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THE BLUE SKY OF WASHINGTON: REGISTRATION OF SECURITIES OF A NEW VENTURE

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I. INTRODUCTION

The present Securities Act of Washington,[1] adopting a modified version of the Uniform Securities Act, was enacted in 1959, not long after approval of the Uniform Act by the American Bar Association in 1956.[2] In its choice of all of the three principal options available under the Uniform Act, the state legislature continued the regulatory policy of prior law[3] by enacting provisions (a) prohibiting fraudulent and other undesirable practices, (b) requiring the licensing of persons engaged in the business of selling securities, and (c) requiring registration of securities offered or sold in this

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† The author acknowledges the cooperation of the Washington State Administrator of Securities, Mr. Bernard Lonctot. However, the statements and views expressed are those of the author and are not to be attributed to the Administrator.

[1] WASH. REV. CODE ch. 21.20 (1959) [hereinafter sometimes the "Act"].

[2] L. Loss & E. COWETT, BLUE SKY LAW 235 (1958) [hereinafter Loss & COWETT].

[3] Ch. 69, [1923] Wash. Sess. Laws 207; ch. 133, [1929] Wash. Sess. Laws 350; ch. 178, [1937] Wash. Sess. Laws 689; *formerly*, WASH. REV. CODE ch. 21.04, 21.08, 21.12; *prior*, REM. REV. STAT. § 5853-1. Washington's first Securities Act was enacted in 1923. It was followed in 1937 by an act relating to issuer sales of securities of metalliferous mining corporations and in 1939 by an act relating to oil, gas and mining leases. A bill which would have substituted a single act on the disclosure philosophy failed to pass in 1953. Loss & COWETT, at 70 n.18.

state. While uniformity was a paramount objective,[4] the draftsmen of the Uniform Act consciously left open, in addition to these principal options, a number of additional choices intended to permit expression of each state's individual regulatory policy. Moreover, administration under the Act in many instances involves judgment determinations. The selection of statutory options and subsequent administrative practice provide some measure of the state's policy of providing protection to the securities-investing public while leaving room for the development of free enterprise. After very brief mention of relationships of the Act to federal securities laws and to the principal regulatory philosophies of other states, this article will review the statutory framework and administrative practice in this state in the light of the problems involved in an intrastate offering of securities of a new venture.

II. Relationship to Federal Securities Laws

While overshadowed by the federal securities laws, state laws are by no means eclipsed. The federal Securities Act of 1933 expressly reserves to the states jurisdiction to regulate the offering and sale of securities within their borders.[5] State regulation is thus a second hurdle to an interstate offering of securities to the public. In the case of a wholly intrastate offering, where an exemption is applicable under the Securities Act of 1933,[6] the state's regulation alone is operative.

Registration of an offering with the Securities and Exchange Commission[7] is by no means the end of an issuer's problems, for he must also meet, in state registration, standards which are often very different from those of federal laws. While the federal philosophy is essentially that the public investor should be in a position to protect himself if all the relevant facts about the proposed investment are truthfully and fairly disclosed to him, Washington law, in common with that of many states, provides a more paternalistic protection by permitting the offer to be made only after an administrative evaluation (within specified limits) of what the investor will get for his money. Although disclosure is required of the issuer under Washington law as well as under the federal, its purpose in the state-law context is as much to inform the regulatory authorities, as a basis for judgment, as to inform the investor.[8]

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[4] Loss & Cowett, at 230.

[5] 15 U.S.C. § 77r. *See also* Annot., 145 A.L.R. 1252 (1943). Armstrong, *The Blue Sky Laws*, 44 Va. L. Rev. 713 (1958), argues on policy grounds that the federal law should pre-empt the field.

[6] 15 U.S.C. § 77c(a)(11). Discussion of this exemption is beyond the scope of this paper.

[7] Hereinafter cited S.E.C.

[8] Loss & Cowett, at 36-37.

The now famous Rule 10b-5 under the federal Securities Exchange Act of 1934 has its counterpart in the opening section of the Uniform Act (Wash. Rev. Code § 21.20.010), and in fact served as the model for it.[9] Most of the next section of the Uniform Act (Wash. Rev. Code §§ 21.20.020 and .030) is modeled after sections of the federal Investment Advisers Act of 1940.[10] Registrations of broker-dealers, agents and investment advisers under the Uniform Act have their parallels in the Securities Exchange Act of 1934 and the Investment Advisers Act.[11] The statutory prescription for the content of a registration statement, where registration is sought by "qualification" of the securities under the Uniform Act, is modeled after the S-1 form of a registration statement under the Securities Act of 1933.[12] The foregoing examples of derivation and parallelism are capped by the statement of statutory policy of the Uniform Act[13] which includes the objective "to coordinate the interpretation and administration of this act with the related federal regulation."

The Uniform Act includes one innovation designed particularly to facilitate the work of state registration when registration is also being effected with the S.E.C. This is the procedure of registration by "coordination," in which the mechanics of the state registration are simplified and related to the federal registration; the substantive standards of state regulation are not changed, however.[14]

In a number of areas, the state parallel, to the extent that it exists, is ordinarily found in general corporation law rather than in the Act. The proxy regulation and insider profit provisions of the Securities Exchange Act of 1934 for example, are not a part of the regulatory scheme of the Washington Act applicable to issues generally. State law in Washington[15] does, however, regulate insurance companies in these two particular areas under an exemption contained in the Exchange Act[16] for insurance companies subject to such state regulation.

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[9] Uniform Securities Act § 101, Comment. (The Draftsmen's Commentaries, hereinafter referred to, are found in Loss & COWETT. The Uniform Act is reprinted in 1 BLUE SKY L. REP. ¶ 4901-53).

[10] Uniform Securities Act § 102(a) & (b), Official Comment.

[11] Uniform Securities Act § 201, Official Comment.

[12] Uniform Securities Act § 304(6), Official Comment. The Washington Act citation is WASH. REV. CODE § 21.20.210 (1959).

[13] Uniform Securities Act § 415 (WASH. REV. CODE § 21.20.900 (1959)). (*See also* Uniform Act § 412(6), WASH. REV. CODE § 21.20.450 (1959)).

[14] Uniform Securities Act § 303, Official Comment. (WASH. REV. CODE § 21.20.180 (1961)).

[15] WASH. REV. CODE § 48.08.090-.170 (1965).

[16] 15 U.S.C. § 78*l*(g)(2)(G).

III. RELATIONSHIP TO LAW AND ADMINISTRATION IN OTHER STATES

Twenty-seven states have enacted statutes based on the Uniform Securities Act;[17] the movement toward uniformity has thus barely passed the half-way mark. Moreover, most of these statutes bear an individualistic imprint in their choice of the options of the Uniform Act and in various modifications of their own.[18] Diversity of approach is still the rule in states which have not adopted the Uniform Act.[19] Of even more importance to the blue sky practitioner is the wide variation of administrative practice, even among states having similar statutes. Delaware is the only state at present without a blue sky law.

The three principal options of the Uniform Act were developed from the three different regulatory philosophies, sometimes but not always, found in combination in prior state laws.[20] At present no state relies solely on legislation of the anti-fraud type, but a few require registration only of persons engaged in selling securities on the one hand, or registration of securities offerings on the other. Most present-day statutes, like the Washington Act, combine all three philosophies.

In general, from the standpoint of the statutory standard applied to securities offerings by state regulatory authorities, the Washington Act relies on the pattern of the Uniform Act and is directed primarily against offerings which appear unduly to favor promoters and insiders at the expense of public investors. A number of other state statutes go well beyond the Uniform Act, for example, the California and Oregon statutes[21] which require that the offering be found to be "fair, just and equitable" to the public offerees. It should be noted that the previous Washington statute did impose this standard, and some of the discussion in this article may suggest a present tendency in that direction. In any event, although Washington is not so restrictive as some states, it must be regarded a staunch member of that group of states which attempts to assess the "merit" of a security offering rather than looking to the extent of disclosure alone. The desirability of the restrictive, or merit,

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[17] 1 BLUE SKY L. REP. ¶ 4901. *See also* L. LOSS, SECURITIES REGULATION 4160-1 (2d ed. 1961, Supp. 1969) [hereinafter Loss].

[18] *See* Batemen, *The Missouri Uniform Securities Act*, 34 MO. L. REV. 463 (1969), in which the author is critical of the modifications to the text of the Uniform Act which carry forward prior law and practice.

[19] For a review of the types of act in force prior to the adoption of the Uniform Act, *see* LOSS & COWETT, at 17. *See also* LOSS, at 23. A more recent comparative study may be found in Mofsky, *Blue Sky Restrictions on New Business Promotions*, 1969 DUKE L.J. 273.

[20] LOSS & COWETT, at 236.

[21] CALIF. CORP. CODE § 25140 (1969); ORE. REV. STAT. § 59.170 (1939).

philosophy of state securities regulation has long been a contentious subject and has recently again come under question.[22]

The Washington Act suggests cooperation with the securities administrators of other states in the matter of prescribing rules and forms.[23] Two organizations serving this function, in which Washington is represented, are of national significance.

The North American Securities Administrators is a principal contributor to the development of cooperation among blue sky administrators and of uniformity of their practice. Its membership presently comprises representatives of virtually all states and Canadian provinces. Its annual meetings are well attended not only by its membership but also by representatives of the S.E.C. and of the securities industry. In addition to exchange of information and discussion of developments and common problems at these meetings, this association has drafted statements of policy on preliminary prospectuses[24] and options and warrants,[25] and uniform forms of application for registration of securities by coordination, forms of corporate resolutions pertaining to registration and forms of consent to service of process. Washington accepts these forms and has approved these statements of policy.

A smaller group, comprising representatives of 24 states, is called the Midwestern Securities Commissioners Association, although its membership is no longer representative of a single geographic area. It has issued a number of statements of policy reflecting the fairly restrictive philosophy of regulation which originally brought the group together. Generally speaking, these statements reflect Washington policy. As an example, the Statement of Policy regarding Real Estate Investment Trusts[26] forms the basis of much of the Washington rules on this subject.[27] However, this statement has in one respect been modified for the purposes of the Washington rule: 10% (instead of 5%) of the assets of a real estate investment trust may be invested in vacant land, by reason of

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22 Mofsky, *supra* note 19; Mofsky, *State Securities Regulation and New Promotions: A Case History*, 15 WAYNE L. REV. 1401 (1969); Bloomenthal, *Blue Sky Law and the Theory of Overkill*, 15 WAYNE L. REV. 1447 (1969). For an earlier criticism of the blue sky laws *see generally* Armstrong, *supra* note 6. *But see* Hueni, *Application of Merit Requirements in State Securities Regulation*, 15 WAYNE L. REV. 1417 (1969). *See also* Jennings, *The Role of the States in Corporate Regulation and Investor Protection*, 23 LAW & CONTEMP. PROB. 193, 207 (1958), for a criticism of the Uniform Act in failing to adopt, at least as an option, the "fair, just and equitable" standard. *Cf.* Loss, at 121.

23 WASH. REV. CODE § 21.20.450 (1959).

24 1 BLUE SKY L. REP. ¶ 4451.

25 *Id.* ¶ 4577. *See infra* note 132.

26 1 BLUE SKY L. REP. ¶ 4751.

27 WASH. AD. CODE § 308-132-136; expected recodification: WASH. AD. CODE ch. 460-36 (*see* note 36 *infra*).

the Administrator's determination that vacant land has better investment potential in this state than in many of the states represented in the Midwestern Association. The Association has also issued a number of statements of policy affecting new securities offerings, which will be mentioned in this article.

Another form of cooperation among state securities administrators is the routine notification by one administrator to another of his receipt of an application for registration of a securities offering which discloses (as is required in the Washington registration statement)[28] any other states where a registration statement has been or will be filed.

IV. Administration of the Securities Act of Washington

The Act states that its administration shall be under the department of licenses,[29] and references in the Act to the "director" are to the director of licenses.[30] However, in 1965 the powers, duties and functions of the director and department of licenses were transferred to the director and department of motor vehicles, and those pertaining to the Act were delegated to the division of professional licensing of the department of motor vehicles.[31] In fact, administration of the Act is actually carried out by the Administrator of Securities, to whom the director is obliged by the Act to delegate the necessary powers, subject to his authority; the Administrator is appointed by, and holds office at the pleasure of, the director.[32] The present Administrator has held office more than 13 years.

The Administrator's principal office in Olympia is staffed by one Examiner and four secretarial personnel. A second Examiner's position is not filled at present on a permanent basis; the Administrator has experienced difficulty in obtaining a qualified permanent staff at the salary level provided. A branch office is maintained in Seattle with a staff of two Auditors. The budget for the Securities Division for fiscal 1969-70 was $129,622. Revenues of the Division for the preceding fiscal year amounted to $336,149. Approximately 2,000 permits to sell securities were issued in that year. During a recent period the Division handled, in an average month, 49 registrations of securities by coordination, 19 mutual fund registrations, and 9 registrations by qualification. Although the registrations by qualification (i.e., basically "intrastate offerings") were numeri-

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28 Wash. Rev. Code § 21.20.210(9) (1959).

29 Wash. Rev. Code § 21.20.450 (1959).

30 Wash. Rev. Code § 21.20.005(1) (1967).

31 Ch. 156, [1965] Wash. Sess. Laws 1615; ch. 170, §§ 41-42, [1965] Wash. Sess. Laws (1st Ex. Sess.) 2698.

32 Wash. Rev. Code § 21.20.460 (1959).

cally the fewest, they constituted the bulk of the workload of the Administrator's office in terms of time expended. Examinations of persons seeking registration as broker-dealers, investment advisers and securities salesmen are given bi-monthly; a total of about 1600 were given during fiscal 1968-69.

The workload of the Securities Division has increased substantially in recent years. In fiscal 1960-61 approximately one-half the business of fiscal 1968-69 was done by the Division, in terms of the number of examinations and permits. The budget for that year was $66,000, and revenues were $96,000. The Administrator's staff during that year comprised one Examiner, one Auditor and two secretarial personnel. Thus it is apparent that the increase in staff has not been commensurate with the increase in business.

The Act permits, but does not require, the Administrator to adopt rules and forms necessary to carry out its provisions.[33] Such rules and forms are to be made only if the Administrator "finds that action is necessary or appropriate in the public interest or for the protection of investors and consistent with the [statutory] policy." When adopted, all such rules and forms are to be published.[34] As of the present writing there are in effect nineteen rules[35] adopted in 1965, primarily relating to securities offerings and real estate investment trusts, broker-dealers and investment advisers; and the Administrator has recently adopted new rules on a variety of subjects after holding a public hearing thereon.[36] Forms published include applications for broker-dealer's, salesman's and investment adviser's certificates; applications for registration of securities by qualification, coordination or notification; periodic reports covering sales of registered securities and issuer's operations; and escrow of promotional stock and impound of offering proceeds. The Administrator is also empowered in his discretion to honor requests for interpretive opinions.[37]

The Act creates a state advisory committee of seven members

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[33] WASH. REV. CODE § 21.20.450 (1959).

[34] *Id. See also* Administrative Procedure Act, WASH. REV. CODE ch. 34.04 & WASH. AD. CODE ch. 308-08.

[35] WASH. AD. CODE ch. 308-08. They are reprinted in 3 BLUE SKY L. REP. ¶ 50,601.

[36] These include new rules on limited partnerships, cheap stock, non-voting stock, promoters' investment and accounting matters; and revised rules on real estate investment trusts and options and warrants. *See* notes 131-33, 136-41, *infra,* and accompanying text. As yet these rules are not codified. It is expected that these rules will be codified, and the existing rules recodified, as WASH. AD. CODE chs. 460-08 through 460-60.

[37] WASH. REV. CODE § 21.20.530 (1959). In practice, such opinions are at present virtually limited to the equivalent of "no action" letters, in which the Administrator responds to a letter-request for confirmation that an exemption applies to a particular factual situation. They are not published.

to be appointed by the Director.[38] In addition to having a general advisory capacity, the committee is charged to acquaint itself with the operations of the Administrator's office in respect of the administration of matters pertaining to securities and to make periodic recommendations for changes in the rules and regulations which they deem advisable. No such recommendations have been made in recent years. The committee has also, at least nominally, the duty of giving qualifying examinations to broker-dealers, salesmen and investment advisers.

Administrative determinations adverse to an applicant for, or fixing conditions of, a permit to issue and sell securities, are made by order of the Administrator. In some cases, for example, a "stop order" denying, suspending, or revoking the effectiveness of a registration statement,[39] the statute prescribes in detail the findings required as a basis of the order. Such an order need not be preceded by a hearing, but the applicant must be notified promptly, and a hearing held if requested.[40] In others, for example, an order for escrow of promotional stock or impounding proceeds of an offering as a condition of registration of securities,[41] the Act permits the Administrator to proceed by order without specifying any grounds for imposition of the condition. Although the rules outline the applicable procedures, they provide no guidelines as to when the condition should be imposed.[42] When hearings are held they must be public unless a private hearing is requested by the respondent and the request is granted in the Administrator's discretion.[43] Violation of the Administrator's orders, as well as of his rules or the Act may be grounds for injunctive relief,[44] or involve civil liability,[45] or, if willful, criminal liability.[46] The Act gives the Administrator investigative powers[47] and makes specific provision for judicial review of his orders, in which his findings as to the facts are conclusive if supported by substantial evidence.[48]

While stop orders are by no means rare, the intended but ag-

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38 WASH. REV. CODE § 21.20.550 (1959). Appointment is in fact made by the Director; the power is not delegated to the Administrator.

39 WASH. REV. CODE § 21.20.280 (1959).

40 WASH. REV. CODE § 21.20.300 (1959).

41 WASH. REV. CODE § 21.20.250 (1959).

42 WASH. AD. CODE §§ 308-132-030 & 040, 308-132-170 & 172.

43 WASH. REV. CODE § 21.20.500 (1959).

44 WASH. REV. CODE § 21.20.390 (1959).

45 WASH. REV. CODE § 21.20.430 (1967).

46 WASH. REV. CODE § 21.20.400 (1965). Prosecution may be instituted by either the Attorney General or the County Prosecutor (WASH. REV. CODE § 21.20.410 (1959)). Under prior law the Attorney General had no power to prosecute violations of the Act, though he was obliged to act as legal advisor to the Administrator. [1957-1958] WASH. OP. ATT'Y GEN. No. 29.

47 WASH. REV. CODE § 21.20.370 (1959).

48 WASH. REV. CODE § 21.20.440 (1959).

grieved issuer almost never requests a hearing or pursues the matter further; no such hearings have been requested in recent years. Likewise, while two broker-dealers were suspended in recent years, no hearing was requested. The virtual absence of formal hearings and litigation testing such orders[49] seems remarkable in view of the sensitive judgments required of the Administrator. Among the many factors which might explain this apparent absence of contention are: the very considerable powers given to the Administrator by the Act; his availability for informal conferences to work matters out; the singleness of the desire of an issuer to get his permit, and get it quickly; the fact that the notoriety and delay of a lawsuit, to say nothing of its expense, would be highly prejudicial to an offering, if not prohibitive; and, perhaps most importantly, the standard of judgment exercised in the administration of the Act.

In a case arising under the prior Securities Act, the Washington Supreme Court observed that the Act was, at least in part, penal in nature and was in derogation of the common law; hence, it should be strictly construed and not "extended beyond its plain terms."[50] Perhaps this rule should be applied to the scope of the Administrator's discretion; there seems to be no statement of the supreme court directly in point. Some idea of the actual scope of the Administrator's discretion will be suggested in the following discussion of his rules and their relationship to the Act.

V. Requirement of Registration of Securities

The starting point of statutory and administrative requirements pertaining to an offering of securities of a new venture in this state is Wash. Rev. Code § 21.20.140.[51] This section states that "it is unlawful for any person to *offer* or *sell* any *security* in this state" [emphasis added] unless an exemption applies or unless the security is registered under one of the three available methods. The scope of the meaning of the italicized words is of major significance in application of the statute, and questions pertaining to their definition and to the available exemptions are mentioned below. Of the three methods of registration provided, notification is not available

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[49] In recent years the Administrator's stop orders have been only indirectly involved in litigation, in a few civil proceedings relating to financially distressed issuers and one criminal proceeding, State v. Rutherford, 66 Wn. 2d 851, 405 P.2d 719 (1965).

[50] Marble v. Clein, 55 Wn. 2d 315, 317-18, 347 P.2d 830, 831 (1959). The action was for recovery of a sales commission; the court refused to hold that the plaintiff was required to be licensed as a broker under the statute.

[51] Discussion of compliance with the federal securities laws, and of their exemptions, is beyond the scope of this article. Securities of insurance companies and related organizations are excluded from the scope of the statutes under consideration by virtue of Wash. Rev. Code § 21.20.930 (1959).

for securities of a new venture since it is designed for seasoned securities,[52] and coordination is limited to cases where federal registration is also effected.[53] Thus registration of an intrastate offering of securities of a new venture must be effected by qualification, the method available for "any security."[54]

In addition to the Administrator's power to enjoin violations[55] and the possibility of criminal liability for willful violations[56] of the Act, any offer *or* sale of an unregistered security in violation of Wash. Rev. Code § 21.20.140 carries with it civil liability for rescission or damages.[57] Not only the offeror or seller is liable; the Act provides for joint and several liability (with right of contribution) of persons controlling the seller and broker-dealers and salesmen who materially aid in the sale.[58] The only statutory escape from such liability on the part of a non-seller requires sustaining the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the existence of the facts giving rise to the violation. Numerous questions may be raised in the application of these provisions to any situation, for instance, whether a director is liable simply because he is a director, or must he materially aid in the sale?[59] What participation is required to invoke liability?[60] Who is a controlling person? Another, and difficult, question is whether these private liabilities apply in the case of a breach of a permit condition, since the statute refers to a breach of the statutory requirement of registration; does breach of a condition imply breach of the statute? Is the nature of the condition material in this connection?[61] That such questions may be

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[52] WASH. REV. CODE § 21.20.150 (1959).

[53] WASH. REV. CODE § 21.20.180 (1961). Registration by coordination is available also for a filing under Regulation A of the Securities Act of 1933, although that technically is an exemption rather than a registration.

[54] WASH. REV. CODE § 21.20.210 (1959).

[55] WASH. REV. CODE § 21.20.390 (1959).

[56] WASH. REV. CODE § 21.20.400 (1965). The possible term of imprisonment was increased from three to ten years by amendment in 1965.

[57] WASH. REV. CODE § 21.20.430 (1967). This statute extends to violations of the requirement of registration by coordination or notification, as applicable, and to offers and sales by means of fraud or misrepresentation. Costs and attorneys' fees are also recoverable. The statute of limitations was increased from two to three years by amendment in 1967. Loss, at 1696, states that the majority view would permit rescission based upon an (illegal) offer prior to registration where the sale took place after registration; the Draftsmen's Commentary to § 410(a) of the Uniform Act emphasizes that the statute reaches offers as well as sales, on the basis that this is the only effective way to control pre-effective offers.

[58] *See* Annot., 59 A.L.R.2d 1030 (1958).

[59] Loss & COWETT, at 136, and authorities cited therein; Wolens, *"Hidden Gold" in the Blue Sky Laws*, 20 SW. L.J. 578, 588 (1966). *See* Annot., 144 A.L.R. 1356 (1943).

[60] *See* Annot., 59 A.L.R.2d 1030 (1958); Note, *Director and Officer Liability Under Blue Sky Laws: A Need for Revision*, 5 GA. L. REV. 128 (1970).

[61] See discussion of permit conditions in § X, *infra.*

largely academic to the issuer at the time of registration does not diminish the effectiveness of these liability provisions, which lies not so much in their actual application as in the threat of application.[62]

The liabilities referred to above are explicitly established by statute; and it was the intention of the draftsmen of the Uniform Act that no implied right of action be created.[63] In adopting the Uniform Act, however, Washington (as well as a number of other states) failed to adopt the section excluding implied liabilities, and in a recently decided case[64] the Washington Court of Appeals has held that a private right of action lies to enforce liabilities created by the statute.

A similar threat may be found in the Administrator's investigative powers, and the power to publish the results of his investigation insofar as they reflect any violation of law, rule or order.[65] A further protection to the public, though it may be of lesser preventive impact on the issuer, is the limitation of enforceability, by the issuer, of a contract for the purchase of a security made in violation of the statute or any rule or order thereunder.[66] Moreover, any attempted waiver of the provisions of this section is void.[67] A tender, or rescission offer, is the only cure afforded by the statute.

Finally, it should be pointed out that these penalties for failure to register a security offering may be brought into play, not only in the case where a statutory violation is inherent from the outset, whether intentional or inadvertent. Violation may also occur, again even inadvertently, in the course of an offering carefully designed to avoid registration requirements; for example, an offering designed to be private may become "public" as a result of a salesman's zeal. The consequence in such a case has a retroactive effect, so that all offers and sales, before or after the single act of impropriety, become violative of the registration requirement. Exposure to liability of such scope and potential expense as above indicated is a counsel of caution to the legitimate promoter and those who

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[62] Loss & Cowett, at 129-30. The class action (Wash. R. Civ. P 23) may be a particularly effective means of carrying out the threat. On the paucity of reported cases see Wolens, *supra* note 59, at 598-99.

[63] *See* Uniform Securities Act § 410(h) and Official Comment.

[64] Shermer v. Baker, 2 Wn. App. 845, 472 P.2d 589 (1970). The particular statute involved was Wash. Rev. Code § 21.20.010 (1959). The court based its reasoning on the fact that the federal courts had established a private right of action under the corresponding SEC Rule 10b-5 prior to the enactment of the Washington Securities Act and upon the provision of the Washington Act prescribing coordination "with the related federal regulation." *See* Note, *Express and Implied Civil Liability Provisions in State Blue Sky Laws*, 17 Case W. Res. L. Rev. 1173 (1966).

[65] Wash. Rev. Code § 21.20.370 (1959).

[66] Wash. Rev. Code § 21.20.430(4) (1967). *See* Annot., 84 A.L.R.2d 479 (1962).

[67] Wash. Rev. Code § 21.20.430(4) (1967). *See* Annot., 61 A.L.R.2d 1308 (1958).

figure in his organization. Little comfort is provided by the statutory "good faith" exemption from liability,[68] since the act or omission concerned must also be in conformity with a rule, form or order of the Administrator.

VI. Defining the Elements

In the ordinary case the scope of "security" as applied to any particular offering gives little difficulty since the statutory definition[69] is broad indeed. After enumerating several readily recognizable forms of security the statute adds several not so readily recognizable, and some very general categories such as "investment contract" and "any interest or instrument commonly known as a 'security.'" The breadth of these general categories, not generally appreciated by persons unfamiliar with securities law, is perhaps responsible for much inadvertent violation of these laws.[70]

Rather than attempting a general discussion of the meaning of "security," a large subject,[71] it may be more useful to cite some specific Washington authorities which may suggest its boundaries as observed in this state. The Washington Attorney General issued a number of opinions during the 1920's and subsequent years, applying prior law, most of which dealing with this subject are presumably equally valid under the present Act. These opinions determined the following particular transactions to involve a security: the sale of debt obligations to the public for purposes of raising capital;[72] the sale of interests in a limited partnership[73] or an investors' syndicate;[74] a contract for undertaking services at cost plus 10%, the deposit to bear interest;[75] a sale of a fractional interest in an apartment house coupled with a management contract;[76] a sale of a fractional interest in an oil lease with an agreement for sharing

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68 WASH. REV. CODE § 21.20.490 (1959).

69 WASH. REV. CODE § 21.20.005(12) (1967). It is derived basically from the definition in the federal Securities Act of 1933. *See* Uniform Securities Act § 401(1), Official Comment.

70 In 1967 the SEC and the securities authorities of Maryland, Virginia and the District of Columbia found it necessary, in response to newspaper advertising of limited partnership interests, and other real estate syndications, to issue a joint release warning that such interests generally constitute securities and require registration. Securities Act Release No. 4877; CCH FED. SEC. L. REP. ¶ 77,462.

71 *See* 1 Loss, at 455; Annots., 87 A.L.R. 42, 74 (1933), 163 A.L.R. 1050 (1946); 50 A.L.R.2d 1103 (1956); CCH FED. SEC. L. REP. ¶ 1011.

72 [1929-1930] WASH. OP. ATT'Y GEN. 453.

73 WASH. OP. ATT'Y GEN., June 17, 1954 [This and others referred to only by date are apparently unpublished and found in the Administrator's files].

74 WASH. OP. ATT'Y GEN., April 29, 1932.

75 [1929-1930] WASH. OP. ATT'Y GEN. 637; *see also* WASH. OP. ATT'Y GEN., March 7, 1932.

76 WASH. OP. ATT'Y GEN., Nov. 9, 1927.

of profits;[77] the sale of coin-operated apple vending machines with an operating contract;[78] the sale of a number of hens with a contract for their care and the marketing of their products;[79] and the sale of an interest in real estate with a poultry raising contract.[80] On the other hand, the sale of particular chinchillas, with rights to service and sales arrangements, was found not to be a security;[81] nor was the offer of an apartment lease for life for a fixed sum.[82] Superior Court litigation involving sales of undivided interests in real property coupled with contractual arrangements between seller and purchaser has held such sales, when made to the public, to require registration.[83]

Turning to more recent matters, the definition of "security" in the Act was amended to include the sale of out-of-state land when not made through a Washington real estate broker;[84] the effect in practice has been to channel such business through real estate brokers so as to avoid securities registration. The Washington statute on condominiums expressly states that an interest in a condominium is real property, and not a security.[85] Nevertheless, the Administrator takes the position that some forms of agreement between owner and manager for rental of condominium units are securities.[86] On the other hand, he has taken the position that employee benefit plans, if voluntary and noncontributory, do not involve the offering of a security; other types may be considered securities but are subject to a short-form registration.[87] He has also taken the position that the sale of whiskey warehouse receipts, or similar evidences, may be the sale of a security where the original seller contracts to sell the whiskey for the owner after ageing.[88] Similarly, with the sale of an undivided interest in real property subject to a management contract, and with the sale of an automobile trailer intended for public rental, subject to a rental arrangement. On the

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77 [1929-1930] WASH. OP. ATT'Y GEN. 504.

78 [1929-1930] WASH. OP. ATT'Y GEN. 723.

79 WASH. OP. ATT'Y GEN., June 1, 1931; *see* [1927-1928] WASH. OP. ATT'Y GEN. 756.

80 WASH. OP. ATT'Y GEN., Sept. 3, 1931.

81 WASH. OP. ATT'Y GEN., Dec. 3, 1938.

82 [1957-1958] WASH. OP. ATT'Y GEN. No. 179, *overruling* [1957-1958] WASH. OP. ATT'Y GEN. No. 42.

83 Order modifying temporary injunction, Dec. 28, 1962, Superior Court for the State of Wash. for Thurston County. Lonctot v. Federal Shopping Way, No. 34427; Brett v. Securities Division, No. 34394.

84 Ch. 199, § 1(12), [1967] WASH. SESS. LAWS 1002.

85 WASH. REV. CODE § 64.32.010(14) (1963); WASH. REV. CODE § 64.32.030 (1963).

86 *See* ROHAN & RESKIN, CONDOMINIUM LAW AND PRACTICE ch. 18 (1969).

87 WASH. REV. CODE § 21.20.310(11) (1959).

88 Two earlier letter opinions of the Attorney General may be *contra*, WASH. OP. ATT'Y GEN., June 30, 1938 and Dec. 19, 1934. *Cf.* Securities Act Release No. 5018, CCH FED. SEC. L. REP. ¶ 77,757.

other hand, franchises are not, generally speaking, regarded as securities.[89]

The statutory definition of "sell" or "sale" is stated to include every disposition of a security (or interest therein) for value, and every contract therefor.[90] "Offer" includes every attempt or offer to sell, or solicitation of an offer to buy, a security or interest therein. While these definitions may not at once appear to give rise to much difficulty of interpretation, the statute goes on to state that any security given as a bonus in connection with a purchase (of anything) is considered as having been sold and that a purported gift of assessable stock is considered to involve an offer and sale. Moreover, every sale or offer of a warrant or right to purchase another security, and every sale or offer of a convertible security is considered to include an offer of the other security.[91] To the broad general definitions the statute thus gives additional reach by the statement of specifics. It should also be noted that, properly speaking, the statute does not define "offer" and "sell," merely stating that certain things are included within them.

Doubtless the most difficult problem in this area is the practical one of what, if anything, can be said or written about an unregistered security.[92] When does mention of a security become an offer? In an advertisement or a conversation is a self-serving statement that no offer is intended, effective? How much does it take to produce an "attempt" or a "solicitation"? To the endless variations of circumstances possible, only a practical answer seems possible in advising a client on questions of this kind. The threat of the statute leaves little room for comfort, however, and such practicality as it carries must be found in its administration.

VII. Exemptions from Registration

If a security is to be offered or sold in this state, registration may lawfully be avoided only if one of the statutory exemptions

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[89] *See* Comment, *The Franchise Agreement: A Security for Purposes of Regulation*, 1970 U. Ill. L.F. 130. Since this article was written the Legislature has enacted the Franchise Investment Protection Act providing for separate regulation of franchise offerings under the jurisdiction of the Securities Administrator. Ch. 252, [1971] Wash. Sess. Laws.

[90] Wash. Rev. Code § 21.20.005(10) (1967).

[91] The Act departs at this point from the Uniform Securities Act by failing to provide that the following are not included in the terms "offer" or "sale"; pledges and loans; stock dividends; actions pursuant to stockholder vote on merger, consolidation, or sale of assets; and judicially approved reorganizations. Most of these (with modifications) are found instead in the exempt transactions section of the Washington Act (Wash. Rev. Code § 21.20.320 (1967)). The distinction is of some significance since (a) if they were excluded from the definition, they would presumably be excluded from all aspects of the Act, including the anti-fraud provisions; and (b) the Administrator may deny or revoke any such exemption by virtue of Wash. Rev. Code § 21.20.325 (1967).

[92] *Cf.* Loss, at 186.

applies,[93] and the burden of proof is upon the person asserting the exemption.[94] Counsel is likely to devote a good deal of attention to the question of availability of an exemption in the usual case of the formation of a new business venture, and it is proposed to confine this discussion to matters generally relevant to an intrastate offering of equity securities in a case of this kind.

Certain kinds of securities are exempt (Wash. Rev. Code § 21.20.310) and certain kinds of transactions are exempt (Wash. Rev. Code § 21.20.320). The former provides no help in the situation under consideration, but the following kinds of exempt transactions may (parenthetical references are to the subsections of Wash. Rev. Code § 21.20.320): (1) isolated transaction, or nonpublic offering; (4) transactions with and among underwriters; (8) transactions with institutional buyers and broker-dealers; (9) transactions pursuant to an offer to not more than twenty offerees, subject to other stated conditions; and (10) offers and sales of preorganization certificates, subject to other stated conditions. Of these, the exemptions for transactions with and among underwriters and with institutional buyers and broker-dealers do not require comment here except to state that for business reasons they are not ordinarily available to a new business venture in this state.

The remaining transactional exemptions have a common thread, in that, generally speaking, they involve a small offering in terms of the number of investors. The first to be considered relates to preincorporation subscriptions and prescribes a maximum of ten subscribers, although there is no limit to the number of offerees. While the promoter thus has license to canvass the state, the exemption's limitations are such as virtually to confine its usefulness to the usual situation of a very small group desiring to incorporate a business. No payment may be made by any subscriber, and no sales commission may be paid. In fact it essentially is a technical exemption,[95] necessary because a preincorporation certificate or subscription is a security itself,[96] distinct from the security subscribed for.[97] The exemption does not extend to the security, but

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[93] No consideration will be given here to the practice reported by one writer to be common, and thought of as legitimate by practitioners, though frowned upon by Administrators: inviting prospective purchasers out of the state and into a climate more favorable to offers. That writer cautions that the invitation must be carefully phrased so that it does not itself constitute an offer. Hoffman, *Blue Skying an Issue*, 13 HOWARD L.J. 108, 112 (1967). For a discussion comparing state blue sky law exemptions *see* Mofsky, *Blue Sky Restrictions on New Business Promotions*, 1969 DUKE L.J. 273, 276.

[94] WASH. REV. CODE § 21.20.540 (1959).

[95] Uniform Securities Act § 402(b)(10), Draftmen's Commentary.

[96] WASH. REV. CODE § 21.20.005(12) (1961). *Cf.* [1931-1932] WASH. OP. ATT'Y GEN. 295.

[97] Uniform Securities Act § 402(b)(10), Draftsmen's Commentary.

only postpones registration until the security is offered, unless another exemption is available for the issuance of the security.[98]

Thus it may be useful to consider the preincorporation subscription exemption in connection with the twenty offerees exemption.[99] Putting aside other conditions to this latter exemption for the moment, it exempts any transaction pursuant to an *offer* to not more than twenty persons. If the promoters have canvassed the public for preincorporation subscriptions, and have obtained ten, may they after incorporation offer the stock to an additional twenty people? The Administrator takes the position that they may not. This position may be based upon the fact that, under the definition of "sale," each subscription carried an offer of stock, so that ten offerees are already accounted for out of the twenty, and only ten more offers, of the stock, may be made. In fact, it would appear possible to go further: the *offer* (under the definition of the term) of a preorganization certificate includes an offer of the stock as well, so that if there have been more than twenty offers of the preorganization certificate, the twenty-offerees exemption would not be available for the stock. It is understood, however, that the Administrator has not taken this position.

The provisions of subsection (9)[100] require some further elaboration. First, to restate the section, the twenty persons must be offerees,[101] not purchasers, except in the unlikely event that every offer produces a sale. In counting the number of offerees, institutional investors and broker-dealers are excluded,[102] although the incorporators and other insiders are included. Once the offering is made to twenty persons, it may not be made to the twenty-first person until a year has elapsed from the date of the first offer. The final conditions of this exemption are (a) the seller must reasonably believe that all the buyers are purchasing for investment (thus as a practical matter necessitating investment letters), and (b) no commission or other compensation is paid for solicitation.

A word should be said regarding this last condition, that no commission or other compensation be paid for solicitation, which

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98 Uniform Securities Act § 402(b)(10), Official Comment.

99 WASH. REV. CODE § 21.20.320(9) & (10) (1961).

100 *Id.*

101 The Uniform Securities Act specifies ten offerees, recognizing that it was only a *prima facie* figure and permitting the Administrator to increase or decrease the number. Uniform Securities Act § 402(b)(9), Official Comment.

102 So also are offers outside the state, producing the possibility that 120 sales might be made in the state if 100 of the offers were made outside the state to persons who later made their purchases in the state. The subsection reaches an offeror outside the state if his offer is made in the state, and offers directed into the state are counted even if they do not reach the offeree. *Cf.* Uniform Securities Act § 414 (not enacted in Washington).

applies also to subsection (10),[103] covering preincorporation subscriptions. While it would eliminate the hiring of professional salesmen to make the offering, it is not intended to prevent solicitation by officers, directors and employees of the issuer[104] so long as this is only an incidental part of their duties and they receive no additional compensation. On the other hand, it is understood that the Administrator takes the position that the payment of a real estate commission on the sale of real estate to a syndicate constitutes indirect compensation and makes this exemption unavailable.

As the twenty-offerees exemption is thus rather strictly defined, and the prohibition of sales commissions may be significant in a given situation, counsel for the issuer may look for what comfort he can find in the private offering exemption, or, more properly, "[a]ny isolated transactions, or sales not involving a public offering. . . ."[105] This exemption imposes no conditions regarding absence of sales commissions, the period of the offers, or whether the offers are made before or after incorporation. But if its virtue is the absence of these specific conditions, its vice is inherent uncertainty of meaning, and it was on this basis that this exemption was deliberately omitted from the Uniform Act.[106] The corresponding exemption under the federal Securities Act of 1933[107] has given difficulty and been the subject of discussion[108] from which the only conclusion can be that its applicability depends upon all the facts and circumstances, including but not limited to the number of offerees, their relationship to the offeror, and the extent of their sophistication in the securities field.[109] Some practitioners take it as a rule of thumb that a private offering may go as high as twenty-five offerees (not purchasers), but the Administrator (like the S.E.C.) gives no credence to this.[110] The most that can be said for this rule of thumb is that it indicates a rough maximum in the usual case (but not always) although there is no real assurance that an offering to twenty-five or fewer offerees is in fact a private offering. Counsel should consider and advise regarding all conceivable circumstances which may be encountered before permitting an issuer to proceed under this exemption and then will likely do so with his fingers crossed. The "isolated transaction" exemption as a practical matter adds little, if anything, to the private offering exemption.[111]

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[103] WASH. REV. CODE § 21.20.320(10) (1961).
[104] Uniform Securities Act § 402(b)(9), Official Comment.
[105] WASH. REV. CODE § 21.20.320(1) (1961).
[106] Uniform Securities Act § 402(b)(9), Draftsmen's Commentary.
[107] 15 U.S.C. 77d(2) (1954).
[108] 1 LOSS, at 641.
[109] CCH FED. SEC. L. REP. ¶ 2740 and ¶ 2770.
[110] *Id.* ¶ 2740.
[111] *See* Annot., 1 A.L.R.3d 614 (1965).

It remains only to consider how these fragile exemptions may be lost. Prior to 1967 the Administrator had no power to deny to an issuer any of the exemptions above mentioned, but by the enactment of Wash. Rev. Code § 21.20.325 in that year he was empowered to do so by order with respect to any specific security or transaction.[112] He cannot, however, do so with respect to a class of transactions or securities, or revoke any exemption generally; such action would amount to amending the statute. The statute requires notice to the interested parties and opportunity for a hearing; but the order may be made summarily, and no grounds for such an order are specified in the statute.

VIII. Registration Procedure

Registration by qualification is initiated by the filing by the issuer, any person on whose behalf the offering is made, or a registered broker-dealer,[113] of a registration statement containing the information and documents specified in the statute,[114] accompanied by the filing fee[115] and consent to service of process if required.[116] The Administrator's published form of statement for registration by qualification is essentially an outline, rather than a fill-in form, of the information to be provided. The form requires a verification by a person authorized by the registrant, a requirement which seems redundant in the light of the statute making it unlawful for any person to make any false or misleading statement in any document filed with the Administrator.[117] The form specifies that the required material and documents be attached as separately numbered and captioned exhibits. Essentially these are the same as provided in the statute, and they may be summarized as follows:

(1) Identification and description of the issuer, its business and properties;[118]

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112 This provision is part of the Uniform Securities Act but was omitted from the Washington Securities Act as originally enacted. The Administrator reports exercising this power twice: once with respect to an employee profit-sharing plan and once with respect to a nonprofit hospital corporation.

113 Wash. Rev. Code § 21.20.240 (1959).

114 Wash. Rev. Code § 21.20.210 (1959). The Administrator may, by rule or otherwise, permit the omission of any item of information or document from any registration statement (Wash. Rev. Code § 21.20.240 (1959)), but no rule of this nature has been promulgated to date.

115 Wash. Rev. Code § 21.20.340 (1965). Payment of the filing fee is apparently not a condition of filing (Wash. Rev. Code § 21.20.510 (1959)) though failure to pay is grounds for denial of registration until payment is made (Wash. Rev. Code § 21.20.280(8) (1959)).

116 Wash. Rev. Code § 21.20.330 (1959).

117 Wash. Rev. Code § 21.20.350 (1959).

118 The rules require an opinion of counsel as to the legality of the form and the status of existence of the registrant (issuer?) and the status of litigation in which

(2) List of officers, directors, ten-percent stockholders and promoters, with a statement of their stockholdings and remuneration; description of stock options outstanding or to be created for these persons and others;

(3) Financial information relating to the issuer, including a recent balance sheet and three years' operating statements (none of these is required by the statute to be certified) and a description of capitalization and long term debt (both current and pro forma);

(4) Description of securities to be offered, underwriting and selling arrangements and compensation, and an attorney's opinion on the legality of the security being registered;[119]

(5) Statement of proposed use of the proceeds of the offering, including information relating to any property proposed to be acquired;

(6) Statement whether the applicant or any asset is involved in or threatened with litigation, or is subject to any adverse order or judgment previously entered with respect to the offering by any court or the S.E.C.;[120]

(7) A copy of any prospectus or offering circular proposed to be issued in connection with the offering. The content of the offering circular is not prescribed by statute but is by rule.[121]

According to the statute, a registration statement becomes effective[122] and the securities may be offered and sold,[123] if no stop order is in effect, at 3:00 P.M. (standard time) of the fifteenth full business day after the filing of the statement or the last amendment. In fact, registration is completed with the issuance by the Administrator of a permit. Nowhere mentioned in the Act, the usage of a permit is a carry-over from prior law.[124] The draftsmen of the Uniform Act saw no inherent difference between registration as contemplated by that Act and the procedure for issuance of a permit.[125]

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it is involved or of which counsel has notice may be pending. WASH. AD. CODE § 308-132-080; expected recodification: WASH. AD. CODE § 460-16-050 (*see* note 36 *supra*).

[119] The rules permit the substitution of a copy of the corporate resolution authorizing the issue for counsel's opinion. *Id.*

[120] *See* note 118, *supra*.

[121] WASH. AD. CODE § 308-132-100; expected recodification: WASH. AD. CODE § 460-16-100 (*see* note 36 *supra*).

[122] WASH. REV. CODE § 21.20.230 (1961). The Administrator may advance the time of effectiveness.

[123] WASH. REV. CODE § 21.20.260 (1959). Offers and sales (except in exempted transactions, WASH. REV. CODE § 21.20.320 (1961)) are unlawful (WASH. REV. CODE § 21.20.040 (1959)) unless made by registered broker-dealers and salesmen.

[124] REM. REV. STAT. § 5853-3.

[125] Uniform Securities Act § 301, Draftsmen's Commentary.

The permit does, however, function as a comprehensive statement of the fact of registration, its limitations, and the conditions upon which it is issued. The director is required by statute[126] to maintain a register of all registration statements and denial, revocation and suspension orders. The register is open to the public, and the information contained in the registration statements may be made available to the public.

In addition to the conditions mentioned below, the permit form carries in full capitals the legend that it is permissive only and that its issuance does not constitute a recommendation or endorsement of the securities to be offered. This is, in effect, notice of the provisions of Wash. Rev. Code § 21.20.360, to the effect that registration does not constitute a finding by the Administrator that the statement is true, complete and not misleading or that he has passed in any way upon the merits of the security.

The effectiveness of a registration statement continues until revoked by the Administrator or terminated by request of the registrant with the consent of the Administrator.[127]

IX. Denial of Registration

Under Wash. Rev. Code § 21.20.280 the Administrator may issue a stop order denying registration, or suspending or revoking a registration previously effected, if he finds such order in the public interest and if any one or more than the nine stated grounds exists. Before considering these grounds, it may be worthwhile to reiterate that the "fair, just and equitable" standard is not among them as it is for example in the California and Oregon statutes.[128] The draftsmen of the Uniform Act, which is substantially identical with the Washington Act in this respect, rejected that standard as vague.[129] Their effort at a more specific statement of the standards upon which the offering would be tested was in the interest of providing more definite guidelines to legitimate business; however, they believed that with vigorous enforcement, especially of disclosure requirements, these standards could be equally effective in protecting the public.

Another notable omission is the absence of any ground related

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126 Wash. Rev. Code § 21.20.510 (1959).

127 Wash. Rev. Code § 21.20.260 (1959). This section also provides that all outstanding securities of the same class as a registered security are considered to be registered for purposes of any *non*-issuer transaction.

128 Calif. Corp. Code § 25140; Ore. Rev. Stat. § 59.170. Under these statutes this standard applies not only to the securities but also to the issuer's proposed plan of business; moreover, the commissioner (administrator) must find that the issuer intends to transact its business fairly and honestly.

129 Uniform Securities Act § 306, Draftsmen's Commentary.

to the apparent financial soundness of the business itself, or the adequacy of plans for business operations.[130] The only ground expressly related to the business is illegality of the business or business methods. Thus the Administrator does not carry the burden of passing judgment upon the possibilities of success of the enterprise.

The principal grounds upon which the Administrator relies in assessing an offering from the standpoint of the investor are found in subsections (5) and (9) of Wash. Rev. Code § 21.20.280. Subsection (5) permits denial of registration if "the offering has worked or tended to work a fraud upon purchasers or would so operate." While this ground seems directed primarily at the method of offering rather than the security being offered, it is probably broad enough to include the latter. It can reasonably be supposed that "fraud" would be interpreted for this purpose in the securities-law sense rather than in the narrower common-law sense. No rules interpreting this ground have been published, and it would seem that this ground provides the Administrator considerable scope for judgment.

The other principal ground is stated in subsection (9) and is somewhat more specific. It reaches: (a) unreasonable amounts of underwriter's and sellers' discounts, commissions or compensation, (b) unreasonable promoters' profits or participation, and (c) unreasonable amounts or kinds of options. These points go to the essence of the bargain being made between the insiders and the public investors, and merit some consideration. The Administrator's rules, some of them recently published, proved indications of how some of these matters may be shaped.

The Administrator's rules do not state a particular amount or percentage of the offering price allowable as compensation for making sales under an offering, for any type of offering. The compensation might be expected to, and does, vary with the type of offering. In cases of the kind under consideration, intrastate offerings of equity securities of new ventures, the Administrator generally permits the "cost of selling" to go as high as 15% of the offering price. These costs are defined by a published rule[131] to include "commissions, salaries, advertising and all other expenses directly or indirectly incurred in connection with the sale of securities," but to exclude attorneys' fees, expenses of qualification and charges for certain services not directly connected with sales.

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[130] In this respect it differs from prior Washington law.

[131] WASH. AD. CODE § 308-132-020. *Cf.* Mofsky, *Blue Sky Restrictions on New Business Promotions*, 1969 DUKE L.J. 273, 278, arguing the case for larger underwriting compensation as a means of attracting investment banking services to such offerings, with anticipated benefit to the public.

A second area of compensation to the promoters, officers, directors and underwriters is the area of options and warrants, the subject of a newly revised and more stringent rule[132] than that in effect since 1965. This new rule, after stating that options and warrants "will hereafter be looked upon with greater disfavor," goes on to set forth certain guidelines upon which they may be justified. Among other things these rules suggest that options and warrants to underwriters may be justified in the case of a relatively small company in the promotional stage where the issuer can show that the issuance of options and warrants is necessary to obtain competent investment banking service, that the commissions to the underwriters are lower than usual, and that the number of shares subject to the options and warrants does not exceed 10% of those to be outstanding at the completion of the offering.

Rules have for some time been published on "promotional shares,"[133] requiring the shares to carry a waiver of dividend rights and rights to participate in distribution on liquidation, in favor of cash investors, so long as the Administrator may require. To this the Administrator has recently added two new rules, again based upon Midwest Statements of Policy[134] and imposing significant new substantive standards upon promoters.[135] The first[136] requires justification for "cheap stock," indicating that it will not be considered justified unless the issuer is in the promotional or developmental stage and unless the amount and price are reasonable. The second new rule[137] states that an offering of an issuer in the promotional or developmental stage will be considered "unfair and inequitable" unless the officers, directors and promoters themselves provide 10% of the total equity investment.

With respect to particular types of public offerings the Administrator has recently amended his rules pertaining to real estate investment trusts[138] and has adopted a comprehensive set of rules pertaining to limited partnerships.[139] The latter reflect a concern

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132 WASH. AD. CODE § 460-16-260 & 270 (expected codification). *See* note 36 *supra*. The rule is based upon a recently approved amendment to the Statement of Policy on Options and Warrants of the Midwest Securities Commissioners Association. The previous text of this Statement, adopted in 1969, is set forth at 1 BLUE SKY L. REP. ¶ 4796. The new rule takes into account options and warrants (a) in the nature of restricted stock, (b) provided in employee stock purchase and profit sharing plans and (c) issued to financing institutions. The rule also provides for the period during which the options may be exercised, a periodic step-up in price, and valuation of the options.

133 WASH. AD. CODE § 308-132-050 and 308-132-110; expected recodification: WASH. AD. CODE §§ 16-410 & 450 (*see* note 36 *supra*).

134 1 BLUE SKY L. REP. ¶¶ 4761, 4771.

135 For a comparative discussion of state rules on this subject, *see* Mofsky, *Blue Sky Restrictions on New Business Promotions*, 1969 DUKE L.J. 273, 274 and n.3.

136 WASH. AD. CODE § 460-16-220 (expected codification). *See* note 36 *supra*.

137 WASH. AD. CODE § 460-16-400 (expected codification). *See* note 36 *supra*.

138 WASH. AD. CODE ch. 460-36 (expected recodification). *See* note 36 *supra*.

139 WASH. AD. CODE ch. 420-32 (expected codification). *See* note 36 *supra*.

for the hitherto unenfranchised limited partner, requiring a vote upon matters significantly affecting the limited partner's interests. In addition, the rules contain numerous specific disclosure requirements and set limitations upon certain types of promoters' profits, self-dealing on the part of the general partner and mandatory contributions by the limited partners to the partnership.

Some question could perhaps be raised as to the propriety of including within the scope of "promoters' profits or participation" the extent of their voting rights. The Administrator does, however, so consider them. In a related rule,[140] dealing with the extent of their participation, the Administrator requires that promotional securities of a new enterprise issuing a single class of securities for financing purposes shall have no greater voting rights than securities issued for cash or its equivalent. This rule, speaking of the case of a single class of stock, does not reach the situation where the promoters seek to reduce or eliminate the vote of the public investors by issuing to them a different class of stock. As to this situation, the Administrator has recently adopted as one of his rules the Statement of Policy on Non-Voting Stock[141] by the Midwest Securities Commissioners Association. Under this rule (which speaks in "unfair and inequitable" terms) the elimination or limitation of voting rights (including those pertaining to election of directors) of shares issued to the public must be compensated by preferential treatment as to dividends and liquidation. An issuer seeking to establish an uneven voting distribution under this new rule might, however, find itself blocked by application of another Midwest Statement of Policy[142] to the effect that issuance of preferred stock (or debentures) by an issuer in the promotional or developmental stage will not be permitted unless justified by the applicant. The Administrator has also evidenced concern with provisions denying cumulative voting or preemptive rights, although there are no published rules on these subjects.

How far all these matters are in fact from the "fair, just and equitable" standard is beyond the scope of this paper to assess; but it seems apparent that the two provisions (5) and (9) of Wash. Rev. Code § 21.20.280 have formed the basis of aggressive enforcement by the Administrator.

It remains to mention briefly some other statutory grounds for denial of registration which may be applicable to a registration of securities of a new venture: the registration statement is incomplete, false or misleading; a willful violation of the statute, or any

140 WASH. AD. CODE § 308-132-060; expected recodification: WASH. AD. CODE § 460-16-460 (*see* note 36 *supra*).

141 WASH. AD. CODE § 460-16-210 (expected codification). *See* note 36 *supra*; 1 BLUE SKY L. REP. ¶ 4781.

142 1 BLUE SKY L. REP. ¶ 4791.

rule, order or condition has occurred; or an injunction is outstanding under the federal or any state securities laws.

X. PERMIT CONDITIONS

If the registrant manages to avoid the foregoing grounds for denial of a permit, he is likely nevertheless to find that his permit is hedged with a formidable array of conditions. The permit not only carries these conditions but also the legend that the violation of any of them, whether intentional or inadvertent, renders the permit null and void, and that acceptance of the permit is deemed full assent to all conditions. Intentional violation of a condition, as has been mentioned, may be grounds for a stop order by the Administrator, but inadvertent violation apparently is only the basis for civil liability (rescission or damages) under Wash. Rev. Code § 21.20.430. The "null and void" language suggests that obedience to the conditions in future transactions will not reinstate the permit and, perhaps, that transactions prior to a violation are invalidated. As applied to some conditions at least, this language seems questionable under the statute, and it can hardly be doubted that the validity of a condition requires statutory authority.[143] As a practical matter, however, in the absence of judicial construction of the permit and statute on these matters, the threat of such liability counsels careful adherence to the stated conditions.

The first condition of the standard form of permit for registration by qualification is simply a statement of the number and kind of securities that may be sold by the issuer and the price of each.

The second fixes the percentage of the selling price allowable as costs of selling, which term is briefly defined, and states that all persons making offers and sales must be registered. Two comments may be made on this condition. First, the language respecting sales commissions states that commissions must be based upon cash received and not on the amount of securities sold or subscriptions taken. The purpose of the restriction is apparently to protect against the practice of the "front-end load," or full commissions on installment subscriptions, in cases where subscriptions are subsequently permitted to lapse. There does not appear to be any express statutory provision or rule on this subject. Second, while all salesmen must be registered, two officers of an issuer may be registered for a particular original offering without taking the usual examination, so that the small venture need not employ professional salesmen.[144]

The third condition requires the following to be filed with and

[143] The Attorney General has advised that a permit conditioned upon sale to a limited segment of the public would be illegal. WASH. OP. ATT'Y GEN. 548 (1927-28).

[144] WASH. REV. CODE § 21.20.070 (1959).

approved by the Administrator in advance of use: the subscription agreement, all literature and advertising, and all written agreements with broker-dealers and salesmen. Some of these would have been filed with the registration statement. The Administrator's rule[145] requires subscription agreements, literature and advertising to be submitted three days in advance of use. The rule does not expressly provide for approval, but only prohibits use after notice from the Administrator that in his opinion they contain false or misleading material. The rule also includes a broad statement of policy regarding advertising.

The next standard condition is a requirement authorized (though not as a permit condition) by statute,[146] requiring the filing of quarterly reports to update the information contained in the registration statement and to disclose the progress of the offering. The published rule[147] under this section indicates that such reports are required only so long as securities remain unsold and are to be made on forms provided by the Administrator. The second subsection of the statute, dealing with the issuer's financial statements to accompany these reports, was amended in 1965[148] to permit the Administrator in his discretion to require certified financial statements and prescribe the information to be presented. This requirement of certified financial statements is set forth in the standard permit form as the ninth condition. In fact, the certification has often been waived in cases where the issuer is small, although the Administrator's adoption of new and comprehensive rules[149] on acceptable accounting procedures suggests that this requirement will be more stringently applied in the future. The final provision of the fourth condition does not seem appropriate as a true condition of the permit: the Administrator shall be notified of the completion of sales under the offering.

The fifth condition pertains to fidelity bonds. Such bonds may be required under a published rule[150] but are often waived.

The sixth condition provides for escrow of promotional shares. The statute expressly permits such a condition by rule or order without (as above noted) specifying the grounds upon which the determination is to be made.[151] The statute provides only that the

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145 WASH. AD. CODE § 308-132-010; expected recodification: WASH. AD. CODE § 460-28-010 (*see* note 36 *supra*).

146 WASH. REV. CODE § 21.20.270 (1965).

147 WASH. AD. CODE § 308-132-174; expected recodification: WASH. AD. CODE § 460-16-320 (*see* note 36 *supra*).

148 Ch. 17, § 3, [1965] WASH. SESS. LAWS 982; *see also* WASH. AD. CODE § 308-132-174 and note 147 *supra*.

149 WASH. AD. CODE ch. 460-60 (expected codification). *See* note 36 *supra*.

150 WASH. AD. CODE § 308-132-070; expected recodification: WASH. AD. CODE § 460-16-060 (*see* note 36 *supra*).

151 WASH. REV. CODE § 21.20.250 (1959).

escrow may not be for more than one year after the termination of the offering.[152] Under his published rules[153] the Administrator must approve the escrowee (usually a bank of an attorney) and any transfer of escrowed shares.[154] The object of the escrow, reflected in the limitation on transfers, is apparently to assure the continued interest of the promoters in the venture and to prevent their profiting by an early sale at the expense of the company. The escrow is required to be documented on a form provided by the Administrator.

The next condition, related to the preceding one, requires that notice of all withdrawals of, and changes in, officers and directors be given to the Administrator.

The final standard condition provides for impound of the proceeds of the offering pursuant to a satisfactory impound agreement (the required text is provided by the Administrator). This condition is authorized by statute[155] and is amplified by published rules.[156] When an impound is required, checks in payment for securities must be made payable to the depository, and the offering circular must so state. It must also state that the depository is performing a limited function and has not passed upon the merits of the security. A portion of the proceeds may be released from the impound prior to attaining the required amount, as permitted by the Administrator. The rule prescribes the procedure for release, including a sworn statement required of the issuer. Although neither these rules nor the statute state any basis for the Administrator's determination to require an impound, it is a means of protecting the first subscribers to an offering from the consequences of the issuer's inability to sell sufficient securities to produce the funds required for his projected undertaking. Thus, if the stated amount is not paid into the impound by the prescribed date, the subscribers' funds will be returned to them, less any portion permitted by the Administrator to be paid out to the issuer from the impound.

Notable by its absence from the foregoing list of conditions is the requirement of an offering circular. There is no statutory re-

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152 This is more favorable to promoters than most state statutes. Of 39 states which require escrows, 18 do not permit release until dividends aggregating 5-6% have been earned or paid; the remainder permit the escrow to continue in the Administrator's discretion or for a period of 2-3 years. Mofsky, *Blue Sky Restrictions on New Business Promotions*, 1969 DUKE L.J. 273, 287.

153 WASH. AD. CODE § 308-132-030 & 040; expected recodification: WASH. AD. CODE §§ 460-16-430 & 440 (*see* note 36 *supra*).

154 In a case arising under prior law, the Washington court refused, in an action by the purchaser, to enforce an arrangement for the sale of shares held in escrow, even though cast in the form of an option exercisable after release of the escrow. Hederman v. George, 35 Wn. 2d 357, 212 P.2d 841 (1949).

155 WASH. REV. CODE § 21.20.250 (1959).

156 WASH. AD. CODE § 308-132-170 & 172; expected recodification: WASH. AD. CODE §§ 460-16-510 & 520 (*see* note 36 *supra*).

quirement of an offering circular, although the Act and the Administrator's published rule[157] state that he may require the use of one. It is understood that he does in fact require the use of one in almost every case. The content of any offering circular is prescribed in the rule, which states also that the subscription agreement must contain an acknowledgment of receipt of a copy of the circular. Under the Act and this rule there appears to be no requirement of delivery of an offering circular at any time prior to the time of sale. The offering circular, if required, need not be printed, and financial statements are not by this rule required to be certified, although they may be under the Administrator's new rules pertaining to accounting matters.[158] The material in the circular must be revised as necessary to reflect material changes in the facts reported and, in any event, must be updated at least once every twelve months. It "must disclose all material facts" and contain information relating to the offering, the underwriting, the securities, the issuer, its financial condition, its officers and directors, and their compensation and interest in the business. In these respects, the Administrator's rule is not significantly different from the prospectus requirements for registration of securities under the federal Securities Act of 1933. In a number of areas, however, the Administrator's practice differs from that of the S.E.C. For example, opinions of experts, such as feasibility studies and appraisals, may be set forth if adequately identified and the expert's permission obtained; and financial projections may be made, if adequate disclosure of the basis of the projections and adequate warning against reliance is given. In further contrast to S.E.C. rules, under which advertising material may not include any statements not permitted in the offering circular, under the Administrator's rule[159] the issuer's opinion may be stated in advertising material if identified as such.

XI. Conclusion

The blue sky law of Washington contains its full share of uncertainties and traps for the unwary. The merits of its present administration mask its potential for administrative abuse. The danger of abuse potential is magnified by virtual immunity, as a practical matter, from judicial review. The administrative orientation seems strongly, and perhaps increasingly, protective, at the expense of promotional enterprises.

How can the present practice be clarified for the practitioner

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157 Wash. Rev. Code § 21.20.230 (1961); Wash. Ad. Code § 308-132-100; expected recodification: Wash. Ad. Code § 460-16-100 (*see* note 36 *supra*). The Uniform Act contemplates the use of a prospectus only in unusual cases, recognizing that it is not primarily a disclosure act. Official Comment to § 304(d).

158 Wash. Ad. Code ch. 460-60 (expected codification). *See* note 36 *supra*.

159 Wash. Ad. Code § 308-132-010; expected recodification: Wash. Ad. Code § 460-28-010 (*see* note 36 *supra*).

and for the public? If statutory or administrative changes are required or desirable, how can they be identified? It is submitted that the Administrator should make greater use of his powers of rule-making and of giving interpretive opinions. The publication of well-conceived rules and opinions would not only educate the practitioner and the public, avoiding the waste of much time of all parties concerned, but would also establish guidelines for the Administrator's discretion, diminishing the possibility of abuse. The increased burden on the Administrator's office could be carried by increased staff financed with a portion of the substantial present surplus of the Securities Division's revenues over expenditures.

At the same time, it is submitted that the suggested development of a body of administrative law should not be used simply to document additional restrictions upon issuers. Recognizing that, in the absence of legislation, the trend toward a more restrictive philosophy is unlikely to be reversed, substantive restrictions should not be increased, and whatever additional protection may be thought necessary for the public investor should be accomplished through more vigorous enforcement of existing disclosure requirements. In the interest of permitting opportunity to the legitimate new enterprise as well as protecting the investing public, the state should have a more discriminating means of regulation than Herodian enforcement.