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Notification Registration under the Proposed Ohio Securities Act: The Section 1707.08(A)(3) Loophole

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NOTIFICATION REGISTRATION UNDER THE PROPOSED OHIO SECURITIES ACT: THE SECTION 1707.08(A)(3) LOOPHOLE

The author examines the requirements of section 1707.08(A)(3) of the proposed Ohio Securities Act and concludes that the provision is inadequate to ensure that only high-grade securities will be permitted the advantages of notification registration. Not only does the section permit extensive dilution of the purchaser's interest in tangible assets, but it also permits dilution of all assets far in excess of 40 percent. The statutory limitation on the number of purchasers and the section's good faith requirement are also criticized. For these reasons the author recommends that the section not be enacted.

I. PATTERNS OF BLUE SKY REGISTRATION

STATE BLUE SKY laws are designed to protect the investing public from fraud, lack of full disclosure, high-pressure sales tactics and the sale of securities that are financially unsound.[1] The state approach, which is primarily concerned with the "merits" of an offering, differs from that of the federal government, which emphasizes full disclosure of all pertinent facts so that investors may make informed decisions with respect to the securities offered.[2] At the state level administrators have considerable discretion to look into the merits of a proposed offering, as well as to require disclosure through an offering circular or prospectus.[3] State administrators have been granted this additional authority because mere disclosure in a prospectus may furnish inadequate protection for the investor.[4]

1. J. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS 15 (1971) [hereinafter cited as MOFSKY]. The Ohio Blue Sky Law is no exception. *See* Grosby v. State, 109 Ohio St. 543, 550, 143 N.E. 126, 128 (1924); Nida, *The Ohio Division of Securities and the Ohio Securities Act*, 13 OHIO ST. L.J. 427, 434-35 (1952) (original purpose was prevention and punishment of fraud, but amendments increased discretion of administrator to rule on soundness of issue); Note, *Ohio Securities Act: Powers, Sanctions and Constitutional Objections*, 17 W. RES. L. REV. 1098, 1098 (1966).

2. *In re* Tucker Corp., 26 S.E.C. 249 (1947); 1 L. LOSS, SECURITIES REGULATION 121-28 (2d ed. 1961); *cf.* Anderson, *The Disclosure Process in Federal Securities Regulation*, 25 HASTINGS L.J. 311 (1974).

3. 3A H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 14.08 (1972) [hereinafter cited as BLOOMENTHAL]; MOFSKY 15-17. *See also* Mofsky, *Reform of the Florida Securities Law*, 2 FLA. ST. L. REV. 1, 3 (1974).

4. Douglas, *Protecting the Investor*, 23 YALE REV. 521, 523-24 (1934); Hueni, *Application of Merit Requirements in State Securities Regulation*, 15 WAYNE L. REV. 1417, 1417-20 (1969) [hereinafter cited as Hueni]. *See*

One means of regulating an issue is to require the registration of securities prior to sale within the state.[5] The three most common methods of registration are coordination, qualification, and notification.[6] These three forms of registration exist in various combinations in different states.[7] Coordination is a simplified method of registration that is only available for those securities that are also being registered with the Securities and Exchange Commission under the Securities Act of 1933.[8] The two forms of registration used by the majority of states are qualification and notification.[9] Generally, any security is eligible for registration by qualification,[10] which requires far more detailed and elaborate information than notification registration.[11] This more complete disclosure requirement provides the administrator with sufficient information to make decisions concerning the "merits" of the proposed offering.[12] In order for the statement to become effective, the administrator must take some affirmative action.[13]

Notification registration, on the other hand, involves the presentation of abbreviated factual information to the administrator[14]

Anderson, *The Disclosure Process in Federal Securities Regulation*, 25 HASTINGS L.J. 311, 351-53 (1974). *See also* SEC REPORT OF SPECIAL STUDY OF SECURITIES MARKET, H.R. DOC. NO. 95, 88th Cong., 1st Sess., pt. 4, at 134-37 (1963) (discussion of the need for state blue sky legislation to supplement federal regulation of securities industry).

5. Other modes of regulation include the registration and licensing of broker-dealers. *See, e.g.*, OHIO REV. CODE ANN. § 1707.14 (Page Supp. 1973); UNIFORM SECURITIES ACT §§ 201-04 [hereinafter cited as USA].

6. *See* MOFSKY app. E, at 162-67 (chart of registration methods in different states).

7. *Id.* Registration by description, which is available in Ohio and a few other states, is the equivalent of notification registration. *See, e.g.*, OHIO REV. CODE ANN. § 1707.08 (Page 1964).

8. USA § 303 (1970); 1 BLUE SKY L. REP. ¶¶ 510-11 (1973); R. JENNINGS & H. MARSH, CASES AND MATERIALS ON SECURITIES REGULATION 583 (3d ed. 1972) [hereinafter cited as JENNINGS & MARSH]. This method of registration is a recent development in the Uniform Securities Act. For earlier suggestions of coordination of federal and state acts, see Smith, *The Relation of Federal and State Securities Laws*, 4 LAW & CONTEMP. PROB. 241, 254-55 (1937); Wright, *Correlation of State Blue Sky Laws and The Federal Securities Acts*, 26 CORNELL L.Q. 258, 278-81 (1941).

9. MOFSKY app. E, at 162-67.

10. *E.g.*, MASS. GEN. LAWS ANN. ch. 110A, § 303(a) (Supp. 1974).

11. 1 BLUE SKY L. REP. ¶ 511 (1973); *see* note 32 *infra*.

12. Mofsky, *Blue Sky Restrictions on New Business Promotions*, 1969 DUKE L.J. 273, 274-75.

13. JENNINGS & MARSH 583.

14. *See* note 32 *infra*.

and becomes automatically effective after a short period of time.[15] For this reason, notification registration is reserved for certain "high-grade" issues.[16] However "high-grade" is defined,[17] the classification is based on a determination that the security is almost certainly fair and its potential for fraud is so low that extended review of the merits of the issue is unnecessary.[18] These securities are generally issued by corporations with an extremely favorable earnings record, or they are secured by mortgages on real estate or pledged collateral of a substantial nature.[19] Owing to the limited scrutiny these securities receive, this method of registration should be available only to those securities that meet both of the following requirements: there is a low probability of the issue being tainted by fraud and the financial package will very probably meet whatever merit standard is used by the state. It is important to note that a high level of assurance that there is no unfairness (both in the substance of the investment and in the extent of disclosure accompanying the offering) is as significant as the diminished likelihood of fraud. This is so for the rather

15. *Compare* MICH. COMP. LAWS ANN. § 451.702(c) (1967) (20 days) *with* KAN. STAT. ANN. § 17-1256(c) (1964) (2 days).

16. JENNINGS & MARSH 583.

17. *See, e.g.*, USA § 302(a); *see* note 19 *infra.*

18. *See* note 33 *infra. See generally* Boesel, *Analysis of The Ohio Securities Act*, 5 W. RES. L. REV. 352, 361 (1954), and Note, *Registration Provisions Under the Ohio Blue Sky Law*, 17 W. RES. L. REV. 1126, 1128 (1966), which discuss registration by description in Ohio.

19. 1 BLUE SKY L. REP. ¶ 510 (1973). In Ohio three types of securities may be registered by description: (1) securities issued by a going concern which has proved its stability, OHIO REV. CODE ANN. § 1707.05(A) (Page 1964); (2) securities backed by interests in land mortgages, land tracts, or steamships, *id.* §§ 1707.05(B)-(D); (3) securities for which the company has collateral deposited in trust with a bank, *id.* § 1707.05(E). In addition there are four types of transactions that may be registered by this simplified method: (1) sales of securities for tangible property located within the state and with a limited commission, *id.* § 1707.06(A)(1); (2) sales of securities to not more than fifteen shareholders, *id.* § 1707.06(A)(2); (3) sales of securities to an unincorporated entity with not more than 10 members, *id.* § 1707.06(A)(3); and (4) sales of securities to current holders, *id.* § 1707.06(A)(4). The Ohio Division of Securities [hereinafter referred to as the Division] has been particularly concerned with the difficulties raised by § 1707.06(A)(1). *See* note 62 and accompanying text *infra.*

For a discussion of notification registration in other states, see Dorwart & Holden, *An Overview of the Oklahoma Securities Act*, 25 OKLA. L. REV. 184, 202 (1972) (must have a "track record"); Rediker, *Alabama's "Blue Sky Law" —Its Dubious History and its Current Renaissance*, 23 ALA. L. REV. 667, 681 (1971) (issues that meet the requirements are more seasoned); Rooks, *The Blue Sky Law of Washington: Registration of Securities of a New Venture*, 6 GONZAGA L. REV. 187, 195-96 (1971) (notification not available for securities of a new venture). MOFSKY app. E, at 162-67, provides a listing of all state statutes which permit notification registration.

obvious reason that the administrator has no real opportunity to scrutinize the offering for fairness because of the speed with which a registration becomes effective and the relatively limited amount of information concerning the issuer available to him.[20]

II. THE PROPOSED OHIO SECURITIES ACT

The proposed Ohio Securities Act[21] provides for all three methods of registration. Section 1707.08 provides for notification registration. Under section 1707.08(A), there are six types of offerings that are eligible for such registration. This Note will focus on section 1707.08(A)(3), which is designed to permit notification registration of securities that are not expected to work a substantial dilution of the purchaser's interest. Despite this design, the proposed section allows registration even though there may be dilution of the purchaser's investment so great that the offering may well be unreasonable or unfair.

A particular offering may be registered in accordance with this section if all of the following four conditions are met:

> a. At least sixty percent of the total consideration paid or given for all of the securities being offered or proposed to be offered, whether or not they are proposed to be registered or offered in this state, plus all other securities issued by the issuer within the two year period preceding the date the registration statement is filed, is cash or tangible property;[22]
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> b. Such security is part of an issue purchased by not more than twenty-five persons in this state;[23]
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> c. The total of commissions and other remuneration paid or given directly or indirectly for soliciting offerees and any other expenses incurred directly or indirectly in connection with the offering, except legal, accounting, and printing expenses incurred by the issuer, does not at any time during the period of distribution exceed three percent of the proceeds received at such time from the sale of such securities;[24]
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> d. Such security is registered and distributed in good faith and not for the purpose of avoiding chapter 1707. of the Revised Code.[25]

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20. *See* notes 28-33 and accompanying text *infra.*

21. Ohio S.B. 338, 110th Gen. Assembly, Regular Sess. (1973-74) [hereinafter cited as OSA].

22. OSA §§ 1707.08(A)(3)(a)-(d).

23. *Id.* § 1707.08(A)(3)(b).

24. *Id.* § 1707.08(A)(3)(c).

25. *Id.* § 1707.08(A)(3)(d).

This section continues by defining "tangible property" for the purpose of subsection (a) to include:

> All property other than patents, copyrights, secret processes, formulas, services, good will, promotion and organization fees and expenses, trademarks, trade brands, trade names, licenses, franchises, or any other assets treated as intangible according to generally accepted accounting principles and practices, or any securities, accounts receivable, or contract rights having no readily determinable value; but the term "tangible property" includes securities, accounts receivable, and contract rights when they have a readily determinable value.[26]

For the purpose of subsection (b) above, "person" is defined to include:

> [A] legal or beneficial owner, except that each of the following are deemed to be a single purchaser: husband and wife, a child and its parent or guardian when the parent or guardian holds the security for the benefit of the child, a corporation, a partnership, an association or other unincorporated entity, a joint-stock company, or a trust, but only if the entities or trusts described in this paragraph were not formed for the purpose of purchasing such security.[27]

A registration statement filed under this provision becomes effective automatically five business days after filing unless there is a proceeding pending or a stop order is issued.[28] Section 1707.12 lists ten grounds for the issuance of a stop order. Those most important to this discussion are the following: The offering has been or would be grossly unfair to the purchasers;[29] the offering has worked or

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26. *Id.* Note that the present form of the proposed Act does not reflect the suggestion of the Advisory Board to eliminate from the definition of tangible property the reference to certain intangibles having a readily determinable value, which is presently embodied in § 1707.01(L)(2). Minutes of the Advisory Board on Revision of Ohio Securities Law, June 5, 1971, at 6, 7 [hereinafter cited as Advisory Board Minutes]. This suggestion was prompted by the valuation problem discussed in note 62 and accompanying text *infra.*

27. OSA § 1707.08(A)(3)(d).

28. *Id.* § 1707.08(D). § 1707.08(E)(1) permits the statement to become effective upon the date of mailing if the registrant guarantees he will refund all proceeds if a stop order is issued retroactively. However, if there is no fund to draw upon, this provision is ineffective.

29. *Id.* § 1707.12(A)(6). However, before the administrator can act under this section, he must have promulgated rules that develop specific standards and criteria defining what is grossly unfair. There is a need for such standards. JENNINGS & MARSH 584. *But see* MOFSKY 16 (rules and regulations give a sense of specificity and objectivity that is misleading in view of the number of variables).

tended to work a fraud on the purchaser, or would so operate;[30] and the offering is ineligible for notification registration.[31] However, the information available to make a decision concerning the fairness of the proposed offering is limited.[32] This factor, combined with the 5-day automatic effectiveness provision, prevents the administrator from giving the offering anything more than superficial inspection. Therefore, the presumption must be that issues that satisfy the four requirements of section 1707.08(A)(3) will be fair.[33] This section, however, permits notification registration of a security that bears a high probability of fraud, and even if the issue is free from fraud, the result may be contrary to what is generally accepted as fair.

An example of the operation of this provision may be instructive. Suppose at the time corporation *X* is formed, promoters purchase 100,000 shares at $1 per share ($0.20 cash and $0.80 various intangibles) while the public purchases 100,000 shares of the identical class of stock at $1 per share (cash). So long as $120,000 of the

30. OSA § 1707.12(A)(5).

31. *Id.* § 1707.12(A)(7). Note that this implies that a notification registration can become effective even if the offering is ineligible for notification registration. If this implication cannot be made then this section is mere surplusage.

32. A comparison of the information required to be submitted for registration by notification, as set forth in § 1707.08(C), with the requirements of § 1707.10(B) for registration by qualification, makes it readily apparent that the Division has limited material available on which to judge the merits of an application for notification registration. For example, to register by qualification the issuer must submit the names of all officers, directors, and promoters. He must also give the names of all shareholders with a greater than 10 percent ownership of any class of security, along with a statement of their present ownership of securities of the issuer and the amount of the securities covered by the registration statement to which they have indicated an intention to subscribe. OSA §§ 1707.10(B)(2)-(5). The registrant must also supply a statement of the estimated cash proceeds expected from the offering and a description of the purposes for which the proceeds will be used. OSA § 1707.10(B)(9). Unless the Division specifically requires it, none of this information need be submitted to register by notification. The information required under the Ohio Securities Act is essentially the same as under the Uniform Securities Act. *See* USA §§ 302, 304.

33. Advisory Board Minutes, June 5, 1971, at 2: "The Board agreed that the policy justification for permitting certain categories of securities or transactions to be registered on the basis of diminished informational requirements and without administrative front-end evaluation is the fact that certain securities and transactions are less likely to generate massive fraud or unfairness." "The Board tentatively agreed that certain securities and transactions could reasonably be identified which are characteristically 'safe' and, therefore, should be permitted to be registered in an automatic process." Advisory Board Minutes, May 29, 1971, at 16.

$200,000 consideration received by the company is cash or tangible property, the major requirement of section 1707.08(A)(3) is met.[34] Thus, the promoters pay $0.20 cash per share for stock with tangible assets backing it up to the extent of $0.60 per share, while the public pays $1 cash per share for stock with the same tangible asset value per share ($0.60). As a result, the public will realize a 40 percent dilution in tangible assets per share.

This possibility of substantial dilution is aggravated by the apparent limitation on the administrator's power to require that the issuer fully disclose the dilution by means of a prospectus or offering circular. Section 1707.11(L) of the OSA gives the administrator power to require by rule that a prospectus be distributed as a condition of registration "if the issue is to be purchased by more than twenty-five persons." By negative implication, the administrator does not have this power if the issue is to be purchased by 25 persons or fewer. Since this is one of the conditions for eligibility under section 1707.08(A)(3),[35] those who seek to register under this section cannot be required as a condition of registration to disclose to their purchasers the existence or extent of any dilution.[36] The situation is ripe for fraud,[37] and even if no fraud has occurred in a given case, the question arises whether the issuance of this secur-

34. The total consideration received ($200,000), minus the intangibles ($80,000), equals $120,000 cash consideration. $120,000 divided by $200,000 equals 60 percent. The requirement that 60 percent of the consideration received be cash or tangible property has been met. *See* text accompanying note 22 *supra.*

35. Text accompanying note 23 *supra.* Note that if this implication is not accepted, the Commissioner of Securities may have power to require a prospectus in offerings not covered by § 1707.43. *But see* note 55 *infra.*

36. *See generally* H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES §§ 105-06 (2d ed. 1970); *cf.* Old Dominion Copper Mining & Smelting Co. v. Lewisohn, 210 U.S. 206 (1908); Old Dominion Copper Mining & Smelting Co. v. Bigelow, 188 Mass. 315, 74 N.E. 653 (1905). There may be civil liability if the promoters who are in control of the corporation cause it to issue securities fraudulently. But securities registration is intended to eliminate the need to resort to these after-the-fact remedies.

37. An argument can be made that information regarding the issuer is available to investors since the registration statement filed with the Commissioner becomes a matter of public record. Thus, the argument continues, the ends of disclosure are met, and all a prospective purchaser need do is contact the Division and peruse the information on file to form a basis for an informed investment decision. The obvious weakness in this argument is that it presupposes a level of sophistication and interest in the ordinary investor that is seldom borne out in practice. It also runs contrary to the fundamental objective of blue sky legislation, the protection of the unwary, unsophisticated investor from securities offerings that are potentially fraudulent or unfair. *See* text accompanying note 1 *supra.*

ity and the resulting 40 percent tangible asset dilution can be considered presumptively fair and reasonable.

Another type of dilution, that which accompanies the issuance of "cheap stock," gives rise to even more serious questions about the fairness and reasonableness of certain offerings that are permitted by this section of the OSA. Cheap stock dilution, in contrast to the type of dilution discussed above, exists when there is a disparity between the fair market value of the consideration (as opposed to the nature of the consideration) paid by a corporate insider, agent or employee and the consideration paid by the public.[38] That cheap stock problems will arise under this section may be illustrated by this hypothetical situation. Suppose at the time corporation *X* is formed promoters purchase 100,000 shares of corporation *X* stock at $0.20 per share and sell another 100,000 shares of the identical class of stock to the public at $1 per share. So long as the $120,000 consideration received by the company is cash or tangible property, the first requirement of section 1707.08 (A) (3) has been met.[39] The public's investment has been diluted by 40 percent without any requirement that the dilution be disclosed or justified by the promoters.[40] Although cheap stock is not necessarily undesirable, it is

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38. The Midwest Securities Commissioners Association presumes the existence of cheap stock under certain circumstances.

> Any securities sold or issued within two years prior to the public offering date to persons who at the time of sale or issuance were underwriters, promoters, finders, officers, directors, employees, or controlling stockholders of the issuer, for a consideration lower than the proposed net public offering price of such securities, including options and warrants exercised, in the absence of any public market for such securities or any substantial change in the earnings or financial position of the issuer, shall be presumed to be "cheap stock."

Midwest Securities Commissioners Association, *Statement of Policy on Cheap Stock*, 1 BLUE SKY L. REP. ¶ 4761 (1968). The statement of policy also specifies two conditions that must be met before cheap stock may be considered justified:

1. The shares are sold or issued by an issuer which is in the promotional or developmental stage.
2. The number of shares sold or issued shall have a reasonable relationship to the proposed offering price.

Id.

Note that § 1707.08(A)(3) is not subject to these promotional limitations. Similar protection could be supplied under § 1707.08(A)(3) by the inclusion of a fairness rule.

39. *See* text accompanying note 20 *supra.*

40. There would be 200,000 shares of stock outstanding: 100,000 shares owned by the promoters and 100,000 shares owned by the public. Upon dissolution the total assets of the corporation, $120,000, would be divided equally between the promoters and the public. Thus the public would receive $60,000,

certainly a proper matter for regulatory concern.[41]

Admittedly cheap stock may lose its character as such and become stock issued for consideration that is not wholly cash or other tangible property. Stock is no longer cheap if the difference between the price at which it was issued and the price to the public is fully accounted for as compensation to the promoters for organizing the company or as a return for intangibles assigned to the company or as a reward to a small insider group for providing early financing.[42] The issuance of stock to insiders at a bargain price might be a valid entrepreneurial increment in many cases. However, adequate safeguards must be provided to prevent excesses and abuse.[43]

Explicit rules or regulations have been adopted in a number of states in order to regulate cheap stock. Such rules are also useful, though to a lesser extent,[44] in determining whether tangible asset dilution percentages are fair and reasonable.[45] One approach in attempting to define what is a "fair, just, and equitable" amount of dilution has been to set a quantitative limit on the dilution permitted. Various limits have been established, but the most common rule prohibits dilution greater than 33⅓ percent.[46] One state, however, permits no dilution and requires that the promoters' preincorporation

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resulting in a $40,000 loss and 40 percent dilution of their original investment of $100,000 (100,000 shares at $1 per share).

41. Hueni 1423-24.

42. For additional justifications, see *id.*

43. *See* note 38 *supra.*

44. Dilution that results from a disparity in the nature of the consideration paid is not so serious as the dilution that results from cheap stock, since the book value of the intangible assets may be at least partially recoverable upon liquidation. Thus, the actual dilution will be decreased.

45. Uniform Securities Act § 306(a)(2)(F) allows the administrator to issue a stop order if there have been "unreasonable amounts of . . . promoters' profits or participation." Clause (E) allows for the issuance of a stop order if "the offering has worked or tended to work a fraud upon purchasers or would so operate." Although fraud is not limited to common law deceit, USA § 401 (d), its application in this clause was not designed to be as broad as the "fair, just, and equitable" standard. USA § 306, Comment E. This Act embodied an attempt to isolate and specify the factors that administrators should consider when using a merit approach. MOFSKY 15.

46. Alabama, 1 BLUE SKY L. REP. ¶ 5601 (1960); Arkansas, *id.* ¶ 7605 (1972); Hawaii, *id.* ¶ 14,831 (1970); Kansas, 2 *id.* ¶ 19,707 (1972); Louisiana 2 *id.* ¶ 21,603 (1973); Michigan 2 *id.* ¶ 25,635 (1968); Utah, 3 *id.* ¶ 47,604 (1973); Wyoming, 3 *id.* ¶ 53,612 (1968). Missouri allows 50 percent dilution, 2 *id.* ¶ 28,606 (1972). Ohio permits 50 percent dilution for a promotional company and 80 percent dilution for a going concern. OHIO SECURITIES BULL., June 1973, at 13-14. In the light of the generally accepted standards of what is fair and reasonable, it would appear that the amount of dilution permitted by the Division is excessive.

subscription equal the public offering price.[47] Other states use a different approach: Instead of setting a specific limit on the percentage of dilution allowable, they provide that to be justified cheap stock must (1) be issued by a corporation in its promotional stage, (2) be issued in an amount that bears a reasonable relation to the total number of shares issued, and (3) be issued for consideration that is reasonably related to the public offering price.[48] The rules in these states plainly respond to the argument that to set a fixed limit is inequitable, since more than 33⅓ percent dilution could conceivably be justified under certain circumstances. Moreover, in other situations such a percentage might be too high. Thus it is contended that each offering should be judged on its own merits.[49]

In any event, if Ohio is to adopt a quantitative standard, it can certainly be concluded that the 40 percent dilution permitted by section 1707.08(A)(3)(a) is not presumptively fair, in view of the general acceptance of the standard that permits only 33⅓ percent dilution. Indeed it exceeds the permissible limits in at least ten states.[50] This is not to assert that 40 percent dilution is presumptively unfair or unreasonable, but merely that the matter is in doubt.[51] If the offering is such that the price differential must be justified, then the nearly automatic notification registration should not be available, since such registration is based on the theory that the issue is presumptively fair and there is little need for administra-

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47. South Carolina, 3 BLUE SKY L. REP. ¶ 43,660 (1963).

48. *E.g.*, South Dakota, 3 *id.* ¶ 44,609 (1969). This is also the approach of the Midwest Securities Commissioners Association Policy on Cheap Stock, 1 *id.* ¶ 4761 (1968). *See* note 38 *supra.*

49. Hueni 1424; *see* Mofsky, *Blue Sky Restrictions on New Business Promotions*, 1969 DUKE L.J. 273, 285-86. Under provisions for registration by qualification, the percentages noted in text above are allowed after administrative scrutiny of the offering.

50. *See* note 46 *supra.*

51. Normally a substantial disparity in price between stock sold to the public and any cheap stock previously sold would of itself be grounds for the denial of the registration without inquiry into whether the disparity can be accounted for in terms of future services.

> The sale of securities to underwriters or promoters, at prices substantially below the public offering price, at a time in close proximity to the public offering date, will hereafter be looked upon with great disfavor and will be considered as a basis for the denial of the application except in unusual circumstances, such as favorable developments after the date of sale to the underwriters or promoters and before the public offering dates, sufficient to justify the differential in price.

NASA PROCEEDINGS 113-15 (1955), *quoted in* L. LOSS & E. COWETT, BLUE SKY LAW 330 (1958). *But cf.* note 38 *supra* (discrepancy in price to promoters within given span of years gives rise to presumption of services).

tive scrutiny.[52]

Codification of a provision permitting 40 percent dilution not only is arguably unfair and clearly contrary to the rationale for notification registration, but it also is unwise, because it eliminates the administrator's discretion in the area. If experience shows that this percentage is too high, the administrator is virtually powerless to effectuate any change. The dilution limitations that other states have adopted are administrative rules and regulations that provide guidelines for the enforcement of the statute,[53] not built in conditions. Section 1707.08(B) allows the administrator to "modify or further condition the eligibility" of any securities registered under section 1707.08(A)(3) by rule, if it is in the public interest, or if there is a continuing history of acts or practices that are prohibited by section 1707.12[54] and such acts or practices cannot be effectively regulated "through the exercise of the other regulatory or enforcement powers authorized" by the Act. However, there remains the serious question whether the power to "modify or further condition the eligibility" would permit the administrator to disregard a definite standard that has been expressly set by statute.[55]

An additional problem, which compounds the difficulty of determining what is a presumptively fair dilution of the public's investment, arises from the specific wording of section 1707.08(A)(3)(a). Suppose promoters purchase 100,000 shares of stock at $0.10 per share from corporation *X*. Then, within two years, they issue 100,000 shares of the same class of stock to the public at $2 per share. The total consideration paid for the 200,000 shares is $210,000. The promoters have $105,000 worth of net asset participation in return for an investment of $10,000 while the public has $105,000 net asset participation in return for an investment of $200,000. The requirement of section 1707.08(A)(3)(a) has, on its face, been met; 100 percent of the consideration paid for the shares appears to be cash. In this particular situation the public's investment is diluted 47½ percent (100 percent, minus $105,-

52. *See* text accompanying notes 14-20 *supra.*

53. *See* note 46 *supra.*

54. § 1707.12 also gives the administrator the power to issue a stop order to deny effectiveness after registration.

55. § 1707.43 gives the administrator a general rule-making authority in addition to the specific authority granted elsewhere in the Act. This authority is limited by § 1707.45, which creates a Board of Securities Review with the power to disapprove any existing or proposed rule or order promulgated by the administration.

000 divided by $200,000) and, depending on the price differential, could asymptotically approach 100 percent. Even though the dilution exceeds 40 percent, the offering will still be eligible since all the consideration is cash.

On the other hand, that cash was received does not mean that it was the only consideration; it may be that the insiders actually provided additional intangible consideration, for example, services, in which case dilution of more than 40 percent would violate the statutory requirement. If it can be shown that the fair market value of the stock was higher than the cash paid in by the promoters, it is reasonable to conclude that they paid additional consideration in the form of intangibles. Courts charged with the application of the tax laws have wrestled with the problem of determining the fair market value of stock at the time it was acquired by the promoter. In *Bruce Berckmans*,[56] the issue was whether a taxpayer who purchased stock at $1 per share which was later sold to the public at $9.50 per share received compensation for his services for income tax purposes in an amount equal to the difference between $1 and $9.50. Before the Tax Court could answer this question it had to determine whether the fair market value at the time of the sale to the taxpayer was greater than the purchase price. The court found that the price paid was the fair market value and that there was no compensation received. The court explained the lower purchase price by pointing out that when the insiders purchased their shares the success of the venture depended upon certain contingencies: obtaining SEC and state blue sky approval and receiving a definite commitment from the underwriters.[57] Faced with a slightly different situation in *Elsie L. Dees*,[58] the court sought to determine whether a taxpayer who had purchased stock for less than the public offering price received compensation for his services. Because some shares had already been sold to the public at a higher price, this was held to be a bargain purchase, and the difference was accounted for as compensation for services rendered or to be rendered. The court implicitly recognized the difficulty of ascertaining the value of the shares purchased when it noted that the price paid by the public might have been excessive and that

56. 30 P-H Tax Ct. Mem. 508 (1961).

57. The contingencies referred to by the court were largely technical in nature and it is unlikely that the taxpayer would have invested if he had had serious doubts concerning the completion of the transaction. D. HERWITZ, BUSINESS PLANNING: MATERIALS ON THE PLANNING OF CORPORATE TRANSACTIONS 275 (1966).

58. 31 P-H Tax Ct. Mem. 915 (1962).

the true value could lie somewhere between the public and the private offering prices.[59]

Both *Berckmans* and *Dees* illustrate the difficulty of determining the fair market value of stock at the time of acquisition. If in fact there was a bargain purchase, it can be presumed that the difference between the fair market value and the purchase price was paid in the form of services.[60] Under the proposed bill compensation for services may not exceed 40 percent of the total consideration. But to determine whether consideration was received in the form of services one must first look to the fair market value of the securities and decide whether it was higher than the cash paid in. This can be an extremely difficult process[61] and because the only ostensible consideration is cash, the burden of proving noncompliance with the statute falls ultimately on the administrator, rather than the issuer asserting eligibility under section 1707.08 (A) (3).[62]

Section 1707.08(A)(3)(a) presents some serious problems. No matter how it is interpreted, the section fixes the permissible dilution at least 40 percent under all circumstances, which conflicts

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59. *Id.* at 930.

60. *See* D. HERWITZ, *supra* note 57, at 274 (despite appearance of purchase, compensation may still be present).

61. *See* text accompanying notes 56-59 *supra*; *cf.* Hueni 1426.

62. The administrator could seek to create a presumption by rule that additional intangible consideration was present, but he would still face the problems created by § 1707.08(B). *See* text accompanying notes 54-55 *supra*.

The counterpart of § 1707.08(A)(3) under the current statute, OHIO REV. CODE ANN. § 1707.06(A)(1) (Page 1964), requires that none of the consideration be in the form of intangibles. It raises a number of problems, however, which are due to the difficulty in determining the value of tangible property and the danger of dilution resulting from a prior issuance of cheap stock. There is a history of Division discomfort with this particular section. A recent Statement of Policy indicated that applications for registration under § 1707.06(A)(1) will be subject to immediate suspension unless the applicant agrees not to commence sale until the Division has reviewed the application or there is a signed statement by the applicant that a large number of terms and conditions have been satisfied. OHIO SECURITIES BULL., May 1973, at 10-11.

This difficulty will not be remedied by the enactment of OSA § 1707.08 (A)(3). In fact, the valuation problem will be compounded since the new section allows 40 percent of the purchase price to be paid with intangibles. Under both provisions the Division is placed in the position of having to second-guess during the brief period allotted by statute for review of the application, the value of consideration received. Such valuation problems cut against the presumption underlying notification registration that the offering in question is very probably free from fraud or unfairness. *See* note 33 *supra* and accompanying text. It was this uncertainty in valuation that the Advisory Board sought to avoid. *See* Advisory Board Minutes, June 5, 1971, at 6.

with the rationale for providing only summary review under the notification registration provision.[63] Furthermore, one interpretation of the section would theoretically permit the dilution to approach 100 percent unless the administrator can prove that part of the consideration paid for the securities was not "tangible property."[64] Even if it is later established that the issue was ineligible for notification registration and a stop order is issued the damage will already have been done. In addition, there will be no remedy available to the purchaser for the nonregistration of securities sold in the interim between the attempted registration and the issuance of the stop order. Section 1707.12(C)(2) provides that a stop order will not have a retroactive effect and securities sold prior to the issuance of the order will be deemed to have been in compliance with the Act.[65] The proposed section, therefore, will not fulfill the prophylactic purpose that blue sky legislation is generally designed to serve.[66]

The three additional requirements for notification registration under section 1707.08(A)(3) present further problems. Section 1707.08(A)(3)(b) states that the offering may not be purchased by more than 25 persons.[67] There are two possible rationales for this provision. The first is that 25 people are too few to be of any consequence to the Division of Securities. However, if the blue sky laws are to protect the investor,[68] individuals should not be deprived of this protection merely because they happen to be members of a group that is arbitrarily deemed too small to warrant Division concern. The more plausible rationale for the limitation is that this is not a public offering but a private one, and that private offerees on the whole are sophisticated enough to understand and avoid the dangers involved.[69] This reasoning presumes the purchasers have all the

63. *See* text accompanying notes 34-53 *supra.*

64. *See* text accompanying notes 26, 54-62 *supra.*

65. Under the existing statute a sale or contract made in violation of any of the registration provisions is voidable at the election of the purchaser. OHIO REV. CODE ANN. § 1707.43 (Page 1964).

66. "It is the policy and purpose of this legislation to prevent ensnarling of the public by unscrupulous dealers . . . and to provide some method of supervision and regulation of what is offered . . . ." 14 W. FLETCHER, CYCLOPEDIA OF CORPORATIONS 164 (perm. ed. 1966); see Emery v. So-Soft of Ohio, Inc., 30 Ohio Op. 2d 226, 199 N.E.2d 120 (Ct. App. 1964); BLOOMENTHAL § 14.08 (administrator may determine if investors are to have access at all to certain types of securities).

67. *See* text accompanying note 23 *supra.* It is worthy of note that this may be extended to 50 or more persons owing to the definition of "person" in § 1707.08(A)(3). *See* text accompanying note 27 *supra.*

68. *See* note 66 *supra* and accompanying text.

69. There was some indication by the Advisory Board that this was the

facts, although there is no requirement that a prospectus or offering circular be made available to the purchasers and, indeed, the Commissioner cannot require their use.[70] Furthermore, the mere limitation of the number of purchasers does not in any way guarantee their sophistication.[71] And even if a numbers limit did preclude all but the sophisticated, the fact remains that this limit applies to purchasers, not offerees, so that the number of those who may be approached in the course of an offering may far exceed the 25 persons who eventually do purchase. Thus, those who purchase could come from a group of offerees so large as to raise absolutely no presumption as to sophistication. Since the actual purchasers are drawn from the entire spectrum of offerees their sophistication cannot be presumed. Accordingly, the numbers test should apply to the offerees rather than the purchasers if it is to have any meaning at all.[72]

The next section, 1707.08(A)(3)(c), limits the amount of commissions paid by the issuer to 3 percent of the proceeds received from the sale of the security.[73] The purposes of this provision are to prevent excessive dilution of the investors' funds over that already allowed,[74] to insure "that the maximum portion of the proceeds would inure to the issue,"[75] and, perhaps, to prevent overly aggressive underwriting.[76] On the other hand, there is "some danger of

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reason for the 25-person limit. "The discussion focused upon a comment to the effect that most attorneys and issuers in Ohio have come to regard 25 as the number of purchasers who may readily purchase securities without concern over a public offering." Advisory Board Minutes, June 5, 1971, at 10.

70. *See* text accompanying note 35 *supra*. *But see* MOFSKY 20 (without some form of limited offering exemption, administrators would be swamped). *See* 3 BLOOMENTHAL §§ 4.05[4]-[5], where the author discusses the implications of the numbers test and emphasizes the requirement that investors have all the facts.

71. *See* SEC v. Ralston Purina Co., 346 U.S. 119 (1953); *cf.* Bryant v. Uland, 327 F. Supp. 439, 442-43 (S.D. Tex. 1971). *See also* 3 BLOOMENTHAL §§ 4.05[4]-[5].

72. The present policy of the Division of Securities is to handle an application for registration on the basis of a cursory review if the offering is limited to 10 persons and such persons might be expected to have sufficient information with respect to the issuer. OHIO SECURITIES BULL., May 1973, at 11. *But cf.* MOFSKY 24-25 (disadvantages inherent in limiting the number of offerees).

73. *See* text accompanying note 24 *supra*.

74. *See* MOFSKY 22 (discussion of limits on commissions with respect to private offerings). Most states also limit the commissions and expenses paid an investment banker in connection with a public offering. *Id.*; *see* USA § 306(a)(2)(F). The National Association of Securities Dealers has imposed restrictions on underwriting compensation. *See generally* Ratner, *Regulation of the Compensation of Securities Dealers*, 55 CORNELL L. REV. 348 (1970).

75. Advisory Board Minutes, June 5, 1971, at 8-9.

76. *Cf.* SEC, DISCLOSURE TO INVESTORS—A REAPPRAISAL OF FEDERAL AD-

discouraging the use of professionals in preparing the registration statement if the limitation on expenses [is] too stringent."[77] The use of professional financial intermediaries can provide experience and expertise that the promoters lack.[78] There is reason for concern when a statute permits an offering to be registered with only limited review by the Division and at the same time discourages resort to professional assistance.

The fourth and final requirement of section 1707.08(A)(3) gives the administrator the power to deny or revoke registration when an offering violates the spirit, but not the letter, of the previous three requirements. This is the "good faith" requirement.[79] This provision might operate, for example, to prevent dilution from approaching 100 percent, as it theoretically could under the proposed statute.[80] However, "good faith" can generally only be determined in retrospect, and the 5-day period before the registration becomes effective is seldom sufficient to make such a determination. The administrator could promulgate rules and regulations that would help define this requirement, but, regardless of further definition, it is unlikely that sufficient information would be available to the administrator with the registration statement to enable him to make a finding before the registration became effective.[81] If this is true, then the requirement is not an effective screening device. It does not enable the administrator to prevent those who are acting in bad faith from registering under section 1707.08(A)(3). The "good faith" requirement can empower the administrator to revoke the registration statements of those who fail to meet this requirement.[82] If the ad-

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MINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS—THE WHEAT REPORT 60-61 (1969).

77. Advisory Board Minutes, June 5, 1971, at 8.

78. *See* MOFSKY 22-23.

79. *See* text accompanying note 25 *supra.*

80. *See* text accompanying notes 26, 54-60 *supra.*

81. *See* note 32 *supra.*

82. One use that the administrator could find for the § 1707.08(3) "good faith" requirement is the discouragement of avoidance of registration requirements through the use of "conduits." As one recommendation to the Advisory Board suggested, the phrases "good faith" and "not for the purposes of avoiding" the provisions of the section have "substantive content":

> Its purpose is to warn an offeror against claiming an exemption upon the ground that he sold securities to a limited number of persons who intended from the start to act as mere conduits in a widespread distribution by immediately reselling the securities which they acquired from the offeror.

OHIO DIVISION OF SECURITIES, COMPREHENSIVE LIST OF PROPOSALS RECEIVED BY THE OHIO DIVISION OF SECURITIES FOR THE REVISION OF SENATE BILL 338,

ministrator makes such a determination, section 1707.12(A)(7) allows the issuance of a stop order when a security registered by notification "is not eligible for such registration."[83] But the stop order will not have retroactive effect.[84] As a result, the good faith requirement will prove to be of limited value.

III. CONCLUSION

The purpose of blue sky laws is to protect public investors. One method of protection is to require the registration of securities. Notification registration is a simplified and nearly automatic form of registration for those high-grade securities, which can be presumed safe. Because of the limited information required before registration and the short interval of time before the registration becomes effective, it is essential that only securities that are almost certainly fair and free from fraud be permitted to take advantage of this simplified procedure.

Section 1707.08(A)(3) of the proposed Ohio Securities Act is inconsistent with the policy behind notification registration. The requirement that only 60 percent of the consideration be in the form of cash or tangible property allows too great a risk of serious dilution, particularly when even greater dilution is possible from the prior

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at 11 (1973). Note that the proper focus of the administrator's scrutiny should be on the investment intent of the offerees (or purchasers). § 402(b)(9)(A) of the Uniform Securities Act expressly requires that "the seller reasonably believes that all the buyers in this state . . . are purchasing for investment." A purchaser's investment intent often determines whether a transaction is a "private offering" within the meaning of the statutory exception or a disguised public offering and as such subject to the registration provision. *See generally* 1 Loss 665. The conduit problem also arises in the context of two exceptions to the Securities Act of 1933, the intrastate offering exception § 3(a)(11), 15 U.S.C. § 77c(A)(11) (1970), and the nonpublic offering exception § 4(2), 15 U.S.C. § 77d(2) (1970). The SEC originally adopted a hard-line attitude toward violating issuers and held them to a standard of strict liability. In time, however, they adopted a due care standard of liability and have not pursued corporate issuers who have taken reasonable steps to insure that their stocks do not pass through conduits to the general public. The recent trend has been to objectify the due care standard for determining whether a purchaser takes with an investment intent. *Compare* SEC Securities Act Release No. 4552 (Nov. 6, 1962) *with* SEC Securities Act Release No. 5223 (Jan. 11, 1972), CCH FED. SEC. L. REP. ¶ 78,487 (1971-1972 Transfer Binder). *See generally* Lewis v. Ling, 353 F. Supp. 241, 244-45 & n.6 (1973).

83. § 1707.12(A)(7).

84. § 1707.12(c)(2) provides that a stop order will not have a retroactive effect and securities sold prior to the issuance of the order will be deemed to have been in compliance with the Act. *See* text accompanying note 66 *supra.*

issuance of cheap stock. Certainly the section could be improved in several ways. The permissible percentage of dilution could be reduced. The Division could be authorized to require an offering circular at its discretion. And the limitation on the number of purchasers could be changed to apply to offerees. These modifications, however, do not correct the fundamental weakness of the section—its inability to assure that only high-grade securities will qualify. Because of its failure to conform with the underlying rationale of notification registration, the section should not be enacted into law.

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