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# A Critical Analysis of the Registration Provisions of the Minnesota Securities Act

Lawrence Perlman

# A Critical Analysis of the Registration Provisions of the Minnesota Securities Act

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This article explores the registration provisions of the Minnesota Securities Act,[1] proceeding on the thesis that such provisions in particular and the Act in general are in need of a substantial overhaul. Included is a brief introduction to the Minnesota Act and to state and federal securities regulation generally, followed by a detailed analysis of the registration provisions of the Act.

## I. INTRODUCTION

The Minnesota Securities Act was enacted in 1917[2] after the United States Supreme Court had upheld the constitutionality of the Blue Sky laws of several other states.[3] It was one of a wave of Blue Sky laws which followed the enactment by Kansas of a comprehensive statute in 1911 regulating the sale of securities and the securities business.[4]

The philosophy underlying these early Blue Sky laws was similar to that which had led previously to the state regulation of public utilities,[5] and is summarized by one contemporary observer:

> The general purpose of these laws [the 19 state Blue Sky statutes which had been passed between 1911 and 1913] is to force those who intend to offer stocks and bonds to the public to make known to some proper state authority their organization,

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1. MINN. STAT. §§ 80.01-80.37 (1969). No official name is given in the statute which is generally known as the Securities Act or the Blue Sky law. In this article it will be generally referred to as "the Act," or "the Minnesota act."

2. Minn. Laws 1917, ch. 429.

3. The so-called "Blue Sky cases" include Hall v. Geiger-Jones Co., 242 U.S. 539 (1917) (Ohio statute); Caldwell v. Sioux Falls Stock Yards Co., 242 U.S. 559 (1917) (South Dakota statute), Merrick v. Halsey & Co., 242 U.S. 568 (1917) (Michigan statute).

4. Kansas Laws 1911, ch. 133. For the historical development of Blue Sky laws see L. Loss & E. COWETT, BLUE SKY LAW 1-13 (1958) and 1 L. LOSS, SECURITIES REGULATION 23-30 (2d ed. 1961, Supp. 1969).

5. *See* Ayres, *Government Regulation of Securities Issues*, 28 POL. SCI. Q. 586 (1913).

plan of business and the purpose for which the income from the securities will be used. If this official does not believe that the project offers a fair opportunity to the investor he may forbid the proposed sale.[6]

The Minnesota act met an early test in *Gutterson v. Pearson*,[7] when the Minnesota Supreme Court refused to apply it to non-issuer transactions.[8] The Minnesota legislature, however, soon rallied to the protection of investors exposed by the *Pearson* decision to the mercy of the "unscrupulous and visionary,"[9] and amended the Act in 1923 to bring nonissuers within its purview.[10]

Apart from this skirmish over nonissuer coverage, the Act and its early administration followed the pattern set under the Kansas Act. The evil sought to be remedied was the loss suffered by the public through investing in worthless enterprises.[11] The regulatory technique chosen was to require deal-

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6. *Id.*
7. 152 Minn. 482, 189 N.W. 458 (1922).
8. This decision presumably caused the State Securities Commission some embarrassment since it had regulated nonissuer transactions from the inception of the Act. Brown, *A Review of Cases on "Blue Sky" Legislation*, 7 MINN. L. REV. 431, 437 (1923).
9. *Id.*
10. Minn. Laws 1923, ch. 4.
11. The conditions which those who administered the Act felt existed at the time of its passage included:

(1) Numerous promotions were in progress in which commissions and other expenses incidental to the sale of the stock amounted to thirty, forty, or fifty per cent, and even more, of the selling price of the stock.
(2) Mining and oil companies and various other fictitious enterprises were selling stock to secure money with which to develop properties not worth developing.
(3) Many stocks and other kinds of securities were sold at grossly excessive prices and without regard to their actual value.
(4) Men with "ideas" formed companies and took fifty-one per cent of the stock for their "ideas," the other forty-nine being sold to finance the project. Very often the "ideas" proved mere dreams and valueless, and only served to swell the sum total of business failures and the number of stock purchasing victims.
(5) Companies were formed to manufacture or exploit patented appliances, articles and devices which were mechanically imperfect or impracticable.
(6) There was no one to question the propriety or legality of the issuance of large blocks of stocks for "goodwill" or other similar intangible assets, and it was not uncommon to find new concerns whose only asset consisted of "goodwill."
(7) Stocks of concerns which were insolvent could be legally offered and sold, subject only to the restrictions against actual fraud.
(8) Grossly excessive valuations were claimed for assets in order to justify a given price for the stock or to cover up losses in operation or other impairments.

ers[12] and persons desiring to sell securities issued by themselves (called "Investment Companies" in the early versions of the Act) to apply for registration with the Securities Commission.[13] The Commission then granted or denied the application or carried out further investigation.

The Act embodied the same paternalism found in most of the Blue Sky laws of the time.[14] The standard for registration apparently applied by the early Securities Commission was a particularly rigorous one:

> The Commission has interpreted the laws to mean that the sale of a security must be classed as fraudulent where the purchaser thereof does not have a fair chance to gain by the investment. It is not sufficient that the money invested be secure against loss; there must be a fair chance to gain . . . . A man engaged in business . . . may desire to sell stock to increase his business or for other reasons. The commission, in such case, wants to know all about the business, its past experiences, present condition, and future prospects. The commission obtains this information. The purpose . . . is to place before the commission the facts in a particular case, so that the commission may determine that the investor in the securities offered may not only not lose what he puts in but have a fair chance to make a reasonable profit on the investment. If the commission can not so determine, it refuses to permit the securities to be sold, for to sell the same would work a fraud on the investor.[15]

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> (9) Enterprises which were impossible of success were being promoted.
> (10) Foreign corporations which had no offices or places of business or permanent representative within a state sent their glib-tongued agents therein to sell their stocks and securities, and were often successful to a remarkable degree. If an investor found that he had been defrauded by false and fraudulent representations, he was compelled to seek redress in some foreign jurisdiction, or submit to his loss without complaint.
> (11) Deliberately planned frauds were common and often very remunerative to the promoters.

Brown, *The Minnesota "Blue Sky" Law*, 3 MINN. L. REV. 149, 149-50 (1919) (the author was one of the first members of the Minnesota Securities Commission).

12. Minn. Laws 1917, ch. 429, § 4.

13. *Id.* at §§ 3 & 4.

14. An example is an early opinion of the Minnesota Supreme Court construing the Act, in which the court said:

> The [Securities] Commission is better qualified than the average investor to ascertain whether any real values lie behind mere paper evidences of value. It has power . . . to compel a full disclosure of the facts upon which to base an intelligent judgment. Schemes devised to get the money of prospective investors are innumerable. Many of them, though not fraudulent are unsound or visionary.

State v. Gopher Tire & Rubber Co., 146 Minn. 52, 55, 177 N.W. 937, 938 (1920). *See also* Kerst v. Nelson, 171 Minn. 191, 213 N.W. 904, 905 (1927) (referring to the "paternalistic character" of Blue Sky laws).

15. Brown, *supra* note 11, at 159-60.

While it has been amended many times, the Minnesota act preserves the basic registration structure it contained when first enacted. Unless an exemption applies or the issuer qualifies for a seasoned security registration, the issuer must file an application for registration, which the Commissioner of Securities may deny

> if [he] is of the opinion that the securities are fraudulent, or if it appears to [him] that the sale thereof would work a fraud or deception on the purchasers thereof, or if the proposed plan of business of the issuer and the terms of the securities are unfair and unjust, or if the applicant has violated any of the provisions [of the Act relating to exemption or registration] or any registration or lawful order of the [Commerce] commission or for good cause appearing to the "Commissioner."[16]

The approach of the Minnesota act and the Blue Sky laws of many other states in protecting securities purchasers stands in sharp contrast to the federal regulatory scheme. Pursuant to Section 80.08 of the Minnesota act, the State Commissioner of Securities must determine whether the terms of the proposed securities issue would be unfair and unjust. The federal Securities and Exchange Commission (SEC), on the other hand, is granted no such authority to pass upon the merits of a securities issue. Instead it focuses on the thoroughness and accuracy of the prospectus supplied to the potential securities purchaser.

Section 5, the key provision of the federal Securities Act of 1933, makes it unlawful for any person to use the mails or any means of interstate commerce to sell a security for which a registration statement (of which the prospectus is the main part) is not in effect.[17] Sections 11, 12 and 17 of the 1933 Act impose civil and criminal liabilities on those who fail to comply with its registration provisions or who utilize a registration statement containing an untrue statement of a material fact or omitting

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16. MINN. STAT. § 80.08 (1969). MINN. STAT. § 80.01(8) (which was adopted in 1969 as part of a comprehensive amendment relating to the Commerce Commission, Minn. Laws 1969, ch. 1129) provides that "whenever necessary to give effect to such provision, the term 'commission' may be construed as meaning or including [the] commissioner of securities . . . ." In an amendment made in 1925, a Commissioner of Securities was provided for who succeeded to the responsibilities discharged by the Securities Commission under § 4 of the 1917 statute. Minn. Laws 1925, ch. 426, art. VIII, § 3. The same amendment created the Commerce Commission, consisting of the Commissioners of the Insurance, Banking and Securities Divisions. [The Securities Division is referred to as "the Division" in this paper].

17. Securities Act of 1933, § 5(a), 15 U.S.C. § 77(e) (1970) [hereinafter called "the 1933 Act"]. The 1933 Act is introduced thoroughly and concisely in E. THOMAS, FEDERAL SECURITIES ACT HANDBOOK (3d ed. 1969).

a material fact.[18] In addition, the SEC has injunctive powers.[19] This pattern of private and governmental enforcement supports the basic thrust of the 1933 Act, which is to require the seller of securities to make full disclosure on which prospective securities purchasers may base decisions. Securities purchasers are to be protected by their informed judgment and not by the substituted judgment of a government administrator.[20]

Some type of Blue Sky law is presently in effect in every American jurisdiction, except Delaware and the Virgin Islands. While the general *registration* pattern of the Minnesota act is similar to that found in many other states, there is by no means uniformity among the Blue Sky laws of the various states. Instead, one finds a bewildering diversity. Not only are there significant substantive differences among the various statutes, but otherwise similar provisions are often interpreted and administered differently by the various Blue Sky administrators.[21]

The various Blue Sky laws may be divided into four general categories:

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18. Securities Act of 1933, §§ 11, 12, 17, 15 U.S.C. § 77(k), (l), & (q) (1970).

19. Securities Act of 1933, § 20b, 15 U.S.C. § 77t(b) (1970).

20. "The fundamental aim of the prospectus requirement was to provide information, and not to shield the public from ventures deemed to be of dubious merit." CCH FED. SEC. L. REP. 49 (1969), *quoting* SECURITIES EXCHANGE COMMISSION, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS, [hereinafter called the "Wheat Report"]. The Wheat Report is a thorough examination of the disclosure philosophy underlying the 1933 Act. For further discussions of the 1933 Act and of its place in the pattern of federal securities regulation see Cohen, *"Truth in Securities" Revisited,* 79 HARV. L. REV. 1340 (1966); Knauss, *A Reappraisal of the Role of Disclosure,* 62 MICH. L. REV. 607 (1964).

A consumer's eye view of the SEC disclosure philosophy was expressed by one David F. Friedman of Hollywood, California, a producer of adult films, who was quoted by Minneapolis Tribune columnist, Will Jones:

> I'm going public. My prospectus is going to be a dazzling work, offering not mere fortune but the chance to meet pretty girls. Every stockholder will be issued a permanent pass to the studio. In order to sell stock, the SEC requires only that you be truthful in the prospectus, and that's exactly what I'm going to be. One of my competitors recently went public and the only assets he listed were the time and talents of himself, and he ended up with two and a half million dollars. I can make a better showing than that in the prospectus, and to show you how serious I am, I've already taken an option on a place in Tahiti.

The Minneapolis Tribune, Oct. 2, 1971, § A at 10, col. 1.

21. *See* L. Loss & E. COWETT, *supra* note 4, at 44. Writing in 1958 when there were 47 Blue Sky laws in effect, Loss and Cowett estimated that there were 2,800 exemptions from registration in such statutes. *Id.* at 19.

1. Fraud: laws providing for criminal and civil sanctions for fraudulently offering or selling securities but not requiring registration of securities or dealers;
2. Broker-Dealer Regulation: laws regulating broker-dealers but not requiring the registration of securities;
3. Intrastate Only: laws not requiring registration of securities registered or exempt from registration under the 1933 Act, except that securities exempt from 1933 Act registration pursuant to Section 3(a)(11) (intrastate exemption) must be registered;
4. Merit: laws requiring the registration of securities and broker-dealers and granting the administrator the power to deny registration on merit grounds.

No jurisdiction presently relies solely on a fraud type statute,[22] and Connecticut and Maine regulate only broker-dealers.[23] Nevada, New Jersey, New York, and Pennsylvania fall into the intrastate only category, although New Jersey, New York, and Pennsylvania are broker-dealer regulation states for offerings registered with the SEC.[24] All remaining states fall into the merit category, although most of these have general antifraud provisions, as does Minnesota,[25] as well as provisions relating to broker-dealer registration.

The standards applied by the various merit states in determining whether to allow a security to be registered vary greatly.[26] Prior to 1956, there was even less uniformity than pres-

22. 1 BLUE SKY L. REP. ¶ 503.

23. CONN. GEN. STAT. REV. §§ 36-320 to 36-347 (1962). (Prior to 1967, Connecticut required that oil and mining securities be registered); ME. REV. STAT. ANN., tit. 32, §§ 751-856 (1964). The District of Columbia's Blue Sky law (D.C. CODE ANN. § 2-2401 *et seq.* (1967) ) regulates only broker-dealers, but the 1933 Act is applicable to the District because it defines "interstate commerce" in § 2(7) as including "trade or commerce . . . within the District of Columbia."

24. NEV. REV. STAT. § 90.075 (1967); N.J. REV. STAT. § 49.3-60 (Supp. 1968); N.Y. GEN. BUS. LAW § 359-ff (McKinney Supp. 1968); PA. STAT. ANN. tit. 70, § 43(c) (1965). Of these four states, two apply merit tests to securities which fall within the scope of their registration requirements. PA. STAT. ANN. tit. 70, § 43(g) (1965) ("fraudulent" sales may be forbidden by the Commissioner); NEV. REV. STAT. §§ 90.140, 90.155 (1965) (regulation of selling costs and organizers minimum equity investment).

25. MINN. STAT. § 80.19 (1969).

26. *See* notes 21-22 *supra,* and accompanying text. L. Loss & E. COWETT, *supra* note 4, discusses the varying standards and practices in chapters I-III. *See also* Bloomenthal, *Blue Sky Regulation and the Theory of Overkill,* 15 WAYNE L. REV. 1447, 1451-78 (1969); Hueni, *Application of Merit Requirements in State Securities Regulation,* 15 WAYNE L. REV. 1417 (1969). The approaches of the various states to nonissuer transactions are covered in Note, *Nonissuer Transactions Under Federal and State Securities Registration Laws,* 78 HARV. L. REV. 1635, 1643-50 (1965).

ently exists, and it was this "pointless complexity" in an area of the law where "uniformity is so essential" which formed the background for the drafting of the Uniform Securities Act and its approval by the National Conference of Commissioners on Uniform State Laws and the American Bar Association.[27]

The Uniform Act consists of four parts and two principal appendices. Part I describes "fraudulent and other prohibited practices"; Part II pertains to registration of broker-dealers, agents, and investment advisors; Part III provides for securities registration; and Part IV contains exemptions and various general provisions. The two appendices enable the Uniform Act to be tailored to a particular jurisdiction's desires by describing the modifications necessary to eliminate the securities registration provisions (Part III) or the broker-dealer registration provisions (Part II), or both. Although a testament to the ingenuity of its draftsmen, the adaptability of the Uniform Act's structure undercuts the very uniformity which was its original objective. While it has been adopted in whole or in part in 27 jurisdictions,[28] many states have tinkered with it substantially enough in the process that there is in fact no real uniformity.

This lack of uniformity among Blue Sky laws is further reflected in the variety of regulations which have been adopted under such statutes. This nonuniformity of regulations has caused the various groups of securities administrators and, particularly, the Midwest Securities Commissioners Association, to attempt to develop consistent standards for implementation of their respective disparate merit statutes through the promulgation of standardized regulations.

Through its approval of various uniform forms and its statements of policy on real estate investment trusts, cheap stock, preferred stock, options and warrants, and other matters, the Midwest Securities Commissioners Association has had a significant impact on the regulations adopted in its member states.[29] Recently a group called the Central Securities Ad-

27. *See* L. Loss & E. Cowett, *supra* note 4, at 230-44, for a history and description of the Uniform Act. The Uniform Act is contained in 1 Blue Sky L. Rep. ¶¶ 4901-53.

28. Included are Alabama, Alaska, Arkansas, Colorado, District of Columbia, Hawaii, Idaho, Indiana, Kansas, Kentucky, Maryland, Michigan, Missouri, Montana, Nebraska, Nevada, New Jersey, New Mexico, Oklahoma, Oregon, Puerto Rico, South Carolina, Utah, Virginia, Washington, Wisconsin and Wyoming. 1 Blue Sky L. Rep. ¶ 4901.

29. Member states of the Midwest Securities Commissioners As-

ministrators Council, consisting of the states of Indiana, Michigan, Minnesota, Missouri, and Wisconsin (apparently with moral support from Ohio which is currently revising its Blue Sky law) has been formed, and on August 31, 1971 it adopted a comprehensive Statement of Policy on Broker-Dealers' Capital, Investment Companies, and Oil and Gas Interests.[30] This group has as one of its objectives the development of procedures of sufficient similarity that the registration of an issue in any member state will serve as virtual clearance in all.

## II. ANALYSIS OF THE MINNESOTA REGULATORY SCHEME

### A. Scope of Act

The heart of the Minnesota Securities Act is found in Section 80.07, which provides:

> No securities, except those exempt under section 80.05 and those sold in sales exempt under section 80.06, shall be offered for sale or sold within the state unless such securities have been registered pursuant to sections 80.08 or 80.09, except that it shall be permissible for licensed broker-dealers and agents to offer for sale in Minnesota prior to registration securities for which a registration statement has been filed under the Federal Securities Act of 1933.

The statutory definition of a security is comprehensive[31] and the Minnesota Supreme Court has taken a broad view in this regard, resulting in a consistent expanding of the coverage of the Act.[32] Thus unless the subject of the sale is not a security,

sociation are Arizona, Arkansas, California, Colorado, Idaho, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, New Mexico, North Dakota, Oklahoma, South Dakota, Texas, Utah, Washington, Wisconsin and Wyoming.

30. 1 Blue Sky L. Rep. ¶ 4851.

31. "Security" means and includes any stock, share, bond, note, debenture, commercial paper, evidence of indebtedness, investment contract, interest in or under a profit-sharing or participating agreement or scheme, or beneficial interest in a trust or pretended trust. Any interest in any security shall be deemed a security. "Security" does not include any insurance or endowment policy, annuity contract or contract on a variable basis issued by a life insurance company holding a current certificate of authority authorizing it to do an insurance business in this state.

Minn. Stat. § 80.01(4) (1969).

32. *See, e.g.*, Donovan v. Dixon, 261 Minn. 455, 113 N.W.2d 432 (1962) (guaranty fund certificates issued by mutual insurance company are securities); Virnig v. Smith, 252 Minn. 363, 90 N.W.2d 241 (1958) (joint venture interests are securities); State v. Lorentz, 221 Minn. 366, 22 N.W.2d 313 (1946) (contracts for burial lots are securities); State v. Golden, 216 Minn. 97, 12 N.W.2d 617 (1943) (oil interests

or an exemption is available, or the sale is not deemed to be a Minnesota sale,[33] registration under the Act is required.

B. REGISTRATION PROVISIONS FOR ISSUER TRANSACTIONS

*1. Registration by Application—Coordination of State and Federal Filings*

Section 80.08[34] covers registration by application, which is

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are securities); State v. Hofacre, 206 Minn. 167, 288 N.W. 13 (1939) (interest in discretionary investment account a security); State v. Robbins, 185 Minn. 202, 240 N.W. 456 (1932) (fur farm profit sharing contracts are securities); State v. Code, 178 Minn. 492, 227 N.W. 652 (1929) (interests in invention being developed are securities); Webster v. U.S.I. Realty Co., 170 Minn. 360, 212 N.W. 806 (1927) (land contracts with options are investment contracts); Kerst v. Nelson, 171 Minn. 191, 213 N.W. 904 (1927) (land contracts by which seller agreed to cultivate and market crops and share proceeds with purchaser are securities); State v. Swenson, 172 Minn. 277, 215 N.W. 177 (1927) (interest in invention a security); State v. Bushard, 164 Minn. 455, 205 N.W. 370 (1925) (contract for sale of bus with profit sharing arrangement a security); State v. Ogden, 154 Minn. 425, 191 N.W. 916 (1923) (profit sharing contract a security); State v. Evans, 154 Minn. 95, 191 N.W. 425 (1922) (contract which included option to purchase real estate a security); State v. Gopher Tire & Rubber Co., 146 Minn. 52, 177 N.W. 937 (1920) (investment contract a security). *But see* Bates v. Equitable Life Assur. Soc. of United States, 206 Minn. 482, 288 N.W. 834 (1939) (annuity contract held not to be a security); Busch v. Noerenberg, 202 Minn. 290, 278 N.W. 34 (1938) (unless incident to an interest in profits from tract, contract for undivided interest in land not security).

33. For discussions of the conflict of laws problem in state securities transactions see L. Loss & E. COWETT, *supra* note 4, at ch. 5; Friedman, *Searching for a Blue Sky Remedy—A Forum Shopper's Guide*, 15 WAYNE L. REV. 1495 (1969).

34. The section states:

> Applications for registration of securities shall be made on forms prescribed by the commission. The application shall contain such information and representations as the commission may require as necessary or appropriate in the public interest or for the protection of investors.
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> When the commissioner deems it necessary he shall have power, in connection with pending applications and at the expense of the applicant, to require the applicant to furnish additional information, to order an appraisal, audit or other examination and report, and, where the applicant is the issuer of the securities, or the proposed sale is to be on behalf of the issuer, to make an investigation of the books, records, property, business, and affairs of such issuer.
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> Upon compliance with all the provisions of sections 80.05 to 80.27 applicable to such application and the requirements of the commission or commissioner, the commission shall either register such securities or deny the application. The commission shall have power to place such conditions, limitations, and restrictions on any registration as may be necessary to carry out the purposes of sections 80.05 to 80.27. Registration shall be by entry in a book called Register of Securities, which entry shall show the securities registered and for whom

the procedure to be followed for all registrations except the relatively few involving "seasoned securities" which are covered by Section 80.09.[35] Mechanically, the procedure for registration by application under the Act will vary depending on whether or not the securities are also being registered under the Federal Securities Act of 1933 or offered pursuant to a Regulation A exemption from such registration. In the absence of a federal registration or Regulation A exemption, the Minnesota application form and required exhibits must be filed.[36]

The Minnesota Securities Commission regulations provide that in lieu of the material required to be filed thereunder, the Uniform Application to Register Securities and the registration statement filed with the SEC may be used for registration in Minnesota of securities concurrently being registered with the SEC.[37] The adoption of the Uniform Application was a major step in reducing to reasonable proportions the task of registering a nationwide distribution of securities, but a serious mechanical problem still remains in the Act because no provision is made for coordination of federal and Minnesota registrations. One of the accomplishments of the Uniform Act is that its "registration by coordination" provisions allow for simultaneous federal and state effectiveness of registrations.[38]

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> registered, and the conditions, limitations, and restrictions, if any, or shall make proper reference to a formal order of the commission on file showing such conditions, limitations, and restrictions. The commission shall have power to deny an application for registration if the commission is of the opinion that the securities are fraudulent, or if it appears to the commission that the sale thereof would work a fraud or deception on the purchasers thereof, or if the proposed plan of business of the issuer and the terms of the securities are unfair and unjust, or if the applicant has violated any of the provisions of sections 80.05 to 80.27 or any registration or lawful order of the commission, or for good cause appearing to the commission. Denial shall be by written order.

MINN. STAT. § 80.08 (1969).

35. *See* part II B 3 *infra*.

36. Regs. S. Div. 2-4. [The Rules and Regulations of the Securities Division of the Minnesota Department of Commerce as filed with the Secretary of State and Commissioner of Administration on July 8, 1970, are cited hereinafter as "Regs. S. Div." and referred to as the "regulations" or as the "Minnesota regulations."]

37. Regs. S. Div. 3. The Uniform Application was prepared by the Committee on State Regulation of Securities of the Section of Corporation, Banking and Business Law of the American Bar Association and approved for use in Minnesota as of October 1, 1962. 1 BLUE SKY L. REP. ¶¶ 4471-72. For the form itself see *id.* at ¶ 4473.

38. UNIFORM SECURITIES ACT § 303(c). In addition to the Uniform Act jurisdictions, the California Corporate Securities Act of 1968 contains a registration by coordination procedure in § 25111(c) which is

The problem of coordinating federal and state registrations derives from the manner in which registrations are treated by the SEC and securities underwriters. While Section 8 of the 1933 Act provides that registration statements automatically become effective 20 days after they are filed (unless a stop-order procedure is initiated), the normal practice is to file a delaying amendment along with the initial registration statement which, under Rule 473,[39] delays the effective date until (i) a further amendment is filed which states that the registration statement shall become effective in accordance with Section 8(a), or (ii) the SEC accelerates the effective date. This procedure is chosen because registrants do not wish to allow registration statements to become effective until after they have received and complied with the SEC letters of comment which spell out deficiencies in the registration statements. When the comments have been satisfied through the preparation and filing of one or more amendments, normally a desired effective date will be selected. The SEC is then asked to accelerate the registration statement's effectiveness to such date. In an underwritten registration where there is a pre-existing public market for the securities to be offered, the price at which the securities are to be offered will not generally be determined until after the market has closed on the day before the effective date, and the underwriter will not sign the underwriting agreement (which commits it to purchase the securities) until the afternoon of that day or until the morning of the effective date itself. When the price is agreed upon and the underwriting agreement signed, the final amendment (called the "price amendment") is filed with the SEC, usually on the effective date. Even if there is no pre-existing public market, the underwriter will generally not sign the underwriting agreement until the afternoon before or the day of SEC effectiveness.[40]

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adapted from UNIFORM SECURITIES ACT § 303(c). CAL. CORP. CODE § 25111 (West Supp. 1970). Texas has also adopted such a procedure. TEX. REV. CIV. STAT. art. 581-7(c) (1964) (also based on UNIFORM SECURITIES ACT § 303(c) ).

39. For discussion relating to Rule 473 of the Securities Exchange Act of 1933, see H. SOWARDS, FEDERAL SECURITIES ACT, ch. 7, (11 BUSINESS ORGANIZATIONS, 1971 Rev.).

40. Underwriters follow this policy not only to minimize the risk of a market break or some other problem occurring between their commitment under the underwriting agreement and the effective date of the registration statement, but because Rule 15c3-1(c)(2)(E) under the Securities Exchange Act of 1934 comes into effect when they sign the underwriting agreement to require a deduction from the underwriter's net capital of a portion of the value of the securities to which

Compliance with SEC procedures and with the customs of securities underwriters requires a substantial amount of coordination among SEC staff members, underwriters, lawyers for the registrant and underwriters, accountants and Blue Sky administrators. Because timing decisions are often made on short notice, the problem of making a sizeable registration effective with the SEC as well as a number of states on the same day can be a logistical nightmare. Section 303(c) of the Uniform Act approaches the problem by declaring that the registration statement filed with the state becomes effective automatically when it becomes effective with the SEC if three conditions are met:

1. No state stop order is in effect and no denial, suspension or revocation proceedings are pending;
2. The registration statement has been on file for at least 10 days (a period designed to give the administrator an opportunity to apply the state's merit requirements to the offering);
3. A statement of the maximum and minimum proposed offering prices and the maximum underwriting commissions have been on file with the state for two days (this procedure obviates the filing of the SEC price amendment with the state *prior to* effectiveness, which is difficult because of the short intervals between determination of the price and SEC effectiveness [usually less than 24 hours] and the filing of the price amendment and SEC effectiveness [sometimes only one or two hours]).

Since the Minnesota act has no such coordination provisions, various Minnesota Securities Commissioners have tried to assist issuers by informal procedures aimed at making registration in Minnesota effective upon SEC effectiveness if the issue meets the appropriate merit standards. Nevertheless, these informal procedures often have not worked satisfactorily and impose a burden on the Security Division's staff. The absence of a clear coordination procedure must be deemed a serious defect in the Minnesota Act.

### 2. *Standards*

The standards which the state Commissioner of Securities is to apply in determining whether or not to grant an applica-

the underwriter is committed to purchase. A thorough discussion of the SEC registration procedure will be found in H. SOWARDS, *supra* note 39, at ch. 7.

tion for registration are set out in the third paragraph of Section 80.08 of the Act.[41] These statutory standards are quite general, and the Securities Commission has, from time to time, enacted regulations to implement them.[42] The current regulations, adopted in 1970, fall into six categories concerning rights of security holders, selling expenses, options and warrants, offering price, minimum investment, and speculative issues.[43] Financial statement requirements, while technically separate from the standards regulations, are closely related and will also be considered under this heading.

a. Rights of Security Holders.

Eight regulations[44] cover voting rights of common and preferred stock, protective provisions for preferred shares, debt securities and trust indentures, convertible senior securities, assessments and restrictions on transfer. In structure and, to a large degree, in substantive content, the regulations are based on Subarticle 1 of Article 4 of the regulations adopted under the California Corporate Securities Law of 1968.[45] The regulation dealing with voting rights of common stock[46] is taken from a Statement of Policy adopted by the Midwest Securities Commissioners Association on June 27, 1968,[47] which has been adopted by several states.[48]

The regulations relating to rights of security holders are part of the difficult problem of reconciling state securities regulation with general corporate law. The rights of a corporation's security holders are governed generally by the corporation statute under which the corporation was formed, as supplemented and limited by the articles of incorporation, bylaws, and certain

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41. *See* text accompanying note 16 *supra*.

42. A complete revision of these regulations was adopted in 1970, and is contained in chapter 3 of the regulations. The closely related regulations pertaining to conditions of registration are found in chapter 4.

43. For a critique of the standards regulations as originally proposed see MACINTOSH, PERLMAN, JOHNSON, HALE & DOLAN, MEMORANDUM: COMMENTS OF THE SECURITIES REGULATION SECTION, HENNEPIN COUNTY BAR ASSOCIATION, ON PROPOSED RULES OF THE MINNESOTA COMMISSIONER OF SECURITIES (1970) [hereinafter cited as "MEMORANDUM"].

44. Regs. S. Div. 212-19.

45. Cal. Regs. 260.140.1 to .10; 1 BLUE SKY L. REP. ¶ 8617.

46. Regs. S. Div. 212.

47. 1 BLUE SKY L. REP. ¶ 4761.

48. *E.g.*, Kansas Regs. 81-7-1(K), *id.* at ¶ 19,707; Wis. Regs. 3.07, *id.* at ¶ 52,603.

other instruments (*e.g.*, the certificate relating to the terms of a preferred stock issue called for by Section 301.14(5) of the Minnesota Business Corporation Act). Such rights normally are not the subject of regulation by states other than the state of incorporation, even though the state in which a security holder resides may have a more rigorous corporation statute. For example, provisions relating to indemnification of directors, cumulative voting, proxy solicitations, percentage of shareholder vote required on certain corporate action, and rights of preferred shareholders vary widely from state to state. While it has been argued that states with more rigorous corporation laws should effect the public policy expressed by such statutes through enforcement of the state's Blue Sky and foreign corporation qualification laws,[49] not only federal constitutional considerations but concern about the impact of such an approach on interstate commerce seems so far to have suppressed such regional excesses.[50]

Certain of Minnesota's regulations relating to the rights of security holders bite deeply into areas traditionally the province of state corporation law. Regulations 213 and 214 prescribe detailed preferred stock provisions, and regulation 217 calls for "an appropriate antidilution provision" in convertible senior securities. This presents a question of what standards the Commissioner should apply in determining the acceptability of preferred stock provisions or the appropriateness of preferred stock terms.[51]

The problems created by wholesale adoption of another state's regulations are demonstrated by regulation 219 which provides in part that "No application . . . will be approved to

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49. Kaplan, *Foreign Corporations and Local Corporate Policy*, 21 VAND. L. REV. 433 (1968).

50. Perhaps the furthest judicial extension of this doctrine to date is found in Western Airlines v. Sobieski, 191 Cal. App. 2d 399, 12 Cal. Rptr. 719 (1961), where the court ruled that the California Commissioner of Corporations had jurisdiction over a change in the rights of outstanding shares of a Delaware corporation. California has since reversed its position on the substantive issue involved in the *Western Airlines* case by no longer requiring the presence of cumulative voting as a prerequisite to a finding of fairness in connection with the registration of securities of a non-California corporation. Cal. Regs. 260.140.1. 1 BLUE SKY L. REP. ¶ 8617.

51. On October 6, 1968 the Midwest Securities Commissioners Association adopted a Statement of Policy on Preferred Stock and Debentures which, to varying degrees, seems to be followed in Minnesota. 1 BLUE SKY L. REP. ¶ 4791.

issue securities, the transfer of which is subject to any restrictions imposed by the *charter documents of the issuer or the indenture or other instrument pursuant to which the securities are issued.*" (Emphasis added). Such a regulation appears clearly reasonable since investor liquidity would be restricted by the resulting lack of a public market if the securities were subject to transfer restrictions. On the other hand, private agreements among shareholders are an important element in many business transactions, are viewed sympathetically in Minnesota,[52] and presumably should not be subject to the Commissioner's review except in extraordinary circumstances. The California regulation,[53] of which regulation 219 is a copy, protects against such interference with private contracts because the term "charter documents" is defined elsewhere[54] to include items such as articles, bylaws, and the like. Since the phrase is not a term of art in the Minnesota regulations (or in the Minnesota Business Corporation Act where the word "charter" is not used), ambiguity is imported into the regulations along with the spectre of the Commissioner asserting jurisdiction over private agreements. The same type of problem is presented by another portion of Regulation 219 which states that "*limited offering qualifications* may be approved for the issuance of securities subject to such restrictions" (on transfer) subject to review by the Commission. (Emphasis added). The concept of "limited offering qualifications" is again taken verbatim from the California regulation,[55] but it is alien to the Minnesota act and to the Minnesota regulations. Since the Act covers many securities transactions involving corporations which are not commonly considered public corporations, and since it is often good corporate practice to include transfer restrictions for such closely held corporations not only in shareholder agreements but in articles of incorporation and corporate bylaws,[56] the regulation could have wholly unintended effects.

b. Selling Expenses

The Minnesota regulation relating to selling expenses defines selling expenses to include not only underwriting discounts

52. *See* Hart v. Bell, 222 Minn. 69, 23 N.W.2d 375 (1946).
53. Cal. Regs. 260.140.8, 1 BLUE SKY L. REP. ¶ 8617.
54. Cal. Regs. 260.001(a), 1 BLUE SKY L. REP. ¶ 8613.
55. Cal. Regs. 260.001(e), 1 BLUE SKY L. REP. ¶ 8613.
56. *See generally* 1 F. O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE (1971).

or commissions, but the value of options or warrants granted to underwriters or persons affiliated with them. Selling expenses may not exceed 15 per cent of the dollar amount of the total offering for "common stocks" and "oil or gas interests," and may not exceed 10 per cent for all other securities.[57]

The provision of Regulation 230 relating to stock sold to underwriters or persons affiliated with underwriters within two years of the offering is one element of the regulation of what, in the parlance of Blue Sky law, has come to be known somewhat indelicately as "cheap stock." The Minnesota regulation on cheap stock (Regulation 295) is more realistic than the Midwest Commissioners' Policy[58] because it recognizes that the unfair opportunity for profit at the expense of the public, which is the reason for regulation of cheap stock, is usually a direct function of when the stock was issued. Under Regulation 295, securities issued between two and three years prior to the public offering may have been sold for as little as one-third of the public offering price before they will be deemed cheap stock, while securities sold within one year of the public offering will be deemed cheap stock unless their sale price was at least two-thirds of the public offering price. As it appears in regulation 230, in connection with selling expenses, the cheap stock concept differs sharply from its expression in Regulation 295. Not only are all sales within a two-year period indiscriminately lumped together with no relative price factor built in, but the Commissioner may deem the price differential an underwriting commission if he considers such sales "to have been in lieu of commissions, or material in the selection of an underwriter . . . or otherwise indirectly connected with the offering . . . ."[59]

An underwriter who makes an equity investment in a company within two years before a public offering would be a very likely choice of that company to be its underwriter on grounds of loyalty if not business judgment. And such investment would

57. At least 25 other states regulate the amount of underwriting commission and selling expenses. In any such state the maximum allowed is 20 per cent, consisting of a 15 per cent commission and 5 per cent selling expenses. Bloomenthal, *supra* note 26, at nn. 129-36. Limitations on commissions are only a part of a pattern of Blue Sky regulation of underwriter's compensation which includes cheap stock and option limitations along with regulation of the selling price itself.

58. Statement of Policy on Cheap Stock, adopted June 27, 1968. 1 BLUE SKY L. REP. ¶ 4761.

59. Regs. S. Div. 230.

surely be "indirectly connected" with the offering even if it served no more important function than keeping the company alive to the point where an underwriting was possible. But why should an underwriter be penalized, in effect, for such an investment? On the contrary, perhaps underwriters should be *encouraged* to make such investments since they are presumably better able to speculate than public investors who would benefit from the underwriter's "front money" on successful investments and be protected from loss on those that are less successful. The rationale for treating the sale of cheap stock to underwriters as part of the underwriting commission when found to be in lieu of commissions on the prior placement[60] seems different from the considerations which apply if the cheap stock is *not* considered to be in lieu of commissions. By scrambling several concepts together which have no logical or realistic connection (*e.g.*, materiality in underwriter selection and direct or indirect connection with offering), the regulation ends up operating arbitrarily and unfairly.

The exclusion of charges of "auditors, accountants, engineers, appraisers, and other experts" from the selling expense category raises the question of whether the charges of such persons would be excluded if hired by the underwriter. The only underwriter's agents specifically mentioned are attorneys, and their fees are included. It would seem desirable to encourage underwriters to utilize accountants and engineers as investigators in connection with public offerings so that the investing public would receive the protection afforded by such expert counsel. If the regulation is to be read to include such items as selling expenses when incurred for the benefit of the underwriter, perhaps consideration should be given to the allowance of a specified percentage over and above the selling expense percentage for accountable underwriter's investigative expenses. In such a case at least some portion, if not all, of the underwriter's lawyer's fees should be excluded from selling expenses since the underwriter's lawyer generally plays a significant investigative role in the offering.

60. An ambiguity lurks even in the language pertaining to commissions. Are the "commissions" those which will be paid in connection with the public offering or those which would have been paid in connection with the prior placement involving the cheap stock itself? If the latter is the case, why should the prior transaction (which presumably was not subject to the Commissioner's purview) be relevant to the proposed public offering?

c. Options and Warrants

Options and warrants consistently have been regulated by Blue Sky administrators, and are covered by policy statements of both the North American Securities Administrators (NASA) and the Midwest Securities Commissioners Association (MSCA).[61] The Minnesota regulations (241-48), while based on both the NASA and MSCA Statements, generally show greater flexibility. Regulation is aimed at three specific groups of option or warrant holders—employees, underwriters and lenders. There is an overall limitation providing that "authorized warrants and options to purchase shares . . . shall not be in excess of 15 per cent (15%) of the common shares to be outstanding if the entire public offering is sold . . . ."[62]

The provisions of Regulation 242 present several problems. While the limitation is presumably aimed at *shares*, it is expressed in terms of "authorized *warrants* and *options* to purchase shares." A warrant or option will not necessarily be for the purchase of *one* share of stock and, to the extent it is not, the literal language of the regulation makes no sense, as it appears to speak in terms of quantities of warrants rather than values of warrants in terms of the number of shares they cover.[63] The use of the word "authorized" is also troublesome because it implies that the warrants and options under consideration have some status different from being issued. Options and warrants are usually issued to their holders in the same manner as other corporate securities.[64] Does the regulation mean actually issued warrants and options or does it mean warrants and options so issued plus those reserved for issuance?

The confusion raised by the word "authorized" is compounded when the 15 per cent numerical limitation is considered. The 15 per cent figure, with its uncertain composition, is applied against the shares to be outstanding if the of-

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61. 1 BLUE SKY L. REP. ¶ 4577 (NASA), ¶ 4796 (MSCA).
62. Regs. S. Div. 242.
63. *Compare* the language of Regs. S. Div. 242, *with* the NASA's language—"the number of shares covered by the options and warrants" 1 BLUE SKY L. REP. ¶ 4577, 3(b)); and the MSCA's language—"the number of shares represented by such options and warrants" *Id.* at ¶ 4796(D).
64. *See, e.g.,* MINN. STAT. § 301.14(6) & (7) (1969). The regulations do not define "warrants" or "options." While the terms are not used with precision in practice, the term warrant is sometimes used to describe the instrument evidencing the option or other right to purchase shares. *See* C. ISRAELS, CORPORATE PRACTICE 55 (1968 ed).

fering is sold. Exempted completely from this limitation are options and warrants issued to purchasers as part of a pro rata offering[65] and exempted to the extent of 20 percent of the offering are options, warrants and convertible debentures issued in connection with financing arrangements.[66] The exception for the latter group raises the question of whether the 20 per cent figure is a mere 5 per cent expansion of Regulation 244's 15 per cent limitation allowing an aggregate of 20 percent or a separate exception for lenders resulting in a possible aggregate of 35 percent.

Employee options (whether qualified under Section 422 of the Internal Revenue Code of 1954 or not) are limited by Regulation 245 to 10 per cent of "the then outstanding" shares of the issuer. Presumably "then outstanding" refers to the number of shares outstanding prior to the offering, although it is not clear why the number of shares under option to employees should be computed on a less generous standard than that applying to lenders (Regulation 248(g)'s 20 per cent test is computed on a *post*-offering basis). Indeed, it is unclear why there should be a limitation at all on the number of shares under qualified options. Such options must be granted at fair market value at date of issue and to be eligible to receive such options, the recipient must be an employee who does not own stock, including the option stock, equal to more than 5 per cent of the voting power of the company (except that in companies where the equity capital is less than two million dollars, the percentage may go as high as 10 per cent).[67] Given the percentage limitation and the fair market value price requirement, it is unlikely that a qualified stock option could be used by an insider to take advantage of public shareholders. In any event, for a new company an option may be the only means by which it can attract highly skilled personnel from an older, well-established company. The usually strict Midwest Securities Commissioners Association places no numerical limitations on employees options, requiring only that they be "reasonable in number and method of exercise."[68] Again, by failing to distinguish between options reserved for issuance but not issued and those in fact issued,[69] Regulation 245 further complicates the comp-

65. Regs. S. Div. 244.
66. Regs. S. Div. 248(g).
67. INT. REV. CODE of 1954 § 422(b)(7).
68. 1 BLUE SKY L. REP. ¶ 4796.
69. Under § 422(b)(1) of the Internal Revenue Code of 1965, an option plan must set out the aggregate number of shares which may be

utation called for by Regulation 242. Options or warrants to underwriters are limited to 5 per cent of the number of shares to be sold (Regulation 246(g)), even though the underwriter takes a correspondingly smaller cash commission and otherwise remains within the percentage limitations of Regulation 230.

The regulations pertaining to options and warrants are not only ambiguous and uneven in application,[70] but regulate with too heavy a hand the delicate areas of a corporation's relationships with its lenders and employees. Except for warrants to underwriters (which may not be very negotiable as a practical matter), the decisions as to warrants and options may have been made well before the public offering for what at the time appeared to be sound business reasons. Even if the corporate officers had Regulations 241-48 in mind, a term loan "in hand" (with numerous warrants) may have seemed more prudent than a public offering "in the bush." It is the small and relatively new corporation that most needs to use warrants and options to obtain financing, to give incentives to employees (who may take smaller salaries because of them) and to attract an underwriter, yet it is the small and relatively new corporation which is penalized when the time for a public offering comes.

The standard justification for stringent regulation of options and warrants was expressed by the Director of the Michigan Securities Bureau in 1969:

> Stock purchase options or warrants, entitling the holders to purchase shares during a stated term at a fixed price or at escalated prices, are a matter of concern because of potential dilution of the equity of the existing and new shareholders . . . .

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issued under option. Assume the number so reserved under a plan is 50,000, but the number of shares actually subject to issued options is 25,000. Which number of shares is "subject to such options" for the purpose of regulation 245?

70. The discussion in the text is not exhaustive. A close analysis of regulation 248(g)(iii), for example, raises the question of why require that "the product obtained by multiplying the number of shares issuable [on exercise of a warrant or conversion of a debenture] by the exercise or conversion price thereof" not exceed the face amount of the loan? Assume a $100,000 loan and a warrant for the purchase of 50,000 shares at escalating exercise prices of $1, $2, $3, $4 and $5 over a five-year term. Such terms would seem to the advantage of the company and yet may be barred by the requirements of the regulations. Regulation 248(e) may restrict lenders from utilizing antidilution language—which is part of their "boiler plate" and which they may well not waive—to the disadvantage of Minnesota corporate borrowers. Limiting underwriter's warrants to 5 per cent (Regs. S. Div. 246(g) ) may not be to the advantage of an issuer which would prefer to grant more warrants and retain a larger portion of the cash obtained in the offering.

> Their use is, in a sense, not an efficient way of raising capital because they tend to be exercised when a company is prospering and less in need of additional capital; and they tend not to be exercised when a company is in difficulty, the market price of its stock is depressed, and it could advantageously use new funds. Substantial amounts of options and warrants outstanding might prevent an issuer from obtaining the best terms in marketing subsequent securities offerings.[71]

A corporate officer's response might well be that whether options are an efficient way of raising capital is quite beside the point; they often may be the *only* way. That warrants and options are an essential financing tool for many small businesses is recognized in a back-handed way by Regulation 246(d) which requires that a corporation be small and in the promotional stage before allowing the grant of options or warrants to investment bankers.

The stock option and warrant regulations represent, to an even greater degree than in the case of the regulations pertaining to the rights of security holders, the application of the statutory fair and just standards in a manner which directly and unevenly affects corporate policy in matters far removed from the question of fairness of a particular securities issue. The offering price regulation, in contrast, is an application of the statutory standard in an area directly related to the registration of securities.

d. Offering Price

The offering price regulation has two sections. Regulation 259(a) provides that if there is "an active and informed public market," the offering price shall bear a "reasonable relationship" to such price. The requirement of such a market would limit the application of subsection (a) to relatively actively traded and widely held securities. Even if an "active and informed" public market exists, the Commissioner may presumably make his own decision as to the reasonableness of the offering price. If an "active and informed" public market as defined in subsection (a) does not exist, Regulation 259(b) applies. It consists of four pricing standards of which the Commissioner may apply any or all. First, the price agreed upon in a firm commitment underwriting is an acceptable standard. This rule was taken from the California Corporate Securities Act of 1968[72] where its function is quite different from that served in the Minnesota regulation. Second, the offering price shall

71. Hueni, *supra* note 26, at 1428.
72. CAL. CORP. CODE § 25140(d) (West Supp. 1970).

be reasonably related to the trading prices of comparable companies in the same industry. Third, the offering price shall not exceed 25 times net earnings per share of the registrant. Fourth, the offering price must be reasonably related to book value.

The incorporation into the Minnesota regulations of that section of the California Corporate Securities Act of 1968 which uses the price agreed upon in a firm commitment underwriting as an alternative standard by which the Commissioner can judge offering price is interesting, since the section was placed in the California Act expressly to *deny* the California Commissioner authority to make price decisions where the security is being offered pursuant to a registration statement filed pursuant to the 1933 Act and the offering is the subject of a firm commitment underwriting.[73] The California experience indicates a possible problem with Regulation 259 in that it puts the Commissioner directly into the price setting business. It is indeed an ironic example of the functioning of our federal system when a statutory section drafted to curtail the authority of one state

73. H. MARSH & R. VOLK, PRACTICE UNDER THE CALIFORNIA CORPORATE SECURITIES LAW OF 1968, 285-86 (1969). The authors explain the reasoning behind the section as follows:

> The Department of Corporations, particularly in the "hot issue" era of the early 1960's sought to restrict the price-earnings multiple at which issuers could sell securities to the public by reviewing the fairness of the offering price of securities to be sold in California. Such efforts were not only rather presumptuous as to the ability of the Department of Corporations to substitute its judgment for the arm's length negotiated bargain of an issuer and underwriter, but in addition had the effect of creating "hot issues" by control of the initial offering price. If an underwriter had priced stock at fifty times earnings because he believed that was fair to the issuer and to his customers and approximately the price at which the securities should trade in the after market following the offering, the action of the Commissioner of Corporations in forcing that price down to twenty-five times earnings simply created a "hot issue." In many such cases the price of the stock doubled on the offering date to the price at which in the underwriter's judgment it should have been offered in the first instance.
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> The peculiar result of this supposed public protection was that the initial purchasers of the securities, in most cases the favored customers of the underwriter and in some cases even the insiders of the underwriter and the issuer, profited by immediate resale of the stock and the public purchaser paid the ultimate price of fifty times earnings. The funds of the public purchaser, rather than going to the issuer went to the first purchaser. Thus, the public purchaser suffered the maximum dilution and was actually injured by the application of price control. Had he "over-paid" the issuer, he would at least have had a portion of the benefit of the increased book value in connection with his holdings of its securities.

*Id.*

securities commissioner can be utilized as part of a regulation which expands the authority of another.

e. Minimum Investment

The regulations covering the minimum amount which promoters must have invested in a corporation offering its securities to the public (Regulations 270-73) are based on a Statement of Policy on Promoters Investment adopted by the Midwest Security Commissioners Association on June 27, 1968.[74] The Minnesota regulations differ, however, in two important respects from the Statement of Policy. First, they set the minimum equity investment at 15 per cent rather than the 10 per cent figure contained in the Statement of Policy, and, second, although Regulation 270, following the Midwest Commissioner's language, makes the regulation applicable to issuers which are in "the promotional, exploratory or developmental stage" the portion of the Statement of Policy which further defines such issuers is omitted from the Minnesota regulation.[75]

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74. 1 BLUE SKY L. REP. ¶ 4771.

75. *Id.* at ¶ 4471(B)(i). "An issuer which is in the 'promotional or developmental stage' [is] an issuer which has no significant record of operations or earnings prior to the proposed offering date . . . ." *Compare* Rule 253(a)(1) & (2) under Regulation A of the 1933 Act defining issuers, which are treated as promotional for Regulation A ceiling computation purposes:

(a) The following provisions of this rule shall apply to any offering under this regulation of securities of any issuer which—

(1) was incorporated or organized within one year prior to the date of filing the notification required by Rule 255 and has not had a net income from operations; or

(2) was incorporated or organized more than one year prior to such date and has not had a net income from operations, of the character in which the issuer intends to engage, for at least one of the last two fiscal years.

Also, *compare* the requirements for the use of Form S-2 under the 1933 Act:

GENERAL INSTRUCTIONS

(A) Rule as to Use of Form S-2. This form is to be used for registration of shares of stock of any corporation which are to be sold to the public for cash, if such corporation—

(a) is not an insurance, investment or mining company;

(b) has not had any substantial gross returns from the sale of products or services, or any substantial net income from any source, for any fiscal year ended during the past five years;

(c) has not succeeded and does not intend to succeed to any business which has had any substantial gross returns from the sale of products or services, or any substantial net income from any source, for any fiscal year ended during the past five years; and

The effect of the difference is to increase the discretion of the Commissioner in allowing him to exercise his judgment as to which corporations will be deemed to be in the "promotional, exploratory or developmental stage."

Other than New Mexico and Utah, which provide that a "substantial" equity investment is required, and Arizona, which has adopted a sliding scale approach relating the minimum equity investment to the total amount to be raised in the public offering, the remaining states which regulate minimum investment follow an approach similar to the Statement of Policy, at least to the extent of adopting the 10 per cent requirement.[76]

Although it does not define the important general concept of "promotional companies," the Minnesota regulation does contain a detailed discussion of the relatively narrow problem of determining when appraised value of real estate may be included as part of the promoter's investment.[77] The appraised value regulation provides that if appraised value is utilized to comply with the minimum equity investment rule, "that appraised value may not be reflected in any form, either in the prospectus or in the issuer's financial statements or any footnotes thereto." Presumably this protects the public from being misled by the speculative and subjective element inherent in any real estate appraisal. However, if the Commissioner has decided to allow appraised value to be used, presumably he has determined that such danger has been substantially mini-

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(d) does not have and does not intend to have any subsidiaries other than inactive subsidiaries with no more than nominal assets.

In addition to Minnesota, Illinois, Michigan and Missouri impose a 15 per cent minimum investment test. The variations among such states defining the corporations to which the minimum investment rule is to apply illustrates the bewildering variety of approaches to Blue Sky regulation. Neither the Illinois nor the Michigan regulations define promotional companies. *See* Ill. Rule 150, 1 BLUE SKY L. REP. ¶16,627; Mich. Rule 451.706.7, 2 BLUE SKY L. REP. ¶ 25,636. The Missouri regulations, however, contain a detailed definition focusing on gross revenues and the relationship between revenues and expenses. Mo. Rule VI (E), *id.* at ¶ 28,606.

76. The New Mexico policy is expressed in Regulation I(B), (C) & (D), 2 BLUE SKY L. REP. ¶ 34,603. Utah combines its regulations on minimum investment and cheap stock. Utah Regs. 3A-D, 3 BLUE SKY L. REP. ¶ 47,604. Arizona's sliding scale approach (10% of the first $200,000 of public offering, 5% of the second $200,000 and 1% of the balance) is set out in Ariz. Regs. S-7, 1 BLUE SKY L. REP. ¶ 6657. An example of the Midwest Securities Commissioners Association approach is the Wisconsin regulation. Wisc. Regs. 3.05, 3 BLUE SKY L. REP. ¶ 52,603.

77. Regs. S. Div. 273.

mized. At that point, perhaps the public should be let in on the secret between the Commissioner and the registrant. Surely the application of fair and just standards does not preclude full disclosure.

f. Speculative Issues—Cheap Stock

The regulations pertaining to promotional securities and cheap stock (Regulations 295-97) have been briefly discussed in part b, *supra*. While the minimum investment regulations do not define promotional companies, Regulation 296 does define those corporations to which the cheap stock regulations *do not* apply. The interests of both consistency and certainty would be served by using the same definition in both the cheap stock and minimum investment areas. Such consistency is particularly desirable because the restriction on the number of promotional shares and shares of cheap stock contained in Regulation 297 is directly related to the equity investment of the issuer as defined in the minimum investment regulations.

The description of corporations to which the promotional securities and cheap stock regulations apply is significant, among other reasons, because the regulations provide that a condition to the registration of securities by such an issuer may be the imposition of restrictions on the transferability of such shares. Such restrictions may take the form of legends imprinted on the stock certificates or escrow agreements.[78] Currently the normal practice of the Division is to utilize escrow agreements for such situations.

g. Financial Statements

In 1962 regulations were adopted in Minnesota requiring that offerings made in the state contain certified financial statements.[79] However, the rule was not followed in practice until 1970 when the financial statement regulations were substantially revised.[80] Regulation 742 requires a certification of the balance sheet as of the close of the latest fiscal year, certifications of profit and loss statements for the two fiscal years immediately preceding the balance sheet for all offerings of less than $300,000, and profit and loss statement certifications for the fiscal years immediately preceding the balance sheet date

78. Regs. S. Div. 401.
79. MEMORANDUM, *supra* note 43, at 2.
80. *Id.*

for all offerings in excess of $300,000. While certified financial statements are required in all filings registered with the SEC under the 1933 Act,[81] they are not required for offerings made pursuant to the Regulation A exemption.[82] Since the adoption of the Minnesota regulations, the maximum dollar amount of securities which may be offered pursuant to Regulation A has been increased by the SEC to $500,000.[83]

A number of states require that certified financial statements be included in Regulation A offering circulars used to offer securities in such states.[84] The SEC recently considered whether or not to amend Regulation A to require certified financial statements, but decided against such an amendment.[85] While recognizing that "a requirement for certification would provide a check on issuer's financial disclosures performed by an independent party at least in some measure responsible both to the Commission . . . and to the public purchasers," the Wheat Report study concluded that "the principal objection is one of cost, together with the fact that such a requirement would narrow the gap between what is designed to be an exemption from registration, and the registration process under Regulations C and S-X." It was also reported that "the strong sentiment" of the SEC Regional Administrators was against requiring certification.[86] The effect of the Minnesota policy is to negate the federal policy expressed in Regulation A. Persons desiring to offer their securities in Minnesota under Regulation A must, therefore, comply with the financial statement certification requirements of Regulation 742.

h. Conclusions

The extended regulations on standards of qualification are intended "to furnish guidelines for the qualification, pursuant to the discretion of the Commissioner authorized by the Minnesota Securities Law, of offers and sales of securities."[87] Providing the flesh on the deceptively frail frame contained in Section 80.08 of the Minnesota Securities Act, the standards reg-

81. *See* L. RAPPAPORT, SEC ACCOUNTING PRACTICE AND PROCEDURE ch. 7 (2d ed. rev., 1966).
82. SEC Schedule I to Notification on Form I-A, Item 11.
83. SEC Securities Act Release, No. 5125 (January 7, 1971).
84. Wheat Report, *supra* note 20, at 300 n.1.
85. *Id.* at 299.
86. *Id.*
87. Regs. S. Div. 201.

ulations are an expansion of the statutory provision permitting the Commissioner to deny an application for registration if he is of the opinion that the terms of the securities are "unfair and unjust." They demonstrate both the Commissioner's power in promulgating the regulations and the refined meanings of the "unfair and unjust" language. Attempts to challenge the Commissioner's authority have generally been unsuccessful,[88] but the scope of the regulations raises the question of the extent to which the specificity and increasing strictness with which the various commissioners have interpreted Section 80.08 is consistent with legislative intent and appropriate public policy. Certainly any legislative revision of the Act which does not come to grips with the regulations, and particularly the standards regulations, will miss a good part of the mark. Given the generality of the Act, clearly the standards regulations are the effective criteria for securities registration in Minnesota.

However, it would be a mistake to conclude that a securities registration in Minnesota is merely a matter of consulting and complying with the standards regulations. To begin with, they are incomplete. Many matters which come up in the course of a registration are not covered. The very specificity of many of the regulations requires the practice of the practical art of execption. The Commissioner's discretion means that negotiation with the Division is a characteristic of Blue Sky practice in Minnesota. Such informality is, however, not unique to Minnesota practice, for as Loss and Cowett point out "most Blue Sky law is practiced informally."[89]

As a result of the regulations which have been promulgated to effect the mandate of Section 80.08, Minnesota joins the company of the most rigorous states in the country in terms of Blue Sky regulation. The rigorous standards of qualification, along with limitations on the number of persons to whom shares in enterprises may be sold without registration[90] must have a significant impact on the creation and growth of new enterprises. However, there appear to be no empirical economic studies whatsoever which analyze the effect of such regulation.[91] It is

88. *See, e.g.*, Northwest Bancorporation v. Benson, 6 F. Supp. 704, 722 (1934); Kerst v. Nelson, 171 Minn. 191, 213 N.W. 904 (1927).

89. L. Loss & E. Cowett, Blue Sky Law 44 (1958).

90. *See* part II E *infra*.

91. Garcia & Kantor, *Dark Clouds in a Blue Sky: An Analysis of the Limited Offering Exemption*, 23 U. of Miami L. Rev. 568 (1969), is an attempt to relate the economic effect of the limited offering exemptions found in many Blue Sky laws on close corporation financing, al-

certainly not clear that the type of Blue Sky regulation embodied in the Minnesota qualification standards is effective in countering fraud.[92] On the other hand, as one commentator has said

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though its analysis is primarily legal as opposed to economic. Professor Mofsky recommends such an in-depth study in the course of an excellent survey of the relative restrictiveness of various Blue Sky laws on new business in J. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS (1971). *See also* Manne & Mofsky, *What Price Blue Sky?*, BARRON'S, August 5, 1968, at 5. In commenting on the need for reform of Blue Sky laws, Mofsky concludes:

> Before any meaningful reform in the blue sky field is undertaken, whether it be through federal pre-emption or on a state-by-state basis, we need more precise answers to the welfare economics aspects of the state securities laws. This treatise attempted to elaborate what seemed to be some of the specialized cost features of the blue sky laws which are probably not familiar to many lawyers, businessmen, economists and statisticians. It is hoped that with this model available, and with the more obvious factors necessary for analyzing the benefit side of such regulation, the cogent measurements and calculations can be made by appropriate specialists. It is also hoped that this work will cause lawyers and businessmen through bar association committees, trade associations and legislative action, to seek meaningful analysis of the blue sky laws rather than merely accepting an area of regulation which has not been fully and rigorously explored.

J. MOFSKY, *supra,* at 86. He is also critical of the new Wisconsin and California statutes arguing that state Blue Sky administrators should not play a key role in the reform of Blue Sky laws:

> It is submitted that while the draftsmen of those statutes did indeed effect considerable improvements over the preexisting laws they did not in fact truly reappraise the philosophy underlying the blue sky laws. Such an examination is necessary before any meaningful revision can be drafted and enacted. If the California and Wisconsin experiences typify the kind of reform which results when state administrators participate and help sponsor the revision, then meaningful change must come without their assistance.

*Id.* at 84.

92. Professor Harold Bloomenthal has recently questioned the efficacy of such regulation:

> In fact, none of the regulation described is designed to prevent "fraud"; rather, it is concerned primarily in limiting the promoter's participation in the event the venture is successful. If the venture is unsuccessful the extent of the promoter's investment, the amount of cheap stock, stock options and the extent of dilution will be of little, if any, consequence. Such ventures are likely to be a complete disaster; the blue sky regulation at best may in a few instances save some assets for the investors upon liquidation. The provisions against transfer of promotional stock will preclude the promoter from personally bailing out in whole or part before the success or failure of the venture is determined, but the public protection is not enhanced in this respect unless it can be established that he is thus provided with an incentive to make the company a successful one.

Bloomenthal, *Blue Sky Regulation and the Theory of Overkill,* 15 WAYNE L. REV. 1447, 1482-83 (1969).

> [I]t is apparent that blue sky legislation may result in important and dangerous economic consequences with respect to three related entrepreneurial problems: financing a new business, promoter control and sufficient reward for entrepreneurship. There are other significant economic ramifications, but these three problems are particularly serious with regard to the development of new firms.[93]

The adoption in 1970 of the substantial portion of the Minnesota regulations was not accompanied by any showing of need based upon a history of fraudulent schemes in Minnesota, and there are suggestions that the present level of regulation may have a chilling effect on some local businesses.[94]

### 3. *Registration by Notification*

Section 80.09 of the Act provides a procedure whereby an issuer, in lieu of registering by application under Section 80.08, may file a notification of intention to sell securities. If no action is taken by the Commissioner within 48 hours of the filing of the notification, the Act provides that the "securities covered thereby shall become registered . . . ."[95] The information required to be filed with the notification is minimal.[96] This so-called "quality securities" registration provision of Section 80.09 is available only to a limited group of securities: (i) securities secured by a first mortgage on real estate; (ii) securities of corporations meeting certain financial history requirements; (iii) certain seasoned securities; and (iv) securities issued by nonprofit associations. For those issuers fortunate enough to qualify under it, Section 80.09 provides a haven from the time-consuming and complex procedures of registration under Section 80.08. Because it provides such a haven, a consideration of it would be unnecessary in this article were it not for the reference to Section 80.09 found in Section 80.06(14), one of the secondary market or "trading" exemptions in the Act. Among the requirements for an exemption stated therein is that "Such securities would qualify for registration by notification *pursuant to the provisions of Section 80.09.*"[97] As part of a secondary market exemption, the reference to Section 80.09 poses

93. Mofsky, *Blue Sky Restrictions on New Business Promotions*, 1969 DUKE L.J. 273, 288-89.

94. *See* MEMORANDUM, *supra* note 43, at 1.

95. MINN. STAT. § 80.09(2)(4) (1969).

96. Loss and Cowett, writing in 1958, indicate that Minnesota's notification provision for quality securities is one of 25 such "streamlined" types of registration, L. LOSS & E. COWETT, *supra* note 89, at 34.

97. MINN. STAT. § 80.06(14(d) (1969) (emphasis added).

serious problems.[98] Indeed it appears that Minnesota is the only state other than North Dakota[99] and (to a limited extent) Texas[100] which utilizes the quality security provision as an element of the secondary market exemption.

Subdivision 2(2) of Section 80.09 applies an earnings test to three different types of securities of issuers which have had five years of continuous operation.[101] The earnings requirement is that the corporation must have had "average annual net earnings . . . and assets [which] together with the proceeds of the sale of such securities accruing to the issuer" as of the close of the fiscal year next preceding such notification equal to a certain figure with reference to each of the three types of securities described in subsections (a), (b), and (c). This subdivision poses difficult accounting considerations. The relevant figure is "annual net earnings", although it is not defined. No guidance is given as to problems posed by changes of accounting methods or periods, and "income taxes" is also undefined (does it refer to federal only, or federal and state, or federal, state and local?)[102] Other questions include: what are "charges"; what are "accepted accounting practices"; must the issuer utilize audited statements or are internally produced figures adequate? The word "assets" is ambiguous in the full paragraph and re-

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98. *See* text accompanying notes 126-28 *infra*.

99. N.D. CENT. CODE § 10-04-06 (1969).

100. TEX. CIV. STAT. § 581-5 (1969) (as an alternative to listing in a recognized securities manual).

101.

> (a) In the case of interest-bearing securities, not less than one and one-half times the annual interest charge thereon and upon all other outstanding interest-bearing obligations of equal rank, and assets at least equal to 125 per cent of the face value of such interest-bearing securities, and all other obligations of equal or prior rank outstanding and not to be retired out of the proceeds of the sale of such securities.
>
> (b) In the case of preferred stock, not less than one and one-half times the annual dividend on such preferred stock and on all other outstanding stock of equal rank, and assets at least equal to 125 per cent of the par value of the aggregate amount of such preferred stock and all other outstanding preferred stock of equal rank, after the deduction from such assets of all indebtedness, which will be existing and all stock of senior rank which will be outstanding after the application of the proceeds of the preferred stock offered for sale.
>
> (c) In the case of common stock, not less than four per cent upon all outstanding common stock of equal rank together with the amount of common stock then offered for sale, all reckoned upon the price at which the stock is then offered for sale or sold.

MINN. STAT. § 80.09(2)(2) (1969).

102. In 1965 the section was amended to add "after income taxes" following "average annual net earnings" and to delete "prior" which had appeared before "charges." Minn. Laws 1965, ch. 333.

mains so where it is used in subsections (a) and (b) and in its absence from subsection (c).[103] Are assets to be included with earnings in making the computation? If included, are they to be omitted from subsection (c) but included in subsections (d) and (e)? At best Subdivision 2(2) contains enough ambiguities to make reliance on it a delicate matter. At worst, it is too vague to be relied upon (particularly in connection with Section 80.06(14)).

*4. Commission Orders*

Assuming one has successfully threaded through Section 80.08 or Section 80.09, an order signed by the Commissioner will evidence success. Section 80.07 provides that "the Commission may provide in the order of registration that the registration permits sale of a specified number only of units of a security and that there may be no secondary market trading in such securities until further order of the Commission." While "secondary market trading" is not defined in the statute, unless the Commissioner's order provides for it, the registration will, in effect, expire upon the sale of the specified number of units covered in the order. Subsequent sales by purchasers of units so covered will be allowable only if an exemption is available for such sale or if the Order for Registration is subsequently amended to cover secondary market sales.

Prior to the 1969 amendment of Section 80.07, a registration limited to sales to original purchasers was termed a "restricted registration."[104] As it then appeared, the section provided that the issuer could request either "unlimited" or "restricted" registrations, and that in the absence of any specific reference the registration was deemed to be "restricted." This was a trap for the unwary, and Section 80.07 as amended in 1969 provides that unless the order specifically limits the registration, it shall allow sales of all outstanding or to be outstanding units of a security without further action. It should be noted, however, that the language of the third paragraph of Section 80.07 is not coextensive with the concept of "secondary market trading" as generally understood in the industry. Among other things, the third paragraph of Section 80.07 refers only to broker-dealers and does not cover the problem of sales by private purchasers. Details of handling the request for sec-

103. *See* note 101 *supra*.
104. MINN. STAT. § 80.07 (1967).

ondary market trading, particularly in connection with the requirement that a $500 fee be paid before such trading will be allowed, are generally worked out by registrants on a case by case basis with the Division. The problem requires particularly close attention when the registrant previously has not been publicly held.[105]

Having obtained an Order for Registration containing "secondary market trading" provisions, can a registrant or broker-dealer rest secure feeling that his encounters with the Minnesota Securities Division are over? Section 80.11(3) of the Act requires that within 30 days after each anniversary date of a registration, the registration must be renewed. Failure to renew the registration by paying a $10 renewal fee and filing certain financial information[106] may result in cancellation by the Commissioner of the registration. An annual report resulting in the renewal of the registration may be filed by "any person."[107] Thus the information necessary to keep a registration in effect does not have to be provided by the issuer or by the broker-dealer who obtained the original order. One rationale for such a provision may be that persons not involved with the original registration can be seriously affected by failures to renew it.

The distinction between a registration for sale to original purchasers only and one which allows for secondary market trading is unique to the Minnesota Act.[108] Hence, broker-dealers and issuers who are not experienced in operating under the Act may assume that its renewal provisions function in the same manner as in many other states. The normal practice in other states is to cancel the registration upon completion of the sale of the shares originally registered. The registration is kept open only while shares are being sold to the original purchasers. As a matter of routine, many non-Minnesota issuers and broker-dealers will notify the Blue Sky authorities of the states involved, at the time an earlier registration comes up for renewal, that it need not be renewed (indeed it is often

105. *See* W. ANASTAS, STATE SECURITIES REGISTRATION 7.51-7.52 (Univ. of Minn., Dept. of Cont. Legal Ed., Practice Manual No. 38, 1970).

106. The renewal is made on Form 102 of the Minnesota Securities Division. Since the renewal date relates to the anniversary of the original registration, as opposed to the registrant's fiscal year, the financial information contained in Form 102 may be quite out of date.

107. MINN. STAT. § 80.11(3) (1969).

108. W. ANASTAS, *supra* note 105, at 7.51.

the procedure to cancel the registration upon the completion of the offering). Thus, an action which is routine in many states may have unintended and disastrous consequences in Minnesota since the effect of a failure to renew is that the securities of the issuer are no longer registered in Minnesota.

The 1969 amendment to Section 80.07 which provides that "any licensed broker-dealer may sell additional units of a security so registered if he had no reason to believe that such additional units were issued in violation of Section 80.08" may have been intended to protect broker-dealers from the trap described above. A more reasonable solution would be to eliminate the requirement of continuing registration. No legitimate regulatory purpose seems to be served by the requirement. Other than very sketchy financial information which the public never sees and which the Commissioner rarely, if ever, acts upon, no information is provided by the renewal application. If the Commissioner becomes concerned about a security being traded in the state, he has ample power to act (*e.g.*, under Section 80.11 or Section 80.23) and would be derelict in his duty if he waited until the annual registration came up for renewal. The matter is one of concern to the investment banking community.[109] Prior to 1969, the problem was even more serious because it was not only one of inadvertent cancellations or inadvertent failure to file the annual renewal. The broker-dealer and issuer then also faced the difficulty of an ambiguity in the registration order itself as to whether it was for a restricted or unlimited registration. Despite the removal of the latter difficulty, the problem of cancellation through inadvertence or misunderstanding still exists and, of course, a registration may be revoked or suspended by the Commissioner.[110]

How is the broker-dealer engaged in transactions in a security based on a prior effective registration order to know of such cancellation, termination, or suspension? Section 80.11(3) provides that "no suspension, revocation, or cancellation of a registration shall become effective as to any person prior to his receipt of actual notice thereof, or, as to any person not there-

109. *See* memorandum dated January 28, 1971 from Merrill, Lynch, Pierce, Fenner & Smith to George J. Crowe, Acting Minnesota Securities Commissioner, at 2, on file with Minnesota Law Review. Among its other comments the memorandum asks with justifiable plaintiveness: "[w]ould [it] not be possible to exempt all outstanding securities for secondary purposes after a registration statement has become effective?" *Id.*

110. MINN. STAT. § 80.11(2) (1969).

tofore receiving actual notice thereof, prior to the second business day following the mailing to such person by the commission of notice thereof or the filing by the commission of telegraphic notice thereof to such person." Read literally, the subdivision seems to say that the broker-dealer (or issuer) must be notified of a suspension, revocation or cancellation as a condition to its effectiveness as against such broker-dealer or issuer. The preceding paragraph of subdivision (3) is quite specific in limiting requests for cancellations of registration to "the person who made the application or gave the notification on which such registration was made."[111] Therefore, "any person" in the third paragraph may be read to cover a broader class than "the person who made the application or gave the notification" in the second paragraph and the broker-dealer engaged in market making or casual trades for a customer would be covered by the notice requirement as well as the issuer and broker-dealer, if any, who obtained the original order. While the Minnesota Supreme Court has dealt with the question of appropriate notice of cancellation of a registration order,[112] it has not done so since the enactment of the amendment containing the notice provision.[113] The Blue Sky laws of at least eight states provide for notice to be given to persons other than those who filed the registration. Three describe the persons to whom notice must be given generally,[114] while five require that notice be given to broker-dealers.[115] In states where there is an ex-

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111. MINN. STAT. § 80.11(3) (1969).

112. In State *ex rel.* Canam Metals, Ltd. v. Dept. of Commerce, Securities Division, 196 Minn. 222, 264 N.W. 789 (1936), the court held that a registration made "for" the issuer and the underwriter could not be withdrawn solely at the request of the underwriter:

> The order having been issued for the protection of two it certainly is not the intention of the law that one by an *ex parte* proceeding may withdraw that protection from the other without notice to the one from whom are so stripped the privileges and immunity conferred by the order.

*Id.* at 226, 264 N.W. at 791.

113. Minn. Laws 1942, ch. 547, ¶ 8.

114. GA. CODE ANN. § 97-109 (1968) ("to the issuer . . . and to all persons who have registered such securities"); ILL. ANN. STAT. ch. 121½, § 137.11(I) (1960) ("to the person or persons concerned"); S.C. CODE ANN. § 62-53 (1962) ("to all interested parties").

115. ARIZ. REV. STAT. ANN. § 44-1924(B) (1967) ("to the issuer of the securities and to all registered dealers engaged in the sale thereof"); LA. REV. STAT. ANN. § 51.709 (1965) ("to the issuer and every registered broker dealer"); N.D. CENT. CODE § 10-04-09 (1960) ("to all registered dealers"); OHIO REV. CODE ANN. § 62-53 (1962) ("to all licensed dealers concerned"); TENN. CODE ANN. § 48-1617 (1964) ("to all registered dealers"). The statutes cited in this note and *supra* at note 114

plicit requirement that notice of revocation be given to the applicant, the courts appear inclined to require prospective plaintiffs to prove that the defendant received actual notice of revocation.[116]

There would appear to be two constitutional questions relevant to the issue of the scope of the Minnesota notice provision. First, is Section 80.11 itself an unconstitutional delegation of discretionary power to the Commissioner? The section is not devoid of standards by which the Commissioner must be governed in exercising his discretion, and it seems unlikely that such an argument would be upheld.[117] Second, if the notice section is not interpreted to require that notice of cancellation be given to all broker-dealers licensed in Minnesota and if a broker-dealer is sued for rescission on a sale of a security which has become unregistered because of such cancellation, is not the section unconstitutional because it would act to deprive such broker-dealer of his property without due process of law? The answer to this question may well differ depending on the party complaining of lack of notice.[118] The due

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generally do not specify whether the notice involved is of final revocation of a registration or of the hearing on the revocation.

116. *See* State v. Fisher, 140 Kan. 544, 547, 38 P.2d 120, 122 (1934); Lefebvre v. Whittier & Co., 84 N.H. 105, 106, 146 A. 527, 528 (1929).

117. *See* Northwest Bancorporation v. Benson, 6 F. Supp. 704, 708, 718, 722 (D. Minn., 1934). The Wisconsin Supreme Court upheld such an attack on the Wisconsin Blue Sky law in Klein v. Barry, 182 Wisc. 255, 196 N.W. 457 (1923). The *Klein* case would seem to be distinguishable from the problem here discussed because of the differences in discretion granted by each statute to the respective commissioners. *See also* Kerst v. Nelson, 171 Minn. 191, 195, 213 N.W. 904, 905 (1927) ("[I]t should be the policy of the courts to refrain from hampering the state officials in the performance of their duties by placing a narrow construction on [Blue Sky Laws]").

118. *Compare* Cities Service Co. v. Koeneke, 137 Kan. 7, 20 P.2d 460 (1933) (cancellation provision of Kansas Blue Sky law unconstitutional as applied against *issuer-registrant* who had no notice of registration cancellation), *with* cases cited in Annot., 35 A.L.R.2d 1067 (1959) (relating to rights of persons other than licensee to have notice and hearing prior to a liquor license suspension, indicating that, generally, the rule is that such persons have no such right). *See* 1 K. DAVIS, ADMINISTRATIVE LAW TREATISE ¶¶ 7.18-.19 (1958). The Minnesota Supreme Court has held that, under certain circumstances, notice and hearing is not a prerequisite to a liquor license revocation. *See* Abeln v. City of Shakopee, 224 Minn. 262, 267, 28 N.W.2d 642, 645 (1947). The extent to which persons are entitled to notice is affected by whether such entitlement is characterized as a "right" or a "privilege" as a matter of constitutional law. The *Abeln* decision indicates that the Minnesota court considered the distinction of significance. *See generally* Van Alstyne, *The Demise of the Right-Privilege Distinction in Constitutional Law*, 81 HARV. L. REV. 1439 (1968).

process argument would seem to offer little solace to the hapless broker-dealer who discovers that he has been trading an unregistered security. Given the continuous registration concept of the Act, fundamental fairness dictates that some reliable and practical mechanism be effected for providing notice of the termination, cancellation, or revocation of registrations.[119]

C. REGISTRATION OF SECONDARY TRADING TRANSACTIONS

The previous discussion of the registration provisions of the Act has focused primarily on issuer transactions. But, the purview of the Act is not limited to the regulation of corporations issuing securities to the public. It also extends to nonissuer securities transactions. Such nonissuers may either be securities dealers or merely individuals who wish to sell their securities. The application of the registration provisions of the Blue Sky laws to nonissuer transactions poses some of the most serious difficulties in Blue Sky practice.[120]

The nonissuer who is not a professional broker-dealer in Minnesota can sell securities owned by him pursuant to one of the exemptions contained in Section 80.06. If his sale is to a licensed broker-dealer, the transaction would be exempt under Section 80.06(8). Such transactions should be exempt regardless of whether the security involved has been registered in Minnesota. On the other hand, a nonissuer, nonprofessional broker-dealer wishing to make several sales of a corporate security may run into difficulties under the Act.[121]

The professional broker-dealer wishing to trade a particular security in Minnesota may undertake to register such security

119. In 1971, because of budgetary limitations, the Securities Division resisted introduction of legislation to require notice of such actions to all licensed broker-dealers. A privately published weekly magazine, COMMERCIAL WEST (published by Sun Newspapers, Inc.) contains a section devoted to actions of the Securities Division, which sometimes prints a report on the disposition of each registration appearing on the Division's docket.

120. In many statutes it is difficult or impossible to say with any certainty when registration is required in such a case; who must or may register; how many units of the security should be registered; who may sell once a registration becomes effective; and as a result who is civilly liable and when a contract to sell is enforceable.

1 L. LOSS, SECURITIES REGULATION 62 (2d ed. 1961, Supp. 1969). For an excellent summary of the problem of nonissuer transactions both under Blue Sky laws and the Securities Act of 1933, see Note, *Regulations of Nonissuer Transactions under Federal and State Securities Regulation Laws*, 78 HARV. L. REV. 1635 (1965).

121. *See* part II E 1 *infra*.

under Section 80.08 or Section 80.09, he may determine that an effective registration statement is in force and base his activities on the fourth paragraph of Section 80.07, or he may rely on an exemption from registration, either for the security or the transaction. The brokerage community generally considers Section 80.06(14) to be the basic secondary market or trading exemption available to it in Minnesota, although agency transactions may be made in reliance on the exemption contained in Section 80.06(10). The trading exemption of Section 80.06(14) exempts from the registration requirements of the Act:

> The sale by a licensed broker-dealer, acting either as principal or agent, of securities theretofore sold and distributed to the public, provided that:
> (a) Such securities are sold at prices reasonably related to the current market price thereof at the time of sale and if such broker-dealer is acting as agent, that the commission collected by such broker-dealer on account of the sale thereof is not in excess of usual and customary commissions collected with respect to securities and transactions having comparable characteristics; and
> (b) Such securities do not constitute an unsold allotment to or subscription by such broker-dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter; and
> (c) Either Moody's, Fitch's or Standard and Poor's securities manuals, or other recognized securities manuals approved by the commissioner of securities contain the names of the issuer's officers and directors, a balance sheet of the issuer as of a date not more than 18 months prior to the date of such sale, and a profit and loss statement of issuer for the fiscal year preceding the date of such balance sheet; and
> (d) Such securities would qualify for registration by notification pursuant to the provisions of section 80.09; and
> (e) Such securities are limited to issuers organized under the laws of any state or territory or insular possession of the United States.

The Act's trading exemption has counterparts in the laws of a number of states, although most require only that the security in question be listed in a recognized securities manual.[122] The Uniform Securities Act exempts a nonissuer distribution if recent financial statements and a list of the issuer's officers and directors are contained in a recognized securities manual or the security being distributed has a fixed maturity, dividend, or interest provision and no default has occurred thereon for a specified period.[123]

122. Note, *supra* note 120, at table facing 1648. The manual exemptions are also summarized in Gray & Rosen, *Section 12(g) and Blue Sky Laws*, 20 BUS. LAW. 1075, 1076 (1965). For a table of statutes which exempt securities listed in manuals and the names of such manuals, *see* 1 BLUE SKY L. REP. 831.

123. UNIFORM SECURITIES ACT § 402(b)(2).

Why securities listed in securities manuals are exempted from registration under Blue Sky laws is far from clear. Inclusion in a manual is not an indication of the quality of a security and this would seem to negate one theory upon which the exemption may have been based.[124] In any event, the securities manuals are not generally available to investors and the inclusion of false or inaccurate information in a securities manual probably does not give rise to civil or criminal liability (at least if the information was not knowingly false or inaccurate when given). Subsection (c) of Section 80.06(14) specifically names three manuals and then goes on to refer to "other recognized securities manuals approved by the Commissioner of Securities." This pattern is similar to the approach followed in some states, while others do not give their administrator discretion to recognize manuals other than those listed in the statute, and still others list no manuals in the statute, giving the administrator full discretion which is generally implemented either in the adoption of regulations or in informal policies which can be determined only by correspondence directly with the administrator.[125]

Perhaps because of the anomaly of the manual exemption as part of a Blue Sky philosophy which emphasizes a qualitative determination, the Minnesota statute has added Subsection (d) to the manual exemption provisions of Section 80.06(14). The requirement that a corporation meet an earnings requirement in addition to meeting the test of the manual exemption in order to qualify for the trading exemption is found in no other state statute containing a manual exemption except in North Dakota.[126] Whatever the reason for the inclusion of Subsection (d) in the trading exemption section, the effect is to transform

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124. "[I]t cannot be assumed that because a company appears in the Manuals that it is in sound financial condition and that its credit is good." Letter from Moody's Investors Service, *quoted in* 1 BLUE SKY L. REP. at 835. Some attempt to increase the quantifiable standards for listing may be occurring. While the letter from Standard & Poor's Corporation (quoted *id.*) states that "[W]e generally exclude companies with less than $1,000,000 asset value and less than 200 stockholders," a list of factors to be considered by the editorial board in determining whether to include a corporation in its manual sent to the author on February 23, 1971, by Standard & Poor's Corporation lists assets of $2,500,000 and not less than 750 shareholders as conditions. A copy of this letter is on file with the Minnesota Law Review.

125. In addition to the three manuals listed in the Act, the Minnesota Commissioner recognizes Moody's *Over-the-Counter Industrial Manual*, 1 BLUE SKY L. REP. 833.

126. N.D. CENT. CODE § 10-04-06-8d (1969).

an exemption which at least might have had the virtue of clarity to one which poses serious problems for those who would rely on it. As has been indicated previously, compliance with Section 80.09 in the context of a registration is difficult because of the many ambiguities in the statutory language itself.[127] To utilize Section 80.09 as part of an *exemption* exacerbates such problems. Subsection (d) states that the securities "would qualify for registration." When must the securities have been eligible for qualification? Since the introductory language to Section 80.06 itself and the introductory language to Subdivision (14) seem to refer to the sale of specific securities, it might be assumed that the relevant date is the date of the transaction in question. However, this places upon the broker-dealers the impractical burden of determining the eligibility for registration under Section 80.09 of the security in question each time a trade is effected. An alternative interpretation is that the securities in question must have been eligible for Section 80.09 qualification as of the close of the fiscal year preceding the transaction in question. Subdivision 2(2) of Section 80.09 employs that concept with regard to the period for making the earnings determination necessary for registration thereunder. The virtue of such an interpretation is that it makes the exemption viable, although it is not compelled by the language of the statute any more than the interpretation which would require the determination of Section 80.09 eligibility to be made at the time of each trade. Another unusual element of Section 80.06(14) is Subsection (e), which limits the exemption to domestic corporate securities. Since the subdivision is a part of a scheme of regulation of broker-dealers rather than corporate issuers, considerations of jurisdiction over corporate issuers should not have dictated the inclusion of Subsection (e), and its presence may be explicable only as a touching, if somewhat naive, example of legislative parochialism. Like Subsection (d), Subsection (e) also appears in the North Dakota law.[128]

An important exemption from the point of view of broker-dealers is contained in Section 80.06 (10), which exempts:

> [t]he solicitation or execution of any orders by a licensed broker-dealer for the purchase or sale of any security; provided, that such broker-dealer acts as agent for the purchaser or seller, and has no direct material interest in the sale or distribution of such security, receives no commission, profit, or other compensation from any source other than the purchase or

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127. *See* text accompanying notes 99-103 *supra*.
128. N.D. CENT. CODE § 10-04-06-8e (1969).

seller and delivers to the purchaser or seller written confirmation of the transaction which clearly itemizes his commission, or other compensation.

Exemptions for brokerage transactions are found in most Blue Sky laws,[129] and the Uniform Securities Act exempts such transactions in Section 402(b)(3). Since one aspect of Blue Sky regulation is registration and supervision of broker-dealers, the regulatory element of the brokerage transaction exemption lies in the continuing supervision exercised by state securities administrators over broker-dealers. It has also been suggested that the brokerage exemption should be further policed by requiring brokers to prepare and keep lists of securities traded pursuant to such an exemption.[130]

Section 80.06(10) differs from the analogous provisions of the Uniform Securities Act and from the laws of most other states in that it exempts both solicited and unsolicited nonissuer transactions. It is thus broader than such other laws which limit the exemption to orders to buy or sell not solicited by the broker-dealer.[131] Since the brokerage transaction exemption in the Minnesota act is not dependent on whether or not the order to buy or sell was solicited, the difficult problem of determining whether or not an order was solicited (a problem under both federal and state securities laws)[132] is not presented by Section 80.06(10). However, the protection against a substantial distribution of unregistered securities provided by the ban on unsolicited transactions in statutes such as the Uniform Securities Act is absent. Perhaps because of this, the Minnesota Securities Division has demonstrated some hostility to the exemption,[133] and an amendment to the Act in 1969 had the apparent effect of negating the whole brokerage transaction exemption.[134] However, the 1969 amendment was further

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129. Note, *supra* note 120, at table facing 1648.

130. L. Loss & E. Cowett, Blue Sky Law 364 (1958).

131. For statutes similarly broad see La. Rev. Stat. § 51.705(10) (1965); W. Va. Code § 32-1-4-(J) (1966).

132. *See, e.g.*, L. Loss & E. Cowett, *supra* note 130, at 364-65; H. Marsh & R. Volk, Practice Under the California Corporate Securities Law of 1968, 357-58 (1969).

133. In a communication to all Minnesota licensed broker-dealers dated March 4, 1971, from the then Acting Commissioner of Securities, the Division expressed concern about transactions in which the brokerage exemption and the exemption for sales to licensed broker-dealers (Section 80.06(8) ) are combined to effect a large scale distribution. Copy on file with Minnesota Law Review.

134. In 1969, Subdivision 2(c) was added to Section 80.06 (Laws 1969, ch. 848) which exempted:

[t]he sale in this state by a licensed broker-dealer, acting either

amended in 1971 to eliminate the conflict between Section 80.06 (2)(c) and Section 80.06(10), and the brokerage transaction exemption seems to have been reaffirmed by the legislature as it originally was enacted.

The proviso to Section 80.06(10) relates to the required brokerage nature of the transaction, although the phrase "has no direct material interest in the sale or distribution of such security" has never been judicially construed. Presumably, it was intended to cover something other than additional commission or other payment made in connection with the particular transaction since the language directly following the quoted phrase is aimed at the additional remuneration situation.

The very important area of nonissuer secondary market transactions for securities not listed on stock exchanges is, then, covered in the Minnesota Act by the exemptions of Subdivisions (14) and (10) of Section 80.06. The Act's approach to nonissuer secondary market exemptions is similar to that found in many other states, although, for no apparent reason, the manual exemption is narrower (because of the inclusion of Subsections (d) and (e)) and the brokerage transaction exemption is broader (because it is not limited to unsolicited transactions) than the statutory pattern generally found elsewhere.

Since the manual exemption clearly does not serve as any assurance that a qualitative judgment has been made on the securities involved (in contrast with the *theory* which is presumably behind exempting securities listed on stock exchanges), the exemption must be premised on the theory that securities about which information is available need not be registered for non-

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> as principal *or agent* of the securities of a single issuer; provided (1) that the persons to whom the sales are made by such broker-dealer during any period of 12 consecutive months, whether or not the seller or any of the buyers are then present in this state, do not exceed five in number, other than those designated in subdivision 8 of this section; and (2) that the securities sold meet the requirements of clauses (a), (c), and (e) of subdivision 14 of this section; but the commission may by rule or order, as to any security or transaction, or any type of security or transaction, withdraw or further condition this exemption, or increase or decrease the number of buyers permitted. (Emphasis added).

This subdivision was inconsistent with subdivision 10 of that section, and the Division indicated orally that it would resolve the conflict by taking the position that Subdivision 2(c) governed. The effect was, of course, to read Subdivision 10, out of the Act, and in 1971, with the cooperation of the Commissioner, subdivision 2(c), was amended to remove any reference to agency transactions with the objective of clarifying that subdivision 10 was to be the operative provision relating to broker-dealer agency transactions.

issuer sales. However, a much more comprehensive and current source of information on corporations than found in the manuals is provided by the reporting requirements under the Securities Exchange Act of 1934.[135] It would require no radical change in the underlying philosophy of the Minnesota act to exempt from the requirement that nonissuer transactions be registered, (i) those securities of issuers which have securities registered under Section 12 of the Securities Exchange Act of 1934, (ii) securities exempted from such registration by Section 12(g) (2) (G) of the Exchange Act, and (iii) securities issued by investment companies registered under the Investment Company Act of 1940.[136] While the Uniform Securities Act does not follow such an approach (utilizing for nonissuer transactions both seasoned security and manual exemptions),[137] at the time the Uniform Act was drafted registration under the Securities Exchange Act of 1934 was limited to corporations whose securities were listed on national stock exchanges. The 1964 amendment of the Securities and Exchange Act of 1934 added Section 12(g),[138] which provides for registration with the Securities and Exchange Commission by corporations of any outstanding security held of record by more than 500 shareholders if the issuing corporation has at least one million dollars in total assets. Since 1964 there has been a consistent expansion of the reporting requirements for corporations registered under the 1934 Act and recently adopted amendments to rules under the 1933 Act will result in the registration with the SEC under the 1934 Act of a number of corporations which are not required to do so pursuant to Section 12(g).[139] The use of the standards of registration pursuant to the 1934 Act to provide exemptions for trading transactions for recognized securities both in the over-the-counter market and on stock exchanges has been made a part of the securities laws of both California and Wisconsin.[140]

135. *See generally* Aalberg, *SEC Disclosure Requirements for Corporations*, 26 BUS. LAW. 1223 (1971).

136. Investment Company Act of 1940, ch. 686, tit. I, 54 Stat. 789 (codified in scattered sections of 15 U.S.C.).

137. UNIFORM SECURITIES ACT, § 402(6)(2).

138. Act of Aug. 20, 1964, Pub. L. No. 88-467, § 3(c), 78 Stat. 565.

139. SEC Securities Act Release No. 5223 (January 11, 1972 (discussing Rule 144 in which the following statement appears: "The Commission . . . believes that it would be in the interest of protection of investors for such issuers [small companies not required to register securities under section 12(g)] to be reporting companies under the Exchange Act, and, therefore, encourages such issuers to register securities voluntarily . . . .").

140. CAL. CORP. CODE § 25101 (1971); WISC. STAT. § 551.23(3)(a)

D. SECURITIES NOT SUBJECT TO REGISTRATION

Section 80.05 of the Minnesota Securities Act describes 14 classes of securities which may be sold without registration under the Act. The exemption provided is only from the registration provisions of the Act, not the antifraud provisions. The classes of securities exempted from registration under Section 80.05 fall into a pattern which is present in most Blue Sky laws throughout the country. As Loss and Cowett point out, "when all of the redundant and fantastically variegated phraseology of the present statutes is disregarded, there is a surprising similarity of basic patterns in the exemptions."[141] The theory apparently underlying most of the exemptions found in Section 80.05 is that it would be redundant to require registration of securities of issuers which are regulated by other governmental bodies. The exemptions are, therefore, arranged by industry: state and federal bank stocks (Subdivision 3), railroad and related securities (Subdivision 4), savings and loan association securities (Subdivision 9), insurance company securities (Subdivision 11), and securities issued or guaranteed by common carriers subject to federal regulation (Subdivision 13). Securities listed on the New York, American, Pacific Coast, and Midwest Stock Exchanges are exempted pursuant to Subdivision 5. Subdivision 14 provides that the Commissioner may "by written order or regulation" suspend or wholly revoke the exempt status of any security or class of security exempted by this section.

E. EXEMPTED SALES

The provisions of the Minnesota act dealing with exemptions are among its most important. Exemptions cut across both the day-to-day trading in securities of publicly held corporations and the activities of closely held corporations. It is perhaps in this latter area where the impact of the Act is least understood. The subdivisions of Section 80.06 dealing with the trading in securities of publicly held corporations have been dealt with above[142] and the following discussion will center on the exemptions relating to isolated sales, limited distributions, and several related exemptions.

(1971). The concept is discussed in Gray & Rosen, *Section 12(g) and Blue Sky Laws*, 20 BUS. LAW. 1075 (1965).

141. L. LOSS & E. COWETT, *supra* note 130, at 353. The Uniform Securities Act analogue to MINN. STAT. § 80.05 is § 402(a).

142. *See* part II C *supra*.

*1. Isolated sales*

The isolated sales provision of Section 80.06 (Subdivision 2(a)) is relied upon, sometimes knowingly and often unknowingly, in most securities transactions within the state. Since Section 80.07 provides that "*no securities*, except those exempt under Section 80.05 and those sold in sales exemptions under Section 80.06" (emphasis added) shall be offered or sold in Minnesota without registration, its importance to many transactions involving closely held corporations is evident.[143]

The central question to any consideration of the isolated sales exemption is how many sales may be made in reliance thereon. The vagueness of the Act's language is not unusual in Blue Sky law. As Loss and Cowett point out with reference to the isolated sales provisions in such laws, "indefiniteness here is traditional and probably inevitable."[144] However, in the Uniform Securities Act the exemption is made specific in that it is limited to an offer directed to not more than 10 persons within a 12-month period.[145] It has been suggested that the basis for the traditional indefiniteness in isolated sales exemptions generally is a legislative fear that a precise definition would aid evasion of the law.[146] But those who wish to comply with the law and who need specific standards by which financial transactions can be carried out would benefit from more precision. A possible compromise would be a specific statutory standard, reserving to the Commissioner the authority to deal directly with those who would attempt to use the exemption to effect an unlawful distribution.[147]

The test employed by the Minnesota Supreme Court in determining whether or not a sale is isolated focuses on its relation in time and purpose to other sales of the same securities by the same person. As expressed in *State v. Swenson*,[148] "[A] sale is

143. The isolated sales exemption has been expressed in substantially similar language since the passage of the Act. Its constitutionality was upheld against a challenge that it was void for vagueness in 1927. State v. Swenson, 172 Minn. 277, 215 N.W. 177 (1927).

144. L. Loss & E. Cowett, *supra* note 130, at 318.

145. Uniform Securities Act § 402(b) (9).

146. Note, *supra* note 120, at 1647.

147. "[T]here is no reason to believe that state securities agencies could not also look through the form of the transactions to the substance in order to catch the unscrupulous investor, while still providing other investors with an ascertainable standard by which they could judge their transactions." *Id.* For a discussion of the analogous exemption under the 1933 Act, *see* L. Loss, *supra* note 120, at 653-96.

148. 172 Minn. 277, 215 N.W. 177 (1927).

not to be deemed an isolated sale where it bears such a relation to other similar sales occurring sufficiently near the same time as to constitute one of a series of associated acts for the promotion of the same project."[149] The Minnesota court has generally given a narrow construction to the isolated sales exemption,[150] and the conclusion that "isolated" will generally mean "single" is suggested by the expression of the isolated sale rule in the Massachusetts case of *Kneeland v. Emertson*,[151] cited in 1960 by the Minnesota court in *Anderson v. Mikel Drilling Co.*:[152]

> [A]n "isolated" sale means one standing alone, disconnected from any other, and "repeated and successive" mean transactions undertaken and performed one after the other. We think that two sales of securities, made one after the other within a period of such reasonable time as to indicate that one general purpose actuates the vendor and that the sales promote the same aim and are not so detached and separated as to form no part of a single plan, would be "repeated and successive transactions".[153]

The Minnesota Securities Division has operated with informal and varying policies as to how many sales may be made under the exemption. Perhaps the most restrictive view has been taken recently by the Division, appearing in proposed regulations which first came to light in 1970 (and which have not yet been adopted or formally withdrawn). These proposed regulations would limit isolated sales, except in connection with the organization of corporations, to

> a single sale made from time to time, with sufficient time intervals so that the sales do not constitute sales being made in the course of repeated and successive sales of securities of the same issuer. Six months is presumed to constitute the passage of a sufficient time interval. If more than one sale is made during a six-month period without the prior approval of the Division, none of the sales constitute an isolated sale.[154]

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149. *Id.* at 282-83, 215 N.W. at 179.

150. *See, e.g.*, Virnig v. Smith, 252 Minn. 363, 90 N.W.2d 241 (1958). (12 sales in short period but exemption claimed § 80.35, not § 80.06 (2)(a)); State v. Robbins, 185 Minn. 202, 240 N.W. 456 (1932) (rejected argument that all sales of the same issue constituted one offense); State v. Swenson, 172 Minn. 277, 215 N.W. 177 (1927) (10 sales within short period); State v. Gopher Tire & Rubber, 146 Minn. 52, 177 N.W. 937 (1920) (6 sales in 22 days). *But see* Parr v. Canam Metals, 196 Minn. 325, 265 N.W. 287 (1936) (2 sales 14 days apart by brokerage firm exempt). *See generally* Annot., 1. A.L.R.3d 614 (1965).

151. 280 Mass. 371, 183 N.E. 155 (1932).

152. 257 Minn. 487, 102 N.W.2d 293 (1960).

153. *Id.* at 492, 102 N.W.2d at 297.

154. Proposed regulations entitled "Guidelines for Issuers," issued February, 1970.

This restrictive interpretation was based on the Division's reading of the important *Anderson* case.[155]

The *Anderson* case involved rescission claims brought by purchasers of oil and gas leases. Three such cases against the same defendants were consolidated for trial. A substantially similar case had been tried and decided for the defendants in federal district court[156] and the state district court granted defendants' summary judgment motion based on the collateral estoppel effect of the federal court decision. The issue before the Minnesota Supreme Court on appeal by the plaintiffs involved the propriety of the order of summary judgment. In the federal court case, the defendants based their defense to the claim that they sold unregistered securities on an exemption from registration under the 1933 Act based on Section 4(2) of that act. In the state case, the defendants argued that the sales were isolated under Section 80.35 of the state act (the section covering isolated sales of oil and gas interests). On appeal, the court held that the issue of a Section 4(2) exemption from registration under the 1933 Act was not the same as the issue of exemption from registration pursuant to Section 80.35 of the state act and that, therefore, the state district court had improperly applied the doctrine of collateral estoppel. In reaching this conclusion, the court cited *Kneeland v. Emertson*[157] and pointed out that "whether a transaction falls within the purview of our statutory exemption provision is determined by examining the relation of the transactions to each other in point of time and purpose."[158]

This very limited holding does not seem to provide support for the Division's restrictive interpretation of the isolated sales provision. Moreover, the Division's reliance on the *Anderson* opinion in issuing an interpretation under Section 80.06(2)(a) fails to take account of differences in language between that section and Section 80.35, which was the section before the court in the *Anderson* case, and which, as indicated above, applies to oil or gas lands or interests. Section 80.06(2)(a) refers to "any isolated *sales* of any securities . . . such sales not being made in the course of repeated and successive sales of securities *of the same issue*," (emphasis added) while Section 80.35 states that

155. MEMORANDUM, *supra* note 43, at 7.
156. Collier v. Mikel Drilling Company, 183 F. Supp. 104 (D. Minn., 1958).
157. 280 Mass. 371, 183 N.E. 155 (1932).
158. 257 Minn. at 492, 102 N.W.2d at 298.

the oil and gas registration provisions are not appliable to "any isolated *sale* not made or occurring in the course of repeated or successive sales" (emphasis added). The operative word is stated in the plural in Section 80.06(2)(a), while it is stated in the singular in Section 80.35. Furthermore, the issue concept which is present in Section 80.06 (2) (a) is not present in Section 80.35. The *Anderson* case, then, is not an express holding on the scope of the isolated sales exemption and, in any event, the court was not even construing that section of the statute upon which the proposed regulations were based. To ignore, as the proposed regulations do, that "sales" is in the plural in the statute is to engage in gratuitous rewriting of the statute by regulation. The concept of "issue" which is present in Section 80.06 (2) (a) supports the application of the exemption to private placements whereby several purchasers acquire securities in the same placement, often pursuant to a single purchase agreement.[159] A determination of whether or not a particular sale is within the exemption would appear to require not only the application of a numbers test, but also a determination as to whether or not the securities involved are part of the same issue.

Earlier in this article[160] reference was made to the restric-

159. The "issue" concept arises under Sections 3(a)(11), 3(b), and 4(2) of the 1933 Act. The following factors have been cited by the SEC as important in determining whether securities are being offered as part of a single issue:

(a) Are the offerings part of a single plan of financing?
(b) Is the same class of security involved?
(c) Are the offerings made at or about the same time?
(d) Is the same type of consideration to be received?
(e) Are the offerings made for the same purpose?

SEC Securities Act Release No. 4434 (1961). *See generally* 1 L. Loss, *supra* note 120, at 577-78, 591-95. In MEMORANDUM, *supra* note 43, at 8, the following comment appears:

> It appears, however, that the most reasonable interpretation of the statutory framework at the present time would permit sales to a limited number of investors in a private placement effected at one time and not in the course of repeated and successive sales of securities of the same issue. This interpretation would permit a private placement to be made to finance an issuer's immediate objective and would permit a similar private placement to be made at some reasonable time interval thereafter to accommodate a distinctly, different objective or financing need of the issuer. The limited distribution exemption provided in Subdivision (b) would, then, be utilized by an issuer for an offering of its securities over a period of time to unrelated investors within the number restrictions provided by the statute or by order of the Commission, to finance a company's operations irrespective of an identifiable need for the capital to be raised in the limited distribution.

160. *See* text accompanying notes 92-95 *supra*.

tive impact of stringent Blue Sky regulations on the financing of business enterprises. As expressed in the form of the standards of qualification for the registration of securities, such regulation has the effect of limiting a promoter's profit on a successful venture through regulation of matters such as cheap stock, promotional securities, warrants and options. It was pointed out that this regulation proceeds on the assumption that fraudulent deals have certain identifiable characteristics. By regulating the symptoms, Blue Sky law attempts to prevent the disease. Restrictive interpretations of isolated sales exemptions would seem to have a similar limiting effect on business financing. As Professor Mofsky points out,

> If the promoter is forced to give up control by virtue of the restrictions contained in the limited offering exemption or the rules limiting promotion shares, control will shift to those persons who can afford to purchase it. The regulatory system precludes the no-asset promoter from competing effectively with investment bankers and affluent persons for control, and accordingly the latter persons secure control at a lower price than would be paid if the entrepreneur were not hindered by restrictive statutes and rules.[161]

The effect of a restrictive interpretation of the isolated sales exemption will generally be to increase the shares of the enterprise obtained by investors if it is assumed that the amount of financing required by the promoter remains the same. In effect, fewer persons will each acquire larger shares, reducing or, perhaps, eliminating the control of the promoter. Whether or not this fear of loss of control is a significant one among business promoters, of course, only can be determined by sophisticated empirical study.[162]

Serious problems with interpretation of the isolated sales exemption in Minnesota were reduced by the passage in 1969 of an amendment to the Act which became Subdivision 2(b) of Section 80.06.[163] Section 80.06(2)(b) provided an exemption for sales to not more than ten persons during any period of twelve consecutive months if the seller reasonably believed that the buyers were purchasing for investment, if no commis-

161. Mofsky, *Blue Sky Restrictions on New Business Promotions*, 1969 DUKE L.J. 273, 289.

162. One observer points out, with respect to the Minnesota small businessmen interviewed by him, "owners generally appeared to be wary of growth that could require sharing control of the firm." Stevenson, *Equity and Long-Term Financing for Small Manufacturing Firms in Minnesota* (Small Business Administration, 1962).

163. Minn. Laws 1969, ch. 848.

sion was paid, and if certain information was furnished to the Securities Division. The Commissioner was granted authority to increase or decrease the number of purchasers permitted and to waive each of the three conditions. While Section 80.06(2)(b) was a helpful relief, particularly during a period when the Division was interpreting the isolated sales exemption to allow one sale each six months, a substantial disagreement arose as to the type of information which purchasers should obtain in transactions presumably exempt under Section 80.06(2)(b).[164] In addition, the preclusion of the payment of a commission for sales effected under this subsection seemed to be unrealistic and to serve no regulatory purpose. Also, frequent attempts were made to obtain administrative approval to increase the crucial number of purchasers above ten. These dissatisfactions culminated in the preparation and passage of an amendment to the subsection, with the cooperation of the Division, which increased to twenty the number of persons to whom sales could be made, eliminated the prohibition against commissions, and focused the information requirements on material to be supplied to the Commissioner rather than to prospective purchasers.[165]

*2. Subscriptions*

Another provision of Section 80.06 which poses problems is Subdivision (6) relating to subscriptions. This subdivision exempts subscriptions for securities which are conditioned expressly upon registration within one year from the date of subscription. Subdivision (6) is the only place in the Act where subscription agreements are covered, yet Section 301.17 of the Minnesota Business Corporation Act provides for preincorporation subscription agreements and contains detailed provisions as to their irrevocability and other terms. This lack of coordination between Minnesota's corporation and securities laws results in violation of the Minnesota Securities Act whenever preincorporation subscription agreements are obtained and not registered as securities or are not otherwise exempt under

164. *See* MEMORANDUM, *supra* note 43, at 9-12, and letter, dated April 29, 1971, from Securities Commissioner Edward Driscoll to Representative Otto Bang, Chairman of the Committee on Financial Institutions of the Minnesota House of Representatives. Copy on file with the Minnesota Law Review.

165. Minn. Laws 1971, ch. 723.

the Act. Section 401 (b) (10) of the Uniform Securities Act provides an exemption for the offer or sale of preorganization subscriptions to no more than ten persons. Presumably any modification in this area should be consistent with the isolated sales exemption and with Section 80.06 (2) (b).

### 3. *Corporate Acquisitions*

The regulation of corporate acquisitions under the Act is primarily the function of Section 80.06(15). In effect, Subdivision (15) provides an exemption for asset acquisitions for statutory mergers or consolidations if the Commissioner "has been furnished with a general description of the transaction and with such other information as he may prescribe by rules and regulations." No rules or regulations have been issued pursuant to Subdivision 15, and the practice generally seems to be to send a description of the transaction to the Division, which currently is issuing a form of "no-action" letter in connection with asset acquisitions or statutory mergers. Thus, reorganizations such as mergers and asset acquisitions falling under Sections 368(a) (1) (A) and (C) of the Internal Revenue Code of 1954 are exempt. However, stock acquisitions (including "B" reorganizations as defined in Section 368 (a) (1) (B) of the Internal Revenue Code of 1954) are not exempt under Subdivision (15) and, unless an exemption can be found pursuant to Subdivision (2) of Section 80.06, registration is presumably necessary.[166]

## III. CONCLUSION

The preceding discussion focuses on the provisions of the Minnesota Securities Act related to registration of securities. There are many other areas covered by the Act, such as remedies, jurisdiction, and enforcement provisions, all of which pose problems similar to those existing in connection with the registration provisions. But it is the Act's registration provisions which have been at the center of securities regulation in Minnesota because the paternalistic philosophy underlying the Act requires the Securities Commissioner to make a value judgment on a great number of securities issues.

166. The Act's pattern thus is superficially similar to the federal pattern which has emerged around Rule 133 under the 1933 Act. *See* C. SCHNEIDER, SEC CONSEQUENCES OF CORPORATE ACQUISITIONS, chs. 2 and 3 (1971). *See also* Cowett, *Reorganizations, Consolidations, Mergers and Related Corporate Events under the Blue Sky Laws,* 13 BUS. LAW. 418 (part I), 760 (part II) (1958).

There are at least four areas in which the Act's registration provisions seem defective. First, the actual securities registration provisions pose procedural problems. The distinction between registration for sales to original purchasers and secondary market trading has proven confusing and unfair in application. Coordination with federal registration, when available, comes as a matter of administrative grace. Second, the general language of Section 80.08 has spawned a mass of regulations relating to standards which may not be the most effective way to protect the public's interest. Such regulations are ambiguous and uneven in application. Their adoption was not based on a demonstrated need and their impact on business growth has not been considered. Third, the Act's vagueness in matters such as standards for registration and key exemptions has resulted in the Commissioner of Securities being vested with discretion almost as broad as the Act. Correspondingly, the financial community has been exposed to radical shifts in philosophy as administrators change. While administrative flexibility is an essential and desirable part of the Blue Sky regulatory structure, in the absence of definite statutory standards such flexibility can evolve into arbitrariness. Finally, the exemption pattern is simply not rational. The Act applies to situations where its application serves no regulatory purpose, it leaves whole industries free from regulation, and it is ambiguous in areas where ambiguity serves no regulatory purpose but where certainty would further legitimate business activities.

That states should regulate their securities markets by restrictive registration requirements has been assumed with little dissent ever since the Kansas Act was first passed. The Uniform Securities Act was an effort to bring uniformity out of chaos but did not purport to change the conventional wisdom of merit regulation. Recently, however, the soundness of the basic concept of merit regulation has begun to be challenged. The relevant question now is whether the aims of public protection and sound capital markets better can be served by an emphasis on strong antifraud enforcement rather than on restrictive merit regulations. The possible negative effect of restrictive merit regulation on entrepreneurship and new business development cannot be ignored any more than can the existence of a vigorous system of federal securities regulation. Both factors are important for Minnesota. The fact of federal securities regulation emphasizes the inefficiency and wastefulness of duplicate regulation. The importance of access to the capital markets for the development of small business emphasizes the desirability of looking to the needs of our own state in constructing for it an appropriate system of securities regulation.