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The Efficacy of Merit Review of Common Stock Offerings: Do Regulators Know More than the Market?

*Marianne M. Jennings**

October. This is one of the peculiarly dangerous months to speculate stocks in. The others are July, January, September, April, November, May, March, June, December, August and February.

Pudd'nhead Wilson
Mark Twain, 1898

I. INTRODUCTION

As long as there has been greed, there have been financial schemes and frauds created to capitalize on the greed in all of us and to fulfill the greed of their sponsors.¹ The desire to enjoy a high rate of return is part of a sophisticated investor's strategy and the driving force behind the inexperienced, smaller investor's decision to venture into higher risk securities purchases. Government regulation has attempted to create a level playing field for all investors through various means of scrutinizing proposed sales of securities.²

* Professor, Department of Business Administration, College of Business, Arizona State University. A project as complex as one that forms the basis of this article requires much assistance and cooperation. The author appreciates the work of Sheila Bond, April Kasl, Allison Bond Jones, Stephanie Bond Phair, Janette Kasl and Tim West who gathered and assimilated the data on securities registrations. The author also appreciates the legal research assistance provided by Laurel Wala and David Gass.

1. While not all stocks or exchanges have been plagued with fraud, schemes, and greed, they have facilitated many investor losses for some time. As early as the late 1700s, there were commodity exchanges on Wall Street. The New York Stock Exchange was formally organized in 1827. See J. Baer & O. Saxon, *Commodities Exchanges and Futures Trading, Principles and Operating Methods* (1949).

2. It has been noted:

In a world with . . . no mandatory disclosure system, firms could remain silent with impunity. If they disclosed, they would do so in any way they wished . . . [t]hey could attempt to sell securities with ads in glossy magazines and on television featuring sexy models or herds of bulls, as sellers of other products (including brokerage services) do.

At the federal level, Congress created a system for pre-sale registration and approval for proposed offerings through the Federal Securities Act of 1933.³ The federal registration process is one of disclosure. Based on the rationale that a full disclosure of the firm's past events serves some value to investors in making their investment decisions, the federal registration process seeks to ensure that investment decisions may be based on full information.⁴

Even so, that federal "full information" or "full and fair" disclosure standard was insufficient for many state regulators since full disclosure does not preclude fraudulent or high risk offerings.⁵ Many states thus enacted securities regulations that required an examination of the merits of the proposed securities offerings.⁶ These blue-sky laws⁷ were enacted in

A mandatory disclosure system substantially limits firms' ability to remain silent. Just as importantly, it controls the time, place and manner of disclosure. Firms must wait until they file a registration statement before saying anything that may be construed as touting (the "gun jumping" rule); they must wait until the registration statement is effective and a prospectus has been delivered before putting anything else in writing (the "free writing" rule); they must mail prospectuses and proxy statements at designated items but not resort to ads on television.

What does a mandatory disclosure system add to the prohibition of fraud? The implicit public-interest justification for disclosure rules is that markets produce "too little" information.

Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 680-81 (1984).

3. 15 U.S.C. §§ 77a - 77aa (1989).

4. Some dispute the theory that full disclosure is helpful in a regulatory sense since under the "efficient market hypothesis" it is maintained that all existing information about an offering is reflected in the price of the securities and any detailed disclosure of past performance is simply historical and of little value in predicting future securities performance. See, e.g., George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973); James S. Mofsky & Robert T. Tollison, *Demerit in Merit Regulation*, 60 MARQ. L. REV. 367, 368 (1977); See also, Eugene F. Fama, et al., *The Adjustment of Stock Prices to New Information*, 10 INT'L ECON. REV. 1 (1969).

5. Although many states incorporate full disclosure standards, their regulation goes beyond that, to the merits. Both 15 U.S.C. § 77r (1988) and Section 18 of the Securities Act of 1933 authorize such separate regulation to wit: "Nothing in this subchapter shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any state or territory of the United States, or the District of Columbia, over any security or any person."

6. Kansas was the first state to enact securities laws (1911). By 1913 there were twenty-three states with some form of securities law. See, LOUIS LOSS & EDWARD M. COWETT, *BLUE SKY LAW* 3-10 (1958). For a more complete historical perspective, see, *Id.* Most of the state regulatory schemes were merit-based; see Ernest W. Walker & Beverly B. Hadaway, *Merit Standards Revisited: An Empirical*

response to the 1907 panic. They permitted state regulators to require additional information and to review the offerings on the basis of various standards of evaluation.⁸

The wisdom of merit regulation has been much questioned and debated. Issues raised in the ongoing debates are (1) whether merit statutes impede firms' ability to raise capital; and (2) in view of the costs of the often extensive filings and reviews in merit states, whether merit review provides any additional information not already available and analyzed by the market.⁹ Several studies of offerings filed in merit review states have been conducted by evaluating the financial performance of the firms seeking approval in such states.¹⁰ Both the studies' data and the financial analyses have been criticized for various omissions and methodologies.¹¹

The research in this article evaluates the efficacy of Arizona's merit review standards in light of criticisms of previous studies.¹² Even though the full impact of these merit standards cannot be determined,¹³ this article focuses on the

Analysis of the Efficacy of Texas Merit Standards, 7 J. CORP. L. 651, 651-52 (1982).

7. "Blue sky laws" refers to state laws regulating the sale and registration of securities. The term originated in *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917) in which the Court described fraudulent securities as "speculative schemes which have no more basis than so many feet of 'blue sky'." *Id.* at 550.

8. Those standards of evaluation are discussed *infra* at pp. 10-19 and notes 19-46.

9. For a discussion of costs see, JAMES S. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS at 31 (1971). See also, Mofsky & Tollison, *supra* note 4, at 367-368.

10. See, e.g., Conrad G. Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements*, 1976 WIS. L. REV. 79 (Wisconsin study); Ernest W. Walker & Beverly B. Hadaway, *supra* note 6 (Texas). *Contra*, Hugh H. Makens, *Who Speaks for the Investor? An Evaluation of the Assault on Merit Regulation*, 13 BALTIMORE L. REV. 435 (1984). The Goodkind study is criticized by James Mofsky and Robert Tollison in Mofsky & Tollison, *supra* note 4, at 369. For a review of the types of merit regulation and discussion of regulatory and business concerns see, *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785 (1986).

11. Mofsky & Tollison, *supra*, note 4, at 371. Makens, *supra*, note 10, at 455-56.

12. Elaboration regarding those criticisms is found *infra*, part III.

13. For example, it is impossible to determine what types of firms are effectively precluded from the registration process because of cost and complexity; or what firms choose not to register in Arizona because of its strict merit standards. Mofsky & Tollison note:

We do not know how many new firms fail to come into existence because of the blue sky laws. Nor do we know the number of offerings not made in some states but made in others where the merit standards are less intolerable. That information is obviously critical in assessing the costs of state securities regulation.

post-registration financial performance of firms registering offerings in Arizona during the years 1984 - 1987. Those performing the study examined both approved and withdrawn offerings.¹⁴ The results appear in Parts IV and V after Parts II and III, respectively, present an examination of merit review regulation and previous studies.

II. MERIT REVIEW STATUTES—TYPES AND SCOPE

Recent reforms by the SEC of small and private offerings have served to reduce the impact of state merit statutes on raising capital since those rules are largely the result of state regulators working with the SEC and Congress to establish a more universal exemption system for securities registration. Regulation D¹⁵ is perhaps the strongest evidence of a spirit of cooperation in making federal and state standards more uniform.¹⁶ However, even given the parallels of some state statutes with Regulation D, there remain twenty-five states that recognize only some of Regulation D's exemptions.¹⁷ State

Mofsky & Tollison *supra*, note 4, at 369.

14. Although the Securities Division (hereinafter "Division") of the Arizona Corporation Commission has the authority to deny a securities registration, no such denials were found. The common practice seems to be the firm's withdrawal of the offering upon significant objection by the Division or upon requests for additional information. Some withdrawals result when the Division remains unsatisfied with explanations and information, and the parties reach an impasse.

15. 17 C.F.R. §§ 230.501-508 (1992).

16. Regulation D resulted from congressional directives in the Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980) (codified at 15 U.S.C. § 77s(c)(3)(c)(1989))* which was the Congressional response to demands for uniformity and simplicity in the registration and sale of securities at state and federal levels and the authorization in the Omnibus Small Business Capital Formation Act of 1980 (codified at 15 U.S.C. § 77s(a)-(c)(1989))* which permitted the SEC:

To cooperate with any association composed of duly constituted representatives of state governments whose primary assignment is the regulation of securities business within those states for the development of a uniform exemption from registration for small issuers which can be agreed upon among several states or between the States and the Federal Government.

15 U.S.C. §§ 77s(c)(1) and (c)(3).

Twenty states now recognize Regulation D exemptions as state exemptions.

17. The following state laws have exemptions compatible with Parts 505 and 506 of Regulation D: ALASKA STAT. § 45.55.240 (1986); ARIZ. REV. STAT. ANN. § 44-1844 (1987 & Supp. 1991); COLO. REV. STAT. § 11-51-113.2)(O) (1987); CONN. GEN. STAT. ANN. § 36-490(b)(9)(A),(B) (West 1987 & Supp. 1990); DEL. CODE ANN. tit. 18, § 5108, Rule 9 (b)(9)(II) (1989); GA. CODE ANN. § 10-5-9 (Harrison 1990); IDAHO CODE § 30-1435, Rule 27 (1983 & Supp. 1992); KAN. STAT. ANN. § 17-1262(o) (1988

securities laws remain a potpourri of regulation with varying standards, requirements and exemptions.¹⁸ However, states

& Supp. 1991), KAN. ADMIN. REGS. § 81-5-6 (1984); LA. REV. STAT. ANN. § 51:709 (West 1987 & Supp. 1990); MD. CORPS. & ASS'NS CODE ANN. § 11-602, Rule 15 (1985 & Supp. 1992); MASS. GEN. LAWS ANN. ch. 110A, § 402(b)(a)(c) (West 1990); MICH. COMP. LAWS ANN. § 451.803.7 (West 1989) (Mich. Stat. Ann. § 19.776(402) (Callaghan 1990 & Supp. 1992)); MO. ANN. STAT. §§ 409.402, 30-54.210 (Vernon 1990); MONT. CODE ANN. §§ 30-10-105, Rule 6.10.120 (1991); NEB. REV. STAT. § 8-1111 (1991 & Supp. 1992); N.J. STAT. ANN. § 49:3-60(b) (West Supp. 1990) (as to offerings other than real estate syndications); OKLA. STAT. ANN. tit. 71, §§ 401,406 (West 1987 & Supp. 1993); OR. REV. STAT. § 59.025 (1989); OR. ADMIN. R. Rule 815-36-500 (1992); S.C. CODE ANN. § 35-1-320 (Law. Co-op. 1987); TENN. CODE ANN. § 48-2-103, Rule 0780-4-2-.04 (1988 & Supp. 1992); UTAH CODE ANN. § 61-1-14 (Supp. 1990); VT. STAT. ANN. tit. 9, §§ 4203a, 4204a (1984 & Supp. 1992); VA. CODE ANN. § 13.1-514(b)(14), Rule 503 (Michie 1989 & Supp. 1992); VA. R. STATE CORP. COMM'N, Rule 503, Blue Sky L. Rep. (CCH) ¶ 60,439; W. VA. CODE §§ 32-3-305, 15.06 (1992).

Kansas and Tennessee follow the North American Association of Securities Administrators (NAASA), and limit their exemptions to Rule 505. Colorado and New York regulate only intrastate offerings (whereas Regulation D exemptions apply only if the offering is interstate). Oregon and Alaska register by coordination—federal approval or exemption constitutes compliance with their requirements.

The following state statutes provide exemptions based on the number of purchasers, but the exemptions do not parallel Regulation D; hence, a special structure would be necessary under these statutes: FLA. STAT. ANN. § 517.061(11)(a)(1), Rules 3E-500.05 to .07 (West 1988 & Supp. 1992); ILL. ANN. STAT. ch. 121½, § 137.4(G) (Smith-Hurd 1960 & Supp. 1992); IOWA CODE ANN. § 502.203(9)(a) (West 1991 & Supp. 1992); MINN. STAT. ANN. § 80A.15 sub.2(h) (West 1986 & Supp. 1992), MINN. R. 2875.0180 (1989); MISS. CODE ANN. § 75-71-203(9), (10) (1972 & Supp. 1990); NEV. REV. STAT. § 90.530(11)(a) (1990) (25 purchasers); PA. STAT. ANN. tit. 70, § 1-203(d) (Purdon 1965 & Supp. 1992) (25 purchasers); S.D. CODIFIED LAWS ANN. § 47-31A-402 (1991) (25 purchasers for domestic corporations, 5 for other issuers).

State statutes with only Rule 506 exemptions are: ALA. CODE § 8-6-11 (1984 & Supp. 1992); ARK. CODE ANN. § 23-42-504(a)(14) (Michie 1987 & Supp. 1991), Interpretative Opinion, Blue Sky L. Rep. (CCH) ¶ 10,661; CAL. CORP. CODE § 25102(f) (West 1977 & Supp. 1992); CALIF. LOCK REG. tit. 10, Rules 260.102.12 to .14 (1992), 1 Blue Sky L. Rep. (CCH) ¶ 11,780A-C; IND. CODE ANN. § 23-2-1(b)(10) (Burns Supp. 1990); KY. REV. STAT. ANN. § 292.410 (Baldwin 1990); ME. REV. STAT. ANN. tit. 32, § 10502 (1988 & Supp. 1990); N.C. GEN. STAT. § 78A-17, N.C. ADMIN. CODE tit. 18 r.1206 (1990 & Supp. 1991); OHIO REV. CODE ANN. § 1707.03 (Baldwin 1989); TEX. BUS. & COM. CODE ANN. § 8.401 (West 1991), Rule 109.4(11), 3 Blue Sky L. Rep. (CCH) ¶ 55,554; WASH. REV. CODE ANN. §§ 21.20.320 (West 1989); WASH. ADMIN. CODE § 460-44A-501-503, 506 (1990); WIS. STAT. ANN. § 551.23(10) (West 1988).

The other states (Hawaii, Wyoming, North Dakota, New Hampshire, New Mexico, and Rhode Island) have peculiar exemption requirements.

Ten jurisdictions (Alaska, Colorado, Delaware, D.C., Indiana, New York, New Jersey, Oklahoma, Oregon, and Washington) recognize Rule 504 exemptions.

18. This "potpourri" of regulation is troubling to some in the sense that the lack of uniformity places the United States at a distinct disadvantage in international competition and international financial markets. See, e.g., Marianne

with merit standards¹⁹ maintain some common denominators

M. Jennings, *Arizona Corporation Commission v. Media Products, Inc.: Clarification of Competing Federal and State Securities Regulation*, 37 CLEV. ST. L. REV. 449 (1989) ("the wisdom of such a piecemeal approach in a national capital market governed by a significantly detailed federal regulatory scheme is questionable.") *Id.* at 462. See also, Roberta S. Karmel, *Blue-Sky Merit Regulation: Benefit to Investors or Burden on Commerce?* 53 BROOKLYN L. REV. 105 (1987) in which the author noted:

State merit regulation is a burden on interstate commerce and stands as an obstacle to the achievement of the SEC's statutory goals of facilitating capital formation and the establishment of a national market system (NMS). Further, the basic philosophical conflict between federal and state regulation will become increasingly troublesome as the SEC grapples with the problems of regulating the market for corporate control of large public companies and participating in the regulation of international capital markets.

Id. at 107 (footnote omitted).

19. All states regulate securities registration in some way. Thirty-nine states have adopted or substantially adopted the Uniform Securities Act, a product of NAASA's work with securities lawyers and legal scholars including Louis Loss as a principal. See 7B U.L.A. 510 (1985). The thirty-nine states (including Puerto Rico) are as follows:

Alabama	Kentucky	North Carolina
Alaska	Maryland	Oklahoma
Arkansas	Massachusetts	Oregon
Colorado	Michigan	Pennsylvania
Connecticut	Minnesota	Puerto Rico
Delaware	Mississippi	South Carolina
District of Columbia	Missouri	Tennessee
Guam	Montana	Utah
Hawaii	Nebraska	Virginia
Idaho	Nevada	Washington
Indiana	New Hampshire	West Virginia
Iowa	New Jersey	Wisconsin
Kansas	New Mexico	Wyoming

For state citations to U.L.A., see Michael Newman, *Municipal Securities and State Securities Laws: A New Look*, 13 U. BALT. L. REV. 558-59 n.3 (1984).

The following states are generally regarded as "merit" states in that some form of merit regulation is exercised over proposed offerings:

Alabama	Kentucky	Pennsylvania
Alaska	Massachusetts	Puerto Rico
Arizona	Michigan	South Carolina
Arkansas	Minnesota	Tennessee
California	Missouri	Texas
Colorado	Nebraska	Utah
Connecticut	Nevada	Virginia
Delaware	New Hampshire	Washington
Guam	New Jersey	West Virginia
Hawaii	New Mexico	Wisconsin
Idaho	North Carolina	Wyoming
Indiana	Oklahoma	
Iowa	Oregon	
Kansas		

in terms of the types of factors examined in securities registered for state approval. The following sections discuss those common factors.

A. *Uniform Securities Act Merit Standards and General Merit Standards*

Section 306(a)(2)(F) of the Uniform Securities Act incorporates merit standards as grounds for registration or denial of a proposed offering.²⁰ Section 306(a)(2)(F) permits the state to deny registration if "the offering has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, or promoters' profits or participation, or unreasonable amounts and/or kinds of options".²¹ Some states go beyond the Uniform Securities Act standard and deny registration if the offering is not "fair, just and equitable."²²

These types of statutes afford administrators broad discretion in their reviews of offerings and also afford administrators the latitude to develop specific topics for review.²³ Offerors who file for registration in even these general rule states will find themselves required to meet certain specific requirements (discussed below) or to negotiate additional conditions for the offering prior to the regulator's approval. In short, both the Uniform Securities Act and the "fair, just and equitable" standards provide state administrators with broad, discretionary review powers.²⁴

Merit regulators, in addition to mandating the full disclo-

States without merit regulation can review proposed offerings only for full disclosure and fraud. Maryland and Illinois are examples of full disclosure states which parallel the federal disclosure standards.

20. 7A U.L.A. at 621.

21. Unif. Sec. Act § 306(a)(2)(F), 7A U.L.A. 621 (1978).

22. See, e.g., KAN. STAT. ANN. § 17-1260(a)(1) (1988); WIS. STAT. ANN. § 551-28(1)(e) (West 1991).

23. See LOUIS LOSS, COMMENTARY ON THE UNIFORM SECURITIES ACT 84-85 (1976).

24. It is the presence of this broad power that has been disturbing to academicians and the focus of the scholarly debate on the subject. See, e.g., Mofsky and Tollison, *supra* note 4; Walker and Hadeway, *supra* note 6, and Goodkind, *supra* note 10. Judicial challenges to merit regulation have been minimal. Wisconsin's last reported case was *Associated Gas and Elec. Co. v. Public Serv. Comm'n.*, 266 N.W. 205, 209 (Wis. 1936). Arizona's most recent case, *Arizona Corp. Comm. v. Media Prods. Inc.*, 763 P.2d 527 (Ariz. Ct. App. 1988), was not a challenge to the regulations themselves but rather a challenge to the jurisdiction of state regulators over interstate offerings.

sure of the Federal Securities Act of 1933,²⁵ have the authority to employ substantive standards in reviewing proposed offerings and in making decisions regarding the approval of the offering in their states. These substantive standards are the crux of the debate on merit review's "merits"²⁶ and are discussed in the following sections.

B. Capitalization Regulation

One of the substantive standards employed by merit regulators relates to the insufficiency of equity capital in relation to the total capitalization that will exist once the offering is complete.²⁷ Using quantitative standards (such as 10-15% of total

25. See 15 U.S.C. § 77g (1988).

26. For example, Mofsky and Tollison, *supra* note 4, state:

Merit regulation has most often taken the form of rules regulating the maximum expenses of public offerings, requiring a minimum equity investment by promoters, regulating the price that insiders must pay for their stock relative to the proposed price for public investors; regulating securities offering prices in relation to earnings ratios, regulating the amount of warrants and options granted to officers, key employees and underwriters; establishing minimal shareholder voting rights; and regulating interest and dividend coverage with respect to senior securities.

Beyond an efficient market type of criticism, merit rules have been criticized on the grounds that seasoned firms, not subject to the rules, are in effect granted a comparative advantage in raising capital over newly promoted ventures. Newly promoted firms must either adjust the terms of their offerings and their capital structures to the merit rules of particular states or be precluded from publicly offering their securities in those states. Some firms will thus always be at the margin where, for financial and legal reasons, corporate promoters are unwilling to make the adjustment, and a decision not to offer securities in a particular state will be made. Of course, there are a few states that do not have merit rules, and it has been argued that a proposed offering could always be made there, thus avoiding merit regulation altogether. But practical considerations, relating mainly to the local nature of many small offerings, often foreclose capital formation any place except specific areas where the firm and its promoters are well known. There probably exists little geographic choice, based solely on evaluation of local blue sky laws, of the place where capital can be raised.

Id. at 368-369 (footnotes omitted).

27. For example, Missouri requires a 15% investment for aggregate offerings up to \$1,000,000 and a 10% investment in the aggregate offering after \$1,000,000. (MO. CODE REGS. tit. 15, § 30-52.080(1) (1988)). Wisconsin has adopted NAASA's guidelines. (WIS. ADMIN. CODE § Comm'n of Sec. 3.05 (Jan. 1992)). Texas requires a minimum of 10% equity capital investment (TEX. ADMIN. CODE tit. 7, § 113.3 (1992)). Arizona has adopted the following schedule:

10% of the first \$200,000.00

5% of the second \$200,000.00

1% of the balance.

capitalization), regulators are able to set the level of risk offerors must assume in going public with the offering.

C. Regulation of "Cheap Stock"

Often referred to as "promotional securities,"²⁸ "cheap stock" are securities issued to promoters and insiders at prices significantly less than the eventual public offering price.²⁹ Also part of this regulation is the review of means of payment by promoters—that is regulators are not only permitted to review the amount of stock but the means of payment and the value of services and tangible or intangible property given in exchange for the shares.³⁰

D. Regulation of Options and Warrants

Cheap stock regulation controls the amount of stock issued to promoters and insiders prior to the public offering. However, merit regulators also examine the number of options and warrants already issued or to be issued to insiders and promoters and the relation of those numbers to the total capital structure that will exist after the offering is complete.³¹ The options and

ARIZ. COMP. ADMIN. R. & REGS. § R14-4-107 (A) (Supp. 1991).

28. Cheap stock, also called "promotional securities," is defined as:

[s]ecurities issued for services rendered, patents, copyrights or other intangibles, the value of which has not been established to the satisfaction of the Commission by appraisals, by evidence of amounts paid by others for substantially similar services or property, by evidence of a bona fide offer to purchase such services or property, or by other evidence, or for a consideration substantially less in amount than the consideration for which such securities are proposed to be sold to the public

MO. CODE REGS. tit. 15, § 30-52.060 (1988).

29. See MO. CODE REGS. tit. 15, § 30-52.070 (1988) (limits cheap stock to 50%); WIS. ADMIN. CODE § 3.04 (1984) (adopts NAASA guidelines which limit cheap stock to 60%); ARIZ. COMP. ADMIN. R. & REGS. § R14-4-105 A.2 (Supp. 1991), which limits "promotional securities" to 15% of the outstanding securities (those that will be outstanding at the end of the offering). Texas allows for the escrow of cheap stock. TEX. ADMIN. CODE tit. 7, § 113.3(5) (1992).

30. *Supra* note 27, MO. CODE REGS. tit. 15, § 30-52.060 (1988).

31. Texas limits the number of options and warrants to 10% of the aggregate offering price with a maximum five-year exercise period. TEX. ADMIN. CODE tit 7, § 113.3(11)(1983). Wisconsin limits the number and value of warrants and options to 20% of the total number of shares that will be outstanding after the offer and 20% of their value. WIS. ADMIN. CODE § 30.03(c)(1983). ARIZ. COMP. ADMIN. R. & REGS. § R-14-4-106 B (Supp. 1991) allows such options, warrants and rights to purchase so long as:

1. A certificate or instrument in evidence thereof is issued before the commencement of the proposed public offering.

warrants regulation, as well as the cheap stock limitations are designed to allow regulators to limit the amount of compensation and/or profit earned by promoters and insiders and are nearly universally raised in the review of the proposed offering's documentation.³²

E. Offering Price Regulation

Some state merit regulators have the authority to require an adjustment to market price if the proposed public offering price is too high in relation to the firm's current market price (for seasoned offerings) or in relation to the earnings history of those firms with no market history (unseasoned offerings).³³ This type of regulation is particularly disturbing to academicians because of its direct interference with the market place, the efficient market hypothesis and the assignment of price based on past performance as opposed to consideration of future market needs and changes.³⁴

F. Regulation of Underwriter's Commissions and/or Selling Expenses

Excessive offering expenses, including underwriter's commissions, are items for merit review and are often subject to negotiation.³⁵ These forms of regulation provide a means for

2. The number of shares covered thereby does not exceed 20% of the number of securities to be outstanding at the completion of the proposed public offering.

3. The initial exercise price is reasonably related to the public offering price.

4. They do not exceed ten years in duration.

5. The prospectus to be used in connection with the proposed public offering contains a full disclosure as to the terms and reasons for their grant.

32. See Figure 2 and Tables XI-XIII *infra* and accompanying text for data on the number of option/warrant or cheap stock questions raised in the filings.

33. See MO. CODE REGS. tit. 15, § 30-52.050 (1990); (limits price to 25 times the average annual net earnings per share); WIS. ADMIN. CODE §§ 3.02(2), 3.02(1)(a) (1984) (price must be "reasonably related" and "not exceed 25 times its average annual net earnings per share for the last 3 years"); TEX. ADMIN. CODE tit. 7, § 113.3(2) (1992) (allows examination of price earnings ratio over the past years).

34. See Mofsky and Tollison, *supra* note 4, at 377-378.

35. MO CODE REGS. tit. 15, § 30-52.040 (1990) (15% limit); WIS. STAT. ANN. § 551.28(f) (1988); WIS. ADMIN. CODE § 3.01 (1973) (commissions limited to 10% and other expenses to 15% of the aggregate offering price); ARK. REG. R. 14-4-108 (1972) provides:

regulating any excessive indirect profits to promoters and others (as opposed to the more direct profits of "cheap stock" and options).³⁶

G. Regulation of Voting Rights

Most merit states prohibit approval of offerings in which the purchasers of the shares will have no voting rights or will have voting rights disproportionate to those rights in previously issued shares.³⁷ These types of rules serve as a control mechanism of promoters and existing shareholders so that the offering is not one used to raise capital that will be used at the discretion of existing shareholders without the requirement of new shareholder representation or accountability.

H. Earnings Coverage Regulation

This form of regulation is primarily used in proposed offerings for preferred shares or debt securities.³⁸ Regulators examine a history of firm earnings to determine whether the earnings are sufficient to cover interest on the proposed debt securities or preferred dividends on the proposed equity preferred shares.³⁹

A. No issuer shall incur a liability which must be paid by the issuer as a selling expense in connection with the sale of a public issuance greater than 15% of the amount of said issue actually sold to the public.

B. Selling expenses shall include commissions, salaries, advertising and all other expenses directly or indirectly incurred in connection with the sale of securities . . .

36. Some states also prohibit officers and directors from earning commissions, see, e.g. ARIZ. COMP. ADMIN. R. & REGS. R14-4-111 (Supp. 1991); Unif. Sec. Act § 306 (2)(F) (1958) prohibits "unreasonable amounts" of commissions and selling expenses.

37. See, e.g., MO. CODE REGS. tit. 15, § 30-52.110 (1987) (unfair or disproportionate voting rights); WIS. ADMIN. CODE § 3.07(a)(1)(6) (1984) (prohibits giving no voting rights or unequal voting rights); TEX. ADMIN. CODE tit. 7, § 113.3(6) (1992) (prohibits "disproportionate" rights).

38. As discussed in note 62 and accompanying text *infra*, these type of issues were not included in the study and this form of regulation was not used extensively by regulators in reviewing common stock offerings except to note that the firm currently had difficulty meeting existing preferred dividend and debt securities' payments.

39. See, e.g. MO. CODE REGS. tit. 30, § 30-52.120 (1974) (uses a three-year test for earnings coverage); and WIS. ADMIN. CODE § 3.06(1)(1984) (net earnings for last 3 years would be insufficient to cover debt interest).

I. Miscellaneous Regulation

Most merit states, in addition to providing for regulation via the previous seven specific categories, also provide regulators with a broad "miscellaneous" category for use in the review of proposed offerings. Some factors examined in this category include poor or unsound financial condition, the improbability of the offeror succeeding, or unfair transactions by insiders.⁴⁰

Financial requirements and evidence of promoter experience are mandated in some states as part of their miscellaneous regulations.⁴¹

This category of regulation affords administrators in merit states broad discretion in evaluating offerings. For example, in the present study, Arizona regulators examined issues such as loans to officers, affiliates and shareholders, transactions between the offeror and its affiliates, and the number of offerings made by an offeror in recent periods.⁴²

Also appropriately discussed here are the detailed requests for information and corrections that comprise part of the merit review process. For example, Arizona's routine check list for initial review of an offering includes items such as correction of the language for consent to service of process,⁴³ requests for

40. In many states, the "miscellaneous" category is not a codified concept but a discretionary one usually found in the form of policy statements. The policy basis for this discretionary category can be found in 1 Blue Sky L. Rep. (CCH)

¶ 5151-5381# (1984). NAASA has also adopted certain policies with respect to this miscellaneous discretion. See, e.g. Blue Sky L. Rep. (CCH) ¶ 9605 (1984), in which Arizona adopts NAASA policies: "NAASA statements of policy. The Securities Division subscribes to the statements of policy adopted by (NAASA) relating to the registration of securities in Arizona except where in conflict with a state rule or regulation." Blue Sky L. Rep. (CCH) ¶ 9605 (1984).

For a more detailed discussion of Arizona's discretionary review issues, see note 62 *infra* and accompanying text.

For other examples of state regulations, see, e.g., IOWA ADMIN. CODE r. 510-50.33-.40 (1983), as reported in 1 Blue Sky L. Rep. (CCH) ¶ 25,443-25,400. Iowa requires a promoter's investment of at least 10%; limits offering expenses to 7% of the first \$500,000 in aggregate offering price and 5% of any aggregate price above that; employs a 3-year earning test for offering price and limits commissions to 10% and options or warrants to 20% and requires cheap stock to go into escrow for 10 months.

41. In Texas, real estate syndication promoters must contribute at least \$50,000 to the syndicate and have at least two years executive experience in real estate. TEX. ADMIN. CODE tit. 7, § 117.2(a) and (b) (1982).

42. See text accompanying note 62 *infra* for details on offering reviews.

43. Arizona Corporation Commission Form SR 000103 (copy available in offices of BYU J. PUB. L.) lists item 5 as "The Consent to Service of Process must name

market and underwriter information,⁴⁴ requests for additional language in the prospectus,⁴⁵ and requests for financial statements.⁴⁶ In short, the broad discretionary authority can result in a laboriously detailed review and many firms withdraw from Arizona after receipt of the request or requests in the standard checklist.⁴⁷

III. PREVIOUS STUDIES OF MERIT EFFICACY

To date, there have been three quantitative studies of the efficacy of merit review. The first such study was Goodkind's evaluation of Wisconsin's merit system.⁴⁸ Goodkind compared the post offering financial performance of corporate issuers whose offerings were registered or withdrawn⁴⁹ between 1968 and 1971 in Wisconsin.⁵⁰ Goodkind's financial analysis used price, book value and dividend distribution as the indices of firm performance.⁵¹ Goodkind also used a figure of a loss of 75% of the stock's market value as an indicator of business failure, with 23.5% of the withdrawn firms found to be

all members of the Arizona Corporation Commission."

44. Item 6 of Form SR000103 provides: "The Division requests additional information relating to the offering such as the names of the market makers, volume of transactions, and the underwriters memorandum."

45. Item 8 of Form SR000103 provides: "Please represent in the prospectus that all future transactions with affiliates will be on terms no less favorable than could be obtained from unaffiliated parties."

46. Item 10 of Form SR000103 provides: "The Securities Division requests the following exhibits: a. Financial statements in accordance with the requirements of A.R.S. Section 44-1894."

47. See notes 62-64 *infra* and accompanying text for a discussion of the data.

48. Goodkind, *supra* note 10.

49. Withdrawal is the fate of securities not approved by the state. No denials are recorded by Goodkind, or in the present study, (see notes 62-64 *infra*) because a firm faced with regulators unwilling to approve their offerings are able to withdraw. Many firms withdraw if significant objections are raised rather than invest the time and effort required to address regulators' concerns. Further, a withdrawal may result because the offering is terminated due to market conditions, changes in the offeror's needs or underwriting difficulties. The reason for withdrawal is not always given in every file and for the most part, is accomplished by a letter notifying the regulators of withdrawal.

50. Goodkind also provides an analysis of the advantages and disadvantages of the merit system of regulation. Goodkind, *supra* note 10, at 107-23. Other non-quantitative reviews of merit standards include Rutherford B. Campbell, *An Open Attack on the Nonsense of Blue Sky Regulation*, 10 J. OF CORP. L. 553 (1985) and Jeffery T. Haughey and Kevin M. Veler, *Blue Sky Laws and State Takeover Statutes: New Importance for an Old Battleground*, 7 J. OF CORP. L. 689 (1982).

51. See Table I *infra*.

failures.⁵² Critics have cited methodological flaws in Goodkind's study⁵³ and have also criticized its failure to recognize the additional consumer and societal costs of merit review.⁵⁴

Walker and Hadaway's 1982 study of Texas merit review compared common stock offerings between 1975 and 1980.⁵⁵ Although Walker and Hadaway reached a different conclusion than Goodkind, their study was also criticized for its narrow focus in that partnership offerings were not examined and only corporate issues were reviewed.⁵⁶

Jennings' and Kudla's 1983 study of Arizona's merit review process concluded that the financial performance of withdrawn offerings was better than the performance of registered offerings⁵⁷, but was criticized for its lack of significance due to low

52. Goodkind, *supra* at note 10.

53. Mofsky & Tollison, *supra* note 4, state:

[T]he components of the study's empirical test are not designed to shed any light on the issue it purports to investigate, namely investor protection, even within a range of tolerable imprecision. Only one index of performance used in the study—stock price—is relevant. The other two indices used—dividend distribution and book value—are essentially meaningless and misleading measurements in this context.

Id. at 371.

The Wisconsin study is so methodologically flawed that it yields no useful information on the very interesting problem it posed.

Id. at 376.

54. Mofsky and Tollison note:

But it was not only methodology that flawed the Wisconsin study. It was also marred by a priori acceptance that blue sky regulation does not generate unintended costs for consumers and society generally. The study gathered data with respect to only one matter—whether investors who bought issues meeting Wisconsin's merit rules fared better than investors who bought issues denied registration in Wisconsin.

Id. at 370.

(Note: Although Mofsky and Tollison use the term "denied" in their critique, Goodkind compared approved with withdrawn registrations because there were no denials).

55. Walker and Hadaway, *supra* note 6 at 652.

56. Makens, *supra* note 10, notes:

By limiting their review to corporate offerings, Walker and Hadaway focused on only a small percentage of the offerings filed in and subject to review by the Texas Securities Board. Although this study concluded that merit review as a whole is producing its intended result of "equiponderating their positions of the new and existing investors," it is impossible to reach a general policy determination on the basis of this evidence without a review of the performance of partnership as well as corporate issues.

Id. at 455 (footnotes omitted).

57. See Marianne M. Jennings, et. al, *Federalism to An Advantage: The Demise of State Blue Sky Laws Under the Uniform Securities Act*, 19 AKRON L. REV. 395

response rates on the financial performance survey.⁵⁸

The Makens⁵⁹ and Mofsky and Tollison⁶⁰ critiques of the studies are the only remaining portions of the literature offering critiques on the quantitative analysis of merit review.⁶¹ A comparison of the factors analyzed and the conclusions in each of the studies is found in Table I. The present study addresses the omissions and criticisms of the previous studies.

(1986) wherein the authors, in analyzing holding period returns noted:

Although these results cannot be generalized because of the small sample sizes for the withdrawn group, these results suggest that the withdrawn firms did as well financially as the approved group and even better in year 1.

Id. at 408.

58. Makens, *supra* note 10, stated:

A 1983 study by Kudla and Jennings of Arizona registration process appears to be an unsuccessful attempt to provide support for a presumption that merit regulation should be abolished. The authors attempted to compare the performance of issuers of registered and withdrawn offerings but it is difficult to attach any significance to their conclusions since they received a very poor response to their questionnaire.

Id. at 456 (footnotes omitted).

59. *Supra* note 10.

60. *Supra* note 4.

61. The financial literature does include some studies of primary offerings. See, e.g., Carol J. Simon, *The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues*, 79 AM. ECON. REV. 295 (1989). Additionally there are some general qualitative analyses regarding the precision and application of merit regulation. See, e.g., Hal M. Bateman, *State Securities Registration: An Unresolved Dilemma and a Suggestion for the Federal Securities Code*, 27 SW. L. J. 759 (1973); Harold S. Bloomenthal, *Blue Sky Regulation and the Theory of Overkill*, 15 WAYNE L. REV. 1447 (1969); Haughey & Veler, *supra* note 49, at 689; Rex A. Hurley & Carla Green, *Florida's Response to the Need for Uniformity in Federal and State Securities Registration Exemption Requirements*, 12 FLA. ST. U.L. REV. 309 (1984); Mark A. Sargent, *The Challenge to Merit Regulation - Part I*, 12 SEC. REG. L.J. 276 (1984); and Richard B. Tyler, *More About Blue Sky*, 39 WASH. & LEE L. REV. 899 (1982).

TABLE I
SUMMARY OF RESEARCH RESULTS FOR GOODKIND
STUDY AND WALKER AND HADAWAY STUDY
RESEARCH RESULTS OF

Goodkind (1976)	Walker and Hadaway (1981)	Jennings and Kudla (1984)
More than 39 percent of issuers that were denied registration could not be located or refused to respond to requests for information as compared to only 14 percent for the registered issuers.	Less than one percent of all approvals went out of business, as compared with over 18 percent of all withdrawals.	More than 25% of the withdrawn filing issuers could not be located or did not respond to requests for information.
Cumulative dividends for the three years expressed as a percentage of the offering price was higher for the registered group.	Approved firms paid higher dividends per share as a percent of offering price.	Holding period returns were significantly higher in year 1 for those securities withdrawn from the registration process.
Book value per share was approximately 19 percent higher after three years for the registered issuers.	Withdrawn firms had a greater decrease in book value per share as a percent of offering price.	There were no significant differences in holding period returns between withdrawn and approved firms in years 2, 3, and 4.
Average price after three years was approximately 28 percent higher for the registered issuers.	Approved firms had a more than double increase in price per share as a percent of offering price three years subsequent to the offering as compared to withdrawn firms.	Total assets of withdrawn firms were smaller.
Market value of the registered shares in the sample after 3 years had an average gain of \$725,506 per issue while the value of the shares denied registration had an average loss of \$2,117,878 per issue.	Cumulative total returns, considering both capital appreciation and dividends earned, were more than twice as high for the approved firms three years subsequent to the offering as compared to the withdrawn group.	
Issuers that were denied registration because of multiple deficiencies had a substantially poorer performance than the registered issues.	Withdrawals for multiple merit standard reasons had the worst price performance of any group.	

IV. PRESENT DATA - DESCRIPTION AND METHODOLOGY

All 1,807 common stock offerings registered with the Arizona Securities Division between 1984 and 1987 were reviewed.⁶² Limited partnership, bond, and other types of non-common stock offerings were examined for relative quantity figures and amounts.⁶³ For this same period, there were 4,341 non-common stock offerings, with 3,893 being approved and 448 being withdrawn (no denials) with total in-state aggregate offering amounts (for non-common stock offerings) as depicted in Table II. The amounts of common stock offerings along with their approval/withdrawal rates are reflected in Table III. The number of seasoned offerings are also noted in Table III.

After obtaining registration information from the Securities Division files, post-registration financial information was obtained. Approximately 44% of the firms' financial data was available on the Compustat data base. Where Compustat information was unavailable, individual firm contact was made.

TABLE II
REGULATORY REVIEW OF
NON-COMMON STOCK OFFERINGS

Years	Total	Aggregate In-state Offering amount	Approved	Withdrawn
1984-1987	4341	\$135,316,724,755	3893	448

62. See explanation, *infra*, page 34.

63. As noted earlier (see notes 54-55 *supra* and accompanying text), the lack of partnership offerings was a criticism of the Walker and Hadaway study. However, the elimination of them from this study was due to the complexity of comparison because of factors like the lack of a market place price for comparison, the inability to gather financial data and the inherent heterogeneous nature of offerings other than common stock. The only meaningful comparison would be whether the firms were still in business. It is, however, undeniable that a significant portion of capital raised in the state was done through non-common stock offerings and a lack of review of these offerings leaves unanswered questions.

TABLE III
SUMMARY OF REGULATORY REVIEW OF
COMMON STOCK OFFERINGS

Year	Total # offerings	Total # Approved**	Total # Withdrawn **	# Seasoned Approved	# Unseasoned Approved	# Seasoned Withdrawn	# Unseasoned Withdrawn
1984-1987	1807	1137	612	683	454	337	275

After attempted contact of the remaining non-Compustat firms (1013 or 56%), 227 (or 22.4% response rate) provided the same financial data included in Compustat. Financial data for 1,021 or 56.5% of the offering firms were thus evaluated. Of the remaining 786 firms, 479 or 61% did not respond and could no longer be located using either the firm name, names of the CEOs and four other listed officers of the company or through contact with attorneys or other experts listed in the registration materials.

While many conclusions could be drawn from the inability to locate these firms, the most logical one is that the firms are no longer on-going entities. Of the remaining 786 firms, 307 or 39% (16.9% of the total firm universe) refused to provide data and 8 did not respond to requests⁶⁴ or were excluded due to factors such as mergers, spin-offs and other corporate structural changes that produced changes in the stocks' character that made comparison of performance from year-to-year impossible.⁶⁵

64. The firms did respond to the survey, but they took the position that their financial figures were proprietary. This was an interesting posture given that the firms had registered public offerings in Arizona.

65. For example, several of the firms' outstanding stock was purchased in exchange for shares of another company and they became subsidiaries with the parent holding all shares (no longer traded). There was no continuing data in some cases; in others there were only consolidated financial statements.

V. FINANCIAL COMPARISONS

Three different forms of financial comparisons were run on the approved vs. the withdrawn group⁶⁶ of offerings as well as several subsets of that group. Subsets were created according to the objections raised by the Securities Division.⁶⁷ The three forms of financial comparison were: growth in earnings per share (EPS), growth in dividends, and growth in stock price.⁶⁸ The growth was computed as the total growth in these three factors from the time of the offering (for share price) or from the time of initial EPS or dividend figures (in cases where the firm had no earnings record or dividends because the offering was an IPO).⁶⁹ The growth figures for the total set of approved vs. withdrawn offerings are found in Tables IV-VI.

66. In Arizona, as in the Goodkind/Wisconsin study, there were no registration denials, but both withdrawals and approvals were found. Reasons for withdrawal included: no explanation; change in firm plans; changes in the market; loss of the underwriter; withdrawal from Arizona with the offer proceeding in other jurisdictions.

67. See, pp. 32-34 *infra*.

68. It is important to note that the author is cognitive of the relationship between risk and earnings. The higher the risk associated with an offering, the greater the return on the investment. Simon, *supra* note 61, at 295 explains:

Consider a security which has a 50 percent chance of being worth \$100 and a 50 percent chance of being worthless. The rational investor will be willing to pay \$50 for the issue. (All risk may be diversified). *Ex post*, if *ex ante* expectations are correct 50 percent of the investor's portfolio is worth \$0 and 50 percent is worth \$100. There are no average "abnormal" gains or losses. The effects of the investor's uncertainty, however, are reflected in the dispersion of returns. She has earned 100 percent on half of the securities and lost 100 percent on the remaining issues.

The growth was measured after three years. Measuring the results after one year yielded unsatisfactory results. This is best explained by the fact that IPOs (particularly newly founded firms) had not been operational long enough to supply figures at the same time comparisons could be done.

69. IPO = initial primary offering.

TABLE IV
APPROVED vs. WITHDRAWN OFFERINGS
THREE-YEAR COMPARISON
DIVIDENDS

	Mean	Standard Deviation	Standard Error	Minimum	Maximum	T	F Prob > T
Approved	0.56137822	1.99031541	0.07200708	0	15.1579	-2.1987	.0202
Withdrawn	2.45510899	11.32170368	0.85629614	0	81.42999	-4.3450	.0001

Prob > F' = .0001

TABLE V
APPROVED vs. WITHDRAWN OFFERINGS
THREE-YEAR COMPARISON
SHARE PRICE

	Mean	Standard Deviation	Standard Error	Minimum	Maximum	T	F Prob > T
Approved	11.062225	8.28948675	0.29474022	.062	66.00048	2.7001	0.0074
Withdrawn	8.835903	10.2159255	0.77005436	.062	51.0000	3.0808	0.0021

Prob > F' = .0002

TABLE VI
APPROVED vs. WITHDRAWN OFFERINGS
THREE-YEAR COMPARISON
EPS (Fully Diluted)

	Mean	Standard Deviation	Standard Error	Minimum	Maximum	T	F Prob > T
Approved	0.442820992	1.25802	0.4584	-9.309999	10.96099	0.8060	0.4212
Withdrawn	0.32547005	1.80191	.1382	-15.82999	6.75999	1.0059	0.3147

Prob > F' = .0001

Share price for the two groups shows a near \$3 disparity in price at the end of three years, and a T-test comparing the two groups shows the significance of the difference. The withdrawn offerings had a mean figure that was less for earnings per share, but the T test did not establish significance. The dividend level of the withdrawn shares is much higher and is significant. Thus, on a straight across-the-board comparison of approved vs. withdrawn offerings, the approved offerings performed significantly better with the exception of earnings per share. However, the presence of the higher level of dividends can be expected as simply a function of the higher level of risk.

The data was then examined to determine whether other independent variables produced similar results and hence could be an explanation for the performances of the approved offerings. The variable chosen was that of comparing the seasoned offerings with the unseasoned offerings. Tables VII-IX summarize the comparisons.

TABLE VII
SEASONED vs. UNSEASONED OFFERINGS
THREE-YEAR COMPARISON
DIVIDENDS

	Mean	Standard Deviation	Standard Error	Minimum	Maximum	T	F Prob > T
Seasoned	.66774956	2.2595	0.88832	0	15.85399	-1.5139	0.1311
Unseasoned	1.45720949	8.7556	.51385	0	81.42999	-2.1395	0.0327

Prob > F* = .0001

TABLE VIII
SEASONED vs. UNSEASONED
THREE-YEAR COMPARISON
SHARE PRICE

	Mean	Standard Deviation	Standard Error	Minimum	Maximum	T	F Prob > T
Seasoned	10.8372	8.86811	.34158	.062	66.00	1.004	0.3175
Unseasoned	10.2424	8.33039	.48666	.093	46.00	0.9761	0.3293

Prob > F* = .02157

TABLE IX
SEASONED vs. UNSEASONED
THREE-YEAR COMPARISON
EPS (fully diluted)

	Mean	Standard Deviation	Standard Error	Minimum	Maximum	T	F Prob > T
Seasoned	.4242	1.3216	.05228	-9.3099	10.9699	.0959	.9236
Unseasoned	.4141	1.4877	.08828	-15.8299	6.7599	.1004	.9201

Prob > F* = .0169

Whether an offering is seasoned should affect the dividend rate. The new offerings should pay a higher dividend, such being a function of the risk associated with the offering. It is important to note in the seasoned vs. unseasoned comparison of dividends, as well as in the approved vs. withdrawn dividend comparison, that the high standard deviation for the withdrawn offerings and unseasoned offerings indicates a greater number of outliers in terms of dividend level.

Share prices for this group are virtually the same and no significance was found. The resultant share prices for both groups may be more a function of the market at the time of the offer and overall market losses in the Dow Jones Index of Industrial Averages during this period.

Surprisingly, earnings per share for the two groups are similar but not significant. Comparing seasoned and unseasoned offerings with the subset of approved and withdrawn offerings produces the results shown in Table X. With respect to unseasoned offerings, it is clear that merit regulators are prophetic in determining future market behavior of offerings.

An examination of the unseasoned offerings demonstrates that the withdrawn unseasoned offerings will decrease in share price overall and reach a far lesser price than their approved counterparts. Again, the difference in standard deviations should be noted as indicative of a higher number of outliers in the unseasoned withdrawn categories. Also, the T-test failed to show significance in the relationship between seasoned offerings and higher share prices.

Interestingly, there is no significant difference between the seasoned approved and seasoned withdrawn offerings. However, the lack of difference may be explained by the fact that a larger number of the withdrawn offerings in the seasoned category are withdrawn voluntarily due to market conditions as opposed to withdrawal after regulatory review and objection.

**TABLE X
SHARE PRICE COMPARISON
THREE YEARS
SEASONED**

	Mean	Standard Deviation	Standard Error	Minimum	Maximum	T	F Prob > T
Approved	- 0.19745784	0.44615490	0.03000798	- 0.57500000	2.37777778	0.5444	0.4016
Withdrawn	- 0.25875858	0.44844529	0.06610493	- 0.91788383	1.38658551	0.5410	0.4011

Prob > F = 1.0000

**TABLE XI
SHARE PRICE COMPARISON
THREE YEARS
UNSEASONED**

	Mean	Standard Deviation	Standard Error	Minimum	Maximum	T	F Prob > T
Approved	- 1.17089888	10.39961837	0.81293363	- 105.99994561	25.00000298	0.5793	0.5078
Withdrawn	- 2.76911854	14.99807079	2.65190989	- 54.49995900	6.14385787	0.7288	0.4779

Prob > F = 0.0057

Further refinements in the offering group were necessary to accurately reflect the level of regulatory input. There are three types of reviews conducted by the Division. In type one, the review is limited, approval is achieved quickly and coincides with SEC approval. In this type of review, there were no withdrawals and a total of 812 files.

In the second type of review, the division's work is more comprehensive and results in approval only after additional information has been provided, specific questions answered, and concerns of the division addressed. Figure 1 lists the types of questions and requests for information found among this second category of registrations. While offerings may be unique, the questions and requests for information appear to be universal. There were 553 offerings in this category; 195 were withdrawn and 358 or 64.7% were approved. It is important to note at this point that the Division's reviews of the proposed offerings appear to have been handled in a systematic fashion via forms and checklists that had examiners reviewing offering files using the same set of standardized criteria. This systematic approach was found to be near universal since 1983 and markedly different from the review process as it existed in the earlier Jennings/Kudla study.

FIGURE 1
CATEGORY 2 REGISTRATION
ADDITIONAL INFORMATION
REQUESTS AND QUESTIONS

1. Failure to list all commissioners' names*
 2. Failure to provide copy of board resolution for the offering
 3. Failure to provide copy of corporate by-laws
 4. Failure to provide evidence of good standing (for foreign corporations)
 5. Failure to provide the name of a registered Arizona broker**
 6. Reasons for withdrawal of a previous proposed offering
 7. Pledge on future loan transactions (pledge to do arms' length paperwork on all loans to insiders)
-

*The securities division is a part of the Arizona Corporation Commission, a regulatory body with diverse responsibilities headed by 3 elected commissioners whose names must be listed on all filings with any division of the commission.

**The division requires that a locally licensed broker be affiliated with the offering.

In the third and final review category, the division expressed grave concerns about the offering. Four hundred sixty one of the total offerings examined fit into this category; the end result was withdrawal in 237 or 51.4% of the cases. The concerns expressed in this third category parallel the Division's regulations; they are listed in Figure 2.

Critical to the evaluation of the regulators' efficacy in the review process is the subset comparison of Category 3 offerings with the overall performance of approved offerings. It is in the Category 3 cases that regulators assume their most aggressive posture and most clearly state concerns about the proposed offering. These comparisons of Category 3 offerings are found in Tables XII-XIV. In all three tables the comparisons are between the approved firms and the troubled firms in which regulators expressed one or more of the 15 concerns found in Figure 2.

FIGURE 2
THIRD CATEGORY DIVISION
OBJECTIONS TO OFFERINGS

1. Substantial dilution
 2. Excessive underwriters' compensation
 3. Earnings losses for three years
 4. Unsound financial condition
 5. Conflicts of interest
 6. Losses
 7. Cheap stock
 8. Litigation
 9. Officers' compensation excessive
 10. Loans to related parties
 11. Excessive warrants and options
 12. Excessive offering expense
 13. High risk offering
 14. Promoter or officer under investigation in another state (securities)
 15. Firm under investigation (includes tax issues (sales & income), and antitrust concerns)
-

TABLE XII
THREE-YEAR COMPARISON OF TROUBLED
OFFERINGS WITH APPROVED OFFERINGS
DIVIDENDS

	Mean	Standard Deviation	Standard Error	Minimum	Maximum	T	F Prob > T
Approved	0.5613	1.9903	0.0720	0	15.1579	2.0976	0.0374
Troubled	0.2521	1.2126	0.1231	0	6.8689	1.4464	0.1484

Prob > F* = .0001

TABLE XIII
THREE-YEAR COMPARISON OF
TROUBLED OFFERINGS WITH APPROVED OFFERINGS
SHARE PRICE

	Mean	Standard Deviation	Standard Error	Minimum	Maximum	T	F Prob > T
Approved	11.0622	8.289	.29474	.062	66.000	7.6888	0.0001
Troubled	5.490	6.053	.6620	.062	35.75	6.4923	0.0001

Prob > F* = .0064

TABLE XIV
THREE-YEAR COMPARISON OF TROUBLED
OFFERINGS WITH APPROVED OFFERINGS
EARNINGS PER SHARE (Fully Diluted)

	Mean	Standard Deviation	Standard Error	Minimum	Maximum	T	F Prob > T
Approved	0.44282	1.2580	0.04584	-9.3099	10.9699	3.3329	0.0011
Troubled	0.06278	1.0282	0.1044	-3.5999	5.1699	2.8545	0.0044

Prob > F* = .0141

TABLE XV

SUMMARY OF PRESENT STUDY AND COMPARISON

WITH

PREVIOUS WORK

RESEARCH RESULTS OF

Goodkind (1975)	Walker and Hadaway (1981)	Jennings and Kudva (1984)	Jennings (1991)
More than 39 percent of issuers that were denied registration could not be located or refused to respond to requests for information as compared to only 14 percent for the registered issuers.	Less than one percent of all approvals went out of business, as compared with over 18 percent of all withdrawals.	More than 25% of the withdrawn filing issuers could not be located or did not respond to requests for information.	21% of withdrawn filing issuers could not be located or did not respond.
Cumulative dividends for the three years expressed as a percentage of the offering price was higher for the registered group.	Approved firms paid higher dividends per share as a percent of offering price.	Holding period returns were significantly higher in year 1 for those securities withdrawn from the registration process.	48.8% of issuers subjected to intense regulatory review could not be located or not respond.
Book value per share was approximately 19 percent higher after three years for the registered issuers.	Withdrawn firms had a greater decrease in book value per share as a percent of offering price.	There were no significant differences in holding period returns between withdrawn and approved firms in years 2, 3, and 4.	66% of withdrawn issuers could not be located or did not respond.
Average price after three years was approximately 28 percent higher for the registered issuers.	Approved firms had a more than double increase in price per share as a percent of offering price three years subsequent to the offering as compared to withdrawn firms.	Total assets of withdrawn firms were smaller.	Difference in mean figures in dividends not attributable to status of approval or withdrawal (appears to be a function of market perception of risk).
			Share prices for approved firms are higher at end of the three-year period (significant)
			Earnings per share higher for approved group but not attributable to approved status.
Market value of the registered shares in the sample after 3 years had an average gain of \$726,506 per issue while the value of the shares denied registration had an average loss of \$2,117,878 per issue.	Cumulative total returns, considering both capital appreciation and dividends earned, were more than twice as high for the approved firms three years subsequent to the offering as compared to the withdrawn group.		Withdrawals of troubled offerings (as designated by regulators) had a share price less than half of approved offerings and earnings per share only 20% of approved offerings with dividends less than half (not significant).
Issuers that were denied registration because of multiple deficiencies had a substantially poorer performance than the registered issuers.	Withdrawals for multiple merit standard reasons had the worst price performance of any group.		

Due to risk factors, dividend comparison yields no significant results. However, with only slight differences in standard deviation, both share price and earnings per share are significantly less for the troubled offerings. The level of significance is evidence of Arizona regulators' abilities to question correctly those offerings that prove to be poor performers as compared with approved offerings. Additionally, 225 or 48.8% of the 461 offerings were in the group which remained unavailable after two and three-contact efforts. The highest levels of significance came in this comparison group and demonstrate regulator's ability to ferret out those offerings most likely to prove costly to investors.

VI. CONCLUSIONS AND RECOMMENDATIONS

A summary of the study results is found in Table XV. Among numerous other conclusions drawn from the study is one regarding the focus and purpose of merit review. There are two types of investors: (1) knowledgeable investors (those capable of paying for competent evaluations of securities offerings), and (2) all other investors. The knowledgeable investor is as capable as the Division of running standard reviews regarding earnings records, dilution, underwriters' compensation and loans to insiders. In fact, except in category 2 and 3 cases where the Division requests additional information, regulators have no more information the market has.

On the other hand, there is a second type of investor—the investor who lacks either the skills necessary to evaluate an offering or the financial means to pay for such an evaluation. For these investors, regulatory review provides the type of analysis that they are unable to perform or obtain.

Merit review remains a controversial issue because its role remains unclear, and critics voice concerns regarding its indirect impact and its costs. Regardless of the outcome of quantitative comparisons and analysis, it is clear that there are significant administrative costs associated with filings. These administrative costs cannot be measured, nor can the effect they may have in precluding firms from registering offerings. Further, merit review introduces an indirect form of regulation in that, for example, it serves as a control mechanism for compensation of officers and directors through the direct limitations of commissions, warrants options and promotional stock.

In many cases, these items are negotiated with regulators in order to obtain approval and market price controls are thus

eliminated. Additionally, merit review may present unusual barriers for smaller firms that cannot qualify for an exemption and which, as a result, must carry registration costs. Nearly all merit states offer an exemption for national stock exchange firms.⁷⁰ The stringent exchange requirements preclude most new firms from meeting an exemption.⁷¹

Many merit states employ a double standard when reviewing new companies as opposed to companies with earnings records. These standards emerge in the forms of stricter registration requirements,⁷² impounds,⁷³ or escrows.⁷⁴ This form of regulation, based on size and lack of earnings, precludes investors from choosing a high-risk, possibly high-return investment. This form of regulation will exclude from the capital markets those firms with ideas but no capital.

These barriers are costly in terms of innovation, entrepreneurship, and our ability to compete in the international markets.⁷⁵ The effect of these price, impound and escrow require-

70. See, e.g., MO. REV. STAT. § 409.402(a)(8) (1990), which exempts securities listed or approved for listing on the New York, American and Midwest Stock Exchanges. The statute empowered Missouri's administrator to add exchanges and the Pacific Coast Exchange was later added. MO. CODE REGS. tit. 30, § 30-54.060 (1980).

71. For example, New York Stock Exchange has the following eligibility requirements: (a) 2,000 holders of 100 shares or more; (b) 1,100,000 shares publicly held; (c) market value of publicly held shares of at least \$18,000,000. The Exchange does have an alternative method of establishing eligibility—(1) \$18,000,000 in net tangible assets; (2) earning power before federal taxes of \$2,500,000 in the last year and \$2,000,000 in each of the two years preceding. The Exchange can also impose additional requirements for trading shares held in one concentrated geographic area. *New York Stock Exchange Equity Products Listed Company Manual Supplement*, #2, §§ 101.00-104.00 (1985).

72. One such restriction is to set the offering price at the price promoters and other insiders have paid. See, e.g. WIS. ADMIN. CODE § 3.02(2)(1984).

73. Arizona regulators are permitted to impound funds as a condition for registration. The funds are held by a third party but cannot be released without authorization from the administrator (for a maximum of 1 year). See ARIZ. ADM. COMP. R. & REGS. R14-4-112 (1985) and IOWA ADMIN. CODE r. 510-50.31 (502) (1983).

74. Escrow arrangements permit the administrator to hold the stock of promoters in escrow as a condition of registration. The stock is released when the offeror establishes a satisfactory earning record for one year and is solvent. See, IOWA ADMIN. CODE r. 510.50.37 (1983) and TEX ADMIN. CODE tit. 7, § 113.3 (5) (1992).

75. Congress has recognized these peculiar problems of small business financing. In the Omnibus Small Business Capital Formation Act of 1980, the SEC received Congressional authorization "to cooperate with any association composed of duly constituted representatives of state governments whose primary assignment is the regulation of securities business within those states" for purposes of "the development of a uniform exemption from registration for small issuers which can be agreed upon among the several states or between the states and the Federal Government." 15 U.S.C. § 77s(c)(1) and (c)(3)(c) (1982). Regulation D was the result of

ments is administrative control of the risk that can be passed on to the public. For example, a firm with no history of earnings may be forced to accept a price reduction from administrators in order to obtain approval for an offering.

Upon market release of the offering, the market could create a "hot issue" if public perception of the quality of the offering differs from the perceptions of the administrators.⁷⁶ The result is that the offeror clearly could have raised more capital with the profit from underpricing going to initial investors who immediately engage in secondary sales.⁷⁷ If this be the case, administrators interfere with efficient market forces. When this type of interference is characterized as insider trading, it is considered so unfair as to constitute criminal conduct.⁷⁸

The filings, follow-ups and registrations with merit administrators increase the overall offering costs and reduce net capital raised. Although there is a uniform application for state approval, there are no uniform standards; offerors are forced to negotiate on a state-by-state basis.⁷⁹ Further, the presence of the generic "fair, just and equitable" standards offers administrators broad discretion⁸⁰ and many offerings are approved in some jurisdictions but withdrawn in others.⁸¹ Many administrators base their reviews on years of experience and some critics note there is no indication they are any more able to predict risk.⁸²

cooperative efforts. See, *supra*, notes 14-17 and accompanying text.

76. A "hot issue" is one that sells at a price above the established price for the offering because public (market) perception is that the issue is worth more.

77. Bloomenthal, *supra* note 60, at 1486.

78. Federal registration provides for full disclosure—a premise in the efficient market hypothesis and fully supported by market theorists. Beyond full disclosure, manipulation and elimination accomplished by merit standards, creates the secondary sales profit noted earlier. See notes 76 & 77, *supra*, and accompanying text.

79. Bateman, *supra* note 61, at 781.

80. For example Loss and Cowett note: "A midwestern administrator replied that he looked on uranium issues with a 'jaundiced eye' and disapproved them 'unless they are of such a nature that we might be tempted to invest our own money in them.'" Loss & Cowett, *supra* note 6, at 77.

81. Some "merit review" states are simply full disclosure states since merit standards are not always applied. For example, Maryland is listed as an antifraud/disclosure state with a "fair, just and equitable" standard but allows registration by coordination—the state offering is effective upon SEC registration. See MD. CORPS & ASS'NS CODE ANN. §§ 11-502, 503 (1985 & Supp. 1990).

82. Mofsky states: [State] administrators are no better able than anyone else to evaluate the riskiness of a given venture. If they were, it is unlikely that they would be administering the securities law rather than maximizing their wealth in a more profitable way. James F. Mofsky, *Reform of the Florida Securities Law*, 2

It is clear, however, from the Arizona experience, that when regulators target a particular proposed offering because of serious or multiple concerns (as listed in Figure 2), their record is nearly perfect. This area of their work is perhaps the most relevant in an analysis of their efficacy. Because withdrawals are often voluntary, a comparison of approved offerings with withdrawn offerings necessarily groups together offerings that are heterogeneous. A withdrawal may follow a request for information as a means of avoiding administrative costs and focusing attention on the offering in other states. However, it is important to note that fully 224, or 48.5% of these troubled offerings were still eventually approved and 237 or 51.4% of them fell into the category of companies that could not be located.

One of the more interesting findings of the study is that dividend rates for the withdrawn and troubled offerings are higher, a reflection of market perception of higher risk and hence a mandated higher rate of return. The philosophical questions remain about the right to earn that higher rate of return and the heterogeneity of investor goals.

The more appropriate question is not whether regulators are able to screen every offering to maximize investment potential, but whether regulators can actively prevent poor investment decisions regardless of goals. It is clear from their record on multiple problem offerings that Arizona regulators can help to prevent such poor decisions. The follow-up question is whether pre-screening is more effective and less costly than post-offering enforcement action.

While the academic debate may continue, for those who are saved from a bad investment, the answer is that an effective regulatory system is in place that serves to prevent investor losses. Public gratitude for and perception about that system cannot be underestimated—particularly in those states in which regulators report directly to elected officials.

An examination of the Arizona review process and its often

FLA. ST. U. L. REV. 1, 30 (1974). See also Robert H. Edwards, *California Measures the Uniform Securities Act Against Its Corporate Securities Law*, 15 BUS. L. 814 (1960).

Edwards noted: "The commissioner had established specific little rules that had to be followed by the deputies, who could not really exercise basic judgement on the merits of the security as a whole."

Id. at 823.

too-detailed requests of registrants raises the issue of whether a high success rate could be achieved if regulators would focus more on problem offerings and less on crossing "t's" and dotting "i's." Troublesome and time-costly barriers of regulatory details should not be underestimated. The investigation of substantive questions would likely render a more efficient use of administrative resources by returning more effective capital deterrents.