

## NOTE

### SECONDARY TRADING IN SECURITIES: LABYRINTH BENEATH THE BLUE SKY

Secondary trading in securities refers to transactions effected by or through a broker or dealer in securities by persons other than the issuer, or persons in control of the issuer, of such securities.<sup>1</sup> Although secondary trading excludes "issuer" transactions such as the distribution or underwriting of securities on behalf of the issuer or controlling stockholder, it encompasses purchases and sales of securities made in the normal course of investment by individual members of the investing public. In short, secondary trading refers to the day-to-day functioning of the securities markets on organized exchanges or over-the-counter and accounts for the overwhelming majority of dollar-volume transactions in securities.<sup>2</sup>

Protection of purchasers of securities is afforded in varying degrees by

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1. The most satisfactory definition of secondary trading is that it encompasses all transactions exempted from the registration provisions of § 5 of the Securities Act of 1933 by §§ 4(3) and 4(4):

§ 5(a). Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise;

§ 4. The provisions of section 5 shall not apply to—

(3) transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transaction), except—

(C) transactions as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter.

(4) brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders.

15 U.S.C. §§ 77d(3), (4), 77e (1964). The omitted portions of § 4(3) *supra* require a dealer to deliver a statutory prospectus to secondary purchasers for a period of forty or ninety days after the completion of the offering. *See also* Securities Act Regulation 154 interpreting § 4(4) of the Act, 17 C.F.R. § 230.154 (1968).

2. In the first six months of 1967, the total value of distributions registered with the Securities and Exchange Commission (SEC) amounted to \$21,500,000,000. 33 SEC ANN. REP. 154 (1968). Total value of secondary transactions on the securities exchanges for the same period was \$80,458,232,000. *Id.* at 160. If estimates for the over-the-counter securities transactions are included, secondary trading accounts for approximately 90% of the dollar volume of securities transactions.

both federal and state law.<sup>3</sup> The federal scheme of registration and regulation of securities transactions is applied to distributions of securities and to secondary trading through separate, albeit complementary, enactments.<sup>4</sup> On the other hand, the state securities laws, or "blue sky" laws,<sup>5</sup> including the Uniform Securities Act,<sup>6</sup> do not distinguish between these forms of transactions in a systematic manner. In taking this approach, most states have overlooked the theoretical and practical distinctions between distributions or offerings of securities and secondary trading in securities. As a result, the blue sky laws often fail to provide the investor protection sought by their enactment and create obstacles to the orderly functioning of the securities markets<sup>7</sup> and pitfalls of liability for the broker or dealer in securities.<sup>8</sup>

This note proposes to examine both the factors which distinguish secondary trading from distributions and offerings of securities and the objectives of state regulation of securities transactions and, in this light, to consider the effectiveness of the current regulatory pattern applied to secondary trading by the blue sky laws. The reference point for the

3. The federal securities laws contain specific provisions stating that:

Nothing in this subchapter shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, of the District of Columbia, over any security or any person. Securities Act § 18, 15 U.S.C. § 77r (1964). Cf. Securities Exchange Act § 27(a), 15 U.S.C. § 78bb(a) (1964).

4. The Securities Act of 1933, ch. 38, Title I, 48 Stat. 74, as amended, 15 U.S.C. § 77a *et seq.* (1964), is concerned primarily with distributions of securities. The Securities Exchange Act of 1934, ch. 404, 48 Stat. 881, as amended, 15 U.S.C. § 78a *et seq.* (1964), is concerned primarily with secondary transactions in securities.

5. The term "blue sky laws" is derived from the legislative debates which accompanied the Kansas enactment in 1911. The object of the law was to regulate promoters who "would sell building lots in the blue sky in fee simple." For the history of blue sky laws, see I L. LOSS, *SECURITIES REGULATION* 23-30 (2d ed. 1961) [hereinafter cited as LOSS]; L. LOSS & E. COWETT, *BLUE SKY LAWS* 3-21 (1958) [hereinafter cited as LOSS & COWETT].

6. The Uniform Securities Act was adopted by the National Conference of Commissioners on Uniform State Laws and the American Bar Association in 1956. The Act was drafted by Loss and Cowett and appears, with both the official comments and the drafters' comments, in LOSS & COWETT 245ff. The Act is also reproduced in *BLUE SKY L. REP.* at 701-50.

7. Since the blue sky status of securities varies from state to state, barriers to the marketability of securities are necessarily created. The primary obstacle to an orderly market, however, is the frequent inability of brokers and dealers to make a determination of a security's blue sky status.

8. If a broker-dealer sells to or acts as agent for the purchaser of a non "blue-skied" security, the purchaser may have the right to rescind his purchase. UNIFORM SECURITIES ACT § 410(a). See notes 44-46 *infra* and accompanying text. See generally 3 LOSS 1623-43; LOSS & COWETT 129-79.

latter discussion will be the Uniform Securities Act,<sup>9</sup> which represents a codification of the provisions most commonly found in the blue sky laws,<sup>10</sup> against the background of federal regulation.<sup>11</sup> Unusual provisions from particular states' laws will be considered if they differ substantially in practice or theory from the approach of the Uniform Act.<sup>12</sup> A survey of the statutory provisions applicable to secondary trading and suggested amendments to the Uniform Act are contained in the appendices to this note.

## I. FACTORS BEARING ON THE REGULATION OF SECONDARY TRADING

The essential concern of any regulation of securities transactions is the protection of the individual investor by eliminating risks not related to the bona fide operation of the issuer's business.<sup>13</sup> To achieve this end, the laws are generally directed at (1) the prohibition of fraudulent, manipulative, or deceptive acts in connection with the purchase

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9. See note 6 *supra*. The Uniform Securities Act has been adopted, subject to variations, in approximately 25 states. Appendix I makes apparent the generality of the Uniform Act's provisions regarding secondary trading.

10. Since the Uniform Act represented a codification of blue sky provisions in general use, little consideration was given to the possibility of "revolutionary" approaches to securities regulation on the state level. Professor Jennings, while noting that the Uniform Act contains many good features, particularly regarding coordination of registrations and conflict of laws problems, criticizes much of the Act as an "amalgamation" which overlooks more progressive approaches. Jennings, *The Role of the States in Corporate Regulation and Investor Protection*, 23 L. & CONTEMP. PROB. 193, 222-30 (1958).

As a result of the similarity of provisions found in the Uniform Securities Act and most blue sky laws, citations to this note have been made to the Uniform Act alone where possible. Appendix I contains appropriate citations to the blue sky laws of each state and notes where they vary from the Uniform Act with regard to secondary trading provisions.

11. See notes 3 & 4 *supra*; notes 37-44 *infra* and accompanying text.

12. The Uniform Securities Act adopts the disclosure approach of the Securities Act of 1933 with regard to the registration of distributions of securities. Loss & COWETT 236-43. This approach was not carried over into the provisions of the Uniform Act concerned with secondary trading. The exemptions granted by those provisions to certain classes of securities and to certain types of transactions have traditionally been regarded as qualitative in nature. This Note suggests that they be reconsidered from a disclosure oriented approach.

13. See generally 1 Loss 3-30, 121-29; Jennings, *supra* note 10, at 207; Note, *Regulation of Nonissuer Transactions Under Federal and State Securities Regulation Laws*, 78 HARV. L. REV. 1635 (1965). There are, of course, great differences as to the scope of protection and as to the facets of corporate organization which are subject to regulation.

or sale of securities;<sup>14</sup> (2) the disclosure, either to the public in general or to the purchaser, of material information concerning the issuers of securities;<sup>15</sup> and (3) the licensing of brokers, dealers and their agents to provide minimum qualifications and professionalization of the securities industry.<sup>16</sup> With the exception of Delaware, which does not regulate securities transactions or the securities industry,<sup>17</sup> the above approaches are combined in varying degrees in the blue sky laws and the federal securities acts.

### A. *The Investment Pattern of Secondary Trading*

The definition of secondary trading as non-issuer transactions in securities provides the fundamental distinction between secondary trading and distributions of securities. It also explains why the seller in the transaction is incapable of providing his purchaser with the information which an issuer would be compelled to reveal and, perhaps to a lesser extent, why the issuer is not compelled to supply that information on the seller's behalf.

The seller, usually possessing only a small interest in the issuer, is not in a position to know the detailed information which the issuer would have to reveal if the issuer itself were making the sale.<sup>18</sup> Moreover, he is not, by definition, in a position to force the issuer to make

14. *E.g.*, Securities Exchange Act §§ 9, 10, 14, 15, 16, 15 U.S.C. §§ 78i, j, n, o, p (1964); Securities Act §§ 12(2) 17, 15 U.S.C. §§ 771(2), 77q (1964); Securities Exchange Act Rules 10b-5, 15c1-2, 17 C.F.R. §§ 240.10b-5, .15c1-2 (1968); UNIFORM SECURITIES ACT §§ 101, 102.

15. *E.g.*, Securities Act, §§ 5, 10, Schedule A, 15 U.S.C. §§ 77e, j, aa (1964); Securities Exchange Act §§ 12, 13, 15 U.S.C. §§ 78l, m (1964); UNIFORM SECURITIES ACT §§ 301-304, 403.

16: *E.g.*, Securities Exchange Act §§ 15, 15A, 15 U.S.C. §§ 78o, o-3 (1964); UNIFORM SECURITIES ACT §§ 201-204.

17. Common law actions for fraud would, of course, apply to security transactions in Delaware. *See* BLUE SKY L. REP. ¶ 11,101, suggesting that the Delaware Attorney General could bring an action in equity to enjoin fraudulent sales of securities even in the absence of express authority. *See also* 3 Loss 1623-31, discussing common law and equitable liabilities and remedies.

18. This assumption is incorporated in both the Securities Act and the Securities Exchange Act at the federal level. "Controlling persons" or "affiliates of constituent corporations", who presumably do possess such information, may be held to be selling for the indirect benefit of the issuer or to be an underwriter of the issuer's securities. Securities Act § 2(11), 15 U.S.C. § 77b(11) (1964); *see* Securities Act Regulations 133, 154, 405(a), 405(f), 410, 17 C.F.R. §§ 230.133, .154, .405(a), .405(f), .410 (1968). *See generally* 3 Loss 764-83. *But see* Securities Act Regulation 409, 17 C.F.R. 230.409 (1968), which provides for registration despite the existence of information which is unknown or not reasonably available to the registrant.

The presumption of fraud set forth in the "insider" provisions of § 16 of the Securities Exchange Act would seem to indicate that directors, officers, and direct or indirect owners of 10% or more of any class of an issuer's securities possess the requisite knowledge. Securities Exchange Act § 16, 15 U.S.C. § 78p (1964).

the required revelation.<sup>19</sup> The seller's interest is investment oriented rather than proprietorship oriented.<sup>20</sup> In the absence of "inside information" concerning the issuer, the seller and the purchaser of the security are essentially on an equal footing with regard to their knowledge about the worth of the security. Even assuming, *arguendo*, that the seller possessed the requisite knowledge to register the securities for sale, in most circumstances the financial burden of undertaking to do so would exceed the market value of the securities being sold.<sup>21</sup>

The issuer of the securities, while able to provide the requisite information in order to register the securities, has no direct interest in the transaction. Having already received the capital investment represented by the security, the issuer stands to gain nothing by the investor's subsequent sale. Furthermore, the registration statement under which the security was originally distributed is usually ineffective for subsequent transactions.<sup>22</sup> It might be argued that the issuer possesses an

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19. Although the concept of "control" under the Securities Act is more elusive than the statutory definition of "insider" in the Securities Exchange Act, anyone possessing the ability to get the issuer's assistance will be found to be a controlling party and, it would seem, anyone not possessing such ability will not regardless of the percentage ownership. Cf. *United States v. Sherwood*, 175 F. Supp. 480, 483 (S.D.N.Y. 1959). See generally PLI, *Who is a Controlling Stockholder?*, SEC PROBLEMS OF CONTROLLING STOCKHOLDERS AND IN UNDERWRITINGS 3-22 (Israels ed. 1962).

20. Because of the wide distribution of an issuer's securities, both numerically and geographically, only the management is sufficiently related to or in control of the issuer to have a "proprietary interest" in its operations. Although the security-holders nominally possess the power to elect the directors of the corporation, they usually vote by proxy for the management slate. When a proxy-fight or tender offer solicits their securities, they are likely to side with the highest bidder. Moreover, most investors who become involved in secondary trading leave their securities in "street name," *i.e.*, with their broker-dealer for safe keeping, and never appear on the corporate record books. See A. BERLE & G. MEANS, *THE MODERN CORPORATION & PRIVATE PROPERTY*, *passim* (1932); Berle, *Property, Production and Revolution*, 65 COLUM. L. REV. 1 (1965). More recently, John Kenneth Galbraith has characterized this shift of the proprietary interest from the "owner" to the "manager" as one of the badges of the "new industrial state." J. K. GALBRAITH, *THE NEW INDUSTRIAL STATE* 70-85 (1967). See also Brooks, *Stockholder Season*, in J. BROOKS, *BUSINESS ADVENTURES* 276-96 (1969) (the essay originally appeared in (the New Yorker), Oct. 8, 1966, at 159).

21. Although a small part of the cost of registering securities depends on the amount to be offered, the fixed expenses or printing costs and attorney fees will average \$35,000 for most offerings. See Wheat & Blackstone, *Guideposts for a First Public Offering*, 15 BUS. LAW. 539 (1960). The article has been included, with an appendix covering recent developments, in ABA, *SELECTED ARTICLES ON FEDERAL SECURITIES LAW* 1-30 (Wander & Grienberger eds. 1968).

22. Most blue sky laws provide that the registration of a security expires automatically one year following the effective date of the registration statement. UNIFORM SECURITIES ACT § 305(i). There seem to be two reasons for the provisions. (1) If the issuer wants to distribute more shares, it must complete full registration of those shares rather than file a post-effective amendment to the registration statement, giving the securities administrator a second chance to evaluate the issue. (2) The security remains registered

indirect interest in the transaction since the market price of its securities is a legitimate corporate concern.<sup>23</sup> But even assuming that the issuer does have sufficient interest in the transaction to require it to register the securities, the financial burden of such a requirement would constitute a continual drain on the corporate treasury and subject it to further financial liability based on transactions from which it gained no direct benefit.<sup>24</sup>

The decision to sell as well as the decision to purchase a security in a secondary transaction represents an investment decision on the part of both the seller and the purchaser. The issuer or the controlling stockholder in a distribution or offering of a security may be conclusively presumed to have an adequate basis for its decision to sell. Securities regulation need concern itself only with providing the purchaser with an adequate basis for decision when distributions are involved. In secondary transactions, on the other hand, it is necessary that both the seller and the purchaser be provided with the adequate basis for decision.

### B. *Industry Patterns Affecting Secondary Trading*

The fact that a security represents an investment interest rather than a proprietary interest in the issuer has combined with the common law predilection in favor of marketability to result in a sizeable industry

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for one year, however, in order to allow a secondary market to develop and to permit the security to qualify for secondary trading under another available exemption. In some states, where secondary trading can begin under other provisions of the blue sky law, the registration statement is withdrawn shortly after the completion of the distribution of the security. Kansas issues such a permit under Kan. Laws 1967, ch. 121, *appearing as* § 17-1261(m) in BLUE SKY L. REP. ¶ 19,110. Several states allow secondary trading to occur in any security previously registered or exempt from registration. *E.g.*, MO. REV. STAT. § 409.402(b)(13) (Supp. 1967); S.C. CODE ANN. § 62-170 (1962). In Iowa, registration of a security is non-expiring, subject to administrative action suspending trading. IOWA CODE ANN. § 502.7.3 (Supp. 1968); Letter from L. J. Bryant, Superintendent of Securities of Iowa, to the WASHINGTON UNIVERSITY LAW QUARTERLY, July 16, 1968, on file in Washington University Law Library.

The amount of protection afforded investors by such provisions is at least open to question. See text, § IIA. *Secondary Trading in Registered Classes of Securities*, *infra*. See also Note, *supra* note 13, at 1650.

23. The market price of a security unquestionably affects the manner in which additional capital can be raised by the issuer and the amount and terms the issuer must offer (or its shareholders receive) in mergers, take-overs, and buy-outs.

24. The issuer could become liable for a secondary sale because of a faulty registration statement, for example. Securities Act § 11, 15 U.S.C. § 77k (1964). Under present federal law there is no doubt that the issuer does bear this liability when a controlling person forces registration for a secondary *distribution*. It should be noted that the Uniform Securities Act does not provide such liability unless the issuer is the seller of the security. UNIFORM SECURITIES ACT § 410.

devoted to the maintenance of liquid securities markets.<sup>25</sup> Any regulation of securities transactions, and particularly of secondary transactions, must take into account the manner in which such transactions are affected. It is by imposing potential liability upon the securities industry that the task of regulation becomes practicable.<sup>26</sup> The effective operation of all securities laws depends upon the broker-dealer's unwillingness to assume liability for its own or its customers' potential violations of those laws.<sup>27</sup>

### 1. *Types of Transactions Involving Secondary Trading*

As is suggested by the technical term applied to those whom the public regards simply as "stockbrokers," a broker-dealer may execute securities transactions for his customers either as a broker, *i.e.*, as agent, or as a dealer, *i.e.*, as principal, depending on the circumstances.<sup>28</sup>

25. There were 4175 firms and approximately 112,500 agents registered with the Securities and Exchange Commission as of June 30, 1967. 33 SEC ANN. REP. 16, 70, 85 (1968). With the inclusion of administrative and staff personnel and of other persons in the industry not subject to registration, an estimated 1,000,000 persons are employed in the industry. Similarly, the number of corporate shareholders is now estimated at 25,000,000 by the New York Stock Exchange, not including those holding solely mutual funds.

26. Liability under the various laws is extended to underwriters, dealers, brokers, and investment advisors as well as actual sellers. Apart from the ease of identification of the members of the industry as opposed to sellers, such persons are likely to be both solvent and available when enforcement is necessary.

The securities industry assists in its regulation through the rules of the stock exchanges and the National Association of Securities Dealers (NASD). The NASD was formed pursuant to SEC requests in order to facilitate regulation in the over-the-counter market. The enabling legislation, passed in 1938, is the Maloney Act, Securities Exchange Act § 15A, 15 U.S.C. § 78o-3 (1964). See Note, *The NASD—An Unique Experiment in Cooperative Regulation*, 46 VA. L. REV. 1586 (1960); Comment, *Over-the-Counter Trading and The Maloney Act*, 48 YALE L.J. 633 (1939). The self-regulatory powers of the exchanges are also specifically enumerated in federal law. Securities Exchange Act §§ 6, 8, 17, 19, 15 U.S.C. §§ 78f, h, q, s (1964). See generally 2 Loss 1165-84, 1359-92.

27. UNIFORM SECURITIES ACT § 410(b). In addition to their "duty" under state law to observe and enforce blue sky provisions, most of the supervision of sales of control stock under federal law is left to broker-dealers. A broker-dealer may, for example, become liable for a transaction beyond the scope of the brokerage exemption even though his own sale on behalf of the controlling person was within the exemption. Securities Act §§ 4(4), 5, 12, 15 U.S.C. §§ 77d, e, 1 (1964); Securities Act Regulations 133, 154, 17 C.F.R. §§ 230.133, .154 (1968); see note 18 *supra*. For a discussion of the problems surrounding sales of control stock, see Sommer, *Who's in Control?—SEC*, 21 BUS. LAW. 559 (1966); Spies, *Sales of Securities Involving Questions of Control and Distribution Under Federal Securities Act—A Primer*, 16 LA. B.J. 105 (1968).

28. The following definitions are contained in the Securities Exchange Act:

§ 3. . . .

(4) The term "broker" means any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank.

(5) The term "dealer" means any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own

When the broker-dealer is acting as a broker, the charges for his services in executing the transaction are added to or deducted from the price of the security, and he has no direct interest in the transaction. If he is acting as dealer in the transaction, he is either selling from or buying for his own account. In the latter case a commission is not charged, but the dealer retains any profits realized at the time of sale.

The distinction between these types of transactions raises the question whether the broker-dealer's liability should be the same regardless of the nature of his interest in the transaction. Despite the fact that securities laws are directed at the protection of the individual investor rather than the "professional," West Virginia and Louisiana have made the nature of the broker-dealer's role in the transaction determinative of his liability by offering an exemption for all secondary trading executed on an agency basis, even when solicited by the broker.<sup>29</sup> The apparent rationale for this exemption is the assumption that neither the broker nor the issuer has any interest in such transactions. Unfortunately such an approach overlooks the possible indirect interest which either or both may possess. Since the dealer may hold the same securities in his own account, he has an indirect interest in ensuring market liquidity and perhaps even in creating market interest through the execution of agency transactions. The issuer often has a similar indirect interest in the secondary trading of its securities, particularly when management is a significant stockholder. Although disclosure of management's indirect interest may to some extent be required under federal law,<sup>30</sup> the broker-dealer's is not. Indeed, effective public disclosure of such an interest may be both impractical and undesirable.<sup>31</sup>

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account, either individually or in some fiduciary capacity, but not as a part of his regular business.  
Securities Exchange Act §§ 3(4), (5), 15 U.S.C. §§ 78c(4), (5) (1964). A broker-dealer, of course, engages in both types of transactions.

29. LA. REV. STAT. ANN. § 51:705(10) (1965); W. VA. CODE ANN. § 32-1-4(j) (1966).

30. Officers, directors and "10% stockholders" are required to disclose the extent of their ownership of issuers, and transactions in the issuer's securities, by filing forms with the Securities and Exchange Commission. Securities Exchange Act § 16(a), 15 U.S.C. § 78p(a) (1964). Such filing is required if the issuer is registered under § 12 of the Securities Exchange Act, 15 U.S.C. § 78l(g)(1)(B) (1964). Filing is thus required for issuers whose securities are listed on a national securities exchange or if the issuer has assets exceeding \$1,000,000 and its securities are held by more than 500 persons of record.

31. Disclosure may be impractical because the broker-dealer is trading in securities, and information might be inaccurate by the time it was disclosed. Disclosure may be undesirable if the public regarded such "professional" ownership as a recommendation or endorsement of the security. Some brokerage houses, notably Merrill Lynch, Pierce, Fenner & Smith, do disclose their approximate interest in securities they recommend to the public in an effort to disclose possible indirect interests.

Another distinction between types of secondary transactions is whether the investor's order has been solicited by the broker-dealer. Most states provide an exemption for unsolicited transactions on the theory that the broker-dealer's interest is immaterial, since it is not a factor influencing the investor.<sup>32</sup>

Wisconsin has taken an unusual approach which combines these two distinctions and offers an exemption for all unsolicited and certain solicited agency transactions.<sup>33</sup> Interestingly, the exemption is not from the registration provisions, but from the definition of what constitutes a "sale."<sup>34</sup>

## 2. *The Industry's Role in the Dissemination of Information*

Despite the increased availability of information concerning the issuers of securities through the federal disclosure provisions and general improvements in communications, the securities industry has not promoted the systematic dissemination of information to the public through its network of broker-dealers. Most of the news services serving the industry itself are beyond the financial capacity of individual investors. Even when filing with a government agency makes the information nominally available, meaningful access is unlikely.<sup>35</sup>

It should be noted that one consequence of broker-dealer regulation has been a renewal of "faith" in the industry and its representatives.

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Despite the possible disadvantages to public disclosure, disclosure of the broker-dealer's holdings to securities administrators might well be recommended. See notes 146-49 *infra*, and accompanying text.

32. UNIFORM SECURITIES ACT § 402(b)(3). See notes 106-15 *infra* and accompanying text; Appendix I, *infra*.

33. Agency transactions may be solicited provided the commission charged does not exceed the New York Stock Exchange minimum commission. Wis. Securities Regulations § 1.09, Wis. ADM. CODE ch. SEC 1, § 1.09 (1968), BLUE SKY L. REP. ¶ 52,609.

34. Wis. STAT. ANN. § 189.02(3)(a) (1957). The Wisconsin Securities Commission has drafted a proposed revision of its blue sky law based on the Uniform Securities Act. The proposed draft, to be presented to the 1969 Wisconsin legislature, eliminates this exemption and replaces it with a secondary trading exemption modeled after the Missouri provision discussed in notes 142-44 *infra* and accompanying text. Wisconsin Uniform Securities Law, Draft of Nov. 4, 1968, §§ 551.02(11), 551.23(3), on file in Washington University Law Library; see Wisconsin Monthly Securities Bulletin, October, 1968, discussing these and other changes.

35. Letter from Bradley Heald, Deputy Securities Commissioner of South Carolina, to the WASHINGTON UNIVERSITY LAW QUARTERLY, June 27, 1968, on file in Washington University Law Library:

The law makes no specific provision for registration of securities solely for secondary market trading, and indeed such is made impracticable [*sic*] by Section 62-169 requiring the giving of a prospectus in connection with the offering or sale of any security in registration. Obviously no prospectuses are available for most secondary market transactions. The philosophy here is that information filed solely with the Securities Commission and not available to the general public is of little value to the public purchaser.

Even if access to material information were more readily available, most investors would probably prefer to rely on the analysis and expertise of their brokers. Such an attitude on the part of investors nevertheless raises the question whether the broker-dealer should be compelled to provide investors with the essential information upon which an investment recommendation is based. Although this question involves the regulation of investment advisory practices, it is sufficient for present purposes to note that blue sky laws generally provide for the filing of sales literature with the state administrator.<sup>36</sup> While such potential review provides a modicum of investor protection, it seems clear that formal written recommendations play a relatively small role in the conduct of the securities industry.

### C. *The Regulatory Pattern: Federal vs. State*

Since the objective of securities regulation is the protection of the individual investor, both the federal and state laws exempt from regulation sales to or among securities dealers.<sup>37</sup> Thus, individual investors are able to sell their securities holdings to dealers without becoming subject to the registration provisions of the acts and without incurring liability to the purchaser of such securities based upon lack of proper registration. On the other hand, securities sold to individual investors by or through brokers and dealers in securities may be subject to the registration and regulatory provisions of the laws and failure to observe such provisions may result in the broker-dealer's civil liability to its customers for the sale of unregistered securities.

The registration requirement of the Securities Act of 1933 is phrased broadly to make unlawful every sale of a security which ". . . make[s] use of any means or instruments of transportation or communication in interstate commerce or of the mails" unless a federal registration statement is in effect.<sup>38</sup> Secondary trading, however, is exempted from the registration requirement by exemptions for normal brokerage transactions<sup>39</sup> and dealers' sales, provided the securities do not consti-

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36. UNIFORM SECURITIES ACT § 403, while providing for the filing of all sales literature and advertising, does not apply to secondary trading. Sales literature and advertising are available for inspection by the administrator under UNIFORM SECURITIES ACT § 203 regardless of the security or type of transaction.

37. Uniform Securities Act 402(b)(8).

38. Securities Act § 5(a)(1), 15 U.S.C. § 77e(A)(1) (1964).

39. Securities Act § 4(4), 15 U.S.C. § 77d(4) (1964). The text of this subsection is set out in note 1 *supra*.

tute part of an unsold allotment.<sup>40</sup> The Securities Exchange Act of 1934 does, however, provide for disclosure of information regarding specified securities involved in secondary trading<sup>41</sup> and also contains broad anti-fraud provisions,<sup>42</sup> provisions for the registration of broker-dealers and their agents,<sup>43</sup> and provisions for the regulation of the securities markets.<sup>44</sup>

The blue sky laws, on the other hand, contain much narrower exemptions relating to secondary trading and as a result often require that securities be registered as though they formed a part of a distribution even though no proceeds from their sale accrue to the direct or indirect benefit of the issuer.<sup>45</sup> Since the administrators of the blue sky laws are rarely aware of which securities are being marketed by broker-dealers in secondary trading transactions,<sup>46</sup> the blue sky laws have become largely "self-enforcing" to the extent that the broker-dealers wish to avoid potential liability to their customers. Liability under the blue sky laws generally gives the purchaser the right to rescind the transaction.<sup>47</sup> Common sense dictates that such rescission will not be made if the price of the security has risen after the sale. Consequently,

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40. Securities Act § 4(3), 15 U.S.C. § 77d(3) (1964). The text of this subsection is set out in note 1 *supra*.

41. Securities Exchange Act §§ 12, 13, 15 U.S.C. §§ 78I, m (1964).

42. Securities Exchange Act §§ 9, 10, 15(c), 15 U.S.C. §§ 78i, j, o(c) (1964).

43. Securities Exchange Act §§ 15, 15A, 15 U.S.C. §§ 78o, o-3 (1964).

44. Securities Exchange Act §§ 5, 6, 19, 15 U.S.C. §§ 78e, f, s (1964).

45. See text accompanying notes 22-24 *supra*.

46. Unless written sales literature or advertising is involved, the securities administrators cannot know of secondary transactions until after they occur. Since most states have staffs of only five or six persons and frequently operate as a division of some larger agency, meaningful review of a broker-dealer's secondary transactions are selective at best. Inspections, if undertaken at all, are usually directed at broker-dealers not inspected by federal or industry regulatory bodies. This approach finds statutory support only in Nevada which does not require registration of securities involved in interstate commerce without regard to the other aspects of the transaction. NEV. REV. STAT. § 90-140 (1967). Similarly, Nevada does not require registration of broker-dealers or their agents if there has been registration with the Securities and Exchange Commission or the National Association of Securities Dealers. NEV. REV. STAT. § 90-040 (1967).

47. UNIFORM SECURITIES ACT § 410(a). The purchaser is, in effect, given a two-year option on the security. The period may, however, be shortened if the seller offers to repurchase the security and the purchaser fails to accept the offer within thirty days. *Id.*, § 410(e). See generally 3 LOSS 1631-52; LOSS & COWETT 131-42.

See also UNIFORM SECURITIES ACT § 414 codifying the conflicts of laws rules applicable to interstate transactions in securities. When the purchaser is located in a state other than the state in which the office of the broker-dealer handling the transaction is located, the broker-dealer must comply with the provisions of *both* blue sky laws, i.e., the security must be "blue-skied" in both states. See generally LOSS & COWETT 180-229.

a broker-dealer assumes all "down-side" risk on the sale of securities which are not "blue-skied", *i.e.*, not registered for sale or exempted from such registration.

#### D. *The Regulatory Pattern: Approaches and Objectives*

The early securities laws relied almost exclusively upon anti-fraud provisions for investor protection and provided for registration of securities only by the filing of notice that a public distribution was being made.<sup>48</sup> Later refinements required the filing of information concerning the issuer and dissemination of this information to the public and empowered the securities administrator to disallow the distribution if he felt the terms of the offering worked a fraud on investors.<sup>49</sup> The reliance on anti-fraud provisions seems peculiarly well adapted to secondary trading, since such provisions give the purchaser and the seller recourse against each other and are effective against the misuse of inside information.<sup>50</sup> On the other hand, such provisions may nonetheless be inadequate for regulating secondary trading since either the buyer or seller of the security may become a victim of the issuer's failure to disclose information.

New York's Martin Act,<sup>51</sup> first enacted in 1921 and still the core of the New York blue sky law, is the forerunner both legislatively and judicially of the Securities and Exchange Commission's Rule 10b-5 which specifies prohibited fraudulent, manipulative or deceptive conduct in connection with the purchase or sale of securities.<sup>52</sup> Although similar anti-fraud measures continue to be found in most blue

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48. *E.g.*, R.I. Acts & Resolves 1910, ch. 557, § 39; *see* Loss 26-27; Loss & COWETT 3-7.

This "notice" procedure has been retained in New York, N.Y. GEN. BUS. LAW § 359-c (McKinney 1968) (as to interstate issues), and to a lesser extent by Maine, ME. REV. STAT. ANN. tit. 32, § 871 (1968), Massachusetts, MASS. GEN. LAWS ANN. ch. 110A, §§ 5, 5A (Supp. 1968), and Rhode Island, R.I. GEN. LAWS § 7-11-6 (Supp. 1967).

49. *E.g.*, Kan. Laws 1911, ch. 133; *see* Loss 27-30; Loss & COWETT 7-10.

50. The allowance of a civil action under Securities Exchange Act Rule 10b-5, *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), has opened up a federal law of corporate conduct. The most recent development is *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968). A highly readable account of the case and the court's holding is found in Brooks, *A Reasonable Amount of Time*, in J. BROOKS, *supra* note 20, at 118 (the article originally appeared in THE NEW YORKER, Nov. 9, 1968, at 116).

51. N.Y. Laws, 1921, ch. 649, *as amended*, N.Y. GEN. BUS. LAW §§ 352-359 (McKinney 1968).

52. The New York anti-fraud provision, now N.Y. GEN. BUS. LAW § 352-c (McKinney 1968), was the basis of § 17 of the Securities Act, 15 U.S.C. § 77q (1964), which in turn provided the language for Securities Exchange Act Rules 10b-5 and 15c1-2, 17 C.F.R. 240.10b-5, .15c1-2 (1968).

sky laws,<sup>53</sup> they have largely disappeared as a basis for civil liability under such laws.<sup>54</sup> This development appears anomalous in view of the recent characterization of the purpose of Rule 10b-5 as being to place investors on an equal footing with one another regarding their access to information bearing on the value of securities and of the growing treatment of Rule 10b-5 as the keystone of effective securities regulation.<sup>55</sup>

The apparent reason for the discontinuance of anti-fraud provisions as a basis for civil liability under the blue sky laws is the pervasiveness of the federal anti-fraud provisions.<sup>56</sup> The jurisdictional bases for invoking Rule 10b-5 will invariably be present with regard to secondary trading through broker-dealers.<sup>57</sup> By relying on the development of federal interpretation of the anti-fraud provisions, a more uniform application results and prospective plaintiffs are prevented from forum shopping. On the other hand, the antifraud provisions have increasingly relied on the effective disclosure of information to the investing public.<sup>58</sup> Despite the fact that investors may potentially avail themselves of a federal remedy, some regulation to insure that meaningful disclosure has been made within particular states is nonetheless a significant and legitimate objective of those states.<sup>59</sup>

Regardless of the success of the present blue sky regulatory pattern, the requirement by individual states that information be publicly available to investors<sup>60</sup> supplements the federal disclosure pattern contained in the Exchange Act.<sup>61</sup> Moreover, states may legitimately differ

53. UNIFORM SECURITIES ACT § 101.

54. *Id.*, § 410(h).

55. *Cf.* SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968).

56. *Cf.* drafters' comments to UNIFORM SECURITIES ACT § 410(h), in LOSS & COWETT 287.

57. ". . . use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange" regardless of whether the security is registered under or exempted from registration under the Securities Exchange Act. Securities Exchange Act § 10, 15 U.S.C. § 78j (1964).

58. Privity is not required for actions under 10b-5 as is demonstrated by the *Texas Gulf Sulphur* case. SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968). The problem of apportioning civil liability—and recovery—awaits resolution.

59. Where the issuer is small and geographically distant, investors may well be on unequal footing. Letter from Frank J. Healy, Corporation Commissioner of Oregon, to the WASHINGTON UNIVERSITY LAW QUARTERLY, June 28, 1968, on file in Washington University Law Library.

60. This requirement may take the form of registration and public documents but is more directly seen in the exemption of securities listed in certain financial manuals. UNIFORM SECURITIES ACT § 402(b)(2), discussed in notes 119-28 *infra* and accompanying text.

61. Securities Exchange Act §§ 12, 13, 15 U.S.C. §§ 78I, m (1964).

on the quantity or type of information which must be disclosed in order to achieve effective investor protection.<sup>62</sup> While it is true that several states have retained the requirement that distributors of securities obtain the qualitative approval of the blue sky administrator prior to registration for sale,<sup>63</sup> such provisions do not lessen the emphasis on disclosure within those states. At least one factor considered in making the qualitative analysis is the ability of investors in these states to have continuing access to information regarding the issuer.<sup>64</sup>

The regulation and licensing of broker-dealers, apart from its obvious revenue producing aspect, operates on two levels. When used in conjunction with disclosure and registration provisions, it encourages compliance by posing the threat of civil liability.<sup>65</sup> It also supplements the anti-fraud provisions by creating minimum entry standards with regard to knowledge, conduct, and financial stability.<sup>66</sup> Most non-issuer transactions will involve at least one broker-dealer. If the broker-dealer's conduct is effectively regulated, protection of the investor is advanced. Where public disclosure is not required, broker-dealer regulation may promote research into the value of securities rather than encouraging unwarranted speculation.<sup>67</sup> At the same time, the

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62. The minimum requirements for a "manuals exemption" under the Uniform Securities Act are a listing in a recognized securities manual disclosing:

- 1) the names of the issuer's officers and directors,
- 2) a balance sheet of the issuer as of a date within eighteen months (prior to the date of sale), and
- 3) a profit and loss statement for either the fiscal year preceding that date or the most recent year of operations.

UNIFORM SECURITIES ACT § 402(b)(2)(A). Several states require that more information be listed. See Appendix I.

63. *E.g.*, CAL. CORP. CODE §§ 25140(b), (c) (Deering Supp. 1969) (citation is to the *new* California Securities Laws, Laws 1968, ch. 88, effective January 2, 1969); MO. REV. STAT. § 409.306(a)(2)(E) (Supp. 1968); ORE. REV. STAT. § 59.105(1)(a) (Supp. 1968).

64. Letter from Frank J. Healy, Corporation Commissioner of Oregon, to the WASHINGTON UNIVERSITY LAW QUARTERLY, June 28, 1968, on file in Washington University Law Library. Another of the factors is the lack of a prior public market for the securities.

65. See notes 26-27 *supra*.

66. UNIFORM SECURITIES ACT §§ 202-203.

67. *Cf.*, NATIONAL ASSOCIATION OF SECURITIES DEALERS, REPRINT OF THE MANUAL, *Rules of Fair Practice*, art. 3, § 2 1967):

In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

The NASD's Board of Governors, in interpreting the above provision, makes it clear that knowledge of the character of the security as well as the financial resources of the customer is necessary in order to discharge the obligation imposed. *Id.*, at 2051.

higher standards of ethical consciousness<sup>68</sup> derived from placing the broker-dealer in a fiduciary relationship with his customer<sup>69</sup> do not necessarily advance the customer's ability to make an informed decision regarding his investments.

The objectives to be served by regulating secondary trading depend primarily upon the characterization given to securities and to the investor's motive in owning securities. States which grant the securities administrator power to make qualitative judgments regarding securities emphasize the proprietary aspect of securities ownership.<sup>70</sup> States which rely upon disclosure and anti-fraud provisions view the security primarily as an investment vehicle.<sup>71</sup> Particularly with regard to secondary trading, where continued ownership in a proprietary sense is far less likely to occur, disclosure of material information regarding the issuer is the appropriate regulatory objective.

Assuming that disclosure is the immediate objective which regulation of secondary trading is to serve, the type of disclosure to be required will depend on the person or persons to be protected by disclosure. An investment decision is at stake whether one is in the position of seller or buyer in a secondary transaction. Both the security holders as potential sellers, and the investing public in general as potential buyers, should have access to the information required to be disclosed.

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68. A development of "professionalism" and ethical consciousness in the securities industry has been the primary factor in the government's encouragement of dual regulation. See *Report of the Special Study of the Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 4 at 722 (1963); Comment, *Over-the-Counter Trading and the Maloney Act*, 48 YALE L.J. 633, 633-36 (1938). See generally Jennings, *Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission*, 29 L. & CONTEMP. PROB. 663 (1964); Cohen & Rabin, *Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in their Development*, 29 L. & CONTEMP. PROB. 691 (1964).

69. E.g., *Hughes & Co. v. SEC*, 174 F.2d 969 (D.C. Cir. 1949); *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944); see Cohen & Rabin, *supra* note 68, at 702-708.

70. See note 20 *supra*. California is particularly noteworthy in its protection of the proprietary interest and to this end has introduced the "pseudo-foreign" corporation doctrine. Cf. *Western Airlines, Inc. v. Sobieski*, 191 Cal. App. 2d 399, 12 Cal. Rptr. 719 (1961); *accord*, *Western Airlines, Inc. v. Schutzbank*, 258 Cal. App. 2d 291, 66 Cal. Rptr. 293 (1968); *People v. Western Airlines*, 258 Cal. App. 286, 66 Cal. Rptr. 316 (1968). See also Jennings, *The Role of the States in Corporate Regulation and Investor Protection*, 23 L. & CONTEMP. PROB. 193, 213-20 (1958).

71. Letter from Dennis L. Runyon, Deputy Securities Commissioner of Indiana, to WASHINGTON UNIVERSITY LAW QUARTERLY, June 25, 1968, on file in Washington University Law Library.

## II. REGULATION OF SECONDARY TRADING UNDER BLUE SKY LAWS

The traditional distinction drawn between the federal and state approaches to securities regulation has been to characterize the federal regulatory pattern as relying upon disclosure of information regarding the issuers of securities and the blue sky laws as regulatory statutes empowering the local administrator to deny the registration of any security if he finds that the terms of the offering are not "fair, just, and equitable."<sup>72</sup> This distinction has become less valid with the acceptance of the Uniform Securities Act and its provisions for blue sky registration by coordination with federal registration<sup>73</sup> and with the increasing use of a disclosure standard in determining whether to approve or deny registration.<sup>74</sup> Since the administrators retain almost unlimited power to suspend secondary trading in securities, the distinction remains essentially valid when applied to the regulation of secondary trading.<sup>75</sup>

Except for those states whose law relies exclusively on registration of broker-dealers and/or upon anti-fraud provisions for the protection of investors, securities must either be registered for sale in the state, exempted from registration, or sold in exempt transactions. Even in states where the registration of securities is nominally based on the

72. See, e.g., Loss 121-29; Loss & Cowett 3-10; Allen, *Dissemination of Information Under the Securities Act of 1933 and Under State Blue Sky Laws—A Shotgun Wedding*, 18 Bus. Law. 763 (1963); Cowett, *Federal-State Relationships in Securities Regulation*, 28 GEO. WASH. L. REV. 287, 293-94 (1959); Jennings, *supra* note 70, at 209-30.

73. UNIFORM SECURITIES ACT § 303. This provision has made multiple state offerings considerably easier as has the adoption of a standard form (Form U-1) which is accepted by many states even in the absence of a provision based on § 303. See Jennings, *supra* note 70, at 214-16.

74. Letter from Frank J. Healy, Corporation Commissioner of Oregon, to the WASHINGTON UNIVERSITY LAW QUARTERLY, June 28, 1968, on file in Washington University Law Library.

75. The Uniform Securities Act and most states no longer have provisions similar to Mo. REV. STAT. § 409.306(a)(2)(E) (Supp. 1967) which allows the Commissioner to deny, suspend or revoke a registration statement if such action is in the public interest and:

(E)(i) the offering has worked or tended to work a fraud upon purchasers or would so operate; or (ii) any aspect of the offering is substantially unfair, unjust, unequitable or oppressive, or (iii) the enterprise or business of the issuer is based upon unsound business principles; (emphasis added).

The parallel provision in the Uniform Securities Act excludes (ii) and (iii) found in the Missouri Act. UNIFORM SECURITIES ACT § 306(a)(2)(E). While these provisions apply to registered securities, the exemptions which permit secondary trading may also be suspended as to particular securities or transactions. UNIFORM SECURITIES ACT § 402(c). Although notice to interested parties and a hearing prior to final entry of an order are required, no bases for the withdrawal of an exemption are enumerated.

disclosure of information rather than on the fairness, justice, and equitableness of the offering, the securities and transactions exemptions may be denied to specific securities if the administrator feels that continued trading is potentially fraudulent.<sup>76</sup> Since most secondary trading presently relies either upon a securities or a transaction exemption, the state securities administrators have great potential power to affect secondary trading.

#### A. *Secondary Trading in Registered Classes of Securities*

Secondary trading of securities may occur without potential liability to purchasers of the security if the security being traded, or others of the same class, is the subject of a current registration within the state.<sup>77</sup> As a practical matter, however, secondary trading in registered classes of securities plays a relatively minor role in the present markets.

Most securities are not registered in every state at the time of their initial public distribution, making this form of secondary trading unavailable in many states. There appear to be several reasons for this situation. Registration of a new issue of a security is an expensive proposition and the issuer and underwriter will naturally attempt to minimize expenses. Thus, registration of a security in a particular state is usually related to the expected ability to sell the security in that state in sufficient quantity to warrant the expenses of registration. Furthermore, even if securities have previously been registered in a given state it is unlikely that they will be permanently registered for sale.<sup>78</sup> Most statutes provide that a registration statement automatically expires on the completion of the offering<sup>79</sup> or after the passage of one year.<sup>80</sup> In most circumstances, once a genuine market for the securities has been established the registration of a security is not maintained, nor sought

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76. UNIFORM SECURITIES ACT § 402(c).

77. *Id.*, § 305(i):

. . . . All outstanding securities of the same class as a registered security are considered to be registered for the purpose of any non-issuer transaction (1) so long as the registration statement is effective and (2) between the thirtieth day after the entry of any stop order suspending or revoking the effectiveness of the registration under section 306 (if the registration statement did not relate in whole or in part to a non-issuer distribution) and one year from the effective date of the registration statement. . . .

The administrator may require that new or additional information be filed regarding the issuer, UNIFORM SECURITIES ACT § 305(j), or he may revoke the registration statement, UNIFORM SECURITIES ACT § 306.

78. See note 22 *supra*.

79. *E.g.*, N.Y. GEN. BUS. LAW § 359-e(8) (McKinney 1968).

80. UNIFORM SECURITIES ACT § 305(i).

in additional states, because one or more exemptions will exist under which secondary trading in the security can occur.

When an exemption for secondary trading in a security is not otherwise available, a dealer may attempt to register the security if there is sufficient interest to justify the expense. Under the Uniform Securities Act it is arguably possible for a dealer to register a small block of the security, perhaps even as few as 100 shares, and to trade actively because of the "class" registration.<sup>81</sup> On the other hand, the expenses involved make this approach impractical in most circumstances and it is unclear whether such a "sham" registration would actually grant the class exemption.<sup>82</sup> Another barrier to such registration is the possible reluctance of the issuer to cooperate with the dealer by supplying the information necessary for full registration.<sup>83</sup> In recognition of these difficulties, some states have provisions for short-form registration for secondary trading purposes.<sup>84</sup>

Although the "class" registration concept is incorporated in the Uniform Securities Act, it seems to be a vestige of the prior pattern of blue sky laws requiring qualitative approval of registrations. Since secondary transactions based on the "class" registration do not require the delivery of a prospectus, this form of secondary trading provides no insurance of disclosure of information to investors except insofar as the registration statement is a public document.<sup>85</sup> However, this or some similar provision<sup>86</sup> is necessary in order to insure the development of a market for the security.

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81. *Id.* In several states, such class registrations also act to permit secondary trading without limit as to volume or time; *see, e.g.*, IOWA CODE ANN. § 502.7(3) (Supp. 1968); MO. REV. STAT. § 409.402(b)(13) (Supp. 1968). *But see* Mills & Jensen, *The Missouri Uniform Securities Act*, 24 J. Mo. B. 60, 64 (1968), where the authors rely on MO. REV. STAT. § 409.305(i), which permits the Commissioner to require the filing of periodic reports regardless of whether the securities are the subject of a current registration statement.

82. It would certainly seem reasonable to assume that, if the matter came to the attention of a securities administrator, he would require additional information regarding the issuer, require delivery of a prospectus, or revoke the exemption. The determination would depend in part on whether the theory constructive notice applies to information filed with the administrator and whether the administrator himself was concerned with the proprietary or investment aspect of security ownership.

83. This difficulty may be somewhat transparent in view of provisions in the Uniform Securities Act allowing less than the required information to be filed when such information is not known to the registrant. UNIFORM SECURITIES ACT § 305(f).

84. *See* notes 134-41 *infra* and accompanying text.

85. *See* note 35 *supra*.

86. Short form registration for secondary trading purposes, discussed in Section II.D.2 *infra*, is, of course, a variant of this approach and does not require the delivery of a

### B. *Secondary Trading in Exempted Securities*

The blue sky laws generally provide exemption from registration for certain categories of securities. These exemptions apply equally to distributions and to secondary trading.<sup>87</sup> The basis for these exemptions is usually that the securities are adequately regulated, either as to their "fairness" or the availability of information, by other administrative bodies either on the state or federal level, or that they are unlikely to be traded among members of the general public.<sup>88</sup> Included within the former category are securities issued by various governmental bodies,<sup>89</sup> including securities of certain foreign governments,<sup>90</sup> securities issued by banks and insurance companies,<sup>91</sup> securities issued by

prospectus. Another variant which has been adopted by several states parallels the federal exemption for all secondary trading. *See* notes 38-44 *supra* and accompanying text, discussing the federal exemption and notes 129-33 *infra* and accompanying text, discussing the states' adoption of the exemption.

87. The fact that a security itself is exempt (as opposed to being sold in an exempt transaction) is of only minimal importance for purposes of secondary trading. Nevertheless, the distinction should be kept in mind as it affects certain types of transactions. Many transaction exemptions extend only to the seller and to the broker-dealer acting as agent. If an exempt security is involved, the broker-dealer could nonetheless act as principal.

88. *E.g.*, securities issued by charitable or professional organizations (UNIFORM SECURITIES ACT § 402(a)(9)); commercial paper (§ 402(a)(10)); employees benefit plans (§ 402(a)(11)); and cooperatives (§ 402(a)(12)) (optional).

89. UNIFORM SECURITIES ACT §§ 402(a)(1), (2):

(1) any security (including a revenue obligation) issued or guaranteed by the United States, any state, any political subdivision of a state, or any agency or corporate or other instrumentality of one or more of the foregoing; or any certificate of deposit for any of the foregoing;

(2) any security issued or guaranteed by Canada, any Canadian province, any political subdivision of any such province, any agency or corporate or other instrumentality of one or more of the foregoing, or any other foreign government with which the United States currently maintains diplomatic relations, if the security is recognized as a valid obligation of the issuer or guarantor;

90. *Id.*, § 402(a)(2).

91. *Id.*, §§ 402(a)(3)-(6).

(3) any security issued by and representing an interest in or a debt of, or guaranteed by, any bank organized under the laws of the United States, or any bank, savings institution, or trust company organized and supervised under the laws of any state;

(4) any security issued by and representing an interest in or a debt of, or guaranteed by, any federal savings and loan association, or any building and loan or similar association organized under the laws of any state and authorized to do business in this state;

(5) any security issued by and representing an interest in or a debt of, or guaranteed by, any insurance company organized under the laws of any state and authorized to do business in this state; [but this exemption does not apply to an annuity contract, investment contract, or similar security under which the promised payments are not fixed in dollars but are substantially dependent upon the investment results of a segregated fund or account invested in securities;] [*as amended, 1958*]

(6) any security issued or guaranteed by any federal credit union or any credit union, industrial loan association, or similar association organized and supervised under the laws of this state;

common carriers,<sup>92</sup> and securities listed or approved for listing on specified stock exchanges, and securities senior thereto.<sup>93</sup>

With the exception of those issued by governments, the exemption of securities from registration and the consequent allowance of secondary trading to these securities seems to be largely a matter of administrative efficiency. It is doubtful that these exemptions cause any serious deficiency in investor protection. Particularly in regard to the exemption of securities listed on the major stock exchanges, the requirements for listing and the continuing disclosure requirements enforced by the exchanges and the SEC provide considerably greater disclosure to the investor than is available under the other exemptions in favor of secondary trading.<sup>94</sup>

### C. *Secondary Trading By Means of Exempted Transactions*

In addition to exempting whole classes of securities, the blue sky laws generally provide exemptions for certain transactions.<sup>95</sup> It has already been observed, for example, that sales made by an individual investor to his broker-dealer are exempted from the operation of the laws. For the most part these exemptions are concessions to the practical necessities of maintaining a marketplace for securities.

#### 1. *Isolated Transactions*

Section 402(b)(1) of the Uniform Act exempts isolated sales of securities whether or not effected through a broker-dealer.<sup>96</sup> The exemption

92. *Id.*, § 402(a)(7).

(7) any security issued or guaranteed by any railroad, other common carrier, public utility, or holding company which is (A) subject to the jurisdiction of the Interstate Commerce Commission; (B) a registered holding company under the Public Utility Holding Company Act of 1935 or a subsidiary of such a company within the meaning of that act; (C) regulated in respect of its rates and charges by a governmental authority of the United States or any state; or (D) regulated in respect of the issuance or guarantee of the security by a governmental authority of the United States, any state, Canada, or any Canadian province;

93. *Id.*, § 402(a)(8).

(8) any security listed or approved for listing upon notice of issuance on the New York Stock Exchange, the American Stock Exchange, or the Midwest Stock Exchange [, or listed on the (insert names of appropriate regional stock exchanges)]; any other security of the same issuer which is of senior or substantially equal rank; any security called for by subscription rights or warrants so listed or approved; or any warrant or right to purchase or subscribe to any of the foregoing;

94. Compare the disclosure requirements under the Securities Exchange Act § 13, 15 U.S.C. § 78m (1964), with the "manuals exemption," UNIFORM SECURITIES ACT § 402(b)(2), and the discussion of the "manuals exemption" in notes 119-28 *infra* and accompanying text.

95. See note 87 *supra*.

96. UNIFORM SECURITIES ACT § 402(b)(1):

(1) any isolated non-issuer transaction, whether effected through a broker-dealer or not;

is similar in its scope to the exemption of transactions not involving a public offering under federal law<sup>97</sup> except for its limitation to non-issuer transactions.<sup>98</sup> It has been observed that the exemption is based on a de minimis theory to allow non-controlling stockholders, *i.e.*, ones who cannot force the issuer to aid in registration,<sup>99</sup> to dispose of his securities. Although the term "isolated" is indefinite, presumably it would be affected by the same considerations as affect whether an offering is "public" under federal law.<sup>100</sup>

While it is arguable that the exemption amounts to a complete exemption of secondary trading since from the selling investor's standpoint the transaction is isolated, the exemption is actually ineffective for transactions effected on an exchange or in the over-the-counter market.<sup>101</sup> In the first place the exemption extends to the seller and not to the broker-dealer. Since the seller's liability is already exempted if his sale is to a dealer, whether or not for that dealer's own account,<sup>102</sup> it is unnecessary from this standpoint. At the same time, since the offer which the selling investor's broker enters on the market or exchange is effectively made to all dealers or members, it is doubtful that it can truly be termed "isolated."

## 2. Sales to Certain Persons

It has already been observed that sales made to broker-dealers are exempted from the provisions of the blue sky laws.<sup>103</sup> In most states the

97. Securities Act § 4(2), 15 U.S.C. § 77d(2) (1964).

98. Compare UNIFORM SECURITIES ACT § 402(b)(1) with Securities Act § 4(2), 15 U.S.C. § 77d(2) (1964) and UNIFORM SECURITIES ACT § 402(b)(9).

99. See notes 18-21 *supra* and accompanying text.

100. The determination of whether an offer is "public" under federal law depends on a variety of factors, including the number of offerees, their need for information concerning the issuer, their access to information concerning the issuer, and the size of the offering. SEC v. Ralston Purina Co., 346 U.S. 119 (1953); Loss 653-65; R. JENNINGS & H. MARSH, JR., SECURITIES REGULATION—CASES AND MATERIALS 364-84 (2d ed. 1968); Mulford, *Private Placements and Intrastate Offerings of Securities*, 13 BUS. LAW. 297 (1958); Victor & Bedrick, *Private Offering: Hazards for the Unwary*, 45 VA. L. REV. 869 (1959).

101. An offer for sale entered on an exchange or in the over-the-counter market is *prima facie* an offer to the entire world. The fact that the offer may be accepted by as few as one purchaser is irrelevant. See sources cited in note 100 *supra*.

102. UNIFORM SECURITIES ACT § 402(b)(8).

(8) any offer or sale to a bank, savings institution, trust company, insurance company, investment company as defined in the Investment Company Act of 1940, pension or profit-sharing trust, or other financial institution or institutional buyer, or to a broker-dealer, whether the purchaser is acting for himself or in some fiduciary capacity;

103. *Id.*

exemption also extends to sales made to banks, savings institutions, trust companies, insurance companies, investment companies, other financial institutions, or institutional purchasers, whether the purchaser is acting for itself or in some fiduciary capacity.<sup>104</sup>

The exemption is based upon the theory that such purchasers, because of their own financial expertise, are sufficiently able to protect themselves.<sup>105</sup> This is consistent with the aim of the blue sky laws to protect individual investors rather than to inhibit the marketability of securities. Moreover, since banking institutions and fiduciaries are generally regulated by states' "legal investment laws," it is probably unjustified to make the broker-dealer liable for the quality of the security sold.

### 3. *Unsolicited Transactions*

One of the most important exemptions under the current pattern of state regulation of secondary trading is the exemption afforded to transactions executed by broker-dealers based upon unsolicited customer orders.<sup>106</sup> This exemption provides investors who do have access to information concerning the issuer with a means of purchasing non-blue-skied securities without forcing the broker-dealer to assume liability for the "down-side" risk. Since the investor's decision to purchase a non-blue-skied security is not influenced by the broker-dealer,

104. *Id.*

105. The laws of ten states specifically provide that sales to corporations are included in this exemption. *See* Appendix I. Several other states seem to regard corporate purchasers of securities as "institutional investors." *Id.*

It is doubtful that the theoretical justification of financial expertise is always appropriately applied to corporate purchasers. On the other hand, the exemption may be necessary in order to exempt the "sale" of securities to the corporation in a stock for stock merger. The Uniform Securities Act does not adopt the "no-sale" theory found in Securities Act Regulation 133, 17 C.F.R. § 230.133 (1968). While this does not affect many mergers between substantial corporations, because their securities are exempt from registration under the exchange listing exemption, UNIFORM SECURITIES ACT § 402(a)(8), it would present problems where the acquired corporation had more than ten persons. In the latter case, assuming that an investment representation was present, an exemption might be available under UNIFORM SECURITIES ACT § 402(b)(9). The "isolated transaction" exemption would not apply because the selling shareholders would constitute a "controlling group" by definition, putting the transaction beyond the "non-issuer" requirement. *Id.*, § 402(b)(1). The securities administrator is empowered to extend the § 402(b)(9) exemption and this power may offer a partial solution to the problem.

106. UNIFORM SECURITIES ACT § 402(b)(3):

(3) any non-issuer transaction effected by or through a registered broker-dealer pursuant to an unsolicited order or offer to buy; but the [Administrator] may by rule require that the customer acknowledge upon a specified form that the sale was unsolicited, and that a signed copy of each such form be preserved by the broker-dealer for a specified period;

the latter is not forced to assume responsibility for the accuracy of the information upon which the decision is based.

The laws generally provide that customers should acknowledge that the transaction is unsolicited and that the form of such acknowledgement may be prescribed by the state administrator.<sup>107</sup> The administrator is further empowered to require unsolicited transactions to be recorded with his office.<sup>108</sup> No printed forms for acknowledgement have been specified, and some states regard as sufficient mere notation on the confirmation slip that the order was unsolicited.<sup>109</sup> Apart from New Jersey, which requires that the customer's acknowledgement be filed with the state,<sup>110</sup> the administrators take the approach that the broker-dealer need be concerned only with having sufficient evidence to establish the exemption if the customer brings suit.<sup>111</sup> This seeming indifference of the administrators toward determining whether such sales are truly unsolicited demonstrates one of the potential difficulties inherent in relying on the broker-dealer's fear of liability to enforce the blue sky provisions governing secondary trading.

Another problem with the exemption of unsolicited transactions is the absence of authority defining the term "unsolicited." While it is clear that it extends only to secondary transactions and excludes any sale necessitating the use of a prospectus, the status of an advertisement or recommendation accompanied by a disclaimer of solicitation is unclear.<sup>112</sup> Since it is clear that such an advertisement or recommenda-

107. *Id.*

108. UNIFORM SECURITIES ACT § 203(d).

109. Letters from various state securities administrators on file in Washington University Law Library, indicate the following pattern:

- i) no disclaimer required: Alabama, Kentucky, Louisiana, Nebraska, New Mexico, Oklahoma, Texas, Utah;
- ii) disclaimer required, notation on confirmation slip required or recommended: Arkansas, Kansas, South Carolina;
- iii) disclaimer required, no specified form: Colorado, Florida, Illinois, Iowa, Indiana, Michigan, Missouri;
- iv) disclaimer required, no specified form, original must be filed with state: New Jersey.

110. Letter from James L. McKenna, Chief, Bureau of Securities, New Jersey, July 9, 1968, on file in Washington University Law School Library.

111. *Cf.* UNIFORM SECURITIES ACT § 402(d):

(d) In any proceeding under this act, the burden of proving an exemption or an exception from a definition is upon the person claiming it.

112. The following represents a standard disclaimer or "hedge clause" appearing on advertisements or recommendations or market analysis and commentary:

This information is obtained from sources considered reliable, but its accuracy is not guaranteed by A.G. Edwards. Neither the information, nor any opinion which may be expressed constitutes a solicitation by A.G. Edwards for the purchase or

tion creates an interest in secondary trading in the security, allowing their use seems to be beyond the policy which supports the exemption.<sup>113</sup> A partial solution to this difficulty has been the limitation of the unsolicited transaction exemption to agency sales.<sup>114</sup> While this restricts the broker-dealer's interest in the sale to some degree,<sup>115</sup> adequate investor protection in this area requires some disclosure and supervision of a broker-dealer's interest in non-blue-skied securities and some examination for concentrations in "unsolicited" transactions in particular securities to determine whether the broker-dealer is entitled to this exemption.

#### 4. "Qualitative" Exemptions

A variation of the securities exemptions, although available only to non-issuer transactions, is granted to certain "seasoned securities" by Section 402(b)(2)(B) of the Uniform Securities Act. The exemption

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sale of any securities referred to herein. A.G. Edwards and/or its officers, directors or stockholders may have a position in the securities mentioned in this report and may make purchases and/or sales of such securities from time to time in the open market or otherwise.

It is doubtful whether such a disclaimer would be held valid regarding its representation of "non-solicitation"—particularly when the material being circulated is headed "We Recommend."

As noted earlier, Merrill Lynch, Pierce, Fenner & Smith gives a considerably greater indication of the extent of its own and its officers' interests in issuers whose securities appear on its recommended lists. The interests are disclosed as small (less than \$50,000.), moderate (\$50,000. to \$100,000.), or large (over \$100,000.). See note 31 *supra*.

113. It is extremely doubtful that a customer, after being told of a security by his broker, would acknowledge his subsequent purchase of the security to have been unsolicited, or that the acknowledgement would be sufficient. The theory behind the exemption is that since the investor's decision to purchase the security is not fostered by the broker-dealer, the latter should not be forced to assume responsibility for the investor's decision.

114. Although the Uniform Securities Act does not limit the exemption to agency transactions, a sale made as principal by a dealer would at least cast doubt on the unsolicited nature of the transaction. Several states, *e.g.*, Florida, Illinois, Louisiana, Minnesota, Missouri, Ohio, and Texas, do require the broker-dealer to act as agent. See Appendix I. The Wisconsin definition of "sale" as not including agency transactions reaches the same result. WIS. STAT. ANN. § 189.02(3)(a) (1957); see notes 33-34 *supra*, and accompanying text. In Missouri the statute and regulations regarding the unsolicited transaction exemption make it clear that the broker-dealer must act *solely* as the purchaser's agent (rather than as agent for both parties) and receive no compensation or commission from other sources in connection with the transaction. MO. REV. STAT. § 409.402(b)(3) (Supp. 1967); MO. SECURITIES RULES § IX.E. (1968), *appearing in BLUE SKY L. REP.* ¶ 28,609.

115. The broker-dealer may, for example, hold an interest in the security and execute the transaction on an agency basis nonetheless. Moreover, apart from the Missouri provision discussed in note 114 *supra*, the broker-dealer may be acting as agent for the seller as well as the purchaser and receive a commission from both parties.

is available to securities having a fixed maturity date, interest rate, or dividend rate, provided there has been no recent default on the obligation.<sup>116</sup> The apparent basis for this exemption is that such securities are largely conservative investments and that the absence of default and seniority of claims against the issuer in the event of dissolution provide sufficient investor protection. While two states offer a similar exemption to common stocks meeting specified earnings<sup>117</sup> or dividend<sup>118</sup> tests, it is unlikely that these exemptions provide adequate protection. One of the curious aspects of this form of exemption is the absence of a comparable provision in the blue sky laws denying exemption to securities which are otherwise exempt but have interest or preferred dividend arrearages.

### 5. "Manuals Exemptions"

With the exception of the "securities exemption" available to securities listed on exchanges, most secondary trading in securities is exempted from the registration provisions of the blue sky laws under "manuals exemptions" similar to that found in Section 402(b)(2)(A) of the Uniform Securities Act. The exemption is available to the securities of any issuer about whom sufficient information appears in a "recognized securities manual."<sup>119</sup> The exemption is based on the premise that disclosure of information concerning the issuer provides an adequate means for investors to evaluate the risks of investment.<sup>120</sup>

The recognized securities manuals, usually defined by statute or rule as including Standard & Poor's, Moody's and Fitch's manuals,<sup>121</sup> set

116. UNIFORM SECURITIES ACT § 402(b)(2)(B):

(2) any non-issuer distribution of an outstanding security if . . . (B) the security has a fixed maturity or a fixed interest or dividend provision and there has been no default during the current fiscal year or within the three preceding fiscal years, or during the existence of the issuer and any predecessors if less than three years, in the payment of principal, interest, or dividends on the security.

117. MO. REV. STAT. §§ 409.302(a), 402(b)(14) (Supp. 1967).

118. VA. CODE ANN. § 13.1-514(b)(3) (Supp. 1968).

119. UNIFORM SECURITIES ACT § 402(b)(2)(A):

(2) any non-issuer distribution of an outstanding security if (A) a recognized securities manual contains the names of the issuer's officers and directors, a balance sheet of the issuer as of a date within eighteen months, and a profit and loss statement for either the fiscal year preceding that date or the most recent year of operations, . . . .

120. The inclusion of this type of exemption in blue sky laws rather than a complete exemption of secondary trading would seem to support the position that the object of regulation of secondary trading is assuring disclosure of information to the investment community in general.

121. A table of states having manual exemptions and listing the approved manuals appears in BLUE SKY L. REP. at 831-33.

forth a summary of the issuer's history and a synopsis of the information appearing in the latest annual report. In addition to the bound volumes, the manuals are supplemented periodically with more recent information concerning the activities and financial position of the companies.

Despite the functional importance of the exemption for the over-the-counter securities industry, it is doubtful that the exemption is justified by either the disclosure or the regulatory approach of the blue sky laws.

The decision as to what securities are included in the manuals is left entirely to their publishers. While the publishers base their considerations on the size of the issuer and the interest in the securities, there is no systematic manner in which the inclusion of a listing can be obtained.<sup>122</sup> This can result in the exclusion of companies which are financially sound but have only recently become publicly held, while the exemption may be granted to speculative securities on the basis of "interest".

Another difficulty with the manuals exemption is that the type of information presented in the manuals is not necessarily uniform, making comparative evaluations difficult. Given the summary form of presentation which the manuals use, detailed notes to financial statements are usually excluded. Considerably less information is available than that which is publicly available under Section 13 of the Securities Exchange Act<sup>123</sup> and the disclosure is far short of that required to be

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122. Standard & Poor's indicates that \$1,000,000 in assets and 200 shareholders are basic prerequisites to inclusions in its Corporation Records. Letter to Commerce Clearing House, Inc., Dec. 16, 1957, in *BLUE SKY L. REP.* at 833-34. The following letter from Moody's Investors Service is also indicative:

There is no fixed requirement or qualification for companies and their securities to be listed in Moody's Manuals. These factual publications endeavor to include all companies and securities in which there is sufficient public interest to justify the use of space required to show the full statement and details of the company for the benefit of subscribers and users.

The factor of credit and liability is not a qualification for the inclusion of a company in Moody's factual publications. In other words, it 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 to Commerce Clearing House, Inc., Dec. 30, 1957, in *BLUE SKY L. REP.* at 833.

Frank J. Healy, Corporation Commissioner of Oregon, makes the following statement in his letter to the *WASHINGTON UNIVERSITY LAW QUARTERLY*:

At the time we incorporated [the manual] exemption in our law, it was our understanding that the securities listed in the manuals were not listed unless there was an important public market for the securities. This policy however appears to have been changed.

. . . . This experience has indicated to me that this exemption provides a substantial loophole for those states that may deny registration of an initial issue. I am considering suggesting an amendment to this section to require that before the manual exemption is available, a market must have existed for a specified period.

Letter of June 28, 1968, on file in Washington University Law Library.

123. Securities Exchange Act §§ 12, 13, 15 U.S.C. §§ 78l, m (1964).

filed in a registration statement under the Securities Act of 1933.<sup>124</sup> Moreover, neither civil nor criminal liability attaches for misstatements or omissions of material information contained in the manuals.

Finally, since there is no requirement that the investor be apprised of the information presented in the manual in order for the exemption to be available, it is doubtful that effective disclosure is provided. Although copies of the manuals are presumably available for reference, most investors are without direct or indirect access to them.

The securities administrators are empowered to review manual listings and to deny the exemption with regard to specific transactions either on qualitative grounds or because it is felt that insufficient information is presented.<sup>125</sup> Such a denial is rarely invoked, perhaps because a meaningful review of the listings would be beyond the capabilities of a single securities commission.<sup>126</sup>

In making the concession to the industry which the manuals exemption does, the blue sky laws have relinquished effective control over secondary trading. At least one securities commissioner regards the exemption as providing a "substantial loophole" in the regulatory process.<sup>127</sup> Even from the industry's standpoint the manuals exemption is of questionable value. While it is a practical necessity in most states at the present time, it does not provide a particularly satisfactory means of determining whether the exemption is available. Listings must be thoroughly and continually checked for compliance with the various requirements found in the statutes.<sup>128</sup>

#### D. *Secondary Trading Under Special Provisions*

In addition to the provisions contained in the Uniform Securities Act which have been discussed, several states have enacted specific provisions regarding secondary trading. While some states have completely exempted secondary trading from registration and relied upon

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124. Securities Act § 7 & Schedule A, 15 U.S.C. §§ 77g, aa (1964).

125. See note 75 *supra*.

126. Continual analysis of financial information bearing on a minimum of 25,000 companies would be involved. A suggestion is made, at note 150 *infra*, that such an undertaking might be made by the Conference of State Securities Administrators which could recommend denial of the exemption to specified securities.

127. Letter from Frank J. Healy, Corporation Commissioner of Oregon, to the WASHINGTON UNIVERSITY LAW QUARTERLY, JUNE 28, 1968, on file in Washington University Law Library. The text of the letter is quoted in note 122 *supra*.

128. The burden is on the broker-dealer to establish its claim to the manuals exemption. UNIFORM SECURITIES ACT & 402(d). A suggestion is made, note 150 *infra*, that an industry group, such as the National Association of Securities Dealers, undertake analysis of the manuals and the exemptions and supply members of the group with authoritative information regarding the blue-sky status of securities.

anti-fraud provisions, others have introduced "short-form" registration procedures specifically adapted to secondary trading or created special transaction exemptions based on the availability of information to investors. In view of the shortcomings cited in the Uniform Securities Act, some of these provisions seem particularly worthy of note.

### 1. *Secondary Trading Exemptions*

Several states have approached the problem of regulating secondary trading by following the federal pattern and exempting all non-issuer transactions, whether effected through a broker-dealer or not.<sup>129</sup> The only state to specifically incorporate the federal law in its blue sky law is New Jersey, which exempts from civil liability transactions exempted by Section 4 of the Securities Act of 1933.<sup>130</sup> These exemptions differ from the "isolated transactions" exemptions discussed *supra* by extending their exemption to the purchaser's broker-dealer.<sup>131</sup> States following this pattern of regulation rely on general anti-fraud provisions and more intense supervision of broker-dealer activities in order to prevent the sale of worthless securities. Generally such exemptions are also subject to broad authority in the administrator to suspend trading in questionable issues. The somewhat narrower exemptions available in Wisconsin, Louisiana and West Virginia for certain agency transactions have previously been discussed.<sup>132</sup> While such exemptions are preferable from the industry standpoint, most states desire greater substantive control over secondary trading, particularly in view of the breadth of exemption under federal law.

### 2. *Short-Form Registration Provisions*

In the realization that the registration provisions applicable to new issues of securities are not well adapted to the registration of securities for secondary trading, seven states have adopted special provisions for such purposes. The procedures vary considerably in the amount of

129. See notes 37-43 *supra* and accompanying text. See also Appendix I.

130. N.J. STAT. ANN. § 49:3-60(b) (Supp. 1968) declares it unlawful to sell any security unless ". . . (b) the security or transaction is not subject to, or is exempted from, the registration requirements of the Securities Act of 1933 and the rules and regulations thereunder; other than by reason of section 3(a) of such act and the rules and regulations under said section 3(a);". Despite the presence of this blanket exemption, New Jersey has retained the other secondary transaction exemptions found in the Uniform Securities Act. N.J. STAT. ANN. § 49:3-50(b) (Supp. 1968).

131. See notes 96-102 *supra* and accompanying text.

132. LA. REV. STAT. ANN. § 51:705(10) (1965); W VA CODE ANN. § 32-1-4(j) (1966); WIS. STAT. ANN. § 189.02(3)(a) (1957); see notes 29 & 33-34 *supra* and accompanying text.

information required to be filed with the administrator and in the eligibility for such filing.

In Florida<sup>133</sup> and North Dakota<sup>134</sup> registration by announcement is available for any security which has been publicly outstanding for more than one year. Simple notice to the securities commission by telegram is sufficient, and while the registration can be denied at a later time, it takes effect immediately on filing.<sup>135</sup> Kansas,<sup>136</sup> New Mexico,<sup>137</sup> and Rhode Island<sup>138</sup> will grant registration, subject to prior approval from the commission, if a dealer provides the information that would be necessary to obtain a manual exemption. Illinois<sup>139</sup> and Texas<sup>140</sup> are more restrictive regarding the information which must be filed and include an earnings test among the eligibility requirements.

Although these registration provisions offer some control over the securities being sold while enlarging the number of securities eligible for sale, they do not provide any means for disseminating information regarding the issuer to the investing public.

### 3. *Transaction Exemptions Based on Federal Disclosure*

An exemption recently enacted in the Missouri Securities Act and based on the 1964 amendments to the Securities Exchange Act offers a considerable improvement both in theory and practice in providing effective disclosure to investors.<sup>141</sup> The exemption permits secondary

133. FLA. STAT. ANN. § 517.091 (Supp. 1968).

134. N.D. CENT. CODE ANN. § 10-04-07.1 (Supp. 1967).

135. FLA. STAT. ANN. § 517.091 (Supp. 1968); N.D. CENT. CODE ANN. § 10-04-07.1 (Supp. 1967).

136. Kan. Laws 1967, ch. 121, *appearing as* § 17-1261(m) in BLUE SKY L. REP. ¶ 19,110.

137. N.M. STAT. ANN. § 48-18-22(B)(2) (1966).

138. R.I. GEN. LAWS § 7-11-6(a) (Supp. 1967). The only difference between registration for secondary trading purposes and registration for distributions in Rhode Island is in the amount of the filing fee.

139. ILL. ANN. STAT. ch. 121 1/2, § 137.4(F)(2) (Smith-Hurd Supp. 1968).

140. TEX. REV. CIV. STAT. ANN. art. 581, § 5(O)(9) (Supp. 1968).

141. MO. REV. STAT. § 409.402(b)(15) (Supp. 1967):

(15) any non-issuer transaction by a person who does not control, and is not controlled by or under common control with, the issuer if (i) the transaction is at a price reasonably related to the current market price, (ii) the security is registered with the United States Securities and Exchange Commission under Section 12 of the Securities Exchange Act of 1934 and the issuer files reports with the United States Securities and Exchange Commission pursuant to Section 13 of that Act, and (iii) a copy of the registration statement filed with the United States Securities and Exchange Commission has been filed with the Commissioner, together with copies of such other reports and exhibits as he may by rule or order require.

*See* Mills & Jensen, *The Missouri Uniform Securities Act*, 24 J. Mo. B. 60, 67 (1968), in which the drafters of the provision discuss the reasons behind this variation from the Uniform Securities Act.

trading of securities whose issuers are registered under Section 12 of the Exchange Act and required to file reports under Section 13 of the Exchange Act provided a copy of the report is also filed with the Missouri Commission. In Missouri, where the exemption is used in conjunction with the manual exemption it does not significantly increase the number of securities exempted.<sup>142</sup> On the other hand, it represents an exemption which is both easier for the industry to follow and which potentially provides more adequate disclosure to the investing public.<sup>143</sup>

California also relies upon disclosure provisions of the Exchange Act as a means of providing investor protection under its new blue sky law. If the issuer of the security is registered under Section 12 of the Exchange Act, the security is exempted from the registration requirement applicable to nonissuer transactions.<sup>144</sup>

#### 4. Reports of Sales

Although the securities administrators are generally vested with powers to require broker-dealers to file reports disclosing their activities

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The proposed draft of a new blue sky law for Wisconsin, modelled on the Uniform Securities Act, contains a transaction exemption similar to Missouri's innovation in lieu of the manual exemption. Wisconsin Uniform Securities Law, Draft of Nov. 4, 1968, § 551.23(3), on file Washington University Law Library.

142. Indeed the manual exemption may be somewhat broader in this respect. Whereas federal filing is required of issuers involved in interstate commerce (or whose securities are traded in interstate commerce) whose assets exceed \$1,000,000 and have more than 500 shareholders of record, the manual exemption may be available to intrastate issuers with as few as 200 shareholders. Compare Securities Exchange Act § 12(d), 15 U.S.C. § 781(d) (1964) with letters to Commerce Clearing House, Inc., note 122 *supra*.

143. Compare Securities Exchange Act §§ 12, 13, 15 U.S.C. §§ 781, m (1964) with letters to Commerce Clearing House, Inc., note 122 *supra*. See also Wisconsin Monthly Securities Bulletin, October, 1968, on file Washington University Law Library, in which the proposed elimination of the manual exemption in favor of an exemption based on Sections 12 & 13 of the Securities Exchange Act is defended on the basis of express periodic filing requirements found in the latter.

144. CAL. CORP. CODE §§ 25101, 25130 (Deering Supp. 1969). The exemption extends to Any security issued by a person which is the issuer of any security registered under Section 12 of the Securities Exchange Act of 1934 or exempted from such registration by Section 12(g)(2)(G) of that act or which is an investment company registered under the Investment Company Act of 1940; provided, however, that this exemption does not apply to such securities offered pursuant to a registration under the Securities Act of 1933 or pursuant to a registration under Regulation A under that act if the aggregate offering price of the securities offered under such exemption exceeds fifty thousand dollars (\$50,000).

The provision will not really take effect until May 1, 1969, since the regulations issued under the California Securities Law of 1968 extended the prior "blanket" exemption of secondary trading until that date. CAL. ADM. CODE tit. 10, § 260.105.3 (1969).

California also provides a transaction exemption which resembles its former "blanket" exemption of secondary trading and may give rise to some problems of statutory

in particular securities,<sup>145</sup> only Wisconsin requires the filing of reports of sales on a regular basis.<sup>146</sup> Reports of all principal transactions and certain solicited agency transactions must be filed.<sup>147</sup> The requirement provides the Securities Commissioner with an effective means of discovering violation of the registration provisions of the Act and a basis for investigating possible abuses arising from the broker-dealer's direct interest in such sales.<sup>148</sup>

### CONCLUSION

In the course of the preceding examination of the current regulatory pattern governing secondary trading in securities, certain aspects of both the registration provisions and the exemptions from registration have been criticized as being inconsistent with the essential goals of blue sky regulation: disclosure of information regarding the issuers of securities to the investment community at large. The present pattern

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construction under the new act. The exemption extends to

Any offer or sale of a security by the bona fide owner thereof for his own account if the sale (1) is not accompanied by the publication of any advertisement and (2) is not effected by or through a broker-dealer in a public offering. CAL. CORP. CODE § 25104(a) (Deering Supp. 1969) (emphasis added). In view of the general registration requirement applicable to nonissuer transactions under Section 25130, this exemption is apparently intended to be analogous to the "isolated transaction" exemption under the Uniform Securities Act. UNIFORM SECURITIES ACT § 402(b)(1); see note 92 *supra* and accompanying text. On the other hand, there is no indication in either the California law or its regulations as to the meaning of a "public offering" by a broker-dealer in this context. Similarly, there is no indication as to the manner in which the number of offerees is to be computed. While it is arguable that the presence of this exemption means that only nonissuer *distributions* rather than securities involved in secondary trading must be registered under the new law, that approach seems inconsistent with the statutory definition of nonissuer transaction as being any transaction "not directly or indirectly for the benefit of the issuer." CAL. CORP. CODE § 25011 (Deering Supp. 1969).

145. UNIFORM SECURITIES ACT § 203.

146. WIS. STAT. ANN. § 189.04(5) (1957):

(5) The department may require dealers to submit reports of sales of securities at such times and in such forms as it may prescribe, may fix fair and reasonable maximum charges, profits, commissions or other compensation in or for the sale of securities and may establish such other rules and regulations for the conduct of the business of dealers, agents and investment advisers as may be reasonable and necessary to assure compliance with this chapter.

Similar provisions, somewhat broader than those found in the Uniform Securities Act, would be retained in the proposed revision of the Wisconsin law. Wisconsin Uniform Securities Law, Draft of Nov. 4, 1968, § 551.33, on file in Washington University Law Library.

147. Wisconsin Securities Regulation § 1.07, WIS. ADM. CODE ch. SEC 1, § 1.07 (1968), appearing in BLUE SKY L. REP. ¶ 52,607.

148. See notes 29-32 *supra* and accompanying text.

is not satisfactory in disseminating information to the investor (or in insuring its availability to investors), in providing the securities administrators with effective means of controlling secondary trading, nor in providing the industry with a means of effectively functioning in compliance with the blue sky laws.

On the other hand, the basic ingredients of more effective regulation of secondary trading are contained in some of the "aberrations" from the Uniform Securities Act. Drawing upon the experience of those states whose laws reflect a more considered appraisal of the nature of secondary trading in securities, the following alterations in the Uniform Securities Act are suggested:<sup>149</sup>

1. Replacement of the manuals exemption by an exemption based on the filing requirements of Sections 12 & 13 of the Securities Exchange Act.
2. Adoption of special registration procedures applicable to secondary trading.
3. Require broker-dealers to deliver or offer to deliver a short-form prospectus to purchasers of securities registered under (2).
4. Require broker-dealers to file periodic reports with the securities administrator listing the following:
  - (a) all principal transactions,
  - (b) all unsolicited transactions,
  - (c) all securities in which they "make a market" for other dealers,
  - (d) all securities beneficially owned by the broker-dealer and by its partners or officers and directors as a group.

While remaining compatible with the other provisions of the blue sky laws, and while preserving each state's right to deny an exemption to particular securities and to set its own requirements for registration, these proposals would seem to more adequately serve the interests of both the investor and the industry.<sup>150</sup>

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149. Specific statutory proposals are set forth in Appendix II, along with commentary on the sources and purposes of each proposal.

150. Alternative proposals, not requiring legislative action, are (1) that the Conference of State Securities Administrators create a joint office for the examination and evaluation of securities traded under the manual exemption and (2) that the National Association of Securities Dealers provide a computerized service to broker-dealers which would reflect the blue sky status of all securities traded in the over-the-counter market. While such actions would not correct the theoretical deficiencies in the present regulatory pattern, they would lessen the present inadequacies of the manual exemption and make compliance with the blue sky laws easier for the part of broker-dealers.

## SECONDARY TRADING IN SECURITIES: LABYRINTH BENEATH THE BLUE SKY

APPENDIX I: *Statutory Provisions Regulating Secondary Trading*

This Appendix is intended as a practical guide through the labyrinth of statutory provisions regulating secondary trading in securities.<sup>1</sup> In order for a security to be "blue-skied," i.e., lawfully sold by or through a broker-dealer, the security must be either registered with the state securities authority or exempted from such registration or sold in an exempted transaction. Since full registration of a security is inappropriate for secondary trading, this Appendix concentrates on the exemptions from and alternatives to full registration. The Appendix is presented in three sections. Part A presents the statutory citations containing provisions regulating secondary trading in each state. Part B presents the exemptions under which secondary trading occurs without registration and lists the states in which the exemptions are available. Part C discusses the short form registration procedures available in some states to provide registration or exemption of a security for secondary trading purposes.

A. *Statutory Citations*

The exemptions from registration in the Uniform Securities Act are placed in Section 402. States which have adopted the Uniform Securities Act in whole or in part are indicated by an asterisk following the state name.

STATE	STATUTORY CITATION	CCH BLUE SKY L. REP. CITATION
ALABAMA*	ALA. CODE tit. 53, §§ 37, 38 (Supp. 1967).	¶¶ 5210, 5211.
ALASKA*	ALASKA STAT. § 45.55.140 (Supp. 1968).	¶6014.
ARIZONA	ARIZ. REV. STAT. ANN. §§ 44-1843, -1844, -1845, -1846, -1847; Arizona Laws 1968, ch. 186 §1 as appearing in BLUE SKY L. REP. ¶¶ 6133, 6134, 6135, 6136, 6137.	¶¶ 6133, 6134, 6135, 6136, 6137.
ARKANSAS*	ARK. STAT. ANN. § 67-1248 (1966).	¶ 7114.
CALIFORNIA	CAL. CORP. CODE §§ 25,101, 25,102, 25,104, 25,130 (Deering Supp. 1969); CAL. ADM. CODE tit. 10, § 260.105.3 (1969).	¶¶ 8131, 8132, 8135, 8161.
COLORADO*	COLO. REV. STAT. ANN. § 125-1-13 (1963).	¶ 9113.

1. Changes published or effective as of January 2, 1969, are reflected in this Appendix.

STATE	STATUTORY CITATION	CCH BLUE SKY L. REP. CITATION
CONNECTICUT	The Connecticut Securities Act relies on broker-dealer registration and does not require the registration of securities. The antifraud provisions of the Act do give rise to civil liability. CONN. GEN. STAT. REV. § 53-312 (1958), §§ 36-338, 36-346 (Supp. 1967).	¶¶ 10,162, 10,119, 10,127.
DELAWARE	Delaware has no securities registration statute.	¶ 11,101.
DISTRICT OF COLUMBIA*	Although the Uniform Securities Act was adopted for the District of Columbia, the Act was modified and does not require the registration of securities. D.C. CODE § 2-2401 <i>et seq.</i> (1967).	¶ 12,101.
FLORIDA	FLA. STAT. ANN. §§ 517.091, 517.05, 517.06 (1962).	¶¶ 13,109A, 13,105, 13,106.
GEORGIA	GA. CODE ANN. tit. 97, §§ 106, 107 (1968).	¶¶ 14,105, 14,106.
HAWAII*	HAWAII REV. LAWS §§ 199-4, 199-5 (Supp. 1961).	¶¶ 14,704, 14,705.
IDAHO*	IDAHO CODE ANN. §§ 30-1434, -1435 (1967).	¶¶ 15,134, 15,135.
ILLINOIS	ILL. ANN. STAT. ch. 121½, §§ 137.3, 137.4 (Smith-Hurd Supp. 1968).	¶¶ 16,203, 16,204.
INDIANA*	IND. ANN. STAT. §§ 25-855, 25-868 (Supp. 1968).	¶¶ 17,102, 17,115.
IOWA	IOWA CODE ANN. §§ 502.4, 502.5 (Supp. 1968).	¶¶ 18,104, 18,105.
KANSAS*	KAN. GEN. STAT. ANN. §§ 17-1261, -1262 (1964); Kan. Laws 1967, ch. 121, <i>as appearing in</i> BLUE SKY L. REP. ¶¶ 19,110, 19,111.	¶¶ 19,110, 19,111.
KENTUCKY*	KY. REV. STAT. ANN §§ 292.400 -410 (Supp. 1968).	¶¶ 20,111, 20,112.
LOUISIANA	LA. REV. STAT. ANN. §§ 51:704, -:705 (1965).	¶¶ 21,104, 21,105.
MAINE	ME. REV. STAT. ANN. tit. 32, §§ 873, 874 (Supp. 1968).	¶¶ 22,123, 22,124.



STATE	STATUTORY CITATION	CCH BLUE SKY L. REP. CITATION
NEW YORK	New York does not require registration of securities for secondary transaction purposes. The anti-fraud provision is applicable, however. N.Y. GEN. BUS. LAW § 352-c (McKinney 1968).	¶ 35,102-2.
NORTH CAROLINA	N.C. GEN. STAT. §§ 78-3, -4 (1967).	¶¶ 36,103, 36,104.
NORTH DAKOTA	N.D. CENT. CODE ANN. §§ 10-04-05, 10-04-06, 10-04-07.1 (Supp. 1967).	¶¶ 37,105, 37,106, 37,107-1.
OHIO	OHIO REV. CODE ANN. §§ 1707.02, 1707.03 (Page Supp. 1967).	¶¶ 38,102, 38,103.
OKLAHOMA*	OKLA. STAT. ANN. tit. 71, § 401 (Supp. 1968).	¶ 39,151.
OREGON*	ORE. REV. STAT. §§ 59.025, 59.035 (Supp. 1968).	¶¶ 40,203, 40,204.
PENNSYLVANIA	The Pennsylvania Securities Act relies on regulation of broker-dealers rather than registration of securities. Broker-dealers may be required, however, to file reports of sales. PA. STAT. ANN. tit. 70, § 44 (Supp. 1965).	¶ 41,114.
PUERTO RICO*	P.R. LAWS ANN. tit. 10, § 882 (Supp. 1967).	¶ 41,714.
RHODE ISLAND	R.I. GEN. LAWS §§ 7-11-6, -8, -9; R.I. LAWS 1968, ch. 195, §§ 6, 8, 9, <i>as appearing in</i> BLUE SKY L. REP. ¶¶ 42,106, 42,108, 42,109.	¶¶ 42,106, 42,108, 42,109.
SOUTH CAROLINA*	S.C. CODE ANN. §§ 62-51, -52 (1962).	¶¶ 43,222, 43,223.
SOUTH DAKOTA	S.D. CODE §§ 1903, 1904 (1939) <i>as amended</i> by S.D. LAWS 1965, ch. 235, §§ 1-4, S.D. LAWS 1965, ch. 236, § 1, <i>as appearing in</i> BLUE SKY L. REP. ¶¶ 44,103, 44,104.	¶¶ 44,103, 44,104.
TENNESSEE	TENN. CODE ANN. §§ 48-1619, 48-1632 (1964).	¶¶ 45,119, 45,132.
TEXAS	TEX. REV. CIV. STAT. ANN. art. 581, §§ 5, 6 (1964).	¶¶ 46,105, 46,106.

UTAH*	UTAH CODE ANN. § 61-1-14 (Supp. 1967).	¶ 47,314.
VERMONT	VT. STAT. ANN. tit. 9, §§ 4203, 4204.	¶¶ 48,103, 48,104.
VIRGINIA*	VA. CODE ANN. §§ 13-1-514, -514.1 (Supp. 1968).	¶¶ 49,214, 49,214.1.
WASHINGTON*	WASH. REV. CODE ANN. §§ 21. 20.310, 20.320 (1961).	¶¶ 50,132, 50,133.
WEST VIRGINIA	W. VA. CODE ANN. §§ 32-1-3, -4 (1966).	¶¶ 51,103, 51,104.
WISCONSIN	WIS. STAT. ANN. § 189.02(3)(a) (1957), 189.06, 189.07 (Supp. 1968).	¶¶ 52,102, 52,106, 52,107.
WYOMING*	WYO. STAT. ANN. § 17-117.14 (1965).	¶ 53,114.

### B. Exemptions Available for Secondary Trading

Secondary trading may lawfully occur with regard to outstanding securities of a class of securities which is registered. The exemptions listed below, however, may be denied to particular securities or to particular transactions by order of the appropriate state securities administrator.

#### 1. Secondary Trading Exemptions

The following states do not require registration of securities for purposes of secondary trading:

- California (until May 1, 1969)
- Connecticut
- Delaware
- District of Columbia
- Nevada
- New Jersey
- New York
- Pennsylvania

As a result of this complete exemption, the above-named states (other than California whose exemption expires May 1, 1969) are not included elsewhere in this list.

In addition to the states which exempt all secondary trading, Louisiana,<sup>2</sup> West Virginia<sup>3</sup> and Wisconsin<sup>4</sup> exempt all secondary trading provided the transactions are conducted on an agency basis. In West Virginia this exemption is available only to registered broker-dealers. In Wisconsin the exemption applies only to transactions in

2. LA. REV. STAT. ANN. § 51:705(10) (1965).

3. W. VA. CODE ANN. § 32-1-4(j) (1966).

4. WIS. STAT. ANN. § 189.02(3)(a) (1957).

which the broker-dealer receives no more than the minimum commission established by the New York Stock Exchange.

## 2. *Security Exemptions*

a. *Government securities.*<sup>5</sup> All states exempt securities issued by or guaranteed by the United States Government, the government of any state or territory, or any political subdivision thereof.

All states *except* the following exempt securities issued by or guaranteed by any foreign government having diplomatic relations with the United States and having the power of taxation:

Georgia

Iowa (does exempt Canadian government securities)

Kansas (does exempt Canadian government securities)

Maine (does exempt Canadian government securities)

Massachusetts

Minnesota (does exempt Canadian government securities)

Mississippi

New Hampshire (does exempt Canadian government securities)

North Dakota

Rhode Island

Tennessee

West Virginia

b. *Financial institutions' securities.*<sup>6</sup> All states exempt securities issued by insurance companies licensed to do business within the state. All states except Kansas and Wisconsin exempt securities issued by national or state banks. Kansas and Wisconsin exempt securities issued by banks only for banks located within the state and subject to the control of the state banking authority.

c. *Public utilities' & common carriers' securities.*<sup>7</sup> All states *except* those listed below exempt securities issued by or guaranteed by common carriers or public utilities if the issuer of the security is (a) subject to the jurisdiction of the Interstate Commerce Commission; (b) registered with the Securities and Exchange Commission under the Public Utility Holding Company Act of 1935; (c) regulated with respect to its rates and charges by federal or state governmental agencies; or (d) regulated with respect to the issuance of its securities by federal or state governmental authority:

Maine

New Hampshire

5. The text of the Uniform Securities Act provisions are set forth in note 89 of this Note.

6. The text of the Uniform Securities Act provision is set forth in note 91 of this Note.

7. The text of the Uniform Securities Act provision is set forth in note 92 of this Note.

Oregon (exempts such securities only if the issuer is supervised by the appropriate Oregon authority)

Wisconsin (exempts such securities only if the issuer is supervised by the appropriate Wisconsin authority)

d. *Securities listed on certain exchanges.*<sup>8</sup> Securities listed or approved for listing on the New York Stock Exchange, or securities senior thereto, or rights or warrants to purchase such securities, are exempt in all states except Wisconsin.

Securities listed or approved for listing on the American Stock Exchange, or securities senior thereto, or rights or warrants to purchase such securities, are exempt in all states except California, Michigan, and Wisconsin.

Securities listed or approved for listing on the Midwest Stock Exchange, or securities senior thereto, or rights or warrants to purchase such securities, are exempt in all states except California, Maine, Michigan, New Hampshire and Wisconsin.

### 3. *Transaction Exemptions*

a. *"Unsolicited transactions."*<sup>9</sup> Unsolicited transactions are exempt in all but the following states:

Arizona  
Georgia  
Massachusetts  
Mississippi  
North Carolina  
Tennessee

The following states exempt unsolicited transactions only if the broker-dealer or representative acts as agent in the transaction:

Florida  
Illinois  
Minnesota  
Missouri  
New Hampshire  
Ohio  
Texas

All states recognizing the unsolicited transaction exemption specify that the administrator of the law may require specified form in order to establish the exemption. At present no state has adopted such a form. Letters from customers stating that a transaction is unsolicited

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8. The text of the Uniform Securities Act provision is set forth in note 93 of this Note. See also BLUE SKY L. REP. at 851-71, presenting in tabular form the applicable exchange listing exemptions for each state.

9. The text of the Uniform Securities Act provision is set forth in note 106 of this Note.

should be obtained, reciting the name of the security and the issuer, the price, the number of shares and the date purchased. The confirmation slip to the customer should note that the sale was unsolicited.

b. "*Isolated transactions.*"<sup>10</sup> Isolated transactions, whether or not effected through a broker-dealer, are exempt in all states but the following:

New Hampshire  
Ohio  
Texas  
Wisconsin

The following states exempt isolated transactions only if the broker-dealer or representative acts on an agency basis in selling the securities:

Minnesota  
Mississippi

Despite the general inclusion of this provision in blue sky laws, the exemption extends only to the seller and would not be available to broker-dealers involved in secondary trading.

c. *Sales to certain persons.*<sup>11</sup> Sales made to banks, savings institutions, trust companies, investment companies, other financial institutions or institutional purchasers, or to a securities dealer, are exempted, whether the purchaser is acting for itself or in some fiduciary capacity, in all states subject to the following variations:

Minnesota: exempts only sales to banks or financial institutions which are regulated by the U.S. or a state government.  
New Hampshire: exempts only sales to banks or financial institutions which are regulated by the U.S. or a state government.  
Rhode Island: exempts only sales to banks, trust companies, or insurance companies supervised by Rhode Island authorities and only when made for their own account.  
Vermont: exempts only sales to other securities dealers.

Only the following states specifically include sales made to corporations within the scope of this exemption:

Florida  
Georgia  
Illinois  
Louisiana  
Massachusetts  
North Carolina

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10. The text of the Uniform Securities Act provision is set forth in note 96 of this Note.

11. The text of the Uniform Securities Act provision is set forth in note 102 of this Note.

North Dakota  
Virginia

d. "*Manuals exemptions.*"<sup>12</sup> Many states do not require registration for secondary trading if certain information concerning the issuer of the security is available in a recognized financial manual. The following states do *not* have such an exemption:

California  
Massachusetts  
New Hampshire  
Rhode Island  
Vermont  
West Virginia  
Wisconsin

In most states, the information listed in the manual must include: (i) the names of the issuer's officers and directors; (ii) a balance sheet of the issuer as of a date within eighteen months; and (iii) a profit and loss statement for either the fiscal year preceding that date or the most recent year of operations.

The exemption is available in the following states only if the specified additional information is also found in the manual:

Florida: must have profit and loss statement for two preceding years unless in existence for a shorter period of time.

Illinois: must have a profit and loss statement for two preceding years unless in existence for a shorter period of time and must be a U.S. corporation.

Iowa: the issuer must be a going concern.

Michigan: the issuer (including any predecessors) must have been in continuous operation for at least five years before the exemption is available.

Minnesota: the issuer must have been in existence for five years, not in default on any obligations, and have funds available for dividends on common stock (i.e., retained earnings), must be a U.S. corporation, and market price must not be greater than 25 times average earnings for the past three to five years.

North Dakota: the issuer must have been in continuous operation for the past three years and have a net profit from operations in the last three to five years.

Tennessee: must have a profit and loss statement for two preceding years unless in existence for a shorter period.

Texas: must include a statement of the issuer's principal business

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12. The text of the Uniform Securities Act provision is set forth in note 119 of this Note. See also BLUE SKY L. REP. at 831-33, presenting in tabular form a listing of the manuals recognized in each state.

and a profit and loss statement for three preceding years unless in existence for a shorter period.

e. *Miscellaneous transaction exemptions.* Three states have additional transaction exemptions available for secondary trading purposes.

Missouri exempts non-issuer transactions in the following classes of securities: (i) any security which is of a class previously registered or exempt from registration at the time of distribution in Missouri;<sup>13</sup> (ii) any security whose issuer (and any predecessor) has been in continuous operation for at least five years and (A) there has been no default on any fixed obligations by the issuer within the past three years, and (B) the issuer has had average net earnings during the past three years applicable to all securities without a fixed dividend or interest provision equal to at least 5% of the market price (i.e., shares may not sell at more than 20 times average earnings);<sup>14</sup> (iii) any security which is registered with the Securities and Exchange Commission under Section 12 of the Securities Exchange Act and files reports with the SEC under Section 13 of the Securities Exchange Act.<sup>15</sup>

California exempts securities from its non-issuer registration requirement provided the issuer of the security is registered under Section 12 of the Securities Exchange Act and securities of issuers who qualify as investment companies under the Investment Company Act of 1940.<sup>16</sup>

Virginia exempts non-issuer transactions in securities which have been outstanding in the hands of the public for five years *provided* that the issuer has paid dividends on such securities during the past three years aggregating 4% of the current market price.<sup>17</sup>

### C. *Short-Form Registration Procedures*

Several states have enacted special provisions granting either registration or exemption from registration of securities which are not otherwise exempted for purposes of secondary trading. Since there is little uniformity in these provisions, they are summarized below for each state having such provisions.

ARIZONA—The securities commission has the authority to provide additional securities and transaction exemptions where it finds that registration of the security is not necessary for the protection of investors by reason of the special characteristics of the securities or the transactions.<sup>18</sup>

13. MO. REV. STAT. § 409.402(b)(13) (Supp. 1967).

14. *Id.*, § 409.402(b)(14).

15. *Id.*, § 409.402(b)(15). This provision is set out in full in note 142 of this Note.

16. CAL. CORP. CODE § 25101 (Deering Supp. 1969).

17. VA. CODE ANN. § 13.1-514(b)(3) (Supp. 1968).

18. ARIZ. REV. STAT. ANN. § 44-1845 (Supp. 1968).

**FLORIDA**—If there has been a prior public offering of the security and the security has been outstanding for at least one year, registration may take place by “announcement.” Secondary trading in the security may begin upon the filing of the following information with the Florida Securities Commission: 1) the name of the issuer and location of its headquarters or principal office; 2) a brief description of the security; and 3) a statement that the securities have been outstanding and in the hands of the public for not less than one year.<sup>19</sup>

**ILLINOIS**—An application for authorization for a trading exemption may be filed for the following classes of securities: 1) if other securities of the same issuer have been registered in Illinois within the past two years; or 2) securities issued by corporations in continuous operation for seven years, and there is no default on principal or interest of securities or on dividends on preferred stock, and the issuer has had, for the past three to five years, average earnings amounting to 4% of the current market price; or 3) securities whose issuers meet any three of the following requirements: (a) financial statements for the past three years are listed in a recognized securities manual, (b) sales for the past fiscal year exceed three hundred million dollars, (c) total assets as of the end of the last fiscal year exceed one hundred million dollars; (d) a dividend has been paid in each of the last three fiscal years.<sup>20</sup>

**KANSAS**—An order permitting secondary trading may be issued by the Kansas Corporation Commission on the application of a registered broker-dealer. The following information must be filed: the issuer’s latest financial statement, a list of the issuer’s management personnel, and such other information as the Commissioner may require.<sup>21</sup>

**MAINE**—Registration may take place seven days after the filing of the following information and such other information as the Commissioner may require: (1) the name and address of the issuer; (2) the names and addresses of the issuer’s officers and directors; (3) the state or government under which the issuer is incorporated; (4) a statement of all capital accounts, including a description of all rights and preferences applicable to any securities; and (5) a state-

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19. FLA. STAT. ANN. § 517.091 (Supp. 1968).

20. ILL. ANN. STAT. ch. 121 1/2, § 137.4(F)(2) (Smith-Hurd Supp. 1968). Illinois Securities Form 4F(2).

21. Kan. Laws 1967, ch. 121, *appearing as* § 17-1261(m) in Blue Sky L. Rep. 19,110.

ment of the use of the proceeds from the sale of the securities (statement that it is a non-issuer registration, if applicable).<sup>22</sup>

**MASSACHUSETTS**—Sales of the security may begin upon the filing of the following information, however, the Commissioner may require additional information to be filed: (1) a reference to a recognized source of information concerning the issuer; (2) the name and address of the issuer, the names and addresses of the officers and directors of the issuer; (3) the state of incorporation; (4) a statement of the general nature of the business transacted by the issuer; (5) a statement of all capital accounts, including a description of all rights and preferences applicable to any security; (6) a statement of the use of the proceeds from the sale (statement that it is a non-issuer registration, if applicable).<sup>23</sup>

**NEW MEXICO**—Non-issuer transactions in securities may be exempted upon application to the Commissioner.<sup>24</sup>

**NORTH DAKOTA**—If there has been a prior public offering of the security, registered in North Dakota or with the Securities and Exchange Commission, and the security has been outstanding for at least one year, registration for secondary trading purposes may take place by “announcement.” Secondary trading may begin upon the filing of the following information: (1) the name of the issuer and location of its principal office; (2) a description of the security and its current price and earnings; (3) a statement that the securities have been outstanding and in the hands of the public for not less than one year; (4) a statement that a balance sheet not more than one year old has been or will be mailed to the commissioner; and (5) a statement that the security was previously registered (at the time of its public offering) with the Securities and Exchange Commission or in North Dakota. The Commissioner may deny the registration or require additional information to be filed.<sup>25</sup>

**RHODE ISLAND**—Unless an exemption is available, the dealer must file a “notice of intention” to sell or trade in specific securities. The filing is to be on Form 1B and accompanied by the issuer’s most recent annual report and financial reports. Form 1B requires the following in-

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22. ME. REV. STAT. ANN. tit. 32, § 871 (Supp. 1968).

23. MASS. GEN. LAWS ANN. ch. 290, § 5 (Supp. 1968).

24. N.M. STAT. ANN. § 48-18-22(B)(2) (1966).

25. N.D. CENT. CODE ANN. § 10-04-07.1 (Supp. 1967).

formation: (1) the name and address of the issuer and its officers and directors; (2) description of the legal structure of the issuer (*e.g.*, corporation) and a statement of the laws authorizing the issuer (*e.g.*, state of incorporation); (3) a description of the security; and (4) a description of the issuer's business.<sup>26</sup>

TEXAS—A secondary transaction exemption is offered on the same terms as the manual exemption upon a filing with the Securities Commission of the information which would be necessary under the manual exemption: (1) a statement of the issuer's principal business; (2) a balance sheet as of a date within eighteen months of the date of such sale; and (3) profit and loss statements and a record of dividends paid, if any, for a period of not less than three years prior to the date of such balance sheet or for the period of existence of the issuer, if such period is less than three years.<sup>27</sup>

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26. R.I. GEN. LAWS § 7-11-6 (Supp. 1968); Rhode Island Securities Form 1B.

27. TEX. REV. CIV. STAT. ANN. art. 581, § 5(O) (Supp. 1968).

## SECONDARY TRADING IN SECURITIES: LABYRINTH BENEATH THE BLUE SKY

APPENDIX II: *Proposed Amendments to the Uniform Securities Act*

The proposed amendments to the Uniform Securities Act contained in this Appendix are based in the disclosure approach to the regulation of secondary trading.

- I. [Transaction Exemption based on Federal Disclosure]. The following transactions are exempted from [UNIFORM SECURITIES ACT §§ 301, 403]:

...  
 (—) (a) any non-issuer transaction by a person who does not control, and is not controlled by or under common control with, the issuer if (i) the transaction is at a price reasonably related to the current market price, (ii) the security is registered with the United States Securities and Exchange Commission under Section 12 of the Securities Exchange Act of 1934 and the issuer files reports with the United States Securities and Exchange Commission pursuant to Section 13 of that Act, and (iii) a copy of the registration statement filed with the United States Securities and Exchange Commission has been filed with the [administrator], together with copies of such other reports and exhibits as he may by rule or order require.

(b) the [administrator] may by rule or order extend the exemption contained in subsection (a) to normal brokers' transactions even though the seller of the security is a person controlling, controlled by or under common control with, the issuer of the security.

*Comment:* Subsection (a) of this provision has been taken directly from MO. REV. STAT. § 409.402(b)(15) (Supp. 1967). The incorporation of the federal disclosure provisions was made practical by the 1964 amendments to the Securities Exchange Act extending Sections 12 and 13 to certain over-the-counter securities. Section 12 also permits voluntary filing by issuers not required to file under the Act. Although Missouri has retained the manual exemption found in Section 402(b)(2) of the Uniform Securities Act, it is recommended that this provision be used in place of the manual exemption. The advantages to relying on the federal disclosure provisions rather than the manuals' publishers are the regularity and timeliness of disclosure, the uniformity of information disclosed, and the sanctions available in the event of inadequate or fraudulent disclosure.

Subsection (b) of this provision has been added so that persons in a control relationship with the issuer may avail themselves of the exemption if they are not making a distribution of the securities. It is contemplated that the administrator would extend the exemption to transactions which fall within the scope of Rule 154 under the Securities Act of 1933.

- II. [Registration of Securities for the purposes of Secondary Trading]. Any class of securities which is outstanding in the public hands as a result of a prior distribution or offering may be registered for transactions not involving the issuer of the security, or any person controlling, controlled by, or under

common control with the issuer of the security, by a broker-dealer registered under this [Act] in the following manner:

(a) the broker-dealer shall file with the [administrator] a copy of the issuer's latest annual report, if any, together with the information which would be required by Sections 12 and 13 of the Securities Exchange Act of 1934 were the issuer subject to that Act and such other information as the [administrator] deems necessary or appropriate for the protection of the public interest;

(b) the broker-dealer shall undertake to make supplemental filings of information regarding the issuer as would be required of the issuer by Section 13 of the Securities Exchange Act of 1934 were the issuer subject to that Section;

(c) the cost of registration under this section shall be [. . .] and such registration will take effect 10 days after the filing of the information required by subsection (a) unless denied by the [administrator];

(d) registration under this section shall be non-expiring provided the [administrator] receives the supplemental filings required by subsection (b), however, the [administrator] shall not revoke the registration of a security for non-compliance with the requirements of subsection (b) without giving the issuer of the security and other broker-dealers registered under this [Act] an opportunity to make such supplemental filings;

(e) if the [administrator] deems it necessary or appropriate for the protection of the public interest, he may by rule or order require the broker-dealer registering a security under this section to make information regarding the issuer of the security available to other broker-dealers registered under this [Act] or require any broker-dealer selling such security to a resident of this state to deliver a summary statement of the issuer's business and financial condition to such purchaser;

(f) the [administrator] may by rule or order permit securities registered under this section to be sold in normal brokers' transactions even though the seller of the security is a person controlling, controlled by or under common control with, the issuer of the security.

*Comment:* Subsection (a) of this provision is modelled primarily on TEX. REV. CIV. STAT. ANN. art. 579, § 5.0 (1964), which grants a transaction exemption to securities not listed in a recognized manual provided similar information regarding the issuer is filed with the Texas Securities Commission. The proposed provision relates registration for secondary trading to the disclosure provisions of Section 13 of the Securities Exchange Act and, hence, to the proposed replacement for the manual exemption. Since voluntary filing is permitted under the Securities Exchange Act, registration under this provision will probably be used only when the issuer does not wish to make the filing himself. Considerably more information is required by this provision than is required by most "short-form" registration provisions now in effect and is designed to promote disclosure rather than mere notice.

Subsections (b) and (d) of this provision contemplate "permanent" registration for

secondary trading purposes so long as the information on file with the administrator is kept current. The requirement of supplemental filings is analogous to that required in Illinois under ILL. ANN. STAT. ch. 121 ½, § 137.4(F)(2) (Smith-Hurd Supp. 1968) and Form 4(F)(2).

Subsection (c) affords the administrator an opportunity to examine the information filed with his office in order to determine whether to require additional information prior to the effectiveness of the registration. It is suggested that the cost of registration be kept relatively low so that registration is practical from a financial standpoint.

Subsection (e) is designed to allow the administrator to insure adequate dissemination of information regarding the issuer and the security. In most instances it is probably unnecessary for the administrator to invoke such a provision because of general availability of information within the financial industry.

Subsection (f) has been included so that persons in a control relationship with the issuer may avail themselves of the registration of securities under this provision so long as they are not engaged in a distribution of the securities. It is contemplated that the administrator would permit securities registered under this provision to be traded in transactions which fall within the scope of Rule 154 of the Securities Act of 1933. In this context, compare the approach of CAL. CORP. CODE § 25101 (Deering Supp. 1969) permitting a similar type of registration for all sales by persons in a control relationship with the issuer of the security.

- III. [Reports of Sales and Ownership by Registered Broker-Dealers]. On or before the 10th of each month, each broker-dealer registered under this [Act] shall file, with regard to transactions which took place during the preceding month, the following reports on such forms as the [administrator] may prescribe:
- (a) a list of all transactions in which the broker-dealer acted as principal and the prices at which such transactions took place, *provided* that such report need not include transactions not involving residents of this state;
  - (b) a list of all securities sold to residents of this state in reliance upon the unsolicited transaction exemption contained in [UNIFORM SECURITIES ACT § 402(b)(3)] and a copy of the customer's acknowledgement that the transaction was unsolicited;
  - (c) a list of all securities in which the broker-dealer made a market for other broker-dealers; and
  - (d) a list of all securities beneficially owned by the broker-dealer and by its partners or officers and directors as a group, *provided* that the [administrator] may by rule or order limit the operation of this subsection to changes in securities so owned after the initial filing of such a list.

*Comment:* The general purpose of these provisions is to provide the administrator with a means of reviewing transactions in which the broker-dealer may have an otherwise undisclosed direct or indirect interest.

Subsection (a) is modelled after the current Wisconsin requirement that reports of "sales" be made to the Commission. WIS. STAT. ANN. § 189.04(5) (1963); WIS. ADM. CODE ch. SEC 1, § 1.07 (1968). Despite competitive pressures there is often a problem regarding the "fairness" of the price in principal transactions since the dealer's mark-up or mark-down is undisclosed. This type of filing will potentially disclose disparities between the fair market price of the security and the dealer's price.

Subsection (b) is intended to afford additional protection to the broker-dealer by recording the customer's acknowledgement with the securities commissioner. At the same time, it affords the commissioner an opportunity to examine the securities being sold under this exemption and may disclose abusive or manipulative characteristics fostered either by the broker-dealer or by the customer.

Subsections (c) and (d) are designed to disclose the broker-dealer's direct and indirect interest in various securities. It is limited to beneficial ownership since in this context no purpose would be served by disclosing securities which the broker-dealer might hold in street name on behalf of customers. This type of disclosure should enable the administrator to detect instances of manipulation by the broker-dealer such as the "free-riding" which may occur when a broker-dealer acquires an interest in a security and then forces the price to rise by recommending its purchase to his customers.