standards. Instead, the divisions would be involved exclusively in the enforcement of federal antifraud standards. This would avoid duplication while maximizing the coordination between the two systems.

This writer recognizes, as stated earlier, that the changes suggested in this paper will probably be stoutly resisted by the people presently engaged in state regulation of securities. Federal legislation, therefore, may be required to alleviate the problem. Whatever the source of the solution, the problem needs treatment.

151. This writer talked with a number of large brokerage firms concerning the expenses of complying with state broker-dealer requirements. While he was unable to get any exact figures, it was agreed that such expenses were substantial. One firm estimated that it had approximately four full-time employees engaged in state compliance. Another firm estimated that it spent in excess of $700,000 during 1983 in state fees just for renewal applications for their brokers.