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What to Do with Merit Review

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I. INTRODUCTION

The words “merit review”1 conjure up images of overbroad administrative discretion and paternalism in the minds of some members of the legal, financial, and business communities. However, the full scope of merit review is understood and appreciated by few. Armed with a lack of knowledge, state legislatures across the country are debating the propriety of their state’s “blue sky” laws.2 The reasons ad-

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1. “Merit review” is a term used to describe a standard of review for securities offerings by state securities regulators. It is also referred to as the fair, just, and equitable regulation standard.

2. The exact origin of the term “blue sky” is unclear. The term refers to state securities laws. Generally, such laws were known as “blue sky” because they were aimed at preventing “speculative schemes which have no more basis than so
vanced for change do not always withstand challenge, and the justifications given for maintaining the status quo often have little or no empirical support. Thus, it is a visceral and emotional battle: what to do with merit review.

Merit review refers to the discretion of a state securities commissioner to make qualitative decisions regarding the “merits” of an offering or sale of securities in that state. Unlike the Securities and Exchange Commission (SEC), which cannot pass on the merits of a securities offering, most state agencies are empowered to play judge and jury regarding the structure of an offering. These state agencies can refuse to allow the registration of an offering to become effective if it is deemed “unfair, unjust or inequitable,” or if certain statutory or administrative regulations are not satisfied.

The scope of merit review is best defined by what it is not. Merit review is not a government guarantee of the offering. If a “deal” passes state muster there is no promise of success; the investor still bears the risk of his or her investment. Merit review is not the regulation or prevention of fraud. Every state has some form of antifraud language in its “blue sky” laws that is distinct from merit review. Besides, most securities frauds occur because someone failed to register many feet of blue sky.” Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917). See generally L. LOSS & E. COWETT, BLUE SKY LAW 7 (1958); Goodkind, Blue Sky Law: Is There Merit in the Merit Requirements, 76 WIS. L. REV. 79 (1976); Tyler, More About Blue Sky, 39 W. & LEE L. REV. 899 (1971); Walker & Hadway, Merit Standard Revisited: An Empirical Analysis of the Efficacy of Texas Merit Standards, 7 J. CORP. L. 651 (1982); 1 BLUE SKY L. REP. (CCH) 501, at 508 (1985). See infra notes 27-31 and accompanying text.

3. For a listing of each state’s securities administrator and his or her title, see 1 BLUE SKY L. REP. (CCH) 6001 (1985).

4. The Securities and Exchange Commission, created by Congress on July 2, 1934, is an independent, bipartisan, quasi-judicial government agency. The Commission is made up of five members appointed by the President, with Congressional approval. Not more than three members can be from the same political party. The Commission’s duty is to enforce the federal securities laws. It is, however, powerless to pass upon the merits of securities offerings. R. JENNINGS & H. MARSH, SECURITIES REGULATION 22-23 (1981).

5. See, e.g., NEB. REV. STAT. § 8-1109.01(2) (1983) (“The director may issue an order denying effectiveness to, or suspend or revoke the effectiveness of, a registration statement . . . if . . . the plan of financing is unfair, unjust, inequitable, dishonest, oppressive, or fraudulent or would tend to work a fraud upon the purchaser.”).

6. “Deal” is a term used in the securities field that denotes an offering or sale of securities.

7. See Goodkind, supra note 2, at 79 n.2. Antifraud provisions generally make it unlawful to “employ any device scheme or artifice to defraud; (b) make or omit any statement of material fact; or (c) engage in any act, practice or course of business which operates as a fraud.” Id. Merit review goes beyond the scope of antifraud statutes by allowing a securities commissioner to refuse an offering considered to be structured unfairly, even if it is not fraudulent. See also H. BLOOMENTHAL, SECURITIES LAW HANDBOOK § 10.02 (5th ed. 1984).
or fully disclose. Merit review is not such that “bad” deals are refused while “good” deals are allowed. Instead, the state looks at the structure of an offering and the relationship between the public and the insiders. If all of the regulatory or statutory conditions are met, the offering must be allowed, whether it is risky or not. In essence, with merit review, investors must receive some minimum equity for their contribution. Unless the company or promoter can justify less, the offering is not allowed.

The merit controversy revolves around the offer and sale of securities. The situation can be explained by examining an oversimplified hypothetical investment transaction. An individual (X) needs capital to go into business or to expand an existing business. X has many options. She may finance the entire endeavor herself, if possible, or borrow from friends or relatives. She may receive a loan from a bank if she has sufficient credit and collateral. She may try small business investment companies, insurance companies, venture capitalists, or the Small Business Administration. Or she may attempt to sell shares of her business to raise the money. It is the last option, when a security is offered or sold, that state and federal securities laws come into play.

8. See infra notes 72-82 and accompanying text.
9. In order to offer or sell securities in Nebraska, for example, the securities must be registered with the Department of Banking, Bureau of Securities, unless the securities or the transaction is exempt. Neb. Rev. Stat. § 8-1104 (1983). See infra note 15.
11. It must be noted that even loans from friends and neighbors may be considered securities for purposes of federal and blue sky laws. Because this Article is focused on equity securities, the ramifications of debt securities will not be addressed. See infra note 12.
13. “Offer” or “sale” means any transaction by which securities are offered to an individual or to the general public. When a purchaser’s money is received and a stock certificate transferred, both an offer and a sale will be deemed to have occurred under blue sky laws. H. BLOOMENTHAL, supra note 7, at § 10; 1 BLUE SKY L. REP. (CCH) § 1751 (1985).
14. Financing by the sale of securities is not the only method of raising capital. In some situations it is not the best nor the most feasible method. It is simply one alternative. See supra note 11 & infra notes 156-60 and accompanying text.
Unless an exemption exists, any security that X offers or sells in a specific state must be registered with that state and the federal government. The rules and procedures for each state differ radically, however, making it difficult for X to comply with each state’s law. So X hires an attorney, an accountant, a printer, and an underwriter to put the deal together. To cover the costs of the offering, which will be prohibitive, and still retain sufficient working capital, X bargains with her investors. Financially sophisticated investors will generally insist on some amount of control. However, when inexperienced, unsophisticated, or unknowledgeable investors enter the pic-

15. If an exemption applies, the offering may not be subject to either the merit or disclosure requirements. There are two types of exemptions: transaction exemptions and securities exemptions. A transaction exemption allows certain offerings to be made without registration of the securities. For example, transactions by executors, bankruptcy trustees, or guardians and conservators are exempt in Nebraska. NEB. REV. STAT. § 8-1111(6) (1983). The federal law sets forth specific transaction exemptions in § 4 of the Securities Act. See 15 U.S.C. § 77a to 77aa (1982). Section 3(a)(11), the intrastate exemption, is also a transaction exemption even though it is listed under the exempt securities provision. 15 U.S.C. § 77c(a)(11) (1982).

Certain securities are also exempt from registration no matter who sells or offers them. Exempt securities include: United States government securities; securities issued by any state or federal bank, savings institution, or trust company; and securities listed or approved for listing on the New York Stock Exchange, the American Stock Exchange, or the Midwest Stock Exchange. Securities exempt from registration in Nebraska are listed in NEB. REV. STAT. § 8-1110 (1983). For federal securities exemptions, see 15 U.S.C. § 77c (1982). For a general list of transactions and securities that are generally exempt under blue sky laws, see 1 BLUE SKY L. REP. (CCH) ¶¶ 1991-2155 (1985).


19. Although there is no requirement that the prospectus must be professionally printed, see 17 C.F.R. § 230.403 (1985), most offering statements that will be distributed in connection with offerings of securities are formally printed by printing companies at great expense.

20. An “underwriter” sells securities and is defined as “any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security . . . .” 15 U.S.C. § 77b(11) (1982).

21. Schneider, Manko & Kant, Going Public—Practice, Procedure and Consequence, 27 VILLANOVA L. REV. 1, 42 (1981). The authors concluded, five years ago, that legal fees alone for an offering of five million dollars are generally between $75,000 to $100,000. In addition, printing charges run close to $100,000. Larger charges are not uncommon. The underwriter’s discount accounts for another 7-10 percent of the offering price. Id. See also J. MOFSKY, supra note 10, at 47.

22. “[The issuer] will have to approach wealthy individuals if he is to raise the needed sum, and he finds that the few financially sophisticated persons who are willing to invest . . . the requisite capital in the proposed venture insist on receiving a majority stock interest for their group.” J. MOFSKY, supra note 10, at 47.
ture, X has an advantage. She is able to sell a small share of the company to the investor for a grossly disproportionate sum.23

Merit review prohibits such imbalance between the public and the promoter. Clearly not every investor needs or wants government protection or intervention. But merit review is just that: state government steps in between the investor and promoter and requires that the deal be reformed because the relationship between the parties is inequitable.

On January 15, 1985, Nebraska State Senator John DeCamp introduced LB 192,24 which attempted to eliminate merit review from Nebraska's "blue sky" laws. LB 192 was killed in the second session of the Eighty-Ninth Legislature. In its place Sen. DeCamp introduced LB 801. LB 801 is a stronger version of LB 192 and would have the same effect—to eliminate merit review from Nebraska blue sky laws.25 This Article will examine the need for LB 801, its scope, and its potential effects.26 First, a cursory examination of the past history and present trends of merit review will be set forth. Second, the history and current status of Nebraska merit provisions will be reviewed. Third, the results of eliminating administrative discretion will be analyzed. Finally, alternative proposals for change will be offered.

23. A review of several filings in Illinois in 1983 provides excellent examples of such disproportionate control. If the proposed sale of securities by Blackgold Energy Resources, Inc. had been approved, insiders would have owned 50 percent of the company, having paid only $225,000. Public investors would have paid $1,500,000 for their 50 percent, nearly seven times as much for the same amount of control! After the sale of stock proposed by Long Island Video Time, insiders would control 69 percent of the company, for an investment of $8,394. Public purchasers, on the other hand, would own 31 percent of the company, for which they would pay $450,000—over 50 times what insiders paid for a little over twice the control. 1983 ILL. MERIT REVIEW FORMS.

24. The bill remained in committee during the 1985 legislative session. Senator DeCamp indicated last year that he intended to make LB 192 a priority bill in the 1986 session. Interview with Sen. John DeCamp, Chairman of the Nebraska Legislature Banking, Commerce and Ins. Com., in Lincoln, Neb. (Mar. 5, 1985). During the 1985 Legislative session, there was one vote to advance the bill out of committee. The attempt to advance failed, three in favor and three opposed. One Senator abstained, and one Senator was absent.

25. This Article is not intended to be a review or compilation of the various states' securities laws. Only Nebraska merit review is analyzed.

26. LB 801 would, among other things, delete the language in § 8-1102 regarding fraud and add language making it explicit that "[n]o rule shall impose the conditions enumerated in section 8-1109.01 as grounds for issuance of a stop order, for denial of registration, or as a basis for any other action . . . ." LB 801, 89th Neb. Leg., 2d Sess., § 3 (1986). The bill and its amendments, see Neb. Leg. J., Jan. 24, 1986, at 513-18, may be obtained from the Legislature's Bill Room in the State Capitol. The bill was advanced to the floor from the Banking Committee without a dissenting vote. At the time this Article went to printing, the bill was filed for floor debate.
II. HISTORY

At the turn of the century, when worthless securities and fraudulent ventures were widespread, several states enacted consumer protection laws.27 The first registration law, passed in 1903 in Connecticut required the registration of oil and mining securities.28 Kansas, often credited with being the first state to require registration of securities,29 followed in 1911, with a “comprehensive licensing system” applicable to the sale of securities and those engaged in the business of securities.30 The Kansas law, enacted in an emotional climate, had a profound effect on the direction of other state securities laws. Within two years, twenty-three states, including Nebraska, had followed suit.31 At this time, there was no federal legislative scheme.

Federal intervention came in 1933, in the aftermath of the stock market crash of 1929. Upon the recommendation of President Roosevelt, the federal government enacted a comprehensive securities law.32 Simply stated, it requires that any initial interstate offering or sale of securities that is not exempt must be registered with the Securities and Exchange Commission (SEC). The SEC does not have the power to judge the offering on its “merits.”33 Federal registration re-

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28. L. Loss & E. Cowett, supra note 2, at 5.
30. L. Loss & E. Cowett, supra note 2, at 7. The reason for Kansas’ extensive law has been explained as follows: “The state of Kansas, most wonderfully prolific and rich in farming products has a large proportion of agriculturists not versed in ordinary business methods. The State was the happy hunting ground of promoters of fraudulent enterprises; in fact their frauds became so barefaced that it was stated that they would sell building lots in blue sky in fee simple.” Mulvey, Blue Sky Law, 36 Can. L. T. 37 (1916), quoted in L. Loss & E. Cowett, supra note 2, at 7 n.22.
32. 1933 Act, supra note 12. The 1933 Act had two main objectives: “(a) to provide investors with material financial and other information concerning securities offered for public sale; and (b) to prohibit misrepresentation, deceit and other fraudulent acts. . . .” R. Jennings & H. Marsh, supra note 4, at 23. It should be noted that merit review, although in effect in most states, did not play a large role in the stock market crash of 1929. Merit review regulates initial public offerings while the stock market deals in “secondary” trading.
33. See R. Jennings & H. Marsh, supra note 4, at 23-28. The reason that a disclosure only system was selected was explained in the 1933 Congressional debate, which focused on the need for full disclosure:

Since the crash of 1929 we have witnessed a steady downfall in the general price structure of commodities and securities. . . . Today, as a Congress, we are considering a measure to correct the ills of the past. . . . It is generally recognized that the lack of complete disclosure was one of
quires only full and total disclosure of all material information that an investor needs to make an informed investment decision.\textsuperscript{34} The rational for the "disclosure only" system, as explained by President Roosevelt, was "to protect the public with the least possible interference to honest business."\textsuperscript{35}

In the late 1950's and early 1960's, there began a surge of opposition to state merit review.\textsuperscript{36} Although most states retained some form of substantive review of securities offerings, to date there are eight so-called "free"\textsuperscript{37} states: Illinois, New Jersey,\textsuperscript{38} New York, Utah, Colorado, Florida, Louisiana, and Nevada.\textsuperscript{39} Generally, in a "free" state, an application for registration of securities may be denied for inadequate disclosure, fraud, or other specific acts, but not on "merit" grounds.

For nearly a decade the controversy abated. But today the battle against merit review is again in full swing. In 1983, Iowa revised its statutory authority.\textsuperscript{40} The Illinois legislature enacted an entirely re-

\textsuperscript{34} 15 U.S.C. § 77c (1982). Registration is required to provide investors with financial and other information in order to properly evaluate the merits of an offer and sale of securities. "The only standard which must be met in the registration of securities is an adequate and accurate disclosure of the material facts concerning the company and the securities it proposed to sell." R. JENNINGS & H. MARSH, supra note 4, at 23-24.

\textsuperscript{35} 77 CONG. REC. 937 (1933) (Message from the President).


\textsuperscript{37} A free state does not exercise merit review. In addition to the eight states listed and well-known as free states, Pennsylvania, Rhode Island, Connecticut, Hawaii and Georgia have blue sky laws without merit language.

\textsuperscript{38} The New Jersey House and Senate are currently studying proposals to add some form of administrative review to the process of securities registration. Telephone interview with James McClelland Smith, Chief of N.J. Bur. Sec., December 12, 1985.

\textsuperscript{39} States Stop Playing Detective for Investors, BUS. WK., July 16, 1984, at 131 [hereinafter cited as States Stop].

\textsuperscript{40} The 1976 law, IOWA CODE ANN. § 502.209 (West 1976), governed the "[d]enial, suspension and revocation of registration," and provided:

1. The administrator may issue a stop order denying effectiveness to, or suspending or revoking the effectiveness of, any registration statement if the administrator finds that the order is in the public interest and that:

\ldots

(e) The issuance or sale of the securities is or would be unfair or inequitable to purchasers or has worked or tended to work a fraud upon purchasers or would so operate.
The 1983 amendment, effective July 1, 1984, amended subparagraph (e) to provide that:

(e) The issuance or sale of securities has worked or tended to work a fraud upon purchasers or would so operate; . . . and . . .

(h) The financial condition of the issuer affects or would affect the soundness of the securities, except that the applications for registration of securities by companies which are in the developmental stage shall not be denied based solely upon the financial condition of the company.

For purposes of this rule, a “developmental stage company” is defined as a company which has been in existence for five years or less.

IOWA CODE ANN. § 502.209 (West 1985). It should be noted that Iowa is still essentially a merit review state.


There is much dissatisfaction with the new Illinois statute within the Ill. Sec. Dept. However, the statute will probably not be reviewed by the Illinois Legislature for several years. Interview with Jack Herstein, Securities Examiner, Neb. Dept. Banking, in Lincoln, Neb. (Mar. 13, 1985).

42. Telephone interview with Tom Spratlin, Asst. Dir. Tex. Sec. Reg. Div., in Austin, Tex. (Mar. 18, 1985). Mr. Spratlin noted that the Texas Bar Association had taken a position against merit review. In fact, he said that the bar had raised more money to lobby against merit review than his entire operating budget for a year. Estimates of the lobbying efforts expense were upwards of one million dollars. Telephone calls to the Texas Bar Ass’n office in Austin failed to confirm this information.


45. The North American Securities Administrators Association, Inc. (NASAA) is a not-for-profit corporation. The Association’s membership consists of securities administrators from the United States, Puerto Rico, the Canadian provinces and territories, and Mexico, who are charged with the responsibility of administering and enforcing their respective securities laws.

The objectives of the Association include:

1. Supporting the principles of investor protection;
2. Promoting, so far as practical, the uniformity of legislation dealing with the regulation of securities or the suppression of frauds;
3. Preserving the integrity of the legitimate capital markets;
security administrators, directors, and commissioners, is vocally opposed to the elimination of merit review. Bills have been drafted and proposed in Florida and New Jersey to attempt to provide those state securities departments with “merit” review authority. The New Jersey State Bar Association and the New Jersey Business and Industry Association are working to reform New Jersey’s status as a “free” state. The Texas Bar Association has gone on record as being opposed to the Texas merit review, and actively lobbied for passage of a “disclosure only” system. The American Bar Association Securities Division has also established an ad hoc committee to examine state blue sky laws.

It is not clear exactly why there is a renewed fervor to eliminate merit review. Some commentators speculate that it is a result of the Reagan administration deregulation philosophy, or that it is due to a down trend in the securities market. Whatever the source, oppo-

4. Providing a forum for the mutual discussion and treatment of problems common to securities regulatory and enforcement agencies;
5. Developing guidelines, procedures or rules of fair practice related to the offer and sale of securities and rules to prevent fraudulent and manipulative acts.

The regulations of the Association achieve authoritative status by the members’ implementation of such promulgations in their respective jurisdictions.

46. A resolution adopted by the Association at its annual meeting in 1983 states:

Whereas the membership of the North American Securities Administrators Association Association, Inc., recognizes that member states include jurisdictions who afford investor protection by requiring “merit” standards for securities offered to the public;
Whereas efforts have been made to weaken the “merit” standards in some of these jurisdictions;
Now therefore be it resolved that: NASAA strongly supports those member states who have adopted this additional investor protection.
Be it further resolved that NASAA will, when appropriate, provide its resources and support to individual member states who are subject to such attempts to weaken investor protection.

There were no dissenting votes to the resolution.

NASAA was a member of the committee formed to draft a Revised Uniform Securities Act. However, in November, 1984, due to a conference draft of the Act that “greatly undermine[d] merit review and other state substantive regulation,” NASAA withdrew. Braisted, supra note 16, at 20, col. 2.

48. See supra note 42.
49. Sargent, supra note 36, at 284.
51. Telephone interview with Cyril Moscow, Chairman of the ABA Comm., in Detroit, Mich. (Mar. 19, 1985). The first tentative draft of this ABA position paper was publicly available in May of 1985.
52. See, e.g., Sargent, supra note 36, at 278.
ments and proponents of merit review have clearly rallied forces and organized. It is in the wake of this current controversy that the Nebraska Legislature is examining the proposed elimination of merit review.

III. THE NEBRASKA LAW

A. History and Practice

Nebraska's first security law was passed in 1913. It was subsequently amended in 1937, and remained unchanged until 1965. The 1937 statute contained merit review language. In 1965, the Legislature adopted three methods of registering securities: notification, coordination, and qualification. Registration by notification is limited to those securities issued by a company with a favorable earnings history for a minimum number of years. A nominal filing statement is required, accompanied by a filing fee. Registration by coordination is allowed when an offering has been filed with the SEC. A registration statement and prospectus, plus any additional required information, are filed with the state Department of Banking and Finance, Bureau of Securities. If all deadlines are met, Nebraska registration will become effective at the federal effective date. Registration by qualification is the catch-all category, for all securities not entitled to be registered by notification or coordination.

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54. See States Stop, supra note 39, at 131.
55. 1 BLUE SKY L. REP. (CCH) ¶ 501, at 508 (1985).
56. If it appears to the Department of Banking that applicant has complied with all the requirements of law and that the proposed plan of business of the person issuing the securities is not unlawful, unfair, unjust, inequitable or against public policy; and if the bureau shall be satisfied of the good business reputation of the issuing person and of its officers, directors or members... the bureau shall authorize[e] the issuance or sale of securities described.

60. See id. at § 8-1106. See also 1 BLUE SKY L. REP. (CCH) ¶ 511 (1985).
61. "Effective" is a term of art in the securities business. Under federal law the "effective date" is generally the twentieth day after filing with the SEC. 15 U.S.C. § 77h(a) (1982). Once a registration is "effective," the securities may be sold via a final prospectus. Id. at § 77q(c). See also NEB. REV. STAT. § 8-1108 (1983).
62. See supra note 61.
63. The qualification [registration] is registration with our office only. It is designed for the smaller companies. Hearing on LB 263 Before the Committee on Banking, Commerce & Ins., 85th Neb. Leg., 1st Sess. 4 (1977) (statement of Barry Lake, Legal Counsel for the Neb. Dept. Banking, Bureau of Sec.) [hereinafter cited as 1977 Hearing]. Less than 1/2 of 1% of all offerings filed and reviewed by the Bureau of Securities are qualification offerings.
The changes made in 1965 were to provide uniformity with other state laws,64 and, in essence, adopted the language of the Uniform Securities Act.65 The 1965 statute was designed to provide public protection by:

- requiring that all securities offered or sold to the public (unless exempt) be registered with the Department of Banking in one of the manners provided in the Act. Registration, basically, requires the seller to make a full disclosure as to the issuer's business and all major factors pertaining to the particular securities so that the proposed purchaser can make an informed investment decision on whether to purchase the security.66

The 1965 law did not provide for merit review. The unjust, unfair and inequitable language was deleted. The law was designed to parallel the federal law and its language required only full disclosure. As stated by Warren Johnson, a Lincoln attorney speaking in favor of the bill at the committee hearing: “This law is [basically] a full disclosure of fair-play or tell-the-truth. Before you sell securities, you have to tell the truth about the securities.”67

In 1967, the legislature adopted special registration requirements for qualification offerings.68 Specifically, the unjust, unfair and inequitable language was added. Now an application for registration of securities by qualification can be denied in Nebraska if the registration statement is incomplete or misleading or:

1. Such order is in the public interest;
2. The issuer’s plan of business, or the plan of financing is either unfair, unjust, inequitable, dishonest, oppressive or fraudulent or would tend to work a fraud upon the purchaser;
3. . .
4. The securities offered or . . . issued . . . are in excess of the reasonable value thereof, or . . . made with unreasonable amounts of options; . . . [or]
5. The offering [is] . . . made with unreasonable amounts of underwriters’ or sellers’ discounts, commissions . . . , or promoters’ profits . . . .69

Thus, in 1967, the Nebraska legislature enacted the statutory provisions for merit review only of qualification offerings and expressly did not require the same for notification or coordination offerings.

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64. “This bill is a uniform act . . . proposed by a group of commissioners on uniform Laws.” Hearing on LB 848 Before the Committee on Banking, Commerce & Ins., 75th Neb. Leg. 1 (1965) (statement of Mr. Warren Johnson) [hereinafter cited as 1965 Hearing]. The Committee declared that “[u]niformity is desirable and necessary,” Committee Statement on LB 848, 75th Neb. Leg. (1965) [hereinafter cited as 1965 Committee Statement].

65. See 1965 Hearing, supra note 64. The Uniform Securities Act was drafted and adopted in 1956 by the Nat’l Conference of Comm’rs of State Laws. After nearly five years of drafting, a Revised Uniform Securities Act was approved in August, 1958 by the National Conference. The new Act has not been adopted by any state as of the time of this printing. See also Braisted, supra note 14, at 20, col. 3.

66. 1965 Committee Statement, supra note 64 (emphasis added).

67. 1965 Hearing, supra note 64, at 3.


69. Id. at § 8-1109.01.
In 1973 and again in 1977, minor changes were made in the registration by coordination and notification (non merit registration) provisions. The changes did not affect the substance of the law with regard to merit review. Today, under Nebraska law, "[s]ecurities registered with the Nebraska Securities Bureau and not the federal government are subject to fairness standards. However, securities registered with both the Nebraska Securities and the federal government are not subject to fairness standards."71

Although the statutory language appears to provide for merit review only with registration by qualification,72 this is not the current practice or perception of the Nebraska Bureau of Securities. All offerings of securities in Nebraska are reviewed on their merits73 pursuant to regulations promulgated and adopted in 1976.74 There are, in essence, six "merit" hurdles, which the Securities Bureau requires all offerings to clear to be registered in Nebraska.75 Briefly, the regulations first provide that an offering that has underwriting discounts or commissions exceeding 10 percent of the aggregate amount of securities sold and selling expenses exceeding 5 percent of the aggregate amount of securities sold will be looked at with disfavor.76 Second, any cheap stock77 that has been or will be issued must be justified. The number of shares and consideration for the stock must be reasonable, and cheap stock may be required to be deposited in escrow for a specified period.78 Third, the officers, directors, or promoters of a promotional or developmental company, (a start up company with no track record) must personally invest at least 10 percent of the total equity investment resulting from the sale of the initial public offer-

72. See supra notes 67-78 and accompanying text.
73. Herstein, interview, supra note 41. Barry Lake reiterated this fact, stating that the statutory language of § 8-1109.01 is open-ended, and provides much latitude in the merit review. A § 8-1109 registration can be denied only if there was a violation of the merit regulations. Telephone interview with Barry Lake, former Legal Counsel, Neb. Bur. of Sec., in Lincoln, Neb. (Mar. 18, 1985).

Mr. Herstein stated that notification offerings sometimes are not subject to merit review as they have their own requirements. The Nebraska Bureau of Securities reviews only one or two notification filings a year, and none in the past two years. Herstein interview, supra note 41.
74. 2 BLUE SKY L. REP. (CCH) ¶¶ 37,405-10 (1985). These regulations were originally drafted by Barry Lake, based on the recommended regulations of the Midwest Securities Commission (currently NASAA). Lake interview, supra note 73.
75. 2 BLUE SKY L. REP. (CCH) ¶¶ 37,405-10 (1984).
76. Id. at ¶ 37,405.
77. Cheap stock is stock issued to promoters for consideration less than the public offering price. Braisted, supra note 16, at 21, col. 1.
78. 2 BLUE SKY L. REP. (CCH) ¶¶ 37,405, & 37,406 (1985).
Fourth, unless preferential treatment regarding liquidation and dividends is provided, securities without voting rights will not be allowed.\(^7\) Fifth, preferred stock and debentures will be scrutinized if the company's cash flow for a specified period is insufficient to cover the interest on the securities to be offered to the public.\(^8\) Finally, the amount of options and warrants reserved for issuance shall be reasonable in price and number.\(^9\) If the offering does not withstand this merit review, the Bureau of Securities will work with the company in order to help pass the deal.\(^10\) Most issuers will justify the structure of the offering, work with the Bureau to restructure the deal, or withdraw the registration and find a new state in which to register.\(^11\)

Each registration that is filed is reviewed.\(^12\) When securities are registered with the Nebraska Department of Banking, depending on the type of registration, the issuer\(^13\) submits registration statements and a prospectus to the agency.\(^14\) An agency examiner will then review the offering documents, make notes, and compile a "comment letter."\(^15\) This letter sets forth the deficiencies that the examiner found, based on both the full disclosure items listed in the statute, and on the merit regulations outlined above. The issuer is then asked to justify the specified deficiencies. If he cannot or will not, the offering is refused registration.\(^16\) In such a situation, the issuer will be permitted to withdraw the offering or an order denying registration will be issued.\(^17\) Rather than risk refusal, some issuers avoid states in which merit review poses a potential problem.\(^18\) Therefore, application of Nebraska merit review regulations is important.

\(^7\) Id. at ¶ 37,407.
\(^8\) Id. at ¶ 37,408.
\(^9\) Id. at ¶ 37,409.
\(^10\) Id. at ¶ 37,410.
\(^11\) Herstein interview, supra note 41.
\(^12\) Memorandum of Jack Herstein to Garry Rex, Counsel for the Comm. on Banking, Commerce & Ins. (Jan. 30, 1985). This memorandum was drafted to be presented at the public hearing on LB 192, but was not presented. An issuer may choose to withdraw a registration because it does not want a record of a denial. Any denial must be subsequently reported.
\(^13\) During the period between Jan. 1, 1983 and June 30, 1985, 6,242 offerings were filed in Nebraska. Interview with Robert S. Woodruff, legal counsel for the Nebraska Dept. of Banking and Fin., in Lincoln, Neb. (Sept. 3, 1985).
\(^14\) An issuer is defined as "any person who issues or proposes to issue any security . . . ." Neb. Rev. Stat. § 8-1101(6) (1983).
\(^15\) See id. at §§ 8-1105 to 1107; Herstein interview, supra note 41.
\(^16\) This is essentially the same process followed by the SEC.
\(^17\) Herstein interview, supra note 41.
\(^18\) Neb. Rev. Stat. § 8-1108 (1983). See also id. at § 8-1108(3): "When a registration statement is withdrawn before the effective date . . . the director shall retain fifty dollars of the fee."
\(^19\) See supra note 83 and accompanying text. For this reason, the number of denials in a strong merit state may not appear to be substantial.
B. The Validity of the Current Nebraska Regulatory Scheme

1. Statutory Language

In order to determine whether the Nebraska Bureau of Securities has the authority to utilize the merit review regulations for all security offerings, the statute must be examined. Because an administrative agency is limited in its rule-making authority to those powers granted to the agency by the statutes that it is to administer, the specific language of Nebraska's statute is critical. When interpreting a statute, "we look first to its language." Elementary rules of statutory construction provide that unless the language of a statute is ambiguous, no recourse to interpretation from legislative history is necessary. The plain words of the statute, together with its underlying purpose, are the sources from which a statute should be construed.

The statutory language that provides for registration by notification and coordination, section 8-1109, is clearly unambiguous. In order for the Director to deny, revoke, or suspend the effectiveness of an offering, there must be a determination that the order "is in the public interest" and the provisions of any one of ten sections is met. Not one of these sections is discretionary so as to give the Director merit power. The standard merit language "unjust, unfair, or inequitable,"

92. Bond v. Nebraska Liquor Control Comm'n, 210 Neb. 663, 667, 316 N.W.2d 600, 602 (1982); United States Dept. of Agriculture v. Willey, 275 F.2d 264 (8th Cir.), cert. denied, 363 U.S. 827 (1960). See also Northern Nat. Gas Co. v. O'Malley, 277 F.2d 128, 134 (8th Cir. 1960) (power of an administrative board is not power to make law, but rather power to carry into affect will of legislature as expressed by the statute).


94. Hill v. City of Lincoln, 213 Neb. 517, 521, 330 N.W.2d 471, 474 (1983) (no interpretation needed when words of statute are plain and unambiguous); Freese v. Douglas County, 210 Neb. 521, 526, 315 N.W.2d 638, 641 (1982) (primary rule of construction is that intention of legislature is to be found in ordinary meaning of words of a statute).


96. Section 8-1109 clearly refers only to registration by notification or coordination. There is no language in the section providing for a review under the fair, just or equitable standard. In addition, the foremost authority or securities laws cites Nebraska as being a non-merit review state, presumably from reading the statute. See generally H. Bloomenthal, supra note 7. See also Hearing on LB 192 Before the Comm. on Banking, Commerce and Ins., 89th Neb. Leg., 1st Sess. 26 (1985) [hereinafter cited at 1985 Hearing]. See infra note 114 and accompanying text.


98. It should be noted that subsection 2 allows the director to deny effectiveness if "any rule, order, or condition unlawfully imposed under sections 8-1101 to 8-1124 has been violated . . . ." Id. at § 8-1109.01. This language, however, does not provide the Director with power to use the regulations promulgated pursuant to § 8-1109.01 because that statutory language specifically refers only to registration by qualification.
or "tending to work a fraud on the investor," is not in the statutory text. Instead a security offering can be refused registration only if it:

(1) is incomplete or false; (2) violates any Nebraska Securities Act provision; (3) is the subject of an injunction; (4) is not eligible for notification registration; (5) fails to comply with the federal coordination rules; (6) is not accompanied by the filing fee; (7) is made by an issuer who has lost or been denied authority to do business; (8) is incorrect, incomplete, or calculated to deceive; (9) is made by a business found to be unlawful by a court; or (10) is made with a refusal to furnish information. The language "in the public interest" alone is not sufficient to impose merit authority. Most free states have similar language in their blue sky laws.

On the other hand, Nebraska's merit review regulations are clearly warranted by the language of section 8-1109.01, the registration by qualification provision. The statutory language of section 8-1109.01 specifically allows the director to deny, suspend, or revoke the registration of "unfair, unjust, [or] inequitable" security offerings. Thus, only the language of section 8-1109.01, not the statutory language of section 8-1109, empowers the Bureau of Securities to review the merits of notification or coordination offerings.

2. Legislative History

Even assuming that the statutory language is ambiguous, the legislative history can be fairly read to mean that the Legislature intended...

99. Id. at § 8-1109.

101. The regulations are not improperly drafted; they are simply being misapplied. This fact becomes clear by a close reading of the regulations. For example, the regulation titled Ch. 5, Securities, provides that the director may disfavor "any application to register securities as not being in the public interest and tending to work a fraud upon the investors . . . ." (emphasis added). Identical language is found in § 8-1109.01, confirming the fact that the regulation may be applied pursuant to § 8-1109.01. Similar language is not found in § 8-1109. 2 BLUE SKY L. REP. (CCH) ¶ 37,405 (1985). Mr. Herstein contends that merit power to review coordination and notification comes from the rule making provision of the Nebraska Securities Act, NEB. REV. STAT. § 8-1120(3) (1983). See infra text accompanying notes 112 & 113. That section provides that the Director "may from time to time make, amend, and rescind such rules and forms as are necessary to carry out the provisions of sections 8-1101 to 8-1104." Id. However, even though the Security Act is to be liberally interpreted, Labenz v. Labenz, 198 Neb. 548, 550, 253 N.W.2d 855, 857 (1977), as noted previously, rules and regulations cannot exceed the scope of the statute or the statutory language. See supra notes 94-96 and accompanying text. See also NEB. REV. STAT. § 8-1122 (1983) ("Sections 8-1101 to 8-1124 shall be so construed as to effectuate its general purpose . . . and to coordinate the interpretation and administration . . . with the related federal regulation.").
section 8-1109 to be a “disclosure only” provision. In the 1965 committee hearing to adopt notification and coordination registrations, the purpose of the bill was declared to be public protection. It was mandated that all securities offered or sold in Nebraska were to be registered with the State: “Registration, basically, requires the seller to make a full disclosure as to the issuer’s business and all major factors pertaining to the particular securities so that the proposed purchaser can make an informed investment decision on whether to purchase the security.” Without discussion the Banking, Commerce and Insurance Committee voted to advance the bill: five for, none against, and three absent.

During the floor debate, Senator Stromer explained what would eventually become, section 8-1109:

Section 9 is the section which provides for denial suspension or the revocation of a securities registration. Here again if there has been violation on the part of the companies who [sic] securities are being offered in the state of Nebraska, this section allows a provision for the banking director or his subordinates to withdraw the right to be sold in the state of Nebraska and these are provisions which run all the way from a stop order, which is an immediate stop on sales, to a provisional suspension. You will see that they are rather reasonable but are responsible and do protect generally the public who would buy such securities from possible fraudulent sales.

No mention of merit review was made, even though Nebraska previously was considered a merit state and the merit language, “unfair, unjust, or inequitable,” had been removed.

Nebraska was attempting to follow the first Uniform Securities Act by adopting LB 848. The Uniform Act provided two alterna-

102. 1965 Committee Statement, supra note 64 (“The new Act is designed to give the public protection . . .”).
103. 1965 Hearing, supra note 64, at 3 (statement of Warren Johnson).
104. Committee on Banking, Commerce & Ins., Executive Session Minutes on LB 848, 75th Neb. Leg., 1st Sess. (1965).
106. Senator Stromer also explained how registration by coordination was to work: “the registration may have been registered with the Securities and Exchange Commission under the Securities Act of 1933 and we merely coordinate through the federal functionaries and the registration is an academic one more than anything else.” Id. at 2639. It should be noted that the debate took place in 1965. The final rules regarding merit authority were not promulgated until 1976.
107. Senator Bowen, for example, characterized the regulatory scheme as follows: [In Nebraska’s present blue-sky law which has a number of exemptions [sic] has as a standard for issue a permit to sell securities in Nebraska but the proposed plan of business of the person issuing the securities is not unlawful, unjust, unfair, inequitable, or against public policy and that the enterprise contemplated is not to be a mere scheme of a promoter to obtain money or property at the expense of the purchaser.
108. See supra notes 57-58 and accompanying text. See also 1965 Committee State-
tives, one adopting merit review and the other denying it. Any potential merit provisions were removed from the language adopted by the Nebraska Legislature in 1965. Furthermore, if Nebraska had merit authority, pursuant to the statute enacted in 1965, it would not have been necessary to amend the law in 1967 to provide merit review for qualification offerings. It may, therefore, be concluded that the statute contemplates coordination and notification registration only by full disclosure and that merit powers were neither intended nor provided.

3. Rebuttal

In fairness, it must be mentioned that when the regulations were adopted under the Nebraska Securities Act, they were intended to apply to all three types of registration: notification, qualification, and coordination. Barry Lake, then Legal Counsel for the Securities Bureau, testified at the public hearing to adopt the present regulations before the Nebraska Department of Banking:

These rules, if adopted, will apply to all three types of registration in Nebraska, by notification, by coordination and by qualification. It is specifically intended they should have a substantial effect on the coordination offerings in the State and they shall apply to all coordination offerings, and give the Security Bureau more power in regulating the offer of securities by coordination.

Section 1120 of the Act gives the Nebraska Securities Bureau and the Director of Banking authority to adopt rules, and Section 1109(2) gives the Director of Banking authority to deny registration by coordination if any rules promulgated by the Bureau are violated by persons registering securities.

The Securities Bureau may contend that there is broad and inherent:

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(a) The [Administrator] may issue a stop order denying effectiveness to, or suspending or revoking the effectiveness of, any registration statement if [he] finds (1) that the order is in the public interest and (2) that

(e) the offering has worked or tended to work a fraud upon purchasers or would so operate;

The Commissioner's note further provides:

Clause (E): Section 401(a) provides that the term "fraud" is not limited to a common-law deceit. But this clause is not designed to be as broad as the "sound business principles" standard or the "fair, just, and equitable" standard found in some statutes. *Id.* at 574-75, 576. An alternate "fair, just, and equitable" standard was adopted by most states." *See* Braisted, *supra* note 14, at 20, col. 2.

110. Note that there is no discretionary language in § 8-1109. The merit provisions of the Uniform Act set forth in subparagraph (e) above was not included in § 8-1109.

111. Furthermore, the merit regulations, previously cited and discussed, were not promulgated until after Barry Lake, former legal counsel, was employed with the Neb. Bur. of Sec. *See also supra* notes 98-100 and accompanying text.

ent power to subject all security offerings to merit review. This power is arguably derived from the enabling language of section 8-1120(2), which provides the director with the power to make rules and regulations,113 and section 1109(2), which allows denial of any registration in violation of a rule or regulation "lawfully imposed" under the Securities Act.114

This argument, however, is circular. Rules and regulations can only be promulgated if there exists sufficient statutory authority. The agency or department cannot legislate; it can only establish rules that constitute a reasonable exercise of the powers conferred.115 The Nebraska Supreme Court has been clear and consistent in its posture on this point: "An administrative board has no power or authority other than that specifically conferred upon it by statute or constitution necessary to accomplish the purpose of the act."116 The language of the statute does not provide such broad authority, even though it was clearly intended that the regulations apply to all security offerings in the state. There is simply no statutory language that authorizes the application of merit regulations to coordination and notification offerings.

The argument may be made that the fraud provision, § 8-1102, is the basis for merit authority. Section 8-1102 provides that it is unlawful, in connection with a securities offering, "[t]o employ any device, scheme, or artifice to defraud."117 The language was enacted to deter fraud and dishonesty when selling or offering securities because the system is subject to such abuse.118 The language does not operate to equalize the risk of loss or the opportunity for profit between promoters and investors, as is the purpose of merit review.119 As such, the fraud provision is separate from merit power. With a different function and purpose, § 8-1102 cannot be said to empower the Bureau of Securities to pass on the merits of an offering.

4. Approaches

Ninety-nine percent of the offerings filed in Nebraska are coordination or notification registrations.120 Given the express terms of both

113. NEB. REV. STAT. § 1120(3) (1983) ("The director may from time to time make, amend, and rescind such rules and forms as are necessary to carry out the provisions of [this Act].").
114. Id. at § 8-1109(2).
117. NEB. REV. STAT. § 8-1102 (1983). As indicated, see supra note 26, LB 801 would delete the fraud language from the statute.
118. See supra notes 30-35 and accompanying text.
119. See supra notes 7-8 and accompanying text.
120. Woodruff interview, supra note 85.
the statute and its legislative history, those filings may not be subject to merit review under the current statute or regulations. The Securities Bureau appears to have merit review power over only the remaining 1 percent, the qualification offerings. In order to determine whether the Securities Bureau's regulations are within the ambit of the Statutory language, several approaches are available.

First, a law suit could be brought challenging the denial of a coordination offering based on the merit regulations. However, because of the inherent inefficiency of such an action, this course is unlikely. Timing is essential when registering securities, especially in a coordination offering. If the state does not allow the registration to go effective on the SEC effective date, securities cannot be sold in Nebraska. It is simpler and more efficient to either negotiate and justify the terms or to withdraw to another state.

Second, a complaint may be made directly to the Bureau of Securities. Any interested person may petition an agency for the repeal or amendment of any rule. This avenue is unlikely to be productive. The Bureau was instrumental in promulgating the present regulations and has a vested interest in maintaining them.

Third, an issuer could request a hearing before the Nebraska Legislature Administrative Rules and Regulations Committee. The issuer would argue that by applying merit regulations to coordination and notification offerings under section 8-1109, the Bureau of Securities has overstepped its statutory authority. If the Committee agreed, they might recommend that the agency amend or repeal its rules. If the agency does not act within thirty days, the Committee has the power to suspend the operation of the rules, and during the following legislative session submit a bill to formally repeal the

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121. "I think it is important to point out that merit review comes in-to-play when the offering is one which must be made by 'qualification." 1985 Hearing, supra note 96, at 24 (statement of Ralph P. Cuca, Jr., representing BLN Investment Corp.). See also supra notes 96-101 and accompanying text. The author does not suggest that Nebraska should not have merit review for all registrations, only that it does not from the present statutory language.

122. See Goodkind, supra note 2, at 80 n.5.

123. See supra note 61.

124. The lack of case law challenging blue sky laws justifies this contention. See Goodkind, supra note 2, at 81 n.5. See also supra notes 84 & 90.


127. See supra notes 95-101 and accompanying text.


129. Id. at § 84-901. The statute may have constitutional problems. Similar federal statutes have been declared unconstitutional on the ground that a committee does not have the authority to repeal the force of a statute created by the Legislature. Telephone interview with Mary Fischer, Counsel for the Neb. Admin. Rules & Regulations Comm., in Lincoln, Neb. (Apr. 11, 1985).
rules. Of course, this is the worst alternative. If the rules were suspended, the Bureau of Securities would have no merit power until the rules were formally repealed and new regulations promulgated. The period of no statutory or regulatory authority would depend on the speed and efficiency of the Legislature. In the meantime, the Bureau would be helpless to regulate any unfair, unjust, or inequitable security offerings.

Finally, the statutory provisions providing for merit review could be permanently repealed. If enacted, LB 801 would do that and more. In one fell swoop, Senator DeCamp's bill, as amended by the Banking Committee, would delete all statutory authority for merit review and all statutory authority for policing fraud. By implication the rules and regulations relevant to merit review also would be repealed. The result would be disastrous.

V. RESULTS OF ELIMINATING MERIT REVIEW

Although it appears that the Bureau of Securities may have overreached its authority by requiring merit review for all Nebraska security filings, this Article has not reviewed the issue of the propriety of merit power or the consequences of LB 192. At first blush, the elimination of merit review might appear to be a sagacious move. Upon further reflection, it becomes apparent that there is some merit to merit review. The following is an analysis of the arguments generally advanced to support proposals to repeal merit review.

A. Paternalism

It has been argued that merit review is purely government paternalism. Big brother state is watching over the uninformed citizen in order to protect him. There is the belief that the marketplace should be run by supply and demand without government interference. However, such a capitalist market is premised on the notion of full disclosure and complete knowledge. If all material information is available and disseminated through the marketplace, the securities market should run efficiently, and investors could then make intelli-

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130. NEB. REV. STAT. § 84-901 (1983). See also Fischer interview, supra note 129. Ms. Fischer noted that whether the Committee would vote to suspend the rules depends on the various Senators’ theories of legislative delegation.
131. See supra note 26.
134. Schneider, Manko & Kant, supra note 21, at 38-42.
gent choices.\footnote{33-35}

Such a perfect system, unfortunately, does not exist. Although all material information must be available, it is often not disseminated and, more often, not understood.\footnote{36} The prospectus, upon which investment decisions are to be based, allegedly contains all the data upon which to make an intelligent decision.\footnote{37} Yet, there is no requirement that an investor receive a final prospectus prior to the purchase of securities.\footnote{38} In reality, the final prospectus is generally provided at the time that the investor receives the stock he has already agreed to purchase. Furthermore, the prospectus or offering memorandum is usually far too complex. It is covered with disclaimers. Important financial and structural data are often hidden.\footnote{39} The unsophisticated investor usually will not even attempt to wade through the document, often assuming that registration with the state and the SEC means government approval. Even though the information is available in theory, it is not in practice. The full information, free marketplace simply does not exist. If it did, no one would ever purchase a bad security. As the former Nebraska Bureau of Securities counsel stated: “No one buys a pig in a poke if they know they’re buying a pig in a poke.”\footnote{40} As it is, unbelievably inequitable promotion schemes are sold to unwary investors daily.\footnote{41}

\footnote{33-35}{See supra\ notes 33-35 and accompanying text. See also S.E.C. v. Ralston Purina Co., 346 U.S. 119 (1953).}


\footnote{37}{One individual in Nebraska noted:

Many of the types of securities offerings which we are talking about today are so complex that even a sophisticated investor would not be able to ascertain some facts which may clearly alter the deal. . . . I deal exclusively in the securities area and have my jurisdoctorate degree from the University of Nebraska and sometimes I have a hell of a time figuring out the essence of a securities offering even after having read the prospectus. I don’t think it is reasonable to expect an investor to be able to sufficiently analyze these types of offerings.\footnote{95}Hearing, supra\ note 96, at 26 (1985) (statement of Ralph P. Cuca, Jr., representing BLN Investment Corp.).}

\footnote{38}{The Act states only that “[i]t shall be unlawful for any person . . . to carry . . . any security for the purpose of sale . . . unless accompanied or preceded by a prospectus . . . .” 15 U.S.C. § 77e(b)(2) (1982) (emphasis added).}

\footnote{39}{1985\ Hearing, supra\ note 96, at 14-16 (statement of Jack Hiatt, Utah Comm’r of Sec.).}

\footnote{40}{Lake interview, supra\ note 73.}

\footnote{41}{Examples of such schemes were provided to the Banking Comm. at the public hearing on LB 192. Several recent Arizona offerings are also exemplary:

Pleistocene, Inc.—Whose full disclosure showed that company would invest in a product yet to be named “somewhere in the world.”

International Totalizator Systems, Inc.—Producing a race track com-}
Proponents of merit review often stress that securities are sold, not bought. Proponents of merit review often stress that securities are sold, not bought.¹⁴² People who sell securities are not altruistic. Their job is to sell securities. Because “the capital raising process is governed by greed,”¹⁴³ the investor must be cautious, knowledgeable, or powerful in order to protect his investment. Merit review, although possibly overbroad in its scope, assumes that the investor is none of the above and needs the state’s protection; it prevents a promoter from selling a “pig in a poke.”

Unless disclosure is also repealed, eliminating merit review does not remedy the problem of paternalism. Disclosure is not the antithesis of merit review;¹⁴⁴ it is also government intervention. Even with the SEC, which theoretically oversees a pure disclosure system, if reviewers don’t approve of an offering “they can disclose an offering to death.” Paternalism will exist as long as registration exists. It is simply the degree that must be decided upon.

B. Discretion

Very close to the paternalism argument is the issue of dissatisfaction with the amount of discretion afforded each state administrator. It is common knowledge among securities lawyers that some states are “tough” states.¹⁴⁵ If offerings have been cleared in those states, other merit states are more likely to allow registration.¹⁴⁶ These differences among and between states are not justified by the site of the registration. For example, an offering registered in Nebraska, Colorado, and Missouri may be denied in Missouri, registered in Colorado, and only allowed to be registered in Nebraska upon the condition that cheap stock is put in escrow.¹⁴⁷ Clearly any difference in the location of the

puter mechanism which was an insolvent company whose license to sell the products had been revoked by the Colorado Racing Commission. A company offering to produce windmills in Arizona that had represented it had 1,800 windmills sold to the Navajo Indian Tribe turned out not to have had a contract at all and withdrew after the Division raised a comment.


¹⁴³. Lake interview, supra note 73.

¹⁴⁴. Telephone interview with Mark Sargent, Prof., Univ. of Balt., School of Law, in Balt., Md. (Mar. 9, 1985). Professor Sargent is on the ABA Subcommittee studying merit review and authored the subcommittee’s position paper.

¹⁴⁵. Telephone interview with Fred Bunker Davis, attorney with Kutak, Rock & Campbell, in Omaha, Neb. (Mar. 18, 1985); Spratlin interview, supra note 42. Mr. Spratlin noted that Texas was known as a “tough state.”

¹⁴⁶. Davis interview, supra note 145. If an offering possesses the merit requirements of three to six states with strong merit review (depending on their reputation and the terms of offering), “Nebraska will most likely allow the offering. In essence, Nebraska takes a free ride on those states’ examinations.” Id.

¹⁴⁷. See 3 BLUE SKY L. REP. (CCH) § 37,406(c) (1985). (“The administrator may re-
offering is not enough to warrant such disparate results.

Although the discretion argument has some basis, the opposite extreme—no discretion—appears to be as undesirable. Among the administrators of the "free" states, there is a strong feeling that some discretion to police clearly worthless securities is needed. As long as full disclosure is made in most "free" states, the offering cannot be refused. Without discretion to review the securities being offered there is limited or no investor protection.

Furthermore, there is no evidence to indicate that administrator judgment regarding the offering of securities results in fewer registrations. One securities attorney describing the system stated that there are generally "a dozen cases of not exercising authority for every case of exceeding authority." One statement is not an empirical study; but it does indicate that statutory provisions that allow discretion may not always be used. Moreover, merit review works only "if it is done properly." If a philosophy of capital promotion is endorsed and pursued, abuse of discretion should be kept to a minimum.

Uniformity of state review appears to be a better solution to the problem of abuse of discretion than complete elimination of discretion itself. The goal of national uniformity in blue sky laws is not in the foreseeable future. It is true that most states have adopted some form of the Uniform Securities Act, and the National Conference of Commissioners on Uniform State Laws recently approved a revised Uniform Securities Act. Still, each state selected and revised provisions of the first uniform act to fit the temperament of its legislature and various lobbies. The result has been a not-so-uniform set of state laws premised on the original "Act." The outlook for change toward uniformity in the near future is not bright.

C. Capital

Elimination of merit review cannot be discussed without the promise of increased capital in the state. The contention is that if issuers were not faced with the frustration of merit review more offerings...
would be made, resulting in more jobs, more industry, and an enhanced economy. The argument is appealing, but in reality "really baloney."  

First, there is no empirical data to prove that merit review hinders the capital market. On the contrary, securities offerings are "not the favorite form of financing for small businesses." In a 1980 survey of 1,000 small firms, only 2 percent would choose selling shares as their first choice of financing." Most firms cannot justify the fixed costs of issuing equity shares or the maintenance of a secondary market in such stock.  

Second, a 1983 Nebraska study of financing for small businesses concluded that there "is no shortage of equity capital in Nebraska . . ." The problem lies instead in high interest rates and a heavy reliance "on personal savings and bank loans for starting and expanding businesses." Mark Nelson of the Nebraska Investment Finance Authority reiterated this view: "It is not the regulations, but a lack of offerings"; Nebraska doesn't promote its ideas. A glance at the "high tech" investment centers of the country lends further credence to the fact that merit review does not hinder capital growth. California and Massachusetts, two "tough" merit states, lead the country in security offerings. Merit review is not the problem. It appears instead that lack of education, promotional opportunities, and economic development are hindering capital growth in Nebraska. 

An argument can be advanced on the other side. Removal of merit review could impair the capital structure of the state. When substantive review is eliminated, the "penny stock market" grows. Examples abound in Utah, Colorado, and New Jersey, "the hell-hole fraud

\[\text{ gent, supra note 36, at 278; Tyler, More About Blue Sky, 39 W. & LEE L. REV. 899, 904-05 (1971).}\]

155. Sargent interview, supra note 144.


158. Kerrey Study, supra note 156, at ii (chairman's summary).

159. Id.

160. Telephone interview with Mark Nelson (Feb. 25, 1985). Nebraska was recently rated the "next-to-worst" state for starting small businesses by INC. Magazine. Robert Bernier, director of the UNO Business Development Center concluded that Nebraska "tend[s] not to have real strong investment activity in general, and so a lot of our money gets shipped out of state." Lincoln Star, Oct. 1, 1985, at 11, col. 4.


capitals of the world.”

Penny stocks are those that generally sell for under five dollars a share and are traded on the over-the-counter market (OTC), rather than the major stock exchanges. In 1982 and 1983, “nearly half the companies that went public in the $1 and under range had participants with histories of securities injunctions, violations, fraud, or associations with reputed crime figures.” The penny stock market can be analogized to government sanctioned gambling. Because the price of these speculative offerings is so low, the investor’s money can be theoretically doubled or tripled quickly. Investors generally intend to sell the stocks immediately to a “greater fool.” Since the price of the stock bears no relation to the value of the issuing company the balloon inevitably bursts. Just as in a chain letter or pyramid scheme, the last investor bears the loss.

Unethical practices also occur with greater frequency in non-merit

164. Over-the-counter securities are not traded on a registered stock exchange. The OTC is mainly a market conducted over the telephone. GOVERNOR’S SECURITIES FRAUD TASK FORCE, UTAH DEPT. BUS. REGULATION 40 (1984). [hereinafter cited as UTAH STUDY].
165. Griffin letter, supra note 162.
167. Sargent interview, supra note 144. See also Barren, supra note 166, at 44:

To see how 1983’s new issues compare with IPO’s of a year earlier, VENTURE surveyed the 22 new issues at $1 or less that became effective in July of 1983. In fully half (11), participants included felons, convicted or enjoined securities violators or their relatives or associates, or reputed crime figures. They include many of the same lawyers, underwriters, and major shareholders involved in 1982 issues. Among 1983’s new issues:

Venture Consolidated. A creation of attorney Benjamin Sprechter, this $.01 offering lists as vice-president and largest shareholder Daniel Pentelute. In 1978, Pentelute was barred from association with any broker or dealer by the SEC.

Environcare Inc. An entry by attorney Gary Wolff, this company plans to service nuclear power plants. The $500,000 raised at $.10 a share is expected to last it for only three months, according to the prospectus. The second largest shareholder is Pasquale Catizone, who has been enjoined for securities violations numerous times.

168. As one observer noted:

The regional head of the Securities Exchange Commission in Denver describes this phenomena as an application of the “greater fool” theory. This theory states that no matter how stupid I am to buy this worthless stock, I believe there is someone out there stupider than I who will pay more for it than I did. The essential point here is that the people who fall victim to the penny stockmarket are typically not sophisticated investors, but ordinary citizens, bus drivers, secretaries, laborers and virtually anyone else who can put together a hundred dollars.

Griffin letter, supra note 162.
169. Id.
states. Such practices include puffery (wild exaggerations of the stock’s performance), tying (requiring the purchaser to buy stock he doesn’t want in order to get the one he does), contradictory recommendations (creating the appearance of interest and activity in the stock), churning (unnecessary and harmful purchases and sales from a person’s account resulting primarily in commissions to the agent), unauthorized trades, and refusals to sell. The result is a poor economic mood. Legitimate businesses find it difficult to raise capital because of loss of confidence in the marketplace. In Colorado in 1983, for example, “virtually no business could be taken public, no matter how meritorious, because the local investors had been burned so recently and so badly in Denver issues.”

Obviously, removal of merit review will not automatically result in an influx of “penny” stocks. But, “[p]enny stocks are a phenomena which only exist where there is no merit review provided at the state level.” This is because no matter how unfair or ridiculous the terms of an offering are, if they are fully disclosed, the state must permit the offering. If it is true that penny stocks create a poor investor climate, the repeal of merit review could do more harm than good. Still, full merit review of all offerings may not be necessary to combat only securities sold “with no business purpose whatsoever except to raise money from the public.” Less stringent alternatives may be available.

D. Hurts Small Businesses

The argument that small businesses are hurt by merit review is made with little knowledge of the system. Every discussion of merit review mentions the Apple computer offering and contends that Ap-

170. Id. See also Cohen, ‘Penny Stock’ haven: Jersey’s weak laws give promoters a free Reign, Newark Star Ledger, Jan. 20, 1985, at 1, col. 1.
172. Id. In 1982, the Better Business Bureau in Colorado endorsed the return of merit review.
173. Id. See also Burditt interview, supra note 163; Feigan interview, supra note 142.
174. I suppose that if the ‘full disclosure’ statute read that if the Commissioner is allowed to put the following legend on the offering it might work:
   (a.) This offering is probably a fraud.
   (b.) The company officers will probably embezzle the money.
   (c.) There are insider transactions in this filing that amount to looting and theft.
   (d.) The state is not yet able to prove embezzlement, looting or theft, but upon the expenditure of $50,000 to $100,000 we will probably imprison the entrepreneurs on this filing in about a year.
   (e.) Investors are welcome to invest.
175. Smith interview, supra note 38.
ple was turned down in several states. The natural response is that merit review should be abolished. The response is overbroad. Mistakes will be made in any system, and there is the potential for abuse of any amount of discretion. It does not follow that merit review is bad.

Merit review does not entirely preclude the sale of any security. Securities sold in other states may be sold in the secondary market in Nebraska without registration. In addition, an unsolicited order or offer to buy a security through a registered broker-dealer is also not subject to registration. Even with a denial of registration the issuer can still market his stock.

As stated earlier most small businesses do not choose or cannot justify a public offering of stock. For these smaller venture capital deals, exemptions exist both at the federal and state levels that provide for the raising of capital with only disclosure and minimum filing requirements. In addition, there are other methods of financing available. The promoter must choose whether or not to comply with the merit regulations or select an alternative source. Merit review, as defined previously, is a method of maintaining an equity relationship between the issuer and the investor. As such, the issuer always has the option of complying with the regulations—that is, maintaining commissions at 5 percent of sales or not issuing large amounts of warrants to “overhang” on the market. If the issuer chooses not to comply, it is hard to say that merit review thwarted his financing scheme.

E. Poor Training

Securities are reviewed in each state by employees who may or may not have any business or legal training. Often the reviewers have entered their positions directly from undergraduate or law school. Furthermore, it is argued that the reviewers are far removed from the capital market and don’t understand the compromises that must be made in order to finance a deal.

Low pay and poor staffing may be inherent in any government agency. Nevertheless, the training and skill of the administrators does

176. Burditt interview, supra note 163; Herstein interview, supra note 41; Spratlin interview, supra note 42.
178. Id. at § 8-1111(3).
179. See supra notes 155-60 and accompanying text.
180. See supra note 15 & infra notes 193-97. Clearly not every offering will fit within an exemption. However, many offerings can be purposefully structured to avoid the registration requirements.
181. See supra notes 24-26 and accompanying text.
182. 3 BLUE SKY L. REP. (CCH) ¶¶ 37,405-10 (1985).
not have to be, and in many states, is not a problem. NASAA sponsors workshops and committees to train state administrators. Investment bankers, securities lawyers, and broker-dealers participate in these and help explain how and why a deal is structured. Thus, effort is being made to improve the system. Furthermore, removal of merit review won’t solve the problem of undertrained or underbudgeted departments. Training and budget priority are better solutions.

F. Overinclusive

It is argued that merit review, although potentially a necessity, is overbroad in its scope. It is like “using a sledgehammer to swat a fly.” There is some truth to this assertion, at least at the federal level and in the case of the sophisticated investor. Some investments may need review, but well-established, financially sound firms with a proven track record do not need government scrutiny. Such “blue chip” firms provide the prospective investor with federally required, public reports that contain information relevant to making an informed investment decision. In addition, certain persons may not need the government protection, either because they are financially able to bear the burden of the loss, they are powerful enough to demand the requisite information, or they are sophisticated enough to understand the intricacies of the deal. Federal exemptions for such accredited investors exist under the theory that these investors generally can fend for themselves. They don’t need or want government intervention.

The move may prove to be too broad if merit review is eliminated on the state level. Precluding all administrative review in order to give those investors with knowledge, or financial ability to bear the loss, the chance to invest is inefficient. Rather, specific exemptions for the “special” investor seem to be a better solution to the problem.

V. SUGGESTIONS FOR REFORM

The total elimination of merit review and anti-fraud protection, as proposed by LB 801 is a drastic and unwarranted step. Some con-

184. Burditt interview, supra note 163; Herstein interview, supra note 41.
185. Id.
186. Sargent interview, supra note 144.
187. A “blue chip” stock is one issued by a substantial company with a proven historical record that demonstrates its soundness and is generally offered on the OTC market. Twenty states had “blue chip” exemptions in 1983. R. FEIN & S. SOSIN, supra note 41, at 10. See also NEB. REV. STAT. § 8-1110(8) (1983).
188. 17 C.F.R. § 230.252 (1985). An “accredited” investor is one who meets any of eight requirements regarding sufficient net worth, net income or status so as to qualify for special treatment under the federal securities laws.
sumer protection is necessary. This conclusion is bolstered by the many investment “horror” stories recently given press attention.\textsuperscript{189} The authors of studies in several states have also reached the conclusion that something more than disclosure is needed.\textsuperscript{190} The issue then becomes what kind of government intervention will best serve Nebraska investors, yet not intrude too heavily on investor autonomy. LB 801, in its present form, provides for the total elimination of merit review and the anti-fraud sections without due attention being given to the consequences. As such, LB 801 presents the same problem that it is attempting to correct; it is overbroad in its scope. This section of this Article will set forth alternative proposals for revising Nebraska’s securities law.

First, the legislature must determine what the goal of its blue sky law is. Consumer protection has consistently been cited as the function of the Nebraska Securities Act.\textsuperscript{191} If this is so, merit review should not be removed solely for the possibility of increased venture capital in the state. Instead, the decision must be made as to which investors should be protected. As noted previously, not all purchasers of securities need government scrutiny of their investments. Exemptions can be made for “fat cat”\textsuperscript{192} and “big ticket”\textsuperscript{193} investors. Proof of sufficient investment knowledge or financial security could be provided to exempt such investors from merit review. For these investments, full disclosure alone would be sufficient.

Illinois enacted such exemptions in 1984.\textsuperscript{194} The Illinois law exempts persons “with a net worth in excess of $1,000,000 or had individual income in excess of $200,000 in each of the two most recent years and who reasonably expect an income in excess of $200,000 in the current year,”\textsuperscript{195} and persons “who purchase at least $150,000 of securities . . . where the purchase or total price does not exceed 20 percent of the purchaser’s net worth.”\textsuperscript{196} These exemptions are based on the


\textsuperscript{190} See, e.g., ARIZ. HOUSE SELECT COMM. ON ECONOMIC DEVELOPMENT, FINAL REPORT (1983); UTAH STUDY, supra note 156.

\textsuperscript{191} See 1985 Hearing, supra note 96, at 7; 1977 Committee Statement, supra note 71; 1977 Hearings, supra note 62, at 4; 1965 Committee Statement, supra note 66; 1965 Hearings, supra note 64.

\textsuperscript{192} A “fat cat” is an investor who has enough money to absorb the loss should the offering be a bad risk. See S. SOSIN & R. FEIN, supra note 41, at 16.

\textsuperscript{193} A “big ticket” sale is one that is large enough to demonstrate that the purchaser is financially able to afford the deal. Id. at 18.

\textsuperscript{194} Id. See supra note 41 and accompanying text.

\textsuperscript{195} ILL. REV. STAT. ch. 121 1/2, § 137.4(c) (Smith-Hurd 1984).

\textsuperscript{196} Id.
theory that such investors have the knowledge and income to fend for
themselves. Similar revisions in Nebraska law would eliminate some of
the overbreadth of the present merit review system.

Second, the Legislature should direct the focus of the securities bu-
reau. A secondary objective of the blue sky laws should be to promote
a confident and active securities market in the state. Securities should
be reviewed with this goal in mind. "Blue chip"197 issuers with
favorable earnings histories that have been in existence for a deter-
mined number of years should be allowed to register without merit
review. Small offerings,198 where the company intended to use its cap-
ital in the state, could be subject to limited review. If the present stat-
ute were revised to allow more such exemptions, more department
time could be spent reviewing the disclosure statements of those offer-
ings with no stated or specific investment purpose. In this way, com-
panies that could increase or improve the capital market would be
given priority in terms of registration. Yet, those speculative offer-
ings, from which the unwitting investor needs protection, would still
be subject to merit review.

Third, the legislature must decide to fully fund and staff the Secur-
ities Bureau of the Banking Department. Because it is a revenue-pro-
ducer,199 the Department should be allowed to retain more money.
With more funds and staff,200 the Bureau could spend the appropriate
amount of time reviewing those securities and transactions that are
not exempt. Individualized and immediate attention by the Bureau
would encourage issuers to choose Nebraska as a registration site. The
additional funding would also provide a means for training staff in the
nuances of the investment business. The result will be a more effi-
cient and productive system.

With increased exemptions from registration and a larger staff,
more Bureau time can also be devoted to enforcing the fraud provi-
sions and prosecuting violators. Knowledge of a tough enforcement
system will tend to deter fraudulent and unscrupulous promoters. With fewer "bad" deals taking place, the investment climate can flour-

197. See supra note 187 and accompanying text.
198. Nebraska has some small offering exemptions, see NEB. REV. STAT. § 8-1111
(1983), and security exemptions. See id. at § 8-1110. These exemptions need to be
reviewed and expanded in light of the goal of a more active state securities
market.
199. Funds are raised by the filing fee "of one-tenth of one percent of the aggregate
offering price of the securities which are to be offered in this state." Id. at § 8-
1108(3). Because of this fee, the Bureau of Securities is one of the few revenue
producing state offices. In 1983, it had revenues in excess of 3.5 million dollars,
more than enough to pay the costs of running the Bureau. Herstein interview,
supra note 41.
200. The Nebraska Bureau of Securities is presently composed of eight employees.
This number includes the director, two examiners, one counsel, and four staff
assistants who perform clerical duties.
ish. The Bureau could coordinate its activities with the Department of Economic Development to encourage businesses to choose Nebraska as their home and to foster economic growth through the securities market. Confidence in the system will hopefully help to increase the amount of Nebraska dollars that are invested, providing new industry, jobs, and a brighter economy.

Finally, there should be increased public education. Every justification for merit review begins with the idea that the investor lacks the knowledge or the skill to invest.\textsuperscript{201} The government should protect such investors from those who would take advantage. Rather than take away a purchaser's right to purchase, arm that person with sufficient ammunition to make an intelligent choice. This might be done in several ways. Advertising regarding the dangers of "too good a deal" would increase consumer suspicion. The Bureau could develop educational "dog and pony" programs that travel the state to educate investors, especially in times and areas of fraudulent or unscrupulous promotions. An investor "hot line" to answer questions regarding investments or a specific prospectus could be set up. A consumer protection division similar to the Better Business Bureau could be established to enable purchasers to report bad deals and seek information about others.\textsuperscript{202} A summary of the prospectus could be required to be provided to each investor. These proposals would allow the investor to help himself and attempt to eliminate some of the paternalism of an extensive merit system.\textsuperscript{203}

VI. CONCLUSION

Nebraska should not abolish merit review. Implicit in the previous discussion is the assumption that any proposals for reform are in addition to, not to the exclusion of, merit review. Although the scope of merit review may be too broad, some merit power is necessary. The state has a duty to protect its citizens from financial crimes, just as it protects against other offenses. Nebraskans are afforded protection through banking, insurance, health care, education, motor vehicle, and other such laws. Protection of an individual's life-long savings is just as important a state goal, and should not be abolished without much thought and discussion.

It is a sincere hope that the Legislature will not alter the securities law without a thorough study of all of the issues and consequences.

\textsuperscript{201} See supra notes 23 & 132-36 and accompanying text.

\textsuperscript{202} This particularly should be a goal of the Nebraska Legislature in light of the recent numerous bank failures in the state. The public confidence in the economic climate of Nebraska is low. The state must increase investor confidence and boost the Nebraska economy. Improvement of the securities laws could only enhance that effort.

\textsuperscript{203} See also suggestions made in Kerrey Study, supra note 156, at 87-92.
Input should be received from all facets of the investment community, including lawyers, venture capitalists, brokers, dealers, investors, promoters, and issuers. Both sides of the issue must be balanced to insure that the state's goal of protecting the investor is achieved.

LB 801, in its present form, does not accomplish the goals it supposedly sets out to achieve. It is overbroad and is being debated in a vacuum. Instead of eliminating all power the Bureau of Securities has to protect Nebraska investors, the structure and purpose of Nebraska's blue sky laws must be studied. The current misapplication of the merit regulations should be reviewed and remedied with sufficient statutory authority to justify the regulations. A comprehensive study of the needs of state investors must be made. Only then can a bill be introduced to remedy existing ills and provide a flexible vehicle to equalize the risks of loss and the opportunities for profit. The result hopefully will be a strong investment market.

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