

# The California Corporate Securities Act

ITS LEGISLATIVE, ADMINISTRATIVE AND FINANCIAL ASPECTS

## INTRODUCTION

THIS study is written upon the assumption that an understanding of the operation and functions of Blue Sky laws can not be obtained unless those laws are analyzed in light of their administration by state officials. To make such a study of the forty-six Blue Sky laws in this country was an impossibility. It was possible, however, through permission of Commissioners Friedlander and Athearn and by the coöperation of Executive Secretary John L. Davis, to examine the nature of the California Securities Act as that act is administered by the State Corporation Department.<sup>1</sup> The purpose of this paper is to consider the nature of its regulations in light of those found in other states, to describe objectively its administration, as disclosed by a study of the departmental documents and records, and to indicate certain important questions of legislative policy.

It is believed that the material presented in this study should have more than a local interest. California has probably the strictest type of regulatory permit act and the problems involved in its administration are similar to those in other states which have adopted this type of securities regulation. Furthermore, this state is one of the five largest capital markets in the United States and the description of the kinds of securities offered in this market outlines the essential problems which the administration of any Blue Sky law must meet.

It has been stated that the object of these "Blue Sky" laws is "to provide a reasonable method of having schemes in which the public are invited to intrust their funds to the management and control of others safeguarded by some method of examination by public authority, requiring those who would sell securities to the public to make a showing of good faith, solvency and a reasonable chance of return on the investment. Prevention of fraud is far more useful than punishment."<sup>2</sup> The frauds perpetrated in the promotion and financing of corporations have proved far more extensive and serious than the frauds in management. A conflict, however, may arise between the freedom of legitimate business and the attempt at prevention of frauds. It is important to compare the different types of Blue Sky laws to see whether on the one hand

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<sup>1</sup> Acknowledgment is made for coöperation to Assistant Commissioner H. C. Ellis and to Deputy Commissioner D. A. Pearce of the Corporation Department and Professor H. W. Ballantine of the University of California.

<sup>2</sup> BALLANTINE, *PRIVATE CORPORATIONS* (1927) 833.

they fail to protect investors against stock swindles, and on the other whether they unduly hamper the conduct of legitimate business by honest men.

### SECTION 1. TYPES OF BLUE SKY LAWS

There are forty-six states which have adopted security laws in the attempt to eradicate deception and fraud from the promotion of corporations and the traffic in security issues.<sup>3</sup> The wide differences of policy pursued by the several states in Blue Sky legislation make any classification or grouping difficult. Delaware and Nevada have no laws covering the sale of securities. Four states, Connecticut, Maryland, New Jersey and New York, have not yet subscribed to the doctrine that general supervision and regulation, either over dealers or issues of securities, will accomplish enough good to justify the burden which they place upon legitimate business. They have, therefore, adopted "fraud laws" of various types. The remainder of the states have decided that some greater amount of regulation is warranted, but the scope of that regulation and its mode of application differ widely.

The difficulties in any classification of the present regulatory Blue Sky laws which would give an understanding of their economic effect are: (1) the wide difference in the substance of the laws and (2) the differences found in the interpretation and routine administration of the provisions of the acts.

#### (1) DIFFERENCES IN THE SUBSTANCE OF THE SECURITY LAWS

Some of the major differences in the scope and mechanism of the various security acts are the following:

a. *Securities required to qualify.* Connecticut has no general "Blue Sky" law, but requires that only securities in oil and mining enterprises need obtain a permit from the Bank Commissioner. Other states, such as Wyoming, Oklahoma, New Mexico, require permits in those cases in

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<sup>3</sup> See address of Hon. Arthur Snapper on "Uniform Blue Sky Legislation" — 11th annual convention of the National Association of Securities Commissioners, 1928, p. 74; REED AND WASHBURN, *BLUE SKY LAWS* (1924); COWAN, *MANUAL OF SECURITIES LAWS AND SERVICE* (1923).

The following recent law review articles deal with the subject of Blue Sky Laws: Benas, *The Corporate Securities Act* (1926) 14 CALIF. L. REV. 101; *Blue Sky Laws* (1924) 24 COL. L. REV. 79; Meeker, *Preventive v. Punitive Security Laws* (1926) 26 COL. L. REV. 318; *Middle West Blue Sky Legislation* (1927) 1 DAK. L. REV. 138; Ashby, *Federal Regulation of Securities Sales* (1928) 22 ILL. L. REV. 635; Brown, *Minnesota Blue Sky Law* (1919) 3 MINN. L. REV. 149; Brown, *A Review of the Cases on "Blue Sky" Legislation* (1923) 7 MINN. L. REV. 431; (1922) 7 MINN. L. REV. 61, 431; Richards, *Watered Stock and Blue Sky Legislation* (1922-1923) 2 WIS. L. REV. 1, 86; Ashby, *Influence of Securities Legislation Upon Standards of Corporation Financing* (1928) 26 MICH. L. REV. 880. See also Note (1928) 51 A. L. R. 1004.

which speculative securities are to be sold. The other extreme is represented by a state such as Michigan, which requires that, "no security shall be sold to any person within the state of Michigan unless and until the issue of securities, of which such security to be sold as a part shall have been accepted for filing by the commission."<sup>4</sup> These differences determine, necessarily, the amount of effort, time and money expended by the state in exercising its protective function.

*b. Exemption of securities.* As in the definition of the securities which will be affected, so there is a wide divergence in enumerating what classes of securities will be exempted. Vermont gives exemption to the bonds, stocks or notes of those corporations organized within the state.

Other grounds of exemption include the nature of issuer, *i.e.* a national or state bank, or a government or a public utility, or a going corporation with established business, concerns listed and rated in any standard manual of securities; the nature of business (Idaho gives exemption to mines within the state); the nature of security, notes or bonds secured by mortgage on real estate, securities listed on stock exchanges; nature of the transactions, as judicial sales, stock sold to stockholders, private sales by owners.

*c. Manner of Submitting Corporate Information.* It is the common practice in most states to require the submission of corporate information to an administrative board before a security may be registered or a formal permit given for its sale.

In England when a company desires to raise money by a direct appeal to the public, the usual course is to issue a prospectus and a copy of this prospectus must be filed with the Registrar of Companies on or before the date of its publication. Advertisements by which securities are offered for sale to the public are now treated as a "prospectus." A "private company" which makes no offer of securities to the public may commence business without filing any prospectus.

In Colorado, no formal application need be submitted to the Secretary of State. The act is complied with by filing a prospectus by the company issuing the securities to be deposited for inspection by the public. In case any sale is made upon facts not correctly disclosed in the prospectus upon file, the purchaser of the stock "shall have the right to rescind the transaction."<sup>5</sup> In this measure, Colorado has required that the relevant facts about the security are to be placed before the public and this information may be read and examined before purchases are made by prospective investors. The public and not an

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<sup>4</sup> MICHIGAN BLUE SKY LAW, § 7.

<sup>5</sup> COLORADO SECURITIES ACT, § 8.

administrative board is to pass upon the fairness and equity of the securities sold within the state.

## (2) ADMINISTRATIVE DIFFERENCES

Blue Sky acts must be administered by some official or public body and any classification of these acts must consider the interpretation by these state officials. The method and spirit of enforcement must also be given due consideration.

The discretionary power given by these acts to the administrative officials is often broad and the extent and character of the state regulation will be influenced, if not determined, by the administrative decisions. The states of Mississippi and South Carolina, for example, would be classified as having regulatory acts of the permit type. These states, however, report a decided difference of policy towards the issuance of the most common type of security, common stock. The Insurance Commissioner of South Carolina stated: "I might add that my predecessor in office has never encouraged the sale of stocks and therefore very few permits have been issued."<sup>6</sup> The administrative head of the Mississippi Blue Sky Commission expressed his views to this effect: "Very few applications are refused; in fact, none have been where they furnish the [financial] data specified in the statute."<sup>7</sup>

These statements are extreme examples of wide differences of opinion finding expression under the discretionary powers of Blue Sky administration. It is apparent that the method of administration might determine the scope and economic significance of a security act, giving it a meaning not obtainable by a casual reading and analysis of the provisions of the act.

## (3) CLASSIFICATION OF BLUE SKY LAWS

The classification following is made with full realization of the difficulties involved, difficulties due to variation in substance and difficulties from not having complete knowledge of administrative policy in interpretation and enforcement. Correspondence with the several departments and a perusal of yearly department reports have yielded some information on administrative policy. This material, in conjunction with the text of the laws, gives a basis upon which to group the states. The classification is not made as final and inclusive, but as instructive in understanding and appraising the corporate security act of California. The classification is as follows:

- A. Fraud acts.
- B. Regulatory acts without control of dealers.

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<sup>6</sup> In letters to the author.

<sup>7</sup> *Ibid.*

- C. Dealers licensing acts.
- D. Specific approval acts with preferential position to non-speculative securities.
- E. Specific permit acts without preferences.

#### A. *Fraud Acts.*

New York, New Jersey and Maryland have adopted legislation empowering the Attorney General to investigate the sale of questionable securities and prosecute security swindles or frauds. This type of law is most completely developed in New York.<sup>8</sup> Some information on the administration of that act, the Martin Law, is available, making it possible to analyze the actual working of the law in the outstanding security market of America.<sup>9</sup>

The act in question provides two entirely different proceedings by the Attorney General. Each is governed by separate and distinct rules of law and procedure. The one provides for the conduct of investigations and for injunctive relief, the other for criminal prosecutions. A consideration of the first shows that under section 352 the Attorney General has plenary investigatory powers: "Whenever it shall appear to the attorney general, either upon complaint or otherwise, that in the . . . sale within this state . . . of any stocks, bonds, [etc.] . . . any person . . . is about to employ any device, [etc.] . . . to defraud . . . or he believes it to be in the public interest that an investigation be made, he may in his discretion either require or permit such person . . . to file with him a statement in writing under oath or otherwise as to all the facts and circumstances concerning the subject matter which he believes it is to the public interest to investigate, and for that purpose may prescribe forms upon which such statements shall be made." The Attorney General can also compel the production of books, papers and documents subject to inquiry. The refusal to obey such subpoena is made a misdemeanor. The act further makes special provision enabling the Attorney General to obtain information from foreign corporations.

In conjunction with the power to investigate given to the Attorney General, there are provisions in the law which require publication in a state paper by a dealer selling some types of securities of a notice of the fact that he is about to enter the security business. The dealer must publish also an "issue notice," a notice giving the name of the dealer, the security which he proposes to sell and the name and address of the

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<sup>8</sup> GENERAL BUSINESS LAW, art. 23A.

<sup>9</sup> See NEW YORK STATE BAR ASSN. BULL. (Nov. 1929) 389: "License Stock Brokers and Salesmen" by Hon. Hamilton Ward, Attorney General: "Just how the attorney general is to discover in advance who is going to perpetrate a fraud is not made clear in the act."

issuing company. Among the many exceptions are securities which are listed on any exchange. This list of dealers and their securities is scrutinized by the Attorney General and is the basis, in conjunction with complaints received from the public, of the investigation made by his office. Questionnaires from brokers and mining corporations are used to lay a foundation for further oral examination in those cases under examination. In 1926, Attorney General Ottinger stated<sup>10</sup> that, during the previous year, not less than 1200 investigations were made under the powers given by this section of the act.

The Attorney General is empowered, by the Webb-Phelps amendment of 1925 to the Martin Law, to apply to the Supreme Court for an injunction prohibiting further activities of persons engaged in fraudulent financial transactions. This is frequently done between the time of original investigation and the instigation of criminal proceedings for fraud. The report of the Better Business Bureau of New York City for the year 1928 lists the proceedings of the Attorney General from May, 1927, to April, 1928. In the 51 cases listed there were 38 final and 13 temporary or preliminary injunctions received from the New York Supreme Court against further sale or trading in certain securities. The defendants comprised 29 corporations issuing stock through agents, 11 brokers dealing fraudulently or in low grade issues and 11 miscellaneous companies, including 4 tipster sheets and 2 investment trusts.<sup>11</sup>

Under the act, the Attorney General has the fullest powers to prosecute criminally. He may do so either in conjunction with local district attorneys or he may supersede them and appear in person or by his deputy before any court or grand jury. Conviction for fraudulent practice under criminal prosecution is notoriously difficult and it appears that the New York practice, as that in other states, is to obtain an acceptable cash settlement with the defrauded persons in those cases where it is possible rather than to strive for a prosecution through a tedious and prolonged trial. Attorney General Ottinger said: "Many business organizations have actually been put upon a sound basis as the result of mutual agreements between officers of a company and stockholders. Restitution of issues of stock and cash contributions are frequently made in order to stabilize the particular business. Many

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<sup>10</sup> See address of Attorney General Ottinger before the New York Bar Association for material as to his administration and interpretation of the act, January 23, 1926.

<sup>11</sup> It is pointed out by Attorney General Ward that there is a man in Albany who has been enjoined three times under the Martin Law and is still selling securities.

injunctions are remedial in their nature and in themselves vitalize a weak enterprise."

The administration of the Martin Fraud Act in New York is somewhat as follows:

1. The Attorney General has information about every broker or dealer in New York as well as the securities which are offered to the public through them. Although this information is published in a "state paper" rather than submitted directly to the Attorney General, nevertheless the intent of the law is to make known to his office the new securities sold in New York. In this respect, the New York law is similar to that in Massachusetts and Pennsylvania, where licensed dealers notify the administrative board that they are issuing new securities.

2. The examination of brokers and issuing companies by the Attorney General is made, not only upon complaint from the public, but in those cases where "he believes it to be in the public interest." Under this power 1200 examinations were made in 1925.<sup>12</sup> In 1926, the Attorney General made an exhaustive survey of the practices of real estate mortgage houses which resulted in an announcement of rules which were to be followed by New York firms doing this type of business. In 1927, a 136 page report was sent from his office on *Investment Trusts: A Survey of the Activities and Forms of Investment Trusts with Recommendations for Statutory Regulation*. Both of these investigations were followed by similar studies in other states having rigid regulatory laws.

3. There is as yet no system of licensing dealers or brokers.<sup>13</sup> To police the state of New York and to protect its eleven million people from frauds in the sale of securities, the legislature appropriates about \$200,000 a year. With this money the Attorney General maintains an office with about 35 employees in New York City, one in Buffalo with four employees, one in Rochester with two employees, and one employee located in Binghamton, Syracuse, and Auburn.<sup>14</sup>

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<sup>12</sup> Address of Attorney General Ottinger before New York Bar Association, January 23, 1926, p. 14.

<sup>13</sup> A dealer or broker may be defined as one who makes a business of buying securities primarily from issuing companies for resale to the public. Attorney General Hamilton Ward advocates the licensing of stockbrokers and salesmen in the same way that real estate and insurance brokers and salesmen are now licensed. He points out that there is a large field of fraud in which the remedies provided by the Martin Act will help but little. He asserts that there is no other trade, profession or occupation that offers the opportunities of imposing on the public to the extent that the unregulated sale of securities does. *NEW YORK STATE BAR ASSN. BULL.* (Nov., 1929).

<sup>14</sup> In New York in 1926, the Bureau of Frauds engaged 29 persons (13 deputy attorney generals, 5 investigators and 11 clerical assistants) while Pennsylvania had 24 and Illinois 12.

*B. Regulatory Acts without Control of Dealers.*

There is a group of states that have adopted acts which assume that honesty in security transactions can be obtained without permits, licenses or direct supervision over dealers or brokers. It is apparently felt that the state need not regulate the business of dealing in and resale of securities, as the securities sold by the dealers and brokers have come under the surveillance of the administrative commission at some time. This principle is found in the acts of Colorado,<sup>15</sup> Oklahoma, Texas and Wyoming. Although significant, the absence of regulation over brokers should not be a determining factor for classification. Besides this, these states have other phenomena in common: (1) these states grant wide exemptions to the securities which must qualify before the administrative boards, and (2) the administrative personnel and its expense are small when compared with other states.

*Exemptions:* Colorado has exemptions, among others, for any securities not sold by public offering, securities issued by corporations with a record of earnings, and real estate mortgages where the same is secured by property valued at not less than 110 per cent of the principal.<sup>16</sup> Connecticut considers that all securities are safe to be sold to the public without examination, except securities of mining or oil companies. New Mexico, Oklahoma and Wyoming require that "speculative securities" alone must be qualified for sale. In Texas, stocks of local companies are specifically required to obtain a permit. Florida gives exemption to any corporation which does not sell its security outside the county which holds its principal place of business, and Nebraska exempts local companies with securities outstanding of less than \$25,000, as well as new issues of securities sold to stockholders by a going corporation or stock issued by a corporation to its incorporators.

The exemptions as given above are not inclusive for each state. With the obvious exception of those states which define what securities must be qualified, such as Connecticut, where oils and mines alone are affected, these states allow the standard exemptions found in all states.<sup>17</sup>

*Expense of Administration:* In the states mentioned before, the administration of the act is in the hands of a state department organized before the passage of a Blue Sky act, such as the Department of State,

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<sup>15</sup> The Colorado Act is more informative than regulatory. Before certain kinds of speculative securities may be sold, the issuer must file with the secretary of state a detailed prospectus, giving corporate and financial information. Misrepresentation renders the issuer liable to purchasers in damages.

<sup>16</sup> A speculative security is generally defined as one which has assets, either patents, goodwill or properties, of intangible value, or a security in which the sale commission is over a set amount; 10 per cent in Oklahoma.

<sup>17</sup> Such as securities issued by public utilities under a commission, securities of national and state banks, and commercial paper.



Banking or Insurance. The administrative head of that department enforces the Blue Sky law as a subsidiary function. The absence of a special department makes it impossible to calculate the exact expense of administration. Since no one of these states, however, has more than two persons administering the law, it is obvious that the expense is inconsiderable. The fact that there is no supervision over dealers, which means no licensing, no examination, no filing of yearly reports, etc., and that the number of applicant corporations are few, makes administration possible with a minimum of expense. The state of Nebraska reports that "only two persons are actively engaged in the administration of the act on account of numerous exemptions under the act," the yearly expense amounting to \$7000. The total number of issues licensed in 1928 was 18. This may be compared with Oregon, a smaller state, which requires a strict qualification, of 367 issues. Texas, with broad exemptions, issued 115 permits during the year ending May, 1928; other states in this group which qualified an insignificant number were Wyoming 25, Mississippi 24, and New Mexico 9.

It has been seen that there is a group of states which do not require the licensing of dealers in securities, although they do require that unexempted securities be qualified by an administrative board. These states, with the exception of Mississippi, have wide exemptions for securities, making qualification unnecessary before a state official. As a consequence there is little expense entailed by the states. There is no way of appraising the specific effect of these laws in their respective states upon the eradication of security frauds without making a detailed examination of the local conditions and practices. This is beyond the scope of this study. It can be stated, however, that compared with the other states, and upon the grounds of exemptions, control over dealers and brokers and expense, that Colorado, Connecticut, Florida, Mississippi, Nebraska, New Mexico, Oklahoma, Texas and Wyoming consider that the state should exercise its police power in the protection of the investing public with great caution and restraint.

### *C. Dealers Licensing Acts.*

The states of Massachusetts, Pennsylvania, Maine, Rhode Island and New Hampshire regulate the traffic in securities through a system of licensing dealers and brokers. It is felt that state control over the middlemen through whom securities are sold affords greater protection to the investing public than any control through the issuance of permits for individual issues of securities.

In the administration of the licensing acts, there are found to be two types of dealers, dealers selling a general list of securities (includ-

ing stock exchange brokers who execute purchase orders for a commission) and secondly, those corporations which, by the law, must take a dealer's license to sell their own securities.

*Dealers in General List:* This includes all those persons engaged in buying and selling a general list of securities and includes a great variety of underwriters, brokers, members of stock exchanges both local and foreign, dealers in unlisted securities, wire houses and sundry financial specialists. The Pennsylvania Securities Commission reports that about 40% of the dealers registered within the state are of this type, about 300 out of approximately 700, the total of all dealers.<sup>18</sup> The control over these dealers in Pennsylvania is exercised through section 14 of the act: "Nor shall any dealer, agent or salesman issue or publish within this State any circular, advertisement, pamphlet, prospectus, program, or other matter in the nature thereof, concerning any security or securities to be sold or offered for sale, unless the name of the dealer shall be subscribed thereto, and a true copy thereof filed in the office of the commissioner, or deposited in a United States post office, properly enclosed, envelope addressed to the Commissioner of Banking at Harrisburg, Pennsylvania . . ." This section enables the Commission to know what securities are being sold. If the offering of the dealer "has not been made in good faith, but has been made with the intent to deceive or defraud, it may prohibit the dealer from selling or offering such securities as have been sold or offered or from in any way advertising them within the state." Revocation of a dealer's license may take place after a formal hearing has been given.

*Corporations as Dealers in Their Own Securities:* Both in Massachusetts and Pennsylvania, the largest number of licensed dealers are not dealers in a general list of securities, but are corporations which, by the law, must be licensed as such in order to sell their own securities. The Pennsylvania Commission states that 60% of its dealers are of this nature. The laws in both states exempt small, local corporations having a capital stock under \$25,000, or less than twenty-five stockholders. Wide exemptions are given in both states to corporations issuing stock to existing shareholders under a plan of expansion, reorganization or recapitalization. This limits materially the number of corporations which must be licensed."<sup>19</sup>

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<sup>18</sup> Letter from Commission, April 28, 1928. As of August 1, 1928, there were 759 dealers registered. SIXTH ANNUAL REPORT, PENNSYLVANIA SECURITIES COMMISSION (Aug. 1, 1929).

<sup>19</sup> For example, only 299 new applications for dealers' licenses were made in Pennsylvania from August, 1926, to August, 1927. (Part of this, roughly 40 per cent, were from dealers to sell a general list.) In 1926, the Massachusetts Public Utility Commission reported 185 new registrations made for brokers' licenses, the greater

The corporation which cannot gain exemption and which must obtain a dealer's license before it may sell its securities must stand a rigorous examination. In theory, this examination of the corporation is to satisfy the commissioner that it proposes to operate fairly and justly as a dealer; in practice, the examination centers around the fairness, justness and equity of the security which it proposes to sell and this entails an examination of the plan of business, of the value of listed assets and of the capital structure of the corporation. This type of security is often of the promotional, non-income earning type in that it does not fall within the broad exemptions of the act and that the corporation cannot arrange the sale of securities through licensed brokers. Such data as are available indicate that a large proportion of these corporations are not granted licenses to deal in their own issues.<sup>20</sup>

The administration of the dealer licensing acts discloses that the "professional dealers"<sup>21</sup> do not comprise one-half of the list of dealers licensed within the state and that the major administrative problems have been in the examination of securities to be sold by a corporation as a dealer. This examination is of a similar nature, in scope and rigor, to that made by those states where specific permits are required for the sale of securities. In this sense, dealer-license acts are specific approval acts with the information supplied by a "dealer" rather than the issuing corporation. These acts provide, however, a method by which the states may scrutinize all issues, both local and foreign, with a minimum of interference to the free flow of high-grade issues sponsored by reliable investment bankers.

#### *D. Specific Approval Acts with Preferential Position to Non-Speculative Securities.*

The remaining states, not discussed above, have acts requiring a specific approval<sup>22</sup> of each non-exempted security after a formal examination by an administrative board. Sixteen of these states have made some provision in their act whereby selected, non-promotional securities may be sold through *bona fide* dealers under license with a minimum of

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number of these being corporations applying to sell their own securities. This may be compared with Michigan, a smaller state, with an act requiring the issuance of permits for the sale of all securities, with a total of 1325 for the year ending June, 1928.

<sup>20</sup> In 1926, 50 out of 235 new applications for brokers' licenses were refused in Massachusetts. Most of these were corporations asking a license to deal in their own securities. ANNUAL REPORT OF DEPARTMENT OF PUBLIC UTILITIES (1926) 7.

<sup>21</sup> "Professional dealers" are dealers in a general list, rather than a specific issue.

<sup>22</sup> The approval may take the form of a written permit (California) or a registration in a register of qualified securities (Alabama).

obstruction by the administrative board. The manner in which this preferential position is given varies as between states.

About fifteen states, including Iowa, Indiana, Kansas, Kentucky, Minnesota, North Carolina, Ohio, South Dakota, Utah, Virginia and West Virginia, have written their acts after the major provisions as to registration by notification and qualification found in the Draft Bill for a law respecting the sale of securities, the so-called Ideal Blue Sky Act, drafted in 1925 by representatives of the Investment Bankers Association of America. This act was written in an effort to gain uniformity in securities legislation by the incorporation of those provisions and methods of approach "which have proven to be quite uniformly accepted as practical and best calculated to accomplish the purposes of such laws."<sup>23</sup> The principles underlying this bill were made the basis of the "Uniform Sale of Security Act" adopted by the National Conference of Commissioners on Uniform State Laws.<sup>24</sup>

The outstanding features of the Uniform Draft Act are: First, the granting of wide exemption from the application of the regulatory features of the law to that class of securities in which the element of fraud is rarely found, *e.g.* securities issued by the United States, states, or municipalities therein, and securities issued in transactions in which the elements of fraud are not present, *e.g.* stock dividends, reorganizations, exclusive sale of stock by corporations to present stockholders, and mergers. Secondly, non-exempt securities of concerns with established reputation, earning history, and record of achievement are given a preferred position in the manner of registration.<sup>25</sup> They may be "registered by notification," that is, the sale by a licensed dealer may follow after certain corporate and financial information is filed. Thirdly, provision is made for registration by qualification of the securities of newly organized enterprises or of enterprises having no favorable history of earning capacity and of a purely promotional character, which are deemed to call for careful and scrutinizing examination. Fourthly, there is provision made for the registration of dealers and salesmen.

Several states<sup>26</sup> have accepted the basic principle of the Draft Act

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<sup>23</sup> The draft bill has been published by the Investment Bankers Association of America.

<sup>24</sup> Report of the Committee on a Uniform Sale of Securities Act. 37th annual meeting, National Conference of Commissioners on Uniform State Laws, August, 1927.

<sup>25</sup> A few of the criteria of such a security are that it is (1) issued by companies in continuous operation for three years which have earned  $1\frac{1}{2}$  times interest charges on bonds or preferred stock, 5 per cent on common stock, (2) bonds which do not exceed 70 per cent of the value of country land or 60 per cent of urban property.

<sup>26</sup> Alabama, Illinois, Georgia, Missouri, Wisconsin.

without adopting its form or method. Alabama and Louisiana exempt those securities which are given the privilege of being "registered by notification" under the Draft Act. The Alabama administration requires, however, that dealers show proof that their securities are exempt on grounds of earning power and the evidence submitted is tantamount to that submitted by dealers or corporations in those states which have "registration by notification." Georgia and Illinois classify all securities into four classes, A, B, C, D. Classes A and B are exempt, Class C are income earning securities and are to be qualified by notification, Class D securities are permitted for sale only after close scrutiny and examination. Missouri has a provision giving exemption to income securities besides giving an opportunity for non-exempt securities to be qualified by a preliminary examination. This privilege is granted in cases where the issuer or dealer will supply a \$20,000 bond in evidence of good faith. Wisconsin has a similar plan under which Class A securities — income established — may be qualified by preliminary examination if a bond is supplied by the corporation or dealer.

An examination of the administration of permit acts, giving preference to income securities, discloses that the broad exemptions reduce the number of applicants to be examined by the administrative officers. Illinois for example, qualified 620 issues of securities in 1928, either by preliminary notification or final examination; a smaller state of the specific permit type and one having narrow exemptions, Michigan, issued 1325 permits in the same period. Of the 620 securities not exempted in Illinois, there were 410 of the income type and only 210 of the promotional type which qualified after strict examination. The major administrative labors of the department were centered around the examination of these 210 non-income producing concerns. The expense of administering this type of act appears to be modest in comparison with the specific permit type in which full examination is made of all securities.<sup>27</sup>

#### *E. Specific Permit Acts without Preferences.*

The last group of states, Arizona, Arkansas, Idaho, Michigan, Montana, North Dakota, Oregon, South Carolina, Tennessee, Vermont and Washington, have adopted securities legislation characterized in the main by the following major provisions: (1) All non-exempted securities sold within the state, either by foreign or domestic corporations, directly, or through some agency, must be qualified by an administrative officer; (2) all dealers and agents must be licensed by the same officer; (3) the

<sup>27</sup> Illinois expense approximated \$36,000 for 1928; Michigan, a specific permit state, had an expense of approximately \$70,000.

exempted securities, either because of the nature of the security or the nature of the transaction in which the security is sold, are limited. Oregon, for example, exempts mortgages purchased and sold in their entirety, commercial paper eligible for rediscount at the Federal Reserve Bank, state and national bank and trust company stock, securities listed on the New York and Chicago Stock Exchanges and bonds of United States and political subdivisions thereof;<sup>28</sup> (4) no provision is made making it possible for *bona fide* securities, issued by corporations with an earning power and reputation, to receive a permit except in the same manner as that required of promotional issues.<sup>29</sup>

The close scrutiny of brokers and the specific examination of all non-exempt securities require a relatively large personnel and expense in the administration of the act. Oregon, with 100 dealers under its administration, has a force of six persons with an expense of \$17,500, while Illinois, a state with wide exemptions and where less scrutiny is given to securities of established concerns, has 800 dealers under license and administered its act with a force of twelve persons at an expense of about \$36,000.

#### (4) A SUMMARY OF THE DIFFERENT TYPES OF BLUE SKY LAWS

All states, except two, Delaware and Nevada, have passed some kind of security legislation for the eradication of fraud in the traffic in instruments of investment. The most satisfactory basis of classification can perhaps be made upon the provisions made by the laws for a separation of *bona fide* income securities from those of the promotional type in order that the legitimate flotation of capital issues will not be burdened excessively by state control. This problem has been met in three ways:

1. *Speculative, promotional issues alone shall qualify.* This is found in several states, the non-dealer licensing states, either by requiring speculative issues alone to qualify (New Mexico) or by making the exempted securities so broad in number (Nebraska) that promotional issues remain alone to be examined by a state official. The effort and expense incurred by these states in the regulation of the security market is less than other states.

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<sup>28</sup> The exemptions found in the Montana, South Carolina and Michigan Acts are wider than those found in Oregon.

<sup>29</sup> This does not hold in Michigan, where provisions are made for securities to be qualified by temporary approval if the commission is satisfied that such preliminary offering will not be detrimental to the public. Within 3 days, a full application must be presented to the commission. This offer for sale, preliminary to the filing of securities, does not authorize the delivering of securities before the final acceptance by the commission.

2. *All issues to qualify with exemptions or preferences to non-promotional securities.* In those states regulating the security market through the licensing of dealers, *e.g.* Massachusetts, and in those states adopting the major features of the Uniform Draft Act (Illinois) all securities must be made to qualify before a state official. In the former, the qualification is made through dealers and through the exercise of the discretionary powers of the administrative officer, who grants privileges amounting to exemption to non-promotional issues. In the latter type, by the provisions of the act, privileges in the manner of qualification are allowed non-promotional issues. The administration of the Fraud Act in New York indicates that the Attorney General exercised discretionary powers in the examination of low grade, promotional issues. This group of states exercises a control over securities which, measured in terms of scope and expense, occupies a middle ground.
3. *All issues to qualify, promotional or non-promotional.* The remainder of the states, *e.g.* Michigan, assume that fraud can be eradicated by a strict method of requiring all securities (with standard exemptions) to qualify before a state officer. Neither by the provisions of the act nor by discretionary powers of the administrative officer, are there preferences given to *bona fide*, non-promotional securities. These states have elected to control dealers through a system of licensing in addition to the control of securities through permits. In scope and expense, these states exercise a regulation over the issuance of securities which is strict and vigorous in contrast to the other states.

It appears, from this analysis, that there is a wide variation in the means of accomplishing the prevention of security frauds. This variation occurs in the regulations of the various acts, as well as in the strictness and expense of their administration.

## SECTION 2. THE CALIFORNIA ACT

The California Corporate Securities Act, in the light of the classification of Blue Sky laws given in the previous section, falls within the last group; that is, the act requires: (1) that specific approval be obtained from an administrative official before issue or sale of non-exempt securities; (2) no preference is shown in the manner of qualification to established income issues; (3) dealers, brokers and agents are regulated by a system of licensing. A fourth characteristic is that the exemptions of securities are limited to the most obvious cases. It is the purpose of this section to analyze the provisions of the California

Act before examining the manner in which those provisions are administered.

(1) MAJOR PROVISIONS OF THE CALIFORNIA ACT

*A. Specific Approval.*

The heart of the act appears in section 3: "No company shall sell . . . or offer for sale, negotiate for sale of, or take subscriptions for any security of its own issue until it shall have first applied for and secured from the commissioner a permit authorizing it so to do." This provision may be contrasted with section 5 of the present Wisconsin Blue Sky law: " . . . no company, broker, or other person, directly or through an agent shall in this state sell, . . . take subscriptions for . . . any security for the sale of which a permit has not theretofore been issued, until a permit has been issued by the commission authorizing the sale of such security."

Both California and Wisconsin are "specific approval" states, but the security to be "approved by permit" in the former is the security *issued* by a company, in the latter, the security to be approved is any security *sold* by a company, broker or person. In California, a broker need not obtain a permit to sell a security of a foreign corporation if the issuance of that security to the broker took place outside the state. This does allow "sale" without a specific permit in this case, but the spirit of the law is not evaded by this provision as surveillance of these securities is made through the instrumentality of the control given to the Commissioner over the securities sold by the brokers.

The Commissioner of Corporations must examine the application for a permit and it is his duty to issue such a permit if he finds that the proposed plan of business of the applicant is not unfair, unjust or inequitable, that it intends fairly and honestly to transact its business, and that the securities that it proposes to issue and the methods to be used by it in issuing and disposing of them are not such as, in his opinion, will work a fraud upon the purchaser. The permit may be issued stating simply that the securities may be sold or "The commissioner may impose conditions requiring the deposit in escrow of securities, the impoundment of the proceeds from the sale thereof, limiting the expense in connection with the sale thereof and such other conditions as he may deem reasonable and necessary or advisable to insure the disposition of the proceeds of such securities in the manner and for the purposes provided in such permit" (section 4). The Commissioner is to have the "power to establish such rules and regulations as may be reasonable or necessary to carry out the purposes and provisions of this act" (section 4). As a corollary power to the issuance



of permits, the Commissioner may demand a report from the issuing corporation on any matter relating to or affecting the value of the securities (section 8), and may amend, alter or revoke any permit issued by him (section 4).

*B. Exempted Securities.*

The exemptions arising from the provisions of the California Act in section 2 are limited in comparison with those of other states. They are standard in the sense that they have been adopted by nearly all states as a minimum and have seldom been under criticism as having been used to defeat the purpose of the Blue Sky Act. They may be grouped under the heads of exempt classes of securities and exempt transactions.

The provisions of the Corporate Securities Act do not apply to any of the following classes of securities:

1. Any security issued or guaranteed by the United States of America, or any territory or insular possession thereof, or by the District of Columbia, or by any state, territory, county or municipality or taxing district therein.
2. Any security issued or guaranteed by any foreign government with which the United States of America is at the time of the sale or resale or offer of sale thereof maintaining diplomatic relations, or by any state, province, or political subdivision thereof having the power of taxation or assessment, which security is recognized at the time it is offered or resold in this state as a valid obligation by such foreign government or by such state, province or political subdivision thereof issuing the same.
3. Any security issued by and representing an interest in or a direct obligation of a national bank, or issued by any federal land bank or joint land bank, or a national farm loan association, under the provisions of the Federal Farm Loan Act of July 17, 1916, or by any company created and acting as an instrumentality of the government of the United States of America pursuant to authority granted by the congress of the United States of America, or by any company organized and existing under and by virtue of any act of congress.
4. Any security issued by and representing an interest in or a direct obligation of a state bank, trust company or savings institution incorporated under the laws of this state.

5. Any security the issuance of which has been authorized by the Railroad Commission of this state or by the Interstate Commerce Commission.
6. Any security issued by a company organized for the purpose of conducting a building and loan business within this state subject to the supervision of the Building and Loan Commissioner.
7. Any security issued by a company organized for the purpose of transacting an insurance business within this state subject to the jurisdiction of the Insurance Commissioner.
8. Any security (except notes, bonds, debentures or other evidence of indebtedness) issued by a company organized under the laws of this state exclusively for educational, benevolent, fraternal, charitable or reformatory purposes and not for pecuniary profit and no part of the earnings of which inures to the benefit of any private stockholders or individual.
9. Any security which has been certified as a legal investment for savings banks and trust companies under the laws of this state.
10. Bills of exchange, trade acceptances, promissory notes and other commercial paper issued, given or acquired in a *bona fide* way in the ordinary course of legitimate business, trade or commerce.
11. Promissory notes, whether secured or unsecured, where the notes are not offered to the public, or are not sold to an underwriter for the purpose of resale.

The provisions of the Corporate Securities Act do not apply to the sale of a security in any of the following transactions:

1. At any judicial, executor's, administrator's or guardian's sale, or at any sale by a receiver or trustee in insolvency or bankruptcy.
2. By or for the account of a pledge or mortgage selling or offering for sale or delivery in the ordinary course of business, to liquidate a *bona fide* debt, a security pledge in good faith as security for such debt.
3. The sale in a *bona fide* way of any security by an owner who is not the issuer or an underwriter thereof, who sells the same for his own account; and not for the purpose of evading the provisions of this act.

There are at least four important classes of securities exempt in other states which are not exempt under the California law. These exemptions are far reaching and, in those states where they are present, reduce materially the scope of the administrative regulation:

1. *Exemption of going corporations.* Securities of the issuer owning a property, business or industry which has been in continu-

ous operation not less than a prescribed number of years and with certain profits earned as prescribed by the law are exempt in Alabama, Colorado, Louisiana, Missouri, Nebraska, North Carolina, Virginia and Wyoming. In some states information must be furnished, but no permit or approval is required prior to sale.

2. *Exemptions are made for local companies organized within the state* in Florida, Massachusetts, Missouri, Montana, Nebraska, New Hampshire, Pennsylvania, South Carolina, Vermont, Virginia, West Virginia and Wisconsin. This exemption in most of these states is allowed upon the provision that the sale is made by companies of a limited size, for example, the limit in Massachusetts is \$25,000, and at a limited commission, such as 2 or 3 per cent. The principle upon which this exemption is written is that sales of small blocks of securities for a non-promotional nature of local companies do not offer possibilities for the perpetration of any far reaching fraudulent scheme.
3. *Exemptions of stock issued to stockholders in connection with merger or reorganization.* A going corporation may expand either by public or by private (closed) financing. The latter takes place, generally, without a commission being paid upon the sale of the stock. This "sale" of the stock often takes the form of an exchange for stock or assets of another corporation. In many cases, before the stock of the absorbing corporation is exchanged for assets or stock, there may be a reorganization of capital structure of the absorbing corporation which facilitates the execution of the deal. Such a merger and reorganization take place after the consent of the statutory number of stockholders and with their full knowledge of the details of the corporate financing. The sale or exchange of securities under merger and reorganization is exempted in Alabama, Georgia, Indiana, Kentucky, Maine, Massachusetts, Missouri, Nebraska, North Carolina, Pennsylvania, Rhode Island, Utah, Virginia, West Virginia and Wisconsin.
4. *Exemption of stock sold to stockholders.* In addition to the expansion of a corporation through merger, either by exchange of stock for assets or capital stock, the expansion may arise through the sale of stock to the present stockholders. Such an additional issue takes place after a formal decision by the assembled stockholders and is done with their knowledge and consent. Such conditions minimize the opportunity for deception. The stockholders are assumed to know the business risks

and financial structure of their own corporation. Exemption is offered to securities sold under these conditions by the states enumerated above (those giving exemptions in case of merger or reorganization) as well as Arkansas, Illinois, Kentucky, Louisiana, Maine, Michigan, Minnesota, New Hampshire, South Carolina and South Dakota. This list does not include the three Fraud Act states or the five states in which speculative securities alone are required to be qualified. These eight states, added to the twenty-three listed above, show that there are but fifteen states, including California, which require that stock sold to stockholders (including stock dividends) be qualified for sale by means of a formal application, examination and permit.

### *C. Regulation of Brokers and Agents.*

The California Securities Act empowers the Commissioner of Corporations to license dealers and agents. Licenses expire yearly and must be renewed. These licenses are to be issued after examination "If from such examination, the commissioner shall be satisfied of the good business reputation of the applicant and of its officers or members, if any, that the sale of the securities proposed to be sold by it would not be unfair, unjust or inequitable to the purchasers thereof, that neither it nor its officers or members have violated any of the provisions of this act . . . or have engaged or are about to engage in any fraudulent transaction" (section 6). The Commissioner may call for a true statement concerning any security sold or offered for sale by the broker as well as to the financial position of any such broker. The Commissioner may, at any time, temporarily suspend or revoke any broker's or agent's certificate issued by him if he shall find that the holder is of bad business repute, or has violated any provisions of the act, or has engaged or is about to engage in any fraudulent transaction.

The regulation of brokers centers around their initial examination, reports from them concerning the securities sold by them, reports as to their financial condition and the suspension and revocation of licenses. In addition, the broker must furnish a \$5000 bond and said bond shall "be conditioned upon the payment of all damages suffered by any person damaged or defrauded by reason of the violation of any of the provisions of this act." It has been seen that these broad powers given over brokers are not found in the acts of the three states having fraud acts or in Colorado, Connecticut, Florida, Mississippi, New Mexico, Nebraska, Oklahoma, Texas and Wyoming.<sup>30</sup> The acts of the remainder

<sup>30</sup> The states which have patterned their act after the so-called Uniform Law call for such a bond. Twenty-six states have no provision in regard to bonds. In Wyoming, the bond requirements are at the option of the Secretary of State.

of the states, however, give comparable supervisory powers, with the exception of such states as Ohio and Kansas, in which, by their newly enacted measures of 1929, the state officers are given the added power to obtain injunctive relief through the courts against fraudulent transactions of violators of their acts.

(2) SCOPE OF CALIFORNIA ACT AS REFLECTED BY DATA  
ON ADMINISTRATAION

The outstanding features of the California Securities Act — specific permits, narrow exemptions, licensing of bonded brokers and extensive powers of examination, suspension and revocation — place that act in a class having the most extensive scope of regulation. The following schedule reflects the yearly administrative activities of six important states:<sup>31</sup>

	Type of Law	Licensed Dealers or Brokers	Permits or New Licenses	Expense	Per- sonnel	Adminis- trative Body
N. Y.	Fraud	6,500	Not Required	\$200,000	35	Attorney General
Texas	No Dealers' License	Not Required	115	Nil	1	Secretary of State
Penn.	Dealers' License	761	209	\$100,000	24	Securities Commission
Mass.	Dealers' License	850	185	\$27,000	10	Public Utility Dept.
Ill.	Permit with Prefer- ence	850	611 410 Class "C" 201 Class "D"	\$36,000	12	Secretary of State
Calif.	Permit without Prefer- ence	611	5,511	\$325,000	152	Corporation Dept.

These states hold the important financial and corporate centers of the United States<sup>32</sup> and the nature of their security laws include all the types; fraud acts, two types of permit acts, those giving and those not giving preferences to income securities, dealer licensing acts and acts not licensing dealers. The data above reflect summarily the administra-

<sup>31</sup> This information, when not obtainable in official reports, has been given in letters to the author. Last available figures are given.

<sup>32</sup> Measured by the amount of personal and corporate income earned within the states in 1926 as reported by the Income Tax Bureau of the Department of the Treasury. The most important capital states were (in order of income): New York, Pennsylvania, Illinois, California, Ohio, Michigan, Massachusetts, New Jersey, Florida, Missouri and Texas.

tive activity necessitated by the varying scope and extensiveness of regulations as defined by the different types of laws.

The scope and extent of regulation, as defined by the different types of laws, are indicated best by the number of permits written for the issuance of securities (or issues qualified or licensed). This ranges from Texas, with 115, a state with wide exemption, to California with over 5000. Broad exemptions, excluding nearly all securities except sizable promotional ventures, limits the number of companies which must qualify as dealers before selling their issues, to about 200 in Massachusetts and Pennsylvania.<sup>33</sup> The state of Illinois qualified for sale over 600 issues, but about 400 or two-thirds were in class "C," income securities, which were given a preference as to the matter of qualification. The remainder, about 200 issues, fell within class "D," prospective income securities, and were qualified after extensive examination.

This activity, as measured by the issuance of permits, was reflected in the expense of administration<sup>34</sup> as well as the size of the administrative personnel. In Texas, the act is administered through the Secretary of State with the aid of one executive. In California, the personnel numbers 152 and the expense totals over \$300,000. In the middle ground are the states of Massachusetts, Pennsylvania and Illinois with an expense running from \$25,000 to \$100,000. The higher expense in Pennsylvania is due partly, no doubt, to the fact that its budget must support the overhead expense of a separate, independent commission.

### (3) CONCLUSION

The administrative duties imposed by the California Securities Act entail an expense much greater than that found in other states of similar size. This is due primarily to the great number of applications for permits to sell stock which are filed with the corporation department and to the intensive labors performed by the department under the manifold provisions of the act. California must be characterized as the most active and militant state in the regulation of its capital market.

(TO BE CONTINUED)

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<sup>33</sup> In the case of these two states the permit figures are not exactly comparable, as a company selling its securities to a broker need not be licensed as a dealer before the sale. The figure of 200, however, represents approximately, the cases in which detailed examination is made by the state officers.

<sup>34</sup> The figures for expense are not exactly comparable, as they include rent and overhead in case of those states having an independent commissioner or department, this overhead not being included in those states in which the law is administered through an established state official, such as Illinois. This discrepancy is not large enough and does not nullify the conclusions as to general tendencies, however.

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