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COMMENTS

RECENT CHANGES IN THE KENTUCKY SECURITIES LAW

Despite the focus in recent years upon federal¹ rather than state regulation of the securities market, the latter remains quite important. Today every state provides some regulation of securities issues.² A new securities or "blue sky" law was enacted during the 1972 session of the Kentucky General Assembly³ and became effective June 16, 1972.

Blue Sky Laws

Blue sky laws,⁴ a vestige of the early twentieth century, were the result of the rapid economic growth that this nation experienced during the late nineteenth century and of the accompanying sale of speculative securities.⁵ In 1911, Kansas became the first state to enact a comprehensive licensing system applicable to securities and to persons engaging in the securities business.⁶ This act provided for the registration of securities and securities salesmen. Within two years, twenty-three states had enacted their own securities regulations, all

¹ Securities Act of 1933, 15 U.S.C. §§ 77(a)-77(a)(a) (1970); Securities Exchange Act of 1934, 15 U.S.C. §§ 78(a)-78(j)(j) (1970). For a superior work regarding the Securities Act, see E. THOMAS, FEDERAL SECURITIES ACT HANDBOOK (1969). An outstanding account of the drafting and passage of the Securities Act by one of its principal draftsmen is found in Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959).

² The leading text on state regulation of securities is L. LOSS & E. COWETT, *BLUE SKY LAW* (1959) [hereinafter cited as LOSS & COWETT], the authors of which were the principal draftsmen of the Uniform Securities Act.

³ KY. REV. STAT. ch. 292 (Supp. 1972) [hereinafter cited as KRS].

⁴ State securities laws are called "blue sky" laws because early court cases stated that the laws were aimed at "speculative schemes which have no more basis than so many feet of blue sky." The precise date and place where this term was first coined are unknown, but by 1911 the term was in general use. See Mulvey, *Blue Sky Law*, 36 CAN. L.T. 37 (1916).

⁵ During this period the expansion of the nation's rail network, mining industry and heavy manufacturing industry was financed to a great extent by the sale of securities. Such endeavors required vast sums of risk capital, and securities were promoted and sold on a door-to-door basis. Since there was no regulation, many investors often suffered huge losses.

⁶ KAN. LAWS ch. 133, § 5 [1911], (repealed 1965). Although Kansas is generally credited with having passed the first blue sky law or securities law in 1911, Connecticut in 1903 adopted a brief statute which made it unlawful for any mining or oil company to offer its shares for sale, either directly or through a broker, until it had filed in the Secretary of State's Office a certificate showing its financial condition, the location and plans of its properties, the amount of work done and cash expended for improvements, and the condition of its plant and machinery. CONN. PUB. ACTS ch. 196 (1903-05).

but six of which were either identical to the Kansas statute or modeled on it. Most of these statutes exemplified a "paternalistic" approach to the regulation of securities, being designed to protect the "common man" from robber barons. These laws allowed government officials to prevent the sale of securities which they deemed too speculative for investment. Such an approach was appealing to many, including politicians, and state securities acts proliferated during the decades following enactment of the Kansas law.⁷

By present standards these laws were rather crude, having been hastily drafted by persons with little or no experience in the world of finance. The majority of these acts were without adequate definitions. Few acts provided suitable administrative machinery; sensible exemptive schemes had yet to be developed; and, most importantly, almost all of the statutory proposals were not sophisticated enough to carry out the avowed purpose of preventing fraud.⁸ Four basic patterns appeared in state securities laws: prohibition of fraudulent transactions, the requirement of registration of dealers in securities, the requirement of registration of securities, and combinations of fraud provisions and registration requirements.⁹ Most modern statutes, however, *consolidated* the various legislative patterns regarding securities regulation. A diverse set of statutory enactments regulating the securities industry emerged, with the result that a stock offering qualifying under one state law might not qualify under another. Such a situation is entirely incompatible with today's complex economic system. Since interstate rather than intrastate commerce is the norm, any corporation seeking to market securities for capital acquisition must have access to large, nation-wide capital markets. The conclusion is inescapable that uniform state regulation would greatly facilitate and encourage the offer, sale, and purchase of securities on a multi-state basis. In response to this need for uniformity, Professor Louis Loss, with the assistance of Edward Cowett and others, drafted the Uniform Securities Act.

The Uniform Securities Act

In view of the complexity and diversity of the United States economy a large corporation's securities offering may frequently be

⁷ Between 1911 and 1923, when the first federal securities legislation of general applicability was passed, the blue sky movement had spread to forty-seven states and Hawaii.

⁸ For a discussion of the early blue sky laws, their development and shortcomings, see LOSS & COWETT, *supra* note 2, at 11-13.

⁹ LOSS & COWETT, *supra* note 2, at 39-41. The authors provide a table which illustrates the extent to which each philosophy has been adopted by the respective states.

made in 15 to 30 states. The attorney who is asked to qualify an issue under the divergent laws of so many states in addition to federal regulations might inquire why a uniform state statute has not evolved. The Uniform Securities Act of 1956 represents a thoughtful effort to achieve such uniformity.¹⁰ It adopts the basic premise of most blue sky laws: that administrative control of the entrepreneur's access to the securities market is the most effective method of protecting investors. Superior in draftsmanship to prior blue sky laws, the Uniform Act¹¹ has been well received in whole or in part by many states. In 1956, the Midwest Securities Commissioners Association, a group of securities administrators from 22 states, recommended the enactment of the Uniform Securities Act by all states. Since then, 25 states, including Kentucky, have enacted statutes based upon the Uniform Act.¹² The Uniform Securities Act is a comprehensive piece of legislation which attempts to regulate the offer, sale, and purchase of securities within a state. The first three parts of the Act contain provisions governing: (1) fraudulent practices; (2) registration of securities dealers, agents and investment advisers; and (3) registration of securities.¹³ The fourth part of the Act includes, among other provisions: sanctions for violations of the first three parts, machinery for administering the Act, definitions of terms, and a list of exemptions of

¹⁰ For a well written introduction to an analysis of the Uniform Securities Act, see Note, *The Uniform Securities Act*, 12 STAN. L. REV. 105 (1959). See also Note, *Blue Sky Laws-Uniform Securities Act*, 3 B.C. IND. & COM. L. REV. 455 (1962). The complete text of the Uniform Securities Act together with official comments and draftsmen's commentary is contained in LOSS & COWETT, *supra* note 2, at 245-420. The same work also contains a summary of the act. *Id.* at 238-43.

¹¹ An earlier act had been promulgated in 1929. It was entitled the Uniform Sale of Securities Act and was approved by the National Conference of Commissioners on Uniform State Laws and the American Bar Association. For the text of the earlier act, see NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, HANDBOOK AND PROCEEDINGS (1962).

¹² J. HOPPER & R. WOOD, KENTUCKY'S DEVELOPMENT FINANCE SYSTEM AND THE AVAILABILITY OF CREDIT AND EQUITY FOR BUSINESS EXPANSION, SPINDLETOP RESEARCH, Report 343 (1972) [hereinafter cited as SPINDLETOP RESEARCH, Report 343].

¹³ The Uniform Securities Act of 1956 prescribes three forms of registration for securities. (1) Registration by coordination (§ 303), an innovation of the act, attempts to simplify the issuance of securities that are registered with the Securities and Exchange Commission. This method permits the federal prospectus to be substituted for the ordinary application form and coordinates the time when both registrations become effective. (2) Registration by notification (§ 302) is designed to establish a "streamlined" procedure for registering what might be termed "quality" issues. However, this provision can be expected to have a narrow application, since most quality issues that are also federally registered would probably be registered by the coordination procedure. Therefore, it would seem that notification is designed primarily for issues that are exempt from federal registration. (3) Registration by qualification or "merit registration" is the residual method (§ 304) but its main application is in regard to non-federally registered issues of new companies. The various registration procedures will be discussed more fully later.

certain securities. While the Act contemplates complete uniformity in most areas of securities regulation, the draftsmen realized that states with statutes of either the anti-fraud, dealer registration, or securities registration type would be hesitant to adopt an act which embodied *all* these provisions. Therefore, parts of the Act were made severable to enable state legislatures to adopt any one or a combination of the first three parts along with the appropriate sections of part three, thus allowing a state to enact any part which conforms to its philosophy in the field of securities regulation.

Kentucky Blue Sky Law

The former Kentucky blue sky law,¹⁴ which was drafted during the 1960 session of the Kentucky General Assembly and became effective January 1, 1961, was patterned after the Uniform Securities Act of 1956. During the 1972 legislative session the General Assembly revised the blue sky law in order to make it stronger and more effective. One of the major goals of this statutory revision was to classify specific portions of the chapter and to provide more and better investor information. The General Assembly, through the Director of the Division of Securities, commissioned a study of the existing law;¹⁵ it also relied upon recommendations of other studies¹⁶ relevant to the securities industry in formulating a revised blue sky law for Kentucky. The result of this effort was the new Kentucky securities law which became effective June 16, 1972.

The following analysis of the securities law will focus upon the areas of improvement over the old statute and areas where more might yet be done. In discussing the various changes, an attempt will be made to follow the sequence of the act from the definitions section through civil and criminal liabilities.

Definitions

The definitions section¹⁷ of the new securities law contains only

¹⁴ KRS ch. 292.

¹⁵ At the request of the Division of Securities, Mr. Hunter Durham, attorney, of Columbia, Kentucky, carried out an in-depth analysis of Kentucky's securities law. This study was to aid in the drafting of legislation which would provide maximum consumer protection, maximum uniformity with the securities laws of other states and the federal government and to provide Kentucky's industry with better means for economic growth and development. The results of Mr. Durham's study were submitted to the General Assembly in conjunction with a draft of proposed amended legislation published by the Department of Banking and Securities which was, to a great extent, accepted by the legislature and later enacted into law.

¹⁶ For an example of a study relied upon by the General Assembly, see SPINDLETOP RESEARCH, Report 343, *supra* note 13. Various proposals are made in regard to Kentucky's blue sky law. *Id.* at 4-5.

¹⁷ KRS § 292.310 (Supp. 1972).

minor changes from the former act. Several additions made are noted as follows:

Agent means any individual other than a broker-dealer who represents a broker-dealer or issuer in effecting or attempting to effect purchases or sales of securities . . . A partner, officer, or director of a broker-dealer or issuer, or a person occupying a similar status or performing similar functions, is an agent only if he otherwise becomes within this definition. . . . [Italics indicate additions.]¹⁸

The additional language of the latter phrase broadens the definition of agent—a change which will be helpful in the future. Two entirely new paragraphs were added. The first paragraph explicitly defines the term “certified” as used in the securities industry to avoid mistakes in the use of the word or the standard expected.¹⁹ The second paragraph provides that the terms “fraud,” “deceit” and “defraud” are not limited to common-law deceit.²⁰ The final revision limits the definition of an investment-adviser to exclude a broker-dealer “whose performance of . . . services is solely incidental to the conduct of his business as a broker-dealer and who receives no special compensation for them. . . .”²¹

Exemptions

The common practice in the various state blue sky laws and the approach taken by the Uniform Securities Act²² has been to exempt certain securities and transactions from coverage.²³ Such exemptions, which are in effect a form of discrimination, have been upheld by the courts as long as distinctions are based upon a reasonable classification.²⁴ One of the basic differences between security exemp-

¹⁸ KRS § 292.310(2) (Supp. 1972).

¹⁹ KRS § 292.310(4) (Supp. 1972), provides in pertinent part as follows: ‘Certified’ means, when used in regard to financial statements, examined and reported upon in accordance with generally accepted auditing standards with an opinion expressed by an independent public or certified public accountant.

²⁰ KRS § 292.310(5) (Supp. 1972).

²¹ KRS § 292.310(7) (Supp. 1972).

²² UNIFORM SECURITIES ACT § 402(a), (b).

²³ For a brief discussion of the various types of exemptions, see L. Loss, SECURITIES REGULATION 43-44 (Supp. 1955) [hereinafter cited as Loss].

The most common exemptions utilized by states can be categorized as follows.

1. Exemptions characterized by the ultimate number of shareholders.
2. Exemptions limited by the number of buyers and a dollar amount.
3. Exemptions for isolated sales by the issuer.

²⁴ Hall v. Geiger-Jones Co., 242 U.S. 539 (1917).

For a case sustaining a legislative provision exempting securities listed on specific exchanges and markets and any other exchanges approved by the administrative authority, see State *ex rel.* Koeneke v. Doherty, 20 P.2d 460 (Kan. 1933).

tions and transaction exemptions is that the former persist as long as the security retains the characteristics that qualify it for exemption, while the latter last only as long as the transaction itself. Subsequent offerings of the security involved in an exempt transaction would not be automatically exempt.

The portion of the Kentucky securities law dealing with exempt securities²⁵ was left intact except for the omission of one subsection.²⁶ The new law deletes Kentucky Revised Statutes § 292.400(12) [hereinafter cited as KRS] thus abrogating the numerical type of offeree exemption. This subsection dealt with pre-incorporation issuance of securities to raise the capital necessary to commence business. Under the old law, offers to 30 or fewer persons were exempt. None of the stock issued, however, could be exchanged for intangible assets, such as goodwill, services, or rights under patents or leases. In addition, no expense in any form could be paid to anyone for selling the stock. Even though this provision included "offer or sale," the Division of Securities had interpreted it to authorize only 30 offers. If 30 offers were made and the number of sales needed were not made, the exemption was nonetheless considered utilized. Moreover, the 30-person exemption was construed to apply only to equity stock; no debt securities could be sold which would assist a businessman in preserving his equity position and in retaining control of his business.²⁷

The restrictions placed upon persons seeking to commence business in Kentucky through the sale of stock were indeed heavy. The effect of subsection 12 was to discourage incorporation by persons who otherwise would have entered business in this manner. Whether the deletion of this subsection will be beneficial to the people of Kentucky remains to be seen. It will encourage incorporation and "going public" by many more businessmen but may also have the effect of bringing into existence too many undercapitalized and ill-managed enterprises.

The statutory revision of the portion of the securities law dealing

²⁵ KRS § 292.400 (Supp. 1972).

²⁶ KRS § 292.400(1)-(11) (Supp. 1972).

Securities which are still exempt include: securities issued or guaranteed by the United States, any state, or subdivision thereof; securities guaranteed or issued by Canada; any security issued by and representing an interest in or debt of any bank; certificates issued by any federal savings and loan association or any building and loan association; public utility securities; railroad or other common carrier securities; any security listed by the New York, American or Midwest Stock Exchange; any security of a non-profit or charitable organization; commercial paper arising out of a current transaction; and any investment contract used in connection with an employee's stock purchase, savings, pension or profit-sharing plan.

²⁷ For an excellent discussion of the problems arising from subsection 12, see SPINDLETOP RESEARCH, Report 343, *supra* note 13, at 36.

with exempt transactions²⁸ brings this part of the law into conformity with the Uniform Securities Act of 1956. Most subsections of the exempt transactions provision of the law remain the same, but some significant additions have been inserted. Perhaps the most striking change occurred in subsection 9, which deals with limited offering exemptions in post-incorporation issuance of securities.²⁹ Under this subsection both prior to and after the revision, once a corporation is organized, stock can be offered to a maximum of 10 individuals during any 10 month period. Again, as in the pre-incorporation provision, no payment of any kind is allowed for soliciting purchases. The 10-person exemption section in the new law is identical to that contained in the Uniform Securities Act. The former act omitted a very important provision which states that the Director of the Division of Securities can withdraw, further condition the exemption, increase or decrease the number of offerees permitted, or allow commissions to be paid.³⁰ The omission of this section from the earlier law subverted the basic intent of the Uniform Securities Act provision. The Kentucky law brought about restriction and discouragement of the issuance of securities rather than the intended broad exemption provision. With the restoration of this provision, the statute is once again in conformity with the Uniform Act.³¹

In addition to the revision of subsection (9) to present subsection (1)(i), several other significant changes have taken place. Another paragraph has been added, exempting the following:

Any transaction by a person who may control, or may be controlled by or under common control with, the issuer if 1. the transaction is at a price reasonably related to the current market price, 2. the security is registered under section 12 of the Securities Exchange Act of 1934 and the issuer files reports pursuant to section 13 of the act, and 3. copies of such federal registration statements, forms,

²⁸ KRS § 292.410 (Supp. 1972).

²⁹ Subsection (9) has become subsection (1)(i) in the revision.

³⁰ UNIFORM SECURITIES ACT § 402(b)(9).

³¹ KRS § 292.410(1)(i) now reads as follows:

Any transaction pursuant to an offer directed by the offeror to not more than ten persons (other than those designated in paragraph (h)) in this state during any period of twelve consecutive months, whether or not the offeror or any of the offerees is then present in this state, if 1. the seller reasonably believes that all the buyers are purchasing for investment, and 2. no commission or other remuneration is paid or given directly or indirectly for soliciting any prospective buyer in this state (other than those designated in paragraph (h)); but the director *may by rule or order, as to any security or transaction, withdraw or further condition this exemption, or increase or decrease the number of offerees permitted, or waive the conditions in subparagraphs 1. and 2. of this subsection with or without substitution of a limitation on remuneration.* [Italics indicate that portion added by the 1972 revision.]

reports or exhibits as the director may by rule or order require are filed with the director and, 4. such sales by any such person comply with such rules as the director may prescribe.³²

Changes which add much to the rights of the party seeking the exemption also have been made in the law dealing with the denial or revocation of an exemption.³³

The burden of proving an exemption under either KRS § 292.400 or § 292.410 is, under both the new and old securities laws, placed upon the person claiming such exemption.³⁴ However the present law specifically enumerates requirements while the former law left them open to possible speculation by the Director of the Division of Securities. According to the revision, the Director may require any offeror to file a statement of the claim of exemption, if any, upon which he is relying. If at any time the Director believes that the information contained in the statement on file is "misleading, incorrect, inadequate, or fails to establish the right of exemption," he may require that party to file such information as may, in his opinion, be necessary to establish the claimed exemption.³⁵ A refusal to furnish the information within a reasonable time will be considered sufficient ground for entering an order suspending and/or cancelling the registration of the offeror.

The revision also states that the Director shall have authority to determine whether an exemption or exception from a definition should be forthcoming. The exercise of this power is purely discretionary. Section (3) sets forth the procedure required when requesting such exemption.³⁶ The party must submit the following to the director: a verified statement of all material facts relating to the proposed sale, transaction, or issue of the security; a request for a ruling as to the particular exemption or exception from a definition; and a filing fee of ten dollars. After giving notice to all interested parties, and after a hearing, if required, the director may enter an order finding the proposed sale, transaction, issue or security to be either entitled or not entitled to the exemption or the exception from a definition as claimed.

³² KRS § 292.410(p) (Supp. 1972).

³³ Alterations have occurred in KRS § 292.400(9), Exempt Securities and KRS § 292.410(1), Exempt Transactions. Presently no order of denial or revocation may be entered without appropriate prior notice to all parties concerned. There must be an opportunity for hearings and for written findings of fact and conclusions of law. As before, the Director is required to notify all interested parties that such an order has been entered and the reason therefor. Within 15 days of the receipt of a written request the matter will be scheduled for hearing. However, if a hearing is neither requested nor ordered by the Director, the order will remain in effect until it is modified or vacated by him.

³⁴ KRS § 292.420 (Supp. 1972).

³⁵ KRS § 292.420(2) (Supp. 1972).

³⁶ KRS § 292.420(3) (Supp. 1972).

Any order entered in this manner shall be binding unless an appeal is taken.

Consent to Service of Process

Under both the old and the new laws, every applicant for registration as a broker-dealer or agent and every issuer who proposes to offer a security in Kentucky must file an irrevocable consent appointing the Director of Securities as his attorney to receive service of process in any non-criminal proceeding against him which arises under KRS Chapter 292. Service is made by leaving a copy of the process with the office of the Director, but service is not effective unless the plaintiff sends notice of the service and a copy of the process by registered mail to the defendant at his last known address. A new clause broadens the Director's power to take forceful and positive measures against parties who have not filed a consent to service of process with the Director.³⁷

Anti-Fraud Provisions

The anti-fraud provisions contain one major addition. This change³⁸ allows investment advisers, as defined by the Investment Company Act of 1940,³⁹ to charge any incentive compensation fee⁴⁰ not in violation of that act or the rules or regulations promulgated by the Securities and Exchange Commission thereunder, provided that the Director first approves in writing the incentive compensation fee arrangement as being fair and reasonable.

Registration of Broker-Dealers, Agents and Investment Advisers

Frequently, a condition precedent to the right of a person to engage in the sale or marketing of securities is registration with the appropriate state agency. Several statutes, including Kentucky's, provide that sellers of certain types of securities must obtain a license. The license is granted only after due examination of the nature of the

³⁷ KRS § 292.430(2) (Supp. 1972). This subsection requires that when any person including any non-resident of Kentucky, engages in conduct prohibited or made actionable by the Kentucky securities law, or any rule or order thereunder, and he has not filed a consent to service of process and personal jurisdiction over him cannot otherwise be obtained within this state, that such conduct shall be considered equivalent to his appointment of the Director, or his successor in office, to be his attorney to receive service of any lawful process in any non-criminal action. The same rules as those in regard to one who has consented to service of process apply in effecting such service.

³⁸ KRS § 292.320(3)-(4) (Supp. 1972).

³⁹ Investment Company Act of 1940, 15 U.S.C. §§ 80(a)-1-80(a)-52 (1970).

⁴⁰ Incentive compensation may not be based upon capital gains or capital appreciation of a client's funds.

security to be dealt in, and of the knowledge and the character of the applicant. Although every state with a blue sky law, except New Jersey and Wyoming, requires the registration of brokers and dealers, the registration required varies from state to state.⁴¹ Kentucky previously required that all broker-dealers, agents, and investment advisers be registered. This meant they had to pass a written examination and meet certain capital requirements. The new act has been broadened to include nearly everyone who might be involved in a transaction. For example, the registration of a broker-dealer automatically constitutes the registration of any agent who is a partner, officer, director, or a person occupying a similar status or performing similar functions.⁴²

The application still requires such information as the applicant's form and place of organization, his method of doing business, the qualifications and business history of the applicant and, in the case of a broker-dealer or investment adviser, information regarding any partner, officer or director. The new law requires additional information relevant to any person directly or indirectly controlling the broker-dealer or investment adviser; and in the case of an investment adviser, the qualifications and business history of an employer,⁴³ thus forcing disclosure of any "silent partner."

The law presently provides that if no denial order is entered by the Director or if no proceeding is pending, the registration becomes effective at noon of the thirteenth day after the application is filed⁴⁴ and the applicant passes a written examination on the securities industry.⁴⁵ However, the Director may require the existence and maintenance of a minimum liquid net capital for registered broker-dealers and investment advisers and the maintenance of a minimum ratio between net capital and aggregate indebtedness, or both.⁴⁶ The new act also increases the surety bond maximum to \$25,000 (instead of \$10,000 as required under the old law) and further states that the Director may determine the conditions of such bonds, and that no such bond shall be required of any registrant whose net capital exceeds \$100,000 (instead of \$25,000 as required previously).⁴⁷

The new law gives the Director the power to require a registered broker to carry as many fidelity bonds, covering agents, general

⁴¹ For an excellent discussion of such variance in the laws, see Loss & Cowett, *supra* note 2, at 26-30.

⁴² KRS § 292.330(2) (Supp. 1972).

⁴³ KRS § 292.330(2) (Supp. 1972).

⁴⁴ KRS § 292.330(3) (Supp. 1972).

⁴⁵ KRS § 292.330(4) (Supp. 1972).

⁴⁶ KRS § 292.330(5) (Supp. 1972).

⁴⁷ KRS § 292.330(6) (Supp. 1972).

partners and officers, in such amounts, not exceeding \$250,000, as he deems necessary for the protection of the public. The law further states that the Director may require registered broker-dealers to furnish satisfactory evidence of possession of such bonds.⁴⁸

The provisions for renewal of registration remain virtually unchanged with the initial or renewal registration fee being \$100, \$50 and \$15 for a broker-dealer, an investment adviser and an agent respectively. The new law, however, adds a fee of \$5 for the transfer of an agent and prescribes that no fees shall be refundable.⁴⁹

The blue sky law has maintained the requirement that all registrants retain certain records for a period of three years unless the Director orders otherwise. Unlike the old law, it defines records to include "all accounts, correspondence, memoranda, papers, and books . . . which the director by rule prescribes."⁵⁰ If information contained in the records becomes inaccurate or incomplete the registrant is required promptly to file a correcting amendment. The act provides that the Director reserves the right to make periodic examinations⁵¹ of these documents both inside and outside the state of Kentucky.⁵² In addition, the Director may prohibit reasonable compensation of registrants⁵³ and may suggest appropriate rules for conduct of business in the public interest and for the protection of investors.⁵⁴ The law

⁴⁸ KRS § 292.330(7) (Supp. 1972).

⁴⁹ KRS § 292.330(10) (Supp. 1972).

⁵⁰ KRS § 292.330(11) (Supp. 1972). This subsection also requires that all records required shall be kept within Kentucky or shall, at the request of the Director, be made available at any time for examination by him either in the principal office of the registrant or by production of exact copies thereof in this state.

⁵¹ KRS § 292.330(11)(c) (Supp. 1972).

⁵² KRS § 292.330(11)(d) (Supp. 1972). This provision specifically states that:

The director may make periodic examinations within or without this state, of each broker-dealer and investment adviser at such times and in such scope as he determines. These examinations may be made without prior notice to the broker-dealer or investment adviser. The expense reasonably attributable to any such examination shall be paid by the broker-dealer or investment adviser whose business is examined but the expense so payable shall not exceed an amount which the director by rule prescribes. For the purpose of avoiding unnecessary duplication of examinations, the director, insofar as he deems it practicable in administering this subsection, may cooperate with securities administrators of other states, the Securities and Exchange Commission, and any national securities exchange or national securities association registered under the Securities Exchange Act of 1934.

⁵³ KRS § 292.330(11)(e).

⁵⁴ KRS § 292.330(11)(f).

However the Court of Appeals of Kentucky has in the past, under an earlier blue sky law, held that the power of the Director to reject or revoke a license on the ground that the business of the security issuer was not based upon sound business principles *did not* confer on the Director the arbitrary power to permit or refuse registration of proposed securities in view of the right of appeal to the courts from his decision. *See Hampton Realty Co. v. Middleton*, 295 S.W. 704 (Ky. 1927).

has been expanded also in regard to the suspension or revocation of the license of any registrant.⁵⁵ The Director has been given broad discretion in that he may, by order, deny, suspend or revoke any registration if he finds that the order is in the public interest.⁵⁶

Under the new law the Director may not institute a suspension or revocation proceeding on the basis of a fact or transaction known to him when registration became effective unless the proceeding is instituted within thirty days after registration. Finally, the new act sets forth specific provisions governing the procedure to be followed in revoking or suspending a registration.⁵⁷

Registration of Securities—Registration by Coordination

In order to allow simultaneous effectiveness of registration of an interstate offering of securities, both in states where the offering is to be made and under the Securities Act of 1933, the draftsmen of the Uniform Securities Act provided a procedure for registration by "coordination." This method allows a prospectus filed under the Securities Act of 1933 to be submitted in each state as the state registration statement, with authority vested in each state commissioner to request copies of the other documents included in the federal registration statement. It is then provided that all of the state registrations become effective at the same time as the federal registration unless a state official has initiated a stop order proceeding. The Kentucky provision regarding such registration⁵⁸ follows the uniform act's requirements quite closely; the only revision in this portion of the law is the addition of the requirement that three copies of the latest form of prospectus filed under the federal legislation, together with all amendments, be filed with the Kentucky Division of Securities.⁵⁹

Registration by Notification

Registration by notification is a method used by companies which can meet requirements relative to a long and stable financial history.

⁵⁵ KRS § 292.330(12)(a). This subsection now provides: The director may by order, deny, suspend or revoke registration of any broker-dealer, agent or investment adviser if he finds that the order is in the public interest and that the applicant or registrant or, in the case of a broker-dealer, or investment adviser, any partner, officer, or director, or any person occupying a similar status or performing similar functions, or any person directly or indirectly controlling the broker-dealer or investment adviser. [Italics indicates portion added by revision.]

⁵⁶ KRS § 292.330(12)(a)(9) (Supp. 1972).

⁵⁷ KRS § 292.330(12)(b)(1)-(6) (Supp. 1972).

⁵⁸ KRS § 292.360 (Supp. 1972).

⁵⁹ KRS § 292.360(2)(a) (Supp. 1972).

Such registration is designed to establish a streamlined procedure for registering what might be termed "quality" issues. However, this method has narrow application since most quality issues that are also federally registered would probably be registered by the coordination procedure. Therefore, notification is designed primarily for issues that are exempt from federal registration.

The Kentucky registration by notification provision⁶⁰ requires that a company or its predecessors be in existence for at least five years;⁶¹ that there not have been a default during the current fiscal year or within the preceeding three fiscal years in regard to the payment of principal, interest or dividends on any security of the issuer;⁶² and ordinarily, that its average net earnings during the past three fiscal years equal at least five percent of the amount of securities without a fixed maturity or fixed interest or dividend provision outstanding at the date the registration statement is filed.⁶³

The information required in the registration statement now includes the designation of any person on whose behalf the offering is made and his reasons for making the offering.⁶⁴ Additional requirements are that any balance sheet submitted be a *certified* balance sheet⁶⁵ and that it be submitted as of the issuer's last fiscal year.

Registration by Qualification

The most important provision of the majority of blue sky laws is that dealing with registration by qualification⁶⁶ or "merit registration."

⁶⁰ KRS § 292.360 (Supp. 1972).

⁶¹ KRS § 292.350(1)(a) (Supp. 1972).

⁶² KRS § 292.350(1)(a)(1) (Supp. 1972).

⁶³ KRS § 292.350(1)(a)(2) (Supp. 1972). Specifically this subsection requires that:

The issuer and any predecessors during the past three fiscal years have had average net earnings, determined in accordance with generally accepted accounting practices, which are applicable to all securities without a fixed maturity or a fixed interest or dividend provision and which equal at least five percent of the amount of securities without a fixed maturity or a fixed interest or dividend provision outstanding at the date the registration statement is filed (as measured by the maximum offering price or the market price on a day selected by the registrant within thirty days before the date of filing the registration statement, whichever is higher, or if there is neither a readily determinable market price nor an offering price, [the] book value on a day selected by the registrant within ninety days of the date of filing the registration statement), or if the issuers and predecessors have not had any securities without a fixed maturity or a mixed interest or dividend provision outstanding for three full fiscal years, equal to at least five percent of the amount (as measured by the maximum public offering price) of such securities which will be outstanding if all securities being offered or proposed to be offered (whether or not they are proposed to be registered or offered in this state) are issued.

⁶⁴ KRS § 292.350(2)(c) (Supp. 1972).

⁶⁵ KRS § 292.360(2)(k) (Supp. 1972).

⁶⁶ KRS § 292.370 (Supp. 1972).

Securities thus registered are recorded only under the laws of the registering state and are, for the most part, exempt from federal standards. Stock sales by new or local companies are usually registered by qualification. Of the three modes of recording under the Kentucky securities law, this method was the most drastically revised. One of the additions was the requirement that the issuer, in supplying information to the Division of Securities, submit a statement of the general competitive conditions in the industry or business in which he is engaged.⁶⁷ The new act also requires more explicit information on directors and officers of the issuer or a person occupying a similar status or performing similar functions⁶⁸ and disbursement of salaries by issuers.⁶⁹ The revision adds needed clarification and requirements⁷⁰ such as placing on file with the Division contracts which are to be performed either in whole or part after the filing of the registration statement, and all those consummated within the past two years.⁷¹ With regard to foreign issues, the law calls for a signed opinion of counsel as to the legality of the security being registered, and adds the requirement that if the registration statement is in a foreign language an English translation must be provided. Another welcome improvement in the law is the request for more explicit financial data and accounting procedures.⁷²

⁶⁷ KRS § 292.370(2)(a) (Supp. 1972).

⁶⁸ KRS § 292.370(2)(b) (Supp. 1972). This subsection provides as follows:

With respect to every director and officer of the issuer, or person occupying a similar status or performing similar functions: his name, address, and principal occupation for the past five years; the amount of securities of the issuer held by him as of a specified date within ninety days of the filing of the registration statement; *the amount of the securities covered by the registration statement to which he has indicated his intention to subscribe; and a description of any material interest in any material transaction with the issuer or any subsidiary effected within the past three years or proposed to be effected by him or any of his associates as defined in the rules promulgated under the Securities Exchange Act of 1934.* [Italics indicate portion added by revision.]

⁶⁹ KRS § 292.370(2)(c) (Supp. 1972). This subsection adds the requirement that the issuer provide the amounts paid to each person who received, during the past twelve months, or are to receive, more than \$15,000.

⁷⁰ KRS § 292.370(2)(g) (Supp. 1972) adds the phrase "or the method by which it is to be computed" and KRS § 292.370(2)(h) (Supp. 1972) adds "the cost basis or book value of the assets in the hands of the vendors. . . ."

⁷¹ KRS § 292.370(2)(j) (Supp. 1972).

⁷² KRS § 292.370(a)(p) (Supp. 1972). This subsection provides that: A balance sheet of the issuer as of the date *not more than four months prior to the date of filing of the registration statement, a balance sheet certified by an independent public or certified public accountant as of the close of the last fiscal year; statements of income, changes in stock holders equity and changes in financial position for each of the issuer's three fiscal years preceding the date of the most recent balance sheet filed and for the period, if any, between the close of the most recent such fiscal years and date of the most recent balance sheet filed, or, if the issuer has been in existence for less than three years, such statements for the period preceding the date of the most recent balance sheet filed,*

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Civil Liabilities

The inclusion of civil liability provisions in blue sky laws grew out of inadequate budgeting by many offerors and the uneven enforcement of the securities laws. Because of this situation the only really effective sanctions in many states were civil. Even today, outside of California and a few other states, criminal prosecutions are undertaken only sporadically and with extreme reluctance. While some promoters wilfully fail to comply with the requirements of blue sky laws, many persons who attempt to obtain capital for a new or existing business do not realize the wide applicability of these laws and violate them unintentionally. The Kentucky blue sky law's provisions dealing with civil liability⁷³ were left virtually untouched by the 1972 revision. The only portion of this subsection to be changed was the statute of limitations, which was increased from two to three years from the date of contract of sale.⁷⁴

Criminal Penalties

The law was altered very little in regard to criminal sanctions.⁷⁵ The maximum penalty was increased from a \$5,000 to a \$10,000 fine and imprisonment of not more than five rather than three years.⁷⁶

Proposals

The Kentucky securities law has been much improved by the 1972 revision, but further improvements are possible. One recommendation is that the Division of Securities be operated as a separate department within state government. The Division's staff of attorneys and accountants should be enlarged and given statutory authority to halt securities law violations and to prosecute violators. The Division should also have more of an investigative function in regulating the securities industry of Kentucky. It should be required to issue official advisory opinions, which would be available on a subscription basis,

(Footnote continued from preceding page)

and if any of the proceeds of the offering are to be applied to the purchase of any business, the same financial statements which would be required if that business were the registrant. *The statements of income, changes in stockholders equity and changes in financial position shall be certified for the latest fiscal year presented.* [Italics indicate portions added by revision.]

⁷³ KRS § 292.480 (Supp. 1972).

⁷⁴ KRS § 292.480(3) (Supp. 1972).

The Kentucky Court of Appeals has held that the statute of limitations for an action based upon fraud commences running at the time of sale and not from discovery of fraud. See *Thomas v. Fidelity & Cas. Co. of New York*, 80 S.W.2d 8 (Ky. 1935); see also *Craig v. Western & Southern Indem. Co.*, 119 F.2d 591 (6th Cir. 1941) (construing the Kentucky statute in effect at that time).

⁷⁵ KRS § 292.991 (Supp. 1972).

⁷⁶ KRS § 292.991(1) (Supp. 1972).

and should publish annual reports of its activities. The procedures for registration of broker-dealers, although greatly improved, could be enlarged. For example, broker-dealers, agents or investment advisers might be called upon to pass annual or periodic examinations. A continued reappraisal of these and other provisions may suggest additional areas in which the law can be improved.

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