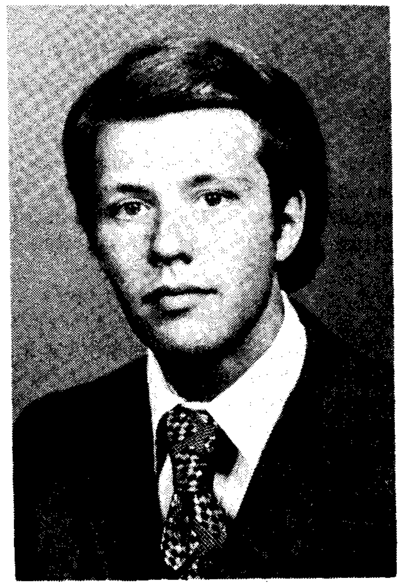
# STATE and FEDERAL SECURITIES LAW PRIMER



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## INTRODUCTION

During the past decade the Bar has witnessed a most dramatic change in the approach to the practice of law. The day when a lawyer was all things to all men seems to have finally yielded to a new era of specialization; an era in which one's energy and expertise gravitates toward a few selected areas of interest so that in those areas one's competence might soar. This phenomena has been accompanied by a corresponding rise in the level of complexity of the law in many of the most sought after fields of specialization. Consequently, it has become increasingly important that general practitioners and specialists alike have a basic understanding and general knowledge of the more technical areas of the law, not only for purposes of identifying legal issues, but also for the purpose of making an intelligent decision as to when one's own knowledge of a subject should be supplemented by further research or outside counsel.

Securities law is one of the above-mentioned technical fields which, until recently, was dominated by a handful of law firms located principally in the greater financial centers of the United States. Now, with the advent of increased specialization coupled with the tendency of government regulation to increase rather than decrease, it is necessary for every lawyer to recognize what the term "security" encompasses and to understand how and when securities are regulated.

This article has been prepared in an effort to partially fill this need by providing a thumbnail sketch of state and federal securities law, so that the Bar might glean an insight into the fundamentals of a field to which law firms everywhere are devoting more and more of their practice.

## SCOPE OF THE LEGAL ISSUES

Though this article will not discuss the legal issues inherent in every securities law problem, it is important for the practitioner to have a perspective enabling him to find the starting point in any securities-related inquiry. In determing whether or not a transaction involves any securities law implications, a lawyer should focus on the following questions:

(1) Is a *security* being offered?

(2) Is it a *regulated security* under applicable law?

(3) Is the *transaction* regulated?

(4) Are any *special exemptions* available?

(5) What is the *nature* and *extent* of the *regulatory requirements?* [1].

These questions should serve as a guide through the maze of securities laws and regulations one must consult to ascertain the nature and the scope of his problem.

## WHAT IS A SECURITY?

The concept of what constitutes a security was first defined by the states in their attempts at regulating securities through the blue sky laws. Later, Congress, having looked to the states' experience, defined the term "security" in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security. [2] Thus under both the state and federal statues' broad definitions of "securities" there is one dominant theme, namely, that whenever an undertaking is so structured that one or more parties are furnishing money, with the expectation of realizing a profit from the uses to which a third party puts that money, a "security" is more than likely involved. Restated in the words of a leading commentator, "The lesson to be drawn from these principles might be stated as follows: If the purchaser of an interest can derive no profit except from his own efforts in relation thereto, the interest is *not a security; and if the profits to be realized* by the purchaser from the interest sold depend on the efforts of the seller or persons other than the purchaser, the interest is probably a security, no matter what terminology is used in the documents." [3]

Clearly then the definition of "security" encompasses not only stocks, bonds and the more conventional interests generally regarded to be securities, but also the more obscure and exotic interests, whether or not represented by any document, such as undivided interests in oil and gas leases or participation interests in limited partnerships designed to engage in chinchilla breeding, fine art investment, oyster farming, oil and gas exploration, real estate development or sheep ranching. [3a] It is the substance of the interest, not its form, which is determinative of its status as a security. [4] More specifically, the test of when a security is a security is resolved by the character given the interest in commerce by the terms of the offer, the plan of distribution and the economic inducements held out to the prospective buyer.

"Securities are by their very nature much different from almost any other 'merchandise' for which there are established public markets. A person who wishes to purchase a new car or a house-hold appliance can determine from personal inspection the quality of the product and the reasonableness of the price in relation to other competing products," but not so with securities.[5] Consequently a vast body of law has developed to protect the unsophisticated investing public.

## BLUE SKY LAWS

## GENERALLY

Beginning with their initial offering, securities are regulated by both state and federal statutes [6] in a dual scheme which is equally dependent on the enforcement of each body of law for its effectiveness. Realizing this need for dual regulation, Congress specifically provided for state control of securities. The state statutes governing securities are commonly referred to as "blue sky laws," [7] and in most states such laws are implemented by a Securities Commission or a Securities Commissioner in recognition of the fact that securities regulation is a full time job for experts.[8]

Through the years, three distinct approaches to state securities regulation have emerged and found their way into most blue sky laws:

(1) Anti-fraud statutes;

(2) Statutes intended to regulate by controlling the distributor or seller of securities; and

(3) Statutes requiring the registration or licensing of securities. [9]

"The justification for the blue sky laws must rest on the degree of protection which they *afford the investing public.*"[10] *Hence, the* combination of the regulatory devices enumerated above has proven to be both the broadest based and the most effective means of providing such protection. Each approach concentrates on an aspect of securities transactions critical to the safeguarding of the public interest.

The anti-fraud provisions are the broadest in scope and apply irrespective of any registration or licensing scheme. Such statutes characteristically define fraud in general terms and impose civil and / or criminal sanctions for making statements which are false or misleading in any material respect in connection with the offer or sale of securities.[11] The statutes controlling the distributor or seller of securities usually do so by requiring the registration or licensing of "brokers", "dealers", "agents", "salesmen", and "investment advisors". These words are customarily defined in broad terms so as to include most persons effecting transactions in securities,[12] and the qualifications for registration or licensing may be set at a level which, in the state administrator's judgment, will ensure that only those meeting certain standards of competence will be authorized to deal with the public. Blue sky laws requiring the registration of securities often provide three alternative methods for satisfying the statutes, each one being available to only certain types of designated securities: (a) registration by notification; (b) registration by coordination; and (c) registration by qualification.[13] Registration by notification provides for legal sales of securities within a short time after a notice of intention to offer for sale is filed containing certain prescribed information. Registration by coordination is afforded to securities for which a registration statement has been filed under the Securities Act of 1933 in connection with the same offering. For such an offering, once certain conditions have been satisfied, the security may automatically be sold in the state at the same moment the federal registration statement becomes "effective" and sales are allowed. Registration by qualification describes the process by which any security may be registered as a result of preparing a registration statement meeting the jurisdiction's specifications and approval as expressed in an order declaring the registration statement "effective."

Though there is a great deal of similarity in the blue sky laws of the several states (as reflected by the selective incorporation of the three approaches numbered 1-3 above), the statues are far from uniform and a thorough investigation of a jurisdiction's regulatory scheme is recommended before any transactions are effected there. It should also be noted that while both state and federal statutes evidence the "disclosure" approach to securities regulation, the federal laws adhere more closely to that approach whereas the states put considerable emphasis on an offering's terms meeting a "fair, just and equitable" standard.

The importance of compliance with the blue sky laws cannot be over-emphasized; without it compliance with the federal securities laws is meaningless. [15]

**OKLAHOMA**

Oklahoma has combined the Uniform Securities Act with the statutory creation of the Oklahoma Securities Commission and the Department of Securities in an effort to regulate securities within this state.[16] The Commission, operating through the Administrator, is the policy making and governing authority of the Department of Securities, being responsible for the enforcement of Title 71 of the Oklahoma Statutes. [17]

The Oklahoma Securities Act[18] prohibits fraudulent practices, requires the registration of broker-dealers, agents and investment advisers, and requires the registration of securities. The earlier general discussion of blue sky laws is applicable here.[19] The Oklahoma Securities Acts goes on to include definitions, exemptions, judicial review, investigatory injunctive and criminal provisions.

By adopting the Uniform Securities Act, Oklahoma joined with the 26 other jurisdictions adopting the Uniform Act, in whole or in part,[20] in the move toward making the law uniform and coordinating the interpretation and administration of blue sky laws with the related federal regulations.[21] This presents the obvious advantage to the Bar of being able to look to and benefit from other states' experience in determining the correct interpretation of the law.

**FEDERAL SECURITIES LAWS**

**GENERALLY**

The Securities and Exchange Commission in its administration and enforcement of six statutes-the Securities Act of 1933, Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940 and the Investment Advisers Act of 1940-is primarily responsible for the Federal government's regulation of securities.[22] The keystone of the Securities Act of 1933, and of the entire legislative scheme of the securities laws, is disclosure;[23] the purposes of disclosure being to place potential securities buyers on a par with their sellers to the greatest extent practicable and to deter misrepresentation, deceit, and other fraudulent acts. However, the ultimate goal is investor protection, and effective disclosure is only a means.

The Federal Acts set out above are not of equal importance from the aspect of securities regulation; therefore, in the interests of time and space, only the first two acts mentioned will be here considered further, thus underlining their importance in this field.

**THE SECURITIES ACT OF 1933**

"President Roosevelt stated in his message to Congress concerning the eventual Securities Act of 1933:[24] 'The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business.' "[25] With this in mind the Securities Act of 1933 (hereinafter referred to as the "1933 Act") has two basic objectives: (1) to provide information as to which an average prudent investor ought reasonably to be informed before making an investment decision, and (2) to prohibit fraudulent acts and practices in the sale of securities generally. The Securities and Exchange Commission is not authorized to approve or pass on the merits of a security; its function is only to see to it that the information filed in each registration statement is accurate and complete.[26]

The thrust of the 1933 Act is directed toward regulating the initial distribution of securities rather than subsequent transactions. This is accomplished primarily through disclosure provisions which are given effect through registration and reporting requirements; however, there are numerous exemptions from, and exceptions to, the registration requirement which should be closely examined. As a general rule an issuer must file a registration statement for securities being offered for sale to the public through channels of interstate commerce or the mails. Registration statements are required to contain information about the security itself, its issuer and other matters necessary to forming an intelligent opinion as to the quality of the security and its suitability for the investment needs of the particular investor. Offers to sell and offers to buy a security may be made through the use of a preliminary prospectus once a registration statement has been filed; nevertheless, no sale of a security may be made until such registration statement has been made effective by the Commission, and then only through the use of a statutory prospectus meeting the requirements of the 1933 act. Disclosure provisions must be satisfied, for civil and possible criminal liability may be imposed for material misstatements or omissions in a registration statement. Moreover, there is a "general anti-fraud provision-enforceable by injunctive and criminal sanctions-which applies whenever securities are sold by use of the mails or the channels of interstate commerce, whether in the course of a distribution pursuant to a registration statement or in the course of ordinary market trading."[27] There are no exemptions from the anti-fraud provision.

The anti-fraud and disclosure concepts utilized in the 1933 Act have become the foundation of subsequent Federal securities legislation as well, though the emphasis shifts from the initial distribution process to other aspects of securities regulation.

**THE SECUTITIES EXCHANGE ACT OF 1934**

The Securities Exchange Act of 1934[28] (hereinafter referred to as the "1934 Act") is primarily intended to regulate post-distribution trading in securities and is necessarily similar in part to the 1933 Act. The 1934 Act differs though in that it goes on to control the instruments through which transactions in securities are affected by requiring the registration and periodic reporting of stock exchanges, over-the-counter brokers and dealers, and national securities associations. The 1934 Act also continues to regulate where the 1933 Act leaves off by continuing the reporting requirements of 1933 Act issuers and providing for the compulsory registration of certain securities exempted by the 1933 Act.[28] A failure to register and report, unless exempted by statute or by the Securities and Exchange Commission, could lead to both civil and criminal sanctions.

The 1934 Act has four basic purposes: "to afford a measure of disclosure to people who buy and sell securities; to prevent and afford remedies for fraud in securities trading and manipulation of the markets; to regulate the securities markets; and to control the amount of the Nation's credit which goes into those markets."[29] To these ends, the Securities and Exchange Commission is given certain authority with respect to various exchange practices, inside trading, the solicitation of proxies, the hypothecation of securities by brokers or dealers for the account of customers, the business of specialists and odd-lot dealers, trading activities such as short-sales, stabilizing and other activities of brokers and dealers. The 1934 Act grants the Commission supervisory powers over the national securities exchanges and invests it with authority to control and enforce margin requirements set by the Board of Governors of the Federal Reserve System. There are also broad provisions prohibiting deceptive practices, fraud and minipulation which by and large parallel similar sections in the 1933 Act.

## CONCLUSION

The foregoing is intended to provide a glimpse, a preview, of the securities laws. It is important to conceptualize securities regulation as the ultimate goal to be realized through the joint and coordinated efforts of the states and the federal government; blue sky laws and federal securities laws arè integral parts of one unit.

## FOOTNOTES

(1). Mosburg, "Regulation of Tax Shelter Investments," 25 *Okla. L. Rev.* § 207-238 at 209 (1972)
(2). H.R. REP. No. 85, 73rd Cong., 1st Sess. (1933) p. 11. See also Securities Act of 1933 § 2(1) (hereinafter cited as the "1933 Act"); Securities Act § 401(1); *S.E.C. v. Starmont*, 31 F. Supp. 264 (D.C. Wash., 1939; 1940), 1 S.E.C. Jud. Dec. 811 (providing for a liberal construction of the 1933 Act definition of "security").
(3). Graham, "Impact of State and Federal Securities Acts on Everyday Oil and Gas Transactions," 8 *Oil and Gas Inst.* 33, 41 (S.W. Legal Fdn. (1957).
(3.1). For definitions of the term "security" see the 1933 Act § 2(1); the 1934 Act %3(10); Uniform Securities Act § 401(1).
(4). For a discussion of what constitutes a security see, *SEC v. W.J. Howey Co.*, 66 S.Ct. 1100, 328 U.S. 293 (1946), 4 SEC Jud. Dec. 725, '45-'47 CCH Dec. ¶90,341.
(5). *S.E.C. v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943); 3 S.E.C. Jud. Dec. 483, '41-'44 CCH Dec. ¶ 90, 227.
(5.1). 1 *CCH Fed. Sec. L. Rep.*, ¶ 102.
(6). State regulation of securities is specifically provided for in §18 of the 1933 Act and in § 28 of the 1934 Act.
(7). For the etymology of the term "blue sky", see, Mulvey, "Blue Sky Law", 36 *Can. L. T. 37* (1916); *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550 (1917).
(8). 1 *CCH Blue Sky L. Rep.*, ¶ 507.
(9). Loss & Cowett, *Blue Sky Law* at 19 (1958).
(10). Ibid, § 401 (c).
(11). Uniform Securities Act § 404.
(12). Ibid, § 401 (c).
(13). Ibid, §§ 301-306.
(14). The Uniform Securities Act, as approved by the National Conference of Commissioners on Uniform State Laws on August 25, 1956, represents the first attempt at blue sky law uniformity; however, the jurisdictions adopting it have freely modified it in several respects. At least 27 jurisdictions, including Oklahoma, have adopted (or substantially adopted with modifications) the Uniform Act.
(15). For a good discussion of blue sky law see, Loss & Cowett, *Blue Sky Law* (1958); and to find what the current blue sky laws prescribe see, *CCH Blue Sky L. Rep.* Vols. 1-3.
(16). 71 O.S. §§ 1-504 (hereinafter cited as the Oklahoma Securities Act) (1971).
(17). Oklahoma Securities Act § 3.
(18). Supra, note 16.
(19). For a discussion of the Oklahoma Securities Act see, Dorwart & Holden, "An Overview of the Oklahoma Securities Act," 25 *Okla. L. Rev.* 184 (1972); Tubb & Wilson, "Securities Legislation in Oklahoma. *21 Okla. L. Rev.* 469 (1968)
(20). 25 other states and Puerto Rico.
(21). For a chart of state securities statutes specifying the parts of the Uniform Securities Acts adopted see Mofsky, *Blue Sky Restrictions on New Business Promotions* at 102 (1971).
(22). The Securities and Exchange Commission also serves as advisor to Federal courts in corporate reorganization proceedings under Chapter X of the National Bankruptcy Act.
(23). Knauss, "A Reappraisal of the Role of Disclosure," 62 *Mich. L. Rev.* 607 (1964).
(24). 15 U.S.C. §§ 77a-77aa.
(25). "The Expanding Liability of Securities Underwriters: from *Barchris* to *Globus*," 1969 *Duke L. J.* 1191 (1969).
(26). Loss, 1 *Securities Regulation* at 130 (1961).
(27). Ibid.
(28). 15 U.S.C. §§ 77b et seq., 78a et seq.
(28.1). See 1934 Act §§ 12 (g), 13, 15(d).
(29). Supra, Note 26.