Merit Regulation via the Suitability Rules

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Abstract

The philosophy underpinning federal securities regulation in the United States is one of disclosure. This has been the case since the inception of federal securities regulation in 1933,[2] and continues to be the case with Congress's most recent enactments on the subject, contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.[3]

In the wake of the financial industry's collapse in 2008, and the recession it helped spark, some have questioned whether this paradigm remains advisable.[4] They have suggested the introduction of merit regulation into the U.S. securities law regime, whereby the government would not merely mandate certain issuer disclosures, but would also prevent the offering of securities deemed too risky.[5] Although not revolutionary (as several American states, and nations such as China, have a merit component to their securities laws), the concept of merit regulation is indeed largely alien to the scheme of U.S. federal securities regulation.[6] As such, it would be a transformative development.

There is, however, a far more modest way of approximating the same result. And it builds upon our existing regulatory infrastructure: suitability rules. Via enhancements to the suitability rules, policymakers can achieve much of what merit regulation promises, without the significant, accompanying drawbacks. Properly enhanced, such rules could provide a system that safeguards investors from unsuitably risky investments on a case-by-case basis, thereby depriving neither corporations, nor investors, of mutually beneficial opportunities that might be fully appropriate for them despite their inappropriateness for others. It could also furnish an additional tool by which authorities could regulate systemic risk.

Like Caesar's Gaul, this Article is divided into three parts. Part I will describe the disclosure-based federal securities regulatory regime that prevails in the United States today. It will highlight the limitations of this regime, as underscored by merit-regulation proponents seeking its reform. Part II will describe merit regulation, both in theory and in practice. It too will end with an articulation of the drawbacks associated with such an approach. Part III will describe the "suitability rules" component of U.S. securities law, as they are currently formulated. Part III will also demonstrate how the suitability rules can be utilized to essentially achieve the desideratum of merit regulation without the costs associated therewith.

Key words: suitability, merit regulation, securities regulation, broker regulation

1.1 The disclosure based regime of U.S. federal securities regulation

Prior to 1933, securities regulation in the United States was largely a matter of state concern – much like corporate law.[7] As will be discussed in Part II, state securities regulation (commonly referred to as the "blue sky laws") followed primarily a merit-based approach.[8] Pursuant to this approach, "securities proposed to be sold in a state [must] be submitted to an administrative agency for review as to their 'merit' or intrinsic

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[2] Securities Act of 1933, ch. 38, 48 Stat. 74 (1938) (current version at 15 U.S.C. §§ 77a-aa (2006)).
[3] Wall Street Reform and Consumer Protection Act, Pub. L. 111-203 , § 171(b)(4), 124 Stat. 1376 (2010).
[4] *See* Joan MacLeod Heminway, *The Best Of Times, The Worst Of Times: Securities Regulation Scholarship And Teaching In The Global Financial Crisis*, 5 J. BUS. & TECH. L. 59, 68 (2011).
[5] *See id.*
[6] Robin Hui Huang, *The Regulation of Securities Offerings in China: Reconsidering the Merit Review Element in Light of the Global Financial Crisis*, 41 HONG KONG L. J. 261, 261 (2011); Jennifer J. Johnson, *Private Placements: A Regulatory Black Hole*, 35 DEL. J. CORP. L. 151, 156 (2010).
[7] 1 FEDERAL REGULATION OF SECURITIES §1 (1995).
[8] *See infra* Part II.

worth."[9] Despite a generation of experience with such an approach,[10] the federal regulation of securities took a decidedly different tack.[11] Instead of following the states' merit-based approach, the U.S. Congress adopted a disclosure-based regime of securities regulation when it moved into action.[12]

Prompting federal action was the stock market crash of 1929, and the practices leading up to it (especially as they came to light in subsequent investigations and inquiries).[13] And it is easy to see why. Quantitatively, the losses were staggering. "The aggregate value of all stocks listed on the NYSE on September 1, 1929, was $89 billion…. In 1932, the aggregate figure was down to $15 billion."[14] Qualitatively, the cover was ripped off of corporate practices that were roundly condemned as unscrupulous and immoral.[15] Among other things, prior to the crash, a nation hungry for speculative securities was willingly fed by promoters whose practices ranged from hype and puffery to downright misrepresentation.[16] "[I]nvestors, who had been given little information about the securities they had invested in, were allured by promises of easy wealth and became victims of widespread fraud and manipulation."[17]

Congress's initial response was the 1933 Securities Act.[18] Pursuant to the 1933 Act, an issuer of securities is required to make certain, specific public disclosures before selling its securities.[19] These disclosures are made to the SEC via a publicly available registration statement – and summarized in a prospectus to be distributed to prospective investors before or at the time of their securities purchase.[20] To buttress the credibility of these disclosures, strict anti-fraud rules are also contained in the 1933 Act, making it far easier (in many cases) for a defrauded investor to recover from an unscrupulous issuer than had been the case under state law.[21]

The 1933 Act was followed up by the 1934 Securities Exchange Act, which added to the volume of required regulatory disclosures.[22] Under the 1934 Exchange Act, the issuer of a publicly traded security is obliged to issue periodic reports well after an offering of securities: annual reports, quarterly reports, and periodic reports triggered by certain specified occurrences.[23]

Additional securities legislation flowed out of Congress throughout the 1930s, but this legislation was more targeted in its focus, as can be gleaned from the names of the acts in question: the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisors Act of 1940.[24] Further, in these acts, Congress demonstrated a greater willingness to engage in aggressively substantive lawmaking – moving beyond simply disclosure and antifraud rules.[25] But, to the extent that this is so, these acts, and their specialized applicability, represent the proverbial exceptions that prove the rule: the overall approach to the regulation of securities issuance and trading in the United States is set forth in the 1933 and 1934 Acts, which are firmly disclosure-based pieces of legislation.

A driving force behind the federal approach was Louis D. Brandeis, who famously remarked that "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[26] In other words, enhanced disclosure would lead to better securities industry practices, by making unsavory practices more difficult to conceal or get away with.[27]

Other factors were at work as well, however. The British experience with securities regulation, with which Congress was also familiar, was disclosure based, giving Congress something other than the blue-sky

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9 Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 348 (1991).
10 *See id.*
11 *See* Louis Loss, Joel Seligman, & Troy Paredes, 1 FUNDAMENTALS OF SECURITIES REGULATION 45-46 (2011).
12 *See id.*
13 *See* Ronald J. Colombo, *Buy, Sell, or Hold?*, 73 BROOK. L. REV. 91, 119-120 (2007).
14 Loss, *supra* note 11, at 45.
15 *See* Colombo, *supra* note 13, at 119-121.
16 *See* Macey, *supra* note 9, at 355.
17 *See* Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 144 (2006).
18 *See* Loss, *supra* note 11, 45-46.
19 *See id*. at 57.
20 *See id.*
21 *See id.* at 47.
22 *See id.* at 58.
23 *See id.* at 58-59.
24 *See* 60-74.
25 *See* 60-61.
26 *Id.* at 46.
27 *See* Ripken, *supra* note 17, at 151.

model to consider.[28] Then there was the prospect of federal merit regulation in practice: would not an enormous and potentially unworkable new apparatus be required to implement such a regime?[29] Further, Congress was attempting to thread the needle and devise a regulatory regime that would simultaneously protect investors without impeding corporate access to the capital markets.[30] It found a disclosure-based approach best suited to this delicate balancing act.[31] Congress also feared the signaling effect that federal merit regulation might bring about, as it wanted to "avoid the implicit approval by the federal government of the merits of any securities offered for sale to the public."[32]

Finally, there was the economic argument that the provision of adequate information via disclosure would lead to increased "transparency and efficiency in the securities markets."[33] This, in turn, produces "increased price stability and diminished market volatility."[34] Although disclosure may not be a panacea, it was seen as something coming very close to one.

In sum, then, the "main goal of the securities laws [was] to provide sufficient disclosure to enable investors to make informed decisions about the securities they buy and sell."[35]

Over time, policymakers have remained fairly faithful to this mission. The two most recent and comprehensive reforms of the securities laws, the Sarbanes-Oxley Act of 2002[36] and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010[37] attest to this. Although each contains an aggressive dose of substantive regulatory reform, each also generally carries on the tradition of regulating through disclosure. Sarbanes-Oxley, for example, requires public companies to disclose *whether* they have at least one "financial expert" on their board of directors – but does not actually require the presence of one.[38] Dodd-Frank directed the SEC to promulgate rules requiring public companies to disclose their efforts to avoid the purchase of "conflict minerals" – without prohibiting the actual purchase thereof.[39] Indeed, it has been observed that "[t]here is a recurrent theme throughout [the federal securities laws] of disclosure, again disclosure, and still more disclosure."[40] As Susannah Kim Ripken observed:

> The disclosure of material information is said to do everything from producing more transparent and efficient markets, to making corporate executives behave more honestly and diligently, to decreasing investor risks and protecting the public interest.

In the wake of continued financial crises since the Great Depression (and especially in the wake of the 2007-2009 recession), some have questioned the effectiveness of the American disclosure-based system of securities regulation.[41] They echo arguments raised long ago by William O. Douglas, expressed in the 1930s, that a disclosure-based would be simply too simplistic for the complex world of modern finance:

> The whole business [that is, the 1933 and 1934 acts] is essentially a "nineteenth-century piece of legislation" that unrealistically envisages a return to "Main Street business." This

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[28] *See* Charles H.B. Braisted, *State Registration of Securities*: *An Anachronism No Longer Viable*, 78 WASH. U. L. Q. 401, 405 (2000).
[29] *See id.* William O. Douglas, who favored a merit-based approach, was apparently fully aware of what it would entail yet not dissuaded: he acknowledged that it would require a "government agency … 'a thousand fold more complex than the … Interstate Commerce Commission.'" *See* Loss*, supra* note 11, at 48.
[30] *See* Braisted, *supra* note 28, at 405.
[31] *Id.* ("Congress chose the disclosure philosophy as the best protection for public investors because it allowed each investor to make his or her own investment decision based on full information, without imposing an unreasonable restraint on legitimate business finance.") James Cox observes that "there is a clear inconsistency between professing obeisance to capitalism and allowing civil servants to dictate what ventures may raise funds in capital markets." James D. Cox, *Regulatory Duopoly in the U.S. Securities Markets,* 99 COLUM. L. REV. 1200, 1200 (1999). Although there is truth in this, I question whether the New Deal policymakers behind the 1933 and 1934 Acts can be said to have professed "obeisance to capitalism."
[32] Braisted, *supra* note 28, at 405.
[33] Ripken, *supra* note 17, at 153.
[34] *See id.* at 154.
[35] *See id*. at 144.
[36] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).
[37] Wall Street Reform and Consumer Protection Act, Pub. L. 111-203 , § 171(b)(4), 124 Stat. 1376 (2010).
[38] *See* Ripken, *supra* note 17, at 144-45.
[39] Sarah A. Altschuller, Amy K. Lehr, & Andrew J. Orsmond, *Corporate Social Responsibility*, 45 INT'L LAW. 179, 183-84 (2011). "'Conflict minerals' include tantalum (coltan), cassiterite (tin), wolramite (tungsten) and gold. The sale of conflict minerals, it is believed, helps armed groups fund the purchase of weapons and allows them to continue hostilities in the [Congo]." *Id.*
[40] Ripken, *supra* note 17, at 145 (alteration in original).
[41] *See id.* at 139-148.

> explains, among other things, the "great reliance placed on truth about securities, as if the truth cold be told to people who could understand it – a supposition that might be justified if little units of business were seeking funds and people were buying shares with the modicum of intelligence with which they are supposed to buy wearing apparel or horses." We cannot "turn back the clock" to simpler says, said Douglas. We must perfect a plan for control of our present forms of organization so as to harness the "instruments of productions not only for the ancient purpose of profit but also for the more solely evolving service in the sense of the public good." … "The control needed is one which would combine regulation by industry with supervision by government." … Ultimately, there must be some form of control over access to the capital market, Douglas believed.[42]

More specifically, the critiques of the U.S. disclosure-based system of securities regulation can be divided into two categories: those criticizing the system from the standpoint of investor protection, and those criticizing the system from the standpoint of systemic risk.

With regard to the question of investor protection, the critics of the disclosure approach mistrust the "prudence of investors."[43] They question whether investors, even if armed with all necessary and relevant information, will make investment decisions that are sound and reasonable.[44] Indeed, they question whether investors will even be able to capably understand the information disclosed to them.[45] In short, these critics seek to protect investors from themselves. Their perspective is unquestionably a paternalistic one, but one also one rooted in historical experience.[46] "Exhibit A" in support of this position has been the financial crisis of 2008.[47]

The critique also draws support from the observation that financial instruments have grown increasingly (and incredibly) complicated.[48] Indeed, it has been stated that "some structures are getting so complex that they are incomprehensible."[49] This calls into question the utility of disclosure as a means of investor protection.[50]

The second line of attack concerns systemic risk. Simply put, the capital markets are deemed simply too vital and complicated to be left, fundamentally, in private hands.[51] As per Douglas, "a more thoroughgoing and comprehensive control is needed."[52] The capital markets "should be lodged 'in the hands not only of the new self-disciplined business groups but also in the hands of government agencies whose function would be to articulate the public interest with the profit motive.'"[53] This concern is not so much about protecting investors from themselves, but about protecting everyone from those who would invest imprudently. It is predicated upon the notion that an individual's (or, more likely, an institution's) poor investment decisions can impose negative externalities upon others. Once again, "Exhibit A" in support of this contention is the financial crisis of 2008.[54] The crisis demonstrates vividly how the disclosure approach

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[42] *See* Loss*, supra* note 11, at 48.
[43] Daniel J. Morrissey, *The Road Not Taken: Rethinking Securities Regulation and the Case for Federal Merit Review*, 44 U. RICH. L. REV. 647, 649 (2010).
[44] *See id.* at 681.
[45] *See id.*
[46] *See id.* at 648.
[47] *See id.* The degree to which the financial crisis of 2008 serves to condemn the U.S. disclosure-based system of securities regulation is an interesting question – and one that is a bit beyond the scope of the this Article. On the one hand, most of the financial instruments and transactions at the heart of the crisis fell outside of the disclosure rules. *See id.* 683. Due, in large part, to the sophistication of the actors in question, much of the activity that precipitated the crisis was exempt from the myriad rules and regulation requiring disclosure. *See id.* This suggests that, if anything, the crisis provides a more trenchant indictment of the *exemptions* from the disclosure regime – rather than an indictment of the disclosure regime itself. That said, the actors involved were typically quite sophisticated – and either had access to (or could have likely obtained) whatever information would have been provided to them had the transactions not been exempt from the disclosure requirements. Thus, it is unlikely that things would have been significantly different had these transactions been fully registered and accompanied by the disclosures required of non-exempt transactions. *See id.*
[48] *See* Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. ILL. L. REV. 1, 12 (2004).
[49] *Id.*
[50] *See id.*
[51] *See* Morrissey, *supra* note 43, at 681.
[52] *Id.* (quoting William O. Douglas, *Protecting the Investor*, 23 YALE L. REV. 521, 522-23 (1934)).
[53] *Id.*
[54] *See id.* at 683.

to regulation leaves each of us exposed to harm and fallout resulting from the poor investment choices of others.[55]

2. Merit regulation

As already indicated, when the United States enacted a regime of federal securities regulation, the road not taken was that of merit regulation.[56] "Merit regulation" is what generally characterized the state regulation of securities at the time of the federal securities laws' promulgation.[57] (Indeed, merit regulation continues to characterize much of the state regulation of securities today – an area of regulation persists to the degree that it has not been preempted by federal legislation.[58])

The American experience with merit regulation (and, moreover, with securities regulation generally) was commenced in the early part of the twentieth century.[59] Prior to that time, securities transactions were not subject to any specialized body of law or regulation.[60] In 1911 Kansas enacted the first law in America regulating the sale of securities – and by the Great Depression, every state had followed suit.[61] The Kansas law, like many, was enacted in response to widespread securities fraud in that state.[62] As a result, these state securities laws were soon given the name "blue sky laws," because they were passed to combat the efforts of securities fraudsters to sell building lots in the blue sky to gullible investors.[63]

As the moniker "merit regulation" suggests, this approach to securities regulation entails "review by a state securities commissioner (or administrator) to determine whether the quality of a given issue of securities was [or is] adequate for sale in that state."[64] As one commentator put it: "Merit regulation seeks to foster fairness, to regulate the riskiness of investments offered, to prevent fraud, and generally to increase investor confidence."[65] Of course, the same can be said (and is said) of disclosure-based regulation. The difference being is that the disclosure approach allows investors and the market to determine whether a given offering is fair or excessively risky, whereas it is a government official who makes that determination in merit regulation.

Merit-regulation does not purport to screen for only the highest-quality investment options – quite the contrary, it endeavors merely to "assure that all securities will be of at least minimum quality."[66] That is, the securities must simply be found fit for sale (and purchase) – they may still be generally undesirable for a host of reasons. The standard employed in determining the fitness of a security is ordinarily that the terms of the securities offering be "fair, just and equitable."[67] Although the factors consulted in making this determination vary somewhat from state to state, a universally important factor is an evaluation of the portion of proceeds going to the issuer versus the portion going to underwriters.[68] Other factors consulted include "options and warrants to be issued in connection with the offering, cheap stock, the extent of the existing capitalization of the issuer, the promoters' investment, dilution, the offering price, voting rights, loans to promoters and offering expenses generally."[69] In short, the merit regulator is (in many states) empowered to "act[] as a negotiator in getting a better deal for investors."[70] The merit regulator polices the transaction to protect investors from offerings that are unscrupulous, unfair, or simply too risky.[71]

Additionally, merit regulators have assumed the power to "directly intervene to require changes in the internal structure of a securities issuer, the relations among insiders and outsiders, and the terms of the

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[55] *See id.*
[56] *See supra* text accompanying notes 7-12; *see also* Morrissey, *supra* note 43, at 647.
[57] *See* RICHARD A. BOOTH, FINANCING THE CORPORATION §9.13 (2012).
[58] *See id.* That said, not all state securities legislation is truly "merit regulation" – some take a different approach. *See* Roberta S. Karmel, *Blue-Sky Merit Regulation: Benefit to Investors of Burden on Commerce?* 53 BROOK. L. REV. 105, 105 (1987).
[59] *See* Booth, *supra* note 57, at §9.2.
[60] *See* Morrissey, *supra* note 43, at 677-78.
[61] *See id.*
[62] *See* Booth, *supra* note 57, at §9.2.
[63] *Id.; see also* James E. Ballowe, Jr. & Penelope Y. F. Tham, *State Blue Sky Regulation*, 816 PLI/CORP 433, 435 (1993).
[64] Booth, *supra* note 57, at §9.2.
[65] *Id.*
[66] *Id.*
[67] *Id.*
[68] *See id.* "As a general rule, commissions in excess of 15 percent will not pass muster in a merit regulation state." *Id.*
[69] *Id.;* see also Ballowe & Tham, *supra* note 63, at 443-46.
[70] Karmel, *supra* note 58, at 116.
[71] *See* Ballowe & Tham, *supra* note 63, at 437.

offering."[72] As such, the merit regular has broad authority to demand changes to a corporation or its proposed offering before allowing a securities offering to proceed.

Further still, most merit-regulation jurisdictions impose licensing requirements on securities broker-dealers, and ban offerings by issuers who officers have run afoul the law.[73]

As with the disclosure regime, merit regulation has its detractors. The screening of proposed securities offerings by government officials "clearly imposes burdens on capital formation."[74] Not only must securities issuers convince the capital markets of their offering's worthiness, but they have the added hurdle (and costs) of having to convince a regulator as well. With that hurdle comes the risk of regulator error: the prospect that a quality offering will be wrongfully rejected.[75] The specter of corruption and bias in the process must also be considered.[76]

The paternalistic philosophy of merit regulation is also challenged.[77] Even if such paternalism could have at one time been justified, it cannot be so today (so goes the argument).[78] For merit regulation arrived on the scene during the era of the individual investor, but today is the era of the institutional and professional investor.[79] Today's investors (many of them at least) may very well be more sophisticated than the regulators themselves. It seems like folly, therefore, to allow a regulator to dictate what offerings an investor can or cannot partake in from some consumer-protection rationale focused on fairness and appropriate risk.[80]

Standing in obvious response to the anti-paternalism argument is the simple fact that even large, sophisticated, institutional investors made a series of tremendously bad investments in the run-up to the 2008 financial crisis.[81] But in an important respect, this criticism misses the mark. The critics of merit regulation's paternalism do not claim that the twenty-first century investor is infallible. Rather, these critics query whether a government regulator would be any less fallible.[82] The point is a good one, and not to be dismissed lightly. There is no reason to believe that the best-and-the-brightest financial experts are inevitably drawn to Washington, D.C. In fact, given the substantial draw of lucrative private sector salaries, it is difficult to see why this would be the case. At best, therefore, one could hope that government regulators are on par with those whom they regulate in terms of expertise and ability.

There is, however, at least one important factor that may help level the playing field – or, perhaps, give the government's regulators an advantage: access to information. Quality information is, arguably, one of the most precious commodities in our modern world – and especially so within the financial services industry and the capital markets. Armed with the new powers and tools by Dodd-Frank Act,[83] today's regulators undoubtedly have greater access to critical information than their counterparts in private industry. Whereas a top flight private analyst has access to abundant publicly-available information, a government regulator has access to all that and much more: to nonpublic information procured via subpoena and other means.

Another line of criticism against merit regulation is that it failed to prevent the crisis of 1929.[84] After

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[72] Karmel, *supra* note 58, at 116.
[73] *See* Ballowe & Tham, *supra* note 63, at 441-42.
[74] *Id*., at 106. *But see* Manning Gilbert Warren III, *Legitimacy in the Securities Industry: The Role of Merit Regulation*, 53 BROOK. L. REV. 129, 140 (1987) ("The argument that capital formation is impeded by state securities regulation, and, more particularly, merit regulation is … highly suspect.").
[75] *But see* Jay T. Brandi, *The Silver Lining in Blue Sky Laws: The Effect of Merit Regulation on Common Stock Returns and Market Efficiency*, 12 J. CORP. L. 713, 734 (1987) (finding that "the criticism regarding market inefficiency due to merit restrictions may be unwarranted").
[76] On a related note, corruption in the traditional process of corporate chartering (which, like the merit regulation of securities, was done on a company-by-company basis) is what led, in part, to the promulgation of statutes of general incorporation (depriving state regulators of discretion in the granting or denial of corporate charters). Gregory A. Mark, *The Court And The Corporation: Jurisprudence, Localism, And Federalism*, 1997 SUP. CT. REV. 403, 414 (1997).
[77] Ballowe & Tham, *supra* note 63, at 448-49.
[78] *See id.* at 448-49.
[79] *See id.*
[80] *See id.*
[81] Morrissey, *supra* note 43, at 681.
[82] Rutheford B. Campbell, Jr., *An Open Attack on the Nonsense of Blue Sky Regulation,* 10 J. CORP. L. 553, 565-67 (1985); Mark A. Sargent, *Report on State Merit Regulation of Securities Offerings,* 41 BUS. LAW. 785, 853 (1986).
[83] Wall Street Reform and Consumer Protection Act, Pub. L. 111-203 , § 171(b)(4), 124 Stat. 1376 (2010); *see* So-Yeon Lee, *Financial Stability Oversight Council*, 30 REV. BANKING & FIN. L. 528, 534-35 (2011).
[84] Joel Seligman, *The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation*, 93 MICH. L. REV. 649, 673 (1995).

all, by the time of the crisis, most states had adopted some form of merit regulation.[85] However, the crisis of 1929 was national in scope, and as such arguably beyond the realistic reach of state regulators to prevent or contain.[86]

Perhaps the most forceful critique of merit regulation – on a federal level, at least – is its simple unworkability. It is difficult to imagine how the SEC, or any federal agency, could effectively provide a merit review of each and every proposed securities offering. An enormous increase in staffing and resources would be required – and even that fails to guarantee whether sufficient expertise would be available to adequately analyze the volume of offerings expeditiously enough.

3. Effectuating Merit Regulation via the Suitability Rules

A. The Suitability Rules

The "suitability rules" require that a broker, when recommending a securities transaction to a customer, does so based upon the informed belief that the transaction is "suitable" for the customer.[87] This requirement is not imposed by the federal securities laws, but rather by the securities exchanges themselves.[88] For brokers of the New York Stock Exchange, the relevant rule is FINRA Rule 2111.[89] Although not absolutely identical, the suitability rules adopted by all other securities exchanges in the United States substantially follow FINRA Rule 2111.[90]

Rule 2111 reads, in its entirety, as follows:

> (a) A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.
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> (b) A member or associated person fulfills the customer-specific suitability obligation for an institutional account, as defined in Rule 4512(c), if (1) the member or associated person has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities and (2) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the member's or associated person's recommendations. Where an institutional customer has delegated decisionmaking authority to an agent, such as an investment adviser or a bank trust department, these factors shall be applied to the agent.[91]

Rule 2111 is frequently, and advisably, read in conjunction with FINRA Rule 2090 – FINRA's "know your

[85] *See supra* text accompanying note 61.
[86] James E. Ballowe, Jr. & Penelope Y. F. Tham, *State Blue Sky Merit Regulation,* 816 PLI/Corp 433, 437 (1995); Thomas E. Geyer, *Viewing the Columbus Skyline: Incorporating Federal Law into the Anti-Fraud Standard of the Ohio Securities Act,* 28 U. TOL. L. REV. 301, 305-06 (1997).
[87] *See* 1 CLIFFORD E. KIRSCH, BROKER-DEALER REGULATION §11:1.1 (2D ED. 2012).
[88] *See id.* That said, courts have held that a violation of the suitability rules can also constitute a violation or Rule 10b-5, the anti-fraud provision promulgated by the SEC under the 1934 Securities Exchange Act. *See id.*
[89] *See* FINRA Rule 2111 (*available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=13390&element_id=9859&highlight=2111#r13390).
[90] *See* Jennifer A. Frederick, *Not Just For Widows & Orphans Anymore: The Inadequacy Of The Current Suitability Rules For The Derivatives Market*, 64 FORDHAM L. REV. 97, 110 n.79 (1995). It should be noted that if a broker is primarily in the business of rendering investment advice, then the broker would instead be regulated by the Investment Advisors Act of 1940. *See* TREATISE ON THE LAW OF SECURITIES REGULATION, 5 Law Sec. Reg. § 14.16[1] (2012).
[91] *See* FINRA Rule 2111 (*available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=13390&element_id=9859&highlight=2111#r13390).

customer" rule.[92] This short rule reads, in its entirety, as follows:

> Every member shall use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer.[93]

Thus, suitability requires a broker to comprehend his or her client's financial situation ("investment profile") via the use of "reasonable diligence." Further, the broker must restrict his or her investment suggestions to those that are "suitable" to the client in light of the client's situation. Observe that what may or may not be suitable is not wholly determined by the client's own wishes, but rather takes into account certain objective factors ("the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance") that go well beyond a client's expressions of interest or desire. The broker is, therefore, expected to exercise a large degree of independent, professional judgment in determining whether to recommend a specific investment as suitable.

Although it is not clear from the Rule's text itself, the broker must (of course) also be well-versed in the security, and/or the security transaction, that he or she is recommending.[94]

Not surprisingly, a client's wealth and income are not dispositive factors. FINRA has held that a dealer "may not rely exclusively on the client's status as an accredited investor under Regulation D of the Securities Act for satisfying suitability obligations," because this status alone does not adequately inform the entire suitability analysis.[95] Further, the suitability requirement does not automatically vanish when a broker's client happens to be an institutional investor. As Rule 2111(b) explains, even in this situation the broker has important suitability obligations. More specifically, the broker must be satisfied that the institutional investor is capable of adequately evaluating the transaction in question, and the institutional investor must affirmative declare that it is indeed exercising independent judgment with regard to the transaction. (If the institutional investor is acting through an investment advisor, or the equivalent, then those factors are applied to that advisor.[96])

B. The Federalization of Suitability to Achieve Merit Regulation

The suitability rules are well-positioned to serve as a means by which the benefits of merit regulation can, to a significant degree, be realized. Moreover, this realization can occur without the more serious drawbacks that often accompany merit-based regulation, as addressed previously.[97]

As currently formulated, suitability rules (such as FINRA Rule 2111) vest a tremendous degree of discretion in the hands of brokers. But this need not be the case. The SEC could adopt guidance and mandates that would help brokers define certain investments as simply "suitable" or "unsuitable" for certain classes of investors defined by regulation.[98] In other words, the SEC could federalize the concept of suitability.

In so doing, the SEC would not be mandating regulatory approval for each and every proposed securities offering (along the lines of typical blue-sky merit regulation). Instead, the SEC would simply be promulgating broad guidelines that brokers would need to incorporate into their suitability analysis. From purely quantitative metrics such as earnings-to-price ratios, to more qualitative ones such as the issuer's particular industry, the SEC could promulgate standards against which a particular security's level of risk could be assessed. Based upon these standards, securities could be classified, by brokers, into particular "risk-bearing" categories themselves defined by the SEC. Thus, a security could be labeled "high risk" if,

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[92] *See* Kirsch, *supra* note 87, at §11:1.1.
[93] *See* FINRA Rule 2090 (*available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=13389&element_id=9858&highlight=2090#r13389).
[94] *See* TREATISE ON THE LAW OF SECURITIES REGULATION, 5 LAW SEC. REG. § 14.16[1] (2012).
[95] Kirsch, *supra* note 87, at §11:1.3.
[96] *See id.*
[97] *See supra* notes 74-86.
[98] This would not be entirely unprecedented, as the SEC has adopted its own suitability rule with regard to the trading of "penny stocks." *See* 1933 Securities Act Rule 15g-9.

upon an examination of its particular characteristics, including those set forth as relevant by the SEC, the security possesses a great deal of investment risk.

Of course, brokers, advisors, and industry analysts already do this, and one might question the utility of the SEC's guidelines, deeming then duplicative. But for at least two inter-related reasons, this is not the case.

First, in the aftermath of the Dodd-Frank Act, the SEC has broader access to non-public information than ever before.[99] Via use of the powers contained in the Act, the federal government can acquire information deemed critical to the nation's economic health, and share that information with agencies (such as the SEC) situated to act upon it. Thus, in promulgating its standards regarding an investment security's risk, the SEC could draw upon this information, and provide guidance that could not otherwise be replicated by private industry professionals. Thus, the risk-bearing classification would be based upon standards that are derived, in part, from important nonpublic information.

Second, the SEC's guidelines would reflect public policy determinations, whereas wholly private risk assessments ordinarily do not. As will be fleshed out momentarily below, depending upon how the risk standards are calibrated, the SEC's guidelines could effectively place certain securities off-limits for certain groups of investors. Moreover, the SEC's guidelines may consciously do this to implement a policy of keeping particular types of securities out of the hands of certain types of investors.[100]

Which brings us to the second prong of the approach: a classification of investors based upon particular, relevant characteristics. The SEC could promulgate an investor classification schema, pursuant to which investors could be placed into particular categories based upon their degree to tolerate and/or withstand risk. This too, is already done by brokers and other securities professionals, which once again begs the question: where is the value added by the SEC's roll-out of such a classification?

Unlike the classifications employed in the private market, the SEC's classification system need not be a simple exercise in lining up groups of investors, in order, between the poles "non-wealthy" and "wealthy" (with the assumption that the more wealthy the investor, generally speaking, the greater his, her, or its ability to withstand risk). Instead, the SEC's classification schema could (and should) take into account the principles embodied in the Dodd-Frank Act (and banking regulation in general) – namely, that certain entities are too systemically important to assume excessive levels of risk. Thus, the investor classification scheme should take into account the fact that certain investors, despite a high level of sophistication, and a substantial degree of wealth, are nevertheless placed into a lower-risk-tolerance classification on account of their systemic importance.

Finally, the SEC would furnish a "suitability matrix," which would tie these two variables together (a security's "risk bearing" classification, and an investor's "risk tolerance" classification). This matrix would identify which securities were suitable for which investors.

The matrix would not be a simple matching of "high risk" bearing securities with "high risk" tolerant investors, and so forth. Rather, it envisions a more complicated classification scheme, in which an investor's "risk tolerance" and a securities "risk bearing" classifications are not simple, one-dimensional characteristics. Rather, these classifications would themselves vary depending upon context. That is, the classifications would interact with one another, and thereby be further delineated. For example, a particular security could be deemed a "low risk" bearing instrument generally, but nevertheless "high risk" for a particular category (or categories) of investor. Or, from the opposite angle, an investor could be generally deemed to have a "high risk" level of tolerance, but that risk level drops to "low" or "intolerant" when confronted with securities of a particular type or bearing particular characteristics (related, perhaps, to an industry or some other factor that

[99] *See supra* note 83 and accompanying text.
[100] It should be noted that the SEC could take a more aggressive approach toward this same end. Instead of simply promulgating guidelines and standards, the SEC could take the next step and actually categorize each securities offering itself in accordance with these guidelines and standards. That is, the SEC could classify each offered security into a pre-established risk category, and make such classification binding upon the securities industry. This would come very close to implementing a federal blue-sky approach. However, there would be at least one significant distinction. Unlike typical blue-sky regulation, the SEC would not be authorized to block the underwriting of a securities offering based upon its substantive risk. Instead, the SEC would be limited to simply assigning the offering a risk classification which, as explained more fully below, would be cross-referenced with an investor's status and situation to determine the security's suitability. Such an aggressive approach would, however, require a tremendous amount of resources, and as such undermine one of the major benefits of the proposal over existing versions of blue-sky regulation, as discussed below.

would be singularly relevant to the investor classification in question).

Of course, not every possible interaction could be foreseen – and there are only so many categories into which securities and investors could be placed. The SEC's guidelines and matrix would not need to, nor purport to cover the entire field of potential securities transactions. Rather, the SEC would attempt to cover most of the field and, moreover, cover those transactions which the SEC believes most seriously need to be covered.

As ambitious as such an approach might initially seem, it does to a large extent build upon existing regulatory infrastructure and practices. At its heart lies the well-established suitability rules. The proposal essentially does little more than augment this privately administered system for regulating risk with federal guidelines and definitions.

Further, the prospect of classifying investors and securities is not entirely new to the SEC. For example, the SEC already classifies investors into certain categories, via its "accredited investor," and "QIB" statuses.[101] Of course, this is not as detailed a classification as the one proposed above (nor as comprehensive). Further, the "accredited investor" and "QIB" classifications are employed to ascertain the degree to which an investor may partake in the sale of a non-registered security – they do not purport to accurately assess the degree to which a particular investor can handle investment risk. Nevertheless, their use does underscore the point that classifying investors is not alien to U.S. securities laws.

Additionally, an argument can be made that the SEC has already adopted a securities classification scheme – albeit indirectly. For ever since the regulatory reforms of 2005, the SEC has classified *issuers* into the following four categories: "(1) the well-known seasoned issuer, (2) the seasoned issuer, (3) the unseasoned Exchange Act reporting issuer, and (4) the non-reporting issuer."[102] These issuer classifications are largely driven by the degree to which a particular issue is publicly known and widely followed in the financial markets.[103] Their purpose is to assess the amount of disclosure deemed necessary in such issuer's public offering of securities.[104] Thus, the securities of some types of issuers (such as "non-reporting issuers") will require greater disclosure in a public offering than the securities of others types of issuers (such as "well-known seasoned issuers").[105] This purpose differs from the proposed classification schema proposed above, which is not to determine the amount of disclosure necessary in a public offering, but rather to categorize the substantive riskiness of the security as an investment. That said, the practice of categorizing issuers as per the 2005 reforms furnishes a precedent pursuant to which the SEC has determined to treat different securities differently.

Further still, U.S. securities laws have long recognized a distinction between securities that are registered versus securities that are unregistered.[106] Depending upon where a security falls within this dichotomy, the entire regulatory disclosure regime may or may not apply to it.[107] Moreover, and more relevantly, their classification in this regard even determines which investors may purchase the security.[108]

C. The Potential Benefits of Merit Regulation via the Suitability Rules

The proposal set forth above would have the SEC play a substantial (if not a leading) role in the assessment of suitability. The classification of both securities, and investors, would be made in accordance with SEC guidelines. Even the ultimate question of suitability would itself be governed by SEC rules, pursuant to which certain risk-classifications of securities would be deemed unsuitable (and thereby off-limits) to certain categories of investors. Effectuating merit regulation via the suitability rules, as proposed here, could offer significant benefits without the costs that usually accompany blue-sky-type merit regulation.

The primary benefit is that, as already noted, such an approach would allow the federal government and the SEC to bring its resources to bear upon the question of investment risk. These resources include

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[101] *See* William K. Sjostrom, Jr *, The Birth Of Rule 144a Equity Offerings,* 56 UCLA L. Rev. 409, 443-44 (2008).
[102] *See* Joseph F. Morrissey, *Rhetoric And Reality: Investor Protection And The Securities Regulation Reform Of 2005,* 56 CATH. U. L. REV. 561, 574 (2007).
[103] *See id.*
[104] *See id.*
[105] *See id.*
[106] *See* Stephen J. Choi, A Framework For The Regulation Of Securities Market Intermediaries, 1 BERKELEY BUS. L.J. 45, 79 (2004).
[107] *See id.*
[108] *See id.; see also supra* note 101.

increased access to vital information under the provisions contained in the Dodd-Frank Act.[109] This information, in conjunction with the information and analysis already publicly available via the work of research analysts and other industry professionals, should yield a more accurate assessment and classification of the riskiness of securities.

But unlike the typical approach taken by merit regulators at the state level, this proposal would not be nearly as resource intensive – for at least two reasons. First, under this proposal the SEC would be limiting itself to promulgating rules and standards for use in assessing suitability – in terms of both security/issuer evaluation and investor classification. This varies from the typical approach of merit regulation, pursuant to which the regulator would pass judgment upon securities offerings on an offering-by-offering basis. Second, the SEC would not even be applying its rules and standards governing suitability – securities brokers would, thus passing on this cost to them.

An added benefit of this approach is the fine-tuning that it enables – another departure from traditional merit regulation, which possesses a certain all-or-nothing quality. That is, the SEC would not be designating certain securities offerings as simply "off limits" to *all* investors, but rather would be effectively placing certain securities off limits to only certain groups of investors (due to the interaction of the security's risk assessment under the SEC's guidelines, and the investor's risk tolerance, also determined under SEC guidelines). This also puts the SEC in a particularly good position to implement public policy regarding both investor protection and issues of systemic risk.

Further fine-tuning would be possible if the SEC were to permit investors to petition for exemption to the applicability of its suitability rules and standards on a case-by-case basis. For example, although SEC standards might deem a particular security unsuitable for a particular class of investor with a given classification, that investor could be permitted an opportunity to explain why its situation does not call for application of the governing standard.

A third improvement that the proposal features over traditional merit regulation is that it reaches secondary market trading in addition to primary market offerings. The typical merit regulator assesses the merits of a security at the time of its offering to the public.[110] Once the security is trading in the marketplace, among investors, there is ordinarily little or no further regulation of the security's merit.[111] By contrast, the instant proposal would establish rules, standards, and guidelines that would apply to every securities transaction involving a broker. Thus, it would not only govern the transaction between an issuer an investor, but would also ensure that trades between investors were suitable and consistent with public policy.

Conclusion

The financial crisis of 2008 has caused many to revisit the merits of merit regulation. The benefits of such an approach, in terms of more robust investor protection, and another tool to address systemic risk, might be as appealing as ever. But so are the approach's drawbacks, including its resource-intensiveness and the risk that certain offerings might be locked out of the capital markets altogether on the basis of a regulator's judgment (which could be erroneous or, worse, biased). Federal commandeering of the suitability rules, along the lines outlined here, offer a means by which the benefits of merit regulation can be largely obtained without many of the costs that the usual accompany such an approach.

Admittedly, much remains to be considered with this proposal, and many questions remain unanswered. As drafted, the proposal only applies to broker's transactions in which the suitability rules are implicated. As such, a large number of transactions, both of individual investors and institutional investors, would not fall under its umbrella. To have its intended effect, this proposal would need to be replicated as necessary to cover such transactions as well.

Thus, as is readily apparent, this proposal is simply an opening foray. It represents an effort to address a critical problem, and a problematic solution, by sketching a course of action that is hopefully

[109] *See supra* note 83 and accompanying text.
[110] *See* Thomas E. Geyer, *Viewing The Columbus Skyline: Incorporating Federal Law Into The Anti-Fraud Standard Of The Ohio Securities Act*, 28 U. TOL. L. REV. 301, 306 (1997).
[111] *See id.*

creative but not unrealistic, modest but not meaningless. My hope is that to the extent it resonates, others will add flesh to its bones and build upon whatever elements are deemed of value.

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