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Let's Make the Law Uniform

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LET'S MAKE THE LAW UNIFORM!

A Plea for Uniformity in State Securities Laws and Regulations

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A SHARP, shrill whistle of incredulous surprise is raised from his quivering lips. And then he falls over into a dead faint.

You have just finished informing him that he will not be permitted to sell shares of stock in his company until he registers under the State Securities Act. But this is not the reason for the whistle nor the faint. These phenomena evidencing the subject's condition of prostrate unbelief and surprise have been caused by your frankness in imparting to him the further painful information that methodical examination must be pursued—carefully and without haste. This will take time.

And this he doesn't like! He recovers from his faint. He is not so easily downed, you see, and his shocked surprise gives way to protesting indignation. "Why, this is preposterous," he says, "we encountered no silly delay of this kind in Nevada!"

The latter part of this statement is doubtless true, inasmuch as there is no securities regulation and no "Blue Sky" law in Nevada. However, he might just as easily refer to some other state having a Blue Sky Law and in which state he has qualified his stock under some provision of the law which enabled him to evade an exhaustive examination of him and his plan and to avoid the consumption of time necessary for it. The overwhelming majority of states have laws regulating securities transactions but there is little uniformity among them. Similarity there is between some but others more than make up for this by the contrary divergence between them on matters of procedure and requirement alike. The first of these so-called "Blue Sky" laws was enacted in Kansas in 1911. They are popularly known as "Blue Sky" laws because an early decision of the courts characterized certain securities transactions as "speculative schemes that have no more basis than so many feet of blue sky." (Hall vs. Geiger-Jones, 242 U. S. 339.)

The District of Columbia, together with the State of Nevada, already mentioned, are still without legislation specifically controlling the business of dealing in securities. This, however, does not mean that the balance of the states are bulwarked with adequate laws covering this field. Delaware, Maryland, New Jersey and New York take care of this subject, if it can be said to be cared for in such fashion, by the enforcement of fraud acts, which are punitive, rather than preventive. We with Blue Sky protection call it "locking the stable after the horse is stolen."

In the testimony taken before the Committee on Interstate and Foreign Commerce of the House of Representatives of the 73rd Congress, we find upon page ninety-eight of the first session, the following classification of the securities laws of the states:

They roughly fall into two classes:

"1. Fraud laws, such as exist in three states* and which are not set in motion until evidence is presented that fraud in the sale of securities has been or is about to be committed.

"2. Regulatory laws existing in forty-three states, which attempt to regulate the traffic in securities by forbidding their sale, until an application has been filed and permission granted by the State. This type of law may be further classified as follows:

"(a) Dealer-licensing laws, which seek to exercise the desired control through dealers, by requiring that they obtain licenses under which they are held responsible for fraud or gross negligence in their transactions.

"(b) Specific issue-permit laws, which prohibit the sale of any security unless a permit has been granted by the State for the sale of each specific issue. Such permits are granted only after the applicant has filed more or less detailed information concerning the issue offered.

"This group of regulatory laws may be further subdivided, in accordance with their classification of securities, as follows:

"1. Speculative laws which treat all securities as either 'speculative' or 'non-speculative' and apply the provisions of the statutes to speculative issues only.

"2. The typical blue-sky laws that divide securities into several different groups, exempting the sounder issues and applying the regulations to others. Some transactions also, such as judicial sales, isolated sales by individuals, and sales to satisfy mortgages, are usually exempted."

The writer cannot agree with the statement made by Lasser and Gerardi in their book "Federal Securities Act Pro-

*Actually four states, as above recited.

cedure" (McGraw-Hill Book Company, 1934), which says that Federal legislation was needed to come to the rescue of the states because "State laws had failed to curb the distribution of unsound securities * * *." The authors hold that such condition was "attributable to a number of facts which may be summarized as follows:

(a) Absence of protective securities legislation in certain states and inadequate legislation in others.
(b) Lack of uniformity in the laws of the various states.
(c) Willingness of victims to condone the offense or accept a compromise.
(d) Evasions possible by conducting sales on an interstate basis.

While disagreeing with the premise, it must be admitted that these above enumerated handicaps do exist and must be recognized, and must be remedied where they can. True it is that the scope of the Federal Acts cannot encompass that of the states. Nevertheless, such an indifferent shrugging of the shoulders on the part of the states does not make toward the achievement of the common goal—that of protection to the investor—whether his is an interstate or an intrastate transaction.

No amount of strict legislation and rigid enforcement can altogether eliminate the "c" and "d" factors listed above. Victims, it is unfortunately true, more often than not, find their civic sense conveniently hidden away in the folds of their pocketbooks. Once they have been reimbursed in whole or even in part, their memory always fails them and they become all too willing to forgive and forget. Strong reasons are sometimes urged why they should accept for their silence restitution of even the most nominal part of that which they have lost. "Either that or else nothing at all," they are threatened, and as they were duped in the beginning, so they are in the end. And this condition obtains whether breach of Federal or State law is concerned. Such is a characteristic of human behavior which transcends fine distinctions between the powers of Congress and those of State legislatures.

As to the "d" factor, this likewise works both ways. States rights protect the crooked promoter and the unscrupulous securities dealers from the heavy hand of Federal agencies, while he hugs the haven of intrastate exemptions and vice-versa he is immune from the enforcement of State laws while he rests upon the immunity of transactions exempt from the State "touch" by reason of these transactions being in interstate commerce.

But by making both State and Federal agencies fully effective, he is placed squarely between two inescapable fires and there is no course for him to pursue except that of honest dealing and adherence to the requirements of both laws.

And that brings us to the consideration of the "a" and "b" factors in the above list. The first of these refers to the absence of any legislation in some few states, as has been referred to, and the inadequacy of protective law in others. The other factor listed as "b" above recites the lack of uniformity in the securities laws of the various states. This lack of uniformity actually covers as well, however, the absence and inadequacy which is the subject matter of the first factor. This is obviously so, because if a standard form of Securities Act were set up for uniform adoption by all of the states and the District of Columbia, then it would follow naturally that at the same time its adoption would be urged to supplant such inadequate measures as presently appear on the statute books in some jurisdictions and serve little purpose other than that. Further, such course would make for the introduction of Blue Sky legislation in those few states still without any such laws.

True it is that the American Bar Association, through the National Conference of Commissioners on Uniform Laws, after seven years of consideration, did adopt a Uniform Securities Act at the meeting in Memphis in 1929, which was subsequently approved by the association itself. This was done only after four drafts of the proposed Act had been made and after three sessions of the conference had considered it section by section.

In making its report, the committee acting for the National Conference of Commissioners on Uniform State Laws said:

"The advantages of uniformity in Sale of Securities Acts, or "Blue Sky Acts" as they are generally called, needs no argument. *In the case of many security issues there is a broad market extending into many states.* All of the states have acts regulating the sale of securities, but there are wide variations between the statutes in different states * * *. *The principal difficulty has been to facilitate the marketing of sound securities of unquestionable merit without burdensome* *formalities while at the same time protecting the public against fraud.*"

The latter statement presents the crux of proper securities regulation. Sometimes, unfortunately, sight is lost of the importance of keeping legitimate business from extinction in the zeal of preventing fraudulent enterprise to flourish. More often, however, the State Securities Commissioner finds himself in the position of not being able to give aid to the honest securities dealer as issuer, because of the maze of diversified law in which such applicant finds himself entangled.

In an overwhelming number of instances, however, much discussion is aroused concerning that portion of the Blue Sky laws devoted to exemptions from registration. And although it is not felt that this subject should be neglected when we clarify the law and make the regulations uniform, still it is sincerely felt that too much time is now consumed in attempting to fit "unfittable" sets of facts into exemptions, from the first not applicable to the circumstances presented. It is a friendly hint to those who have a desire to cooperate in the worthwhile task of securities regulation: Stand on your legal rights, when you are sure of them, and do not view State securities registration as a badge of shame. If there is doubt as to a possible exemption, then register; it shows your confidence in the ability of your security *to be registered.*

But I do not wish to digress here too much from the problem of uniformity.

It may be frankly and boldly stated here that the American Bar Association has not done all that might be done to properly carry out "the work so nobly begun." The conclusion of the report of the committee, quoted in part above, is worded as follows: "The present act (referring to the text of the Uniform Sale of Securities Act referred to hereinbefore) has been unanimously approved * * * and is now submitted to the various states for adoption in the interest of uniformity." Such adoption, however, has not been made the matter of effort or interest on the part of any committee or agency of the American Bar Association, and it appears to benefit little to have a Uniform Act of this character framed without putting it into force. It has lain dormant so long that now in some respects this excellent work on the part of the Uniform Law Commissioners has become needful of change and amendment to make it conform to present-day circumstances.

The point, however, aside from the need of revising the uniform law from time to time (no consideration has been given to it since amendments effected by the conference at its 1930 meeting) is the urgent need of taking measures toward securing its adoption in *all* of the states, including those without any present law of such character. This task logically is one for the American Bar Association, under whose sponsorship this Uniform Law has been created; it is a natural supplement to its work so far done and it is not inconsistent with work of like nature being presently carried on. For instance there is a special committee devoted to the work of opposing the ratification of the Federal Child Labor Amendment by the legislatures of the states and to urge the adoption in its stead of adequate State laws. Why not a special committee to work for the adoption of a Uniform Blue Sky law?

It is to be expected that new problems should arise in the seven years which have elapsed since the drafting of this model Act. In that day perhaps the matter of oil interests was just a faint shadow on the horizon; today it is a consideration of eclipsable proportions. And no one will say that the vague provision for it in the Uniform Act is to any degree adequate. Vying equally with it for attention is the matter of the issuing, offering and sale of the ubiquitous installment investment trust in its many diversified forms and with its endless embellishments, and the problem of so-called "investment counsel." Then again there is that troublesome question mark—the whiskey certificate—ignored entirely by that Uniform Act because the need for giving this question attention did not then exist. Under section fourteen of the Uniform Sale of Securities Act there is provision made for the escrow of promotional stock and for stock issued for intangibles, which is proper. But the trend today is to go further even than that and insist upon the impounding of the proceeds from the sale of the stock offered, until the minimum amount necessary for successful operation has been riased. Inclusion of this provision in the Unifrom Act would today constitute a salutary amendment. We must not be unmindful either of such conditions as have been altered by the advent of the Federal Securities and Exchange Act and its amendments. This is particularly so in matters affecting advertising and the circulation of prospecti in the states. In this regard the Uniform Act as it presently stands is not sufficiently clear and certainly not adopted to meet present conditions and possibilities of conflict between the provisions which may be read into it and the Federal requirements.

A problem which frequently arises under the state of things as they presently exist, concerns itself with the selfsame Federal prospectus. This is the official offering literature of a new issue contemplated to be sold interstate and it is not to be supposed that the issuer or the underwriter is eager in addition to it, to prepare a separate circular for use in each of the individual states.

For instance, it has been the practice for the principal underwriters to display their names on the cover sheet of the Federal prospectus. This has been done so universally that belief has sprung up that this was a requirement of the Securities and Exchange Commission; that it was strictly necessary that the names of the principal underwriters be *printed on the cover*. Dispute arose in instances where the underwriters whose names appeared in such fashion were not registered or licensed in some of the states wherein the prospectus was sought to be circulated and the securities offered.

There was insistence by the states that the names of the unlicensed underwriters be deleted from the cover page under the provision in their laws that none but registered dealers might offer for sale, solicit inquiries about, or deal in securities. This insistence was met with the argument that such deletion would be contrary to Federal regulation. The Securities and Exchange Commission finally helped to clear the air by stating that it was not necessary to place on the cover page the names of the underwriters. It appears to be the better practice under the circumstances, however, to place the names of none of the underwriters on the cover, although some houses prefer to use a separate "jacket" upon which appear only the names of the underwriters registered in the state in which such "jacketed" prospectus is proposed to be used.

More often than is pleasant to contemplate this Federal prospectus innocently involves the issuer or the underwriter or both in a mare's nest of unexpected trouble, little anticipated by him. This rather full and complete book which is the Federal prospectus has been zealously worked over by him and by his accountant, by his attorney and by a host of other experts. Out of these weeks of tedious effort comes the final result. He has done his best to make a full disclosure of all of the material facts and to hide or conceal nothing. The requirement of the Securities and Exchange Commission, of course, is that he should do this. However, in accomplishing this very thing, he may have barred himself from offering the security in some State under the provisions of the Blue Sky law of that particular State.

For instance, to cite an actual example, the registration statement effective in Washington and the prospectus based upon it reveals that the promoter, for an investment of three thousand ($3,000.00) dollars, receives seventy-five per cent of the voting stock of the company. A million and a quarter dollars is to be raised from the sale of the stock and this individual, by reason of his control of the common stock, will control that fund, and his sole investment amounts to only three thousand ($3,000.00) dollars. Having made a full disclosure of this arrangement, he confidently goes ahead and then he meets opposition in his attempt to qualify under the Blue Sky laws of the states.

It is not argued that he should *not* be stopped in carrying out such plan; rather it is believed that such a setup should be everything but encouraged. Such discouragement is the function of the State Commissions, as distinguished from the scope of the Federal Commission. Nevertheless, the legislation under which he is to be prevented from carrying out this design should be so framed as to warn him, at the very outset, from attempting such distribution of the common voting stock as outlined, before he incurs the expense of time, effort and money in Federal registration. Certainly all of the circumstances for which qualification may be refused cannot be listed in any one State statute, but possibly the major ones may be. Take the Pennsylvania law, for instance. The refusal of the application in the example cited, using the wording of that Act, would be upon the basis that the commission is not "satisfied that the proposed plan of business of the applicant is fair, just and equitable."

This stated lack of fairness, justice and equitability in the proposed plan is cited to cover a whole host of situations, from lack of adequate working capital to refusals of registration because of failure to come within the terms of the Act. There is only one other ground for refusal of a new applicant and that is lack of repute. So often a disappointed applicant is a puzzled one as well. He knows the commission's decision but has difficulty in fathoming the reasons. And the commission all the time has just cause for its action, but is handicapped because the Act is framed in the manner indicated.

Nor is the Uniform Act of any great improvement in this regard. In Section 8 (i) it is provided as follows:

"If upon examination of any application the Commission shall find that the sale of the security referred to therein would not be fraudulent and would not work or tend to work a fraud upon the purchaser and *that the enterprise or business of the issuer is not based upon unsound business* principles, it shall record the registration * * *."

This provision may have been designed to give the Commissions generous latitude in passing upon securities applications, but it leaves doubt and uncertainty in the minds of anyone who reads it. It would in no degree curtail the latitude of action if for instance the meaning of "unsound business principles" was amplified. It could be done by listing the chief examples and then providing for others not specifically defined or set forth.

Take the matter of selling commissions. This subject has always been more or less regulated by the State Securities Commissions. The Pennsylvania Act brands as fraudulent any transaction in which there is the "gaining, directly or indirectly through the sale of any security, of an underwriting or promotion fee or profit, so gross and exorbitant as to be unconscionable" (section 2-f). The Uniform Act as cited above in section 8 (i) prohibits fraudulent sales of securities and is it then to be inferred that the bar against fraudulent sales as outlined in that section extends to sales assumed to be fraudulent because of unconscionable profit or commission?

It is sometimes pitiful to see an applicant graduate into a successful S. E. C. registrant only to be "flunked" by the State commissions because the sales commission makes it impossible to clear the issue in the states. The last remembered example of this was an issue providing for a commission of thirty-eight and a half per cent (38½%), and be it said in his favor that the attorney, when it was pointed out to him, was apologetically resigned to omitting its offering in the State in question.

Less pity would be due such an unfortunate had he, in the first instance, the means available to him of clear information as to the matter of sales commissions and underwriting spreads and some sort of notice as to that which under no circumstances would be tolerated; some sort of a warning as to what would be encountered by him when he presented his issue for qualification in the states. Of course, too few lawyers, issuers, underwriters and persons generally give anything but remote second thought to the matter of State securities requirements and for these, needless to say, little anxiety need be exercised.

Further upon this question of selling commission, sales expense and underwriting profit, a factor which is always considered by State Commissions, an examination of the requirements of the respective states shows, first, a lack of uniformity, and second, in a great number of instances, no accurate information as to exactly what the limitation or requisites may be.

The following rough classification will readily show this. Here is the roster:

STATE RESTRICTIONS AS TO COMMISSIONS AND SALES EXPENSE

No Blue Sky Law:

Delaware, Maryland, New York, New Jersey, Nevada, District of Columbia.

No Specific Provision in the Law:

Colorado, Connecticut, Louisiana (by uniform rule, oil and mining securities 20%, industrial issues 15%, bank and insurance shares 10%), Maine, Massachusetts (none, except exorbitant commission or profit makes sale fraudulent), New Hampshire, Ohio (none, except "qualification when selling cost is moderate, e. g. 10%"), Oregon, Pennsylvania (none, except exorbitant commission or profit makes sale fraudulent), South Dakota, Texas (none, but application must show commissions paid, whether in stock or cash), Washington, Wyoming (none, but regulation requires commissions to be paid upon actual cash received and not upon subscriptions taken).

Maximum Amount Made Discretionary with Securities Commission:

Arkansas, Idaho, Indiana, Minnesota, Missouri, New Mexico (discretionary, but prohibits commissions paid to officers and directors), Oklahoma, Utah, Montana, Wisconsin (discretionary, but under such discretionary power, maximum is fixed at 10%).

10% *Maximum:*

Kansas (including all sales expense), North Carolina (10% of sale price).

12½% *Maximum:*

Nebraska (12½% including all sales expense).

15% *Maximum:*

Alabama (generally 15%, but bank and insurance companies 10%, finance and mortgage companies 10%), North Dakota (no commissions to be paid salesmen until cash is received).

20% *Maximum:*

California (generally 20%, building and loan companies 10%, finance and mortgage companies 10%, industrial companies 10%, royalty companies 15%, prospective public utilities 10%, holding companies for stock of insurance companies 15%), Florida (company must receive 80% of proceeds of sale), Iowa (20% of sales price), Kentucky (unlawful to pay or receive more than 20% commission), Michigan (20% including all sales expense), Mississippi (20% including all sales expense), Tennessee (company must receive 80% of proceeds of sale), West Virginia (20% of sales price including all sales expense).

25% *Maximum:*

Georgia (company must receive 75% of proceeds of sale), Montana (25% of sales price).

30% *Maximum:*

Virginia (law provides 20%, which can be extended to 30% by commission).

So we can readily see that if any general distribution of securities is sought the issuer or distributor is placed in a state of most uncomfortable perplexity in arriving at what should be the proper commission to be fixed, so as to conform to the respective State requirements.

At a glance this convinces one that if there is to be a limitation of the percentage to be charged for selling cost, it then should not vary with the geographical locations of the states or in some like arbitrary fashion. It is equally as important that the investor in Texas be fairly dealt with as it is for the securities purchaser in Minnesota. And it is only proper that the securities seller shall have the means of handily available knowledge as to what he may and what he may not charge. Such allowance should be fair to him and primarily fair to the investor. The best arrangement, it appears, is to have it scaled to meet the peculiar conditions applicable to particular classes of investments as provided for by Louisiana, as shown above.

Uniformity in the law itself will go far in aiding meritorious investment business and at the same time will permit the prevention of fraudulent practices and injury to the investor by dishonest undertaking. However, there is need, in addition, for uniformity in regulations of the states, in forms and procedure. The purpose of all legislation in this field is the same, namely, to protect the investor, and there can be seen no deviation from devotion to that purpose by making requirements in all of the states similar. Selfishly, there may be some states which yet feel that by making the rules less stringent, they may attract business that otherwise would center in other states. But, naturally, such view is obviously shortsighted, to say the least, because it is the resident of their own home state that eventually pays for such laxity, and more often than not, pays and pays through the nose.

However, much of what I have said concerns not so much the matter of uniformity and clarification of the law as it possibly does the standardization of rules and procedure. Certainly the matter of selling commission and underwriting fees could well be made the subject of commission rules. Interpretation of the phrase "sound business principle" might even be made the subject of some agreed more or less standard definition. So, if uniformity can be accomplished by making plain and understandable the requirements of the State Securities Commissions by standardizing their rules instead of or as well as their laws, let that be done as well. It is strongly felt, however, that the first step should be in the uniformity of the law. First, because this being the basis of any regulation or ruling, its perfection should therefore be first; secondly, because this work has already been started and it presently needs but to be carried on and, what is more, carried into effect by urging the legislatures of the states to act.

There is a willingness on the part of Securities Commissioners everywhere to do this service for the aid of that part of the securities profession which is committed to the principles of honesty and fair dealing. There should be allowed no false idea that it is the desire of those charged with administration of this most important field of the law, to leave in state of vague confusion and hazy doubt, the law which it is their duty to enforce.

The Securities Commissioner has an abhorrence of "red tape" and delay, and therefore will welcome, I know, any effort toward making the law uniform. Let the lawyer and the American Bar Association do their share!