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A Guide to the Investigative and Enforcement Provisions of the Uniform Securities Act

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A GUIDE TO THE INVESTIGATIVE AND ENFORCEMENT PROVISIONS OF THE UNIFORM SECURITIES ACT

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Enforcement of state securities acts[1] during the last ten years has undergone a major renaissance.[2] With this renaissance has come a grow-

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[1] Beginning with the passage of the first securities act in Kansas in 1911, state regulation of securities pre-dates federal regulation by some 22 years. *See* J. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS 5-14 (1971). (discussion of early state acts). From approximately 1920 through the early 1930's there was intense interest in, and enforcement of, these early blue sky statutes. The large number of court decisions and attorney generals' opinions which date from this period are evidence of this intense interest. With the passage of the Securities Act of 1933 ('33 Act) and the Securities Exchange Act of 1934 ('34 Act), however, emphasis on enforcement of the securities laws passed to the federal government. State agency staffs during the period from 1935 through 1970 generally shrank in size and contented themselves with performing the registration function under the state acts.

[2] A survey of the Security Exchange Commission (SEC) and the state commissions conducted by the Oklahoma Securities Commission in conjunction with the North American Securities Administrators Association (NASAA) supports the conclusion that enforcement of the state securities acts has undergone a major rejuvenation. That survey reveals that in 1976 the states accounted for approximately sixty percent of the total criminal convictions for violation of the securities laws. Of the 248 total convictions during the period, 141 were state convictions. The original data from this 1977 survey is on file at the offices of the Oklahoma Commission. While the number of convictions is pitifully small, the increased interest by the state agencies in enforcement matters is apparent.

The cause for this increased state enforcement activity is difficult to isolate. To some degree, the increased activity is simply a product of the heightened awareness of the general population concerning securities matters which arose from the explosion in securities litigation in the 1960's. In large measure, however, the increased activity stems from a realization by the state agencies that the SEC is not well-equipped to deal with the unusual or exotic securities which corporations marketed during the 1970's as investor confidence in the more traditional common stocks and bonds wained. *See generally* Long, *The Naked Commodity Option Contract as a Security*, 15 WILLIAM & MARY L. REV. 211 (1973); Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971)[hereinafter cited as Long, *Mainstream*]. As a result, a group of young state administrators realized that if any protection was to be afforded the residents of their states the state agencies would have to provide it.

The increased state enforcement of local securities laws, however, has not yet alleviated the problem of securities fraud. A recent survey of 28 state securities administrators conducted by the General Accounting Office lead to an estimate that losses due to fraudulent sale of securities was between $330 and $350 million in 1978. This same survey reveals that ing desire on the part of state agency personnel and the members of the bar who practice before these agencies to learn more about the investigatory and enforcement provisions of the state securities acts. Unfortunately, there has been little publication in the general area of blue sky regulation,[3] and even less dealing with investigative and enforcement matters. This article will help fill this vaccuum.

Of necessity, this article focuses on the provisions of the Uniform Securities Act[4] [Uniform Act or Act] which thirty-five American jurisdictions have adopted in whole or substantial part.[5] Moreover, the investigatory and enforcement provisions of many of the non-uniform acts duplicate or closely parallel the Uniform Act sections. Thus, the article will be of some value to readers in non-uniform act states.[6]

The Uniform Act provides three basic mechanisms for dealing with an actual or threatened violation of the securities laws. First, the violator may face administrative sanctions imposed by the securities agency itself. Second, a court may restrain the violator or potential violator from pursuing his course of conduct through the civil injunctive process. Finally, the violator may face criminal action.

A. *Administrative Enforcement*

The enforcement devices available through administrative action are probably the most varied of any of the three basic enforcement mechanisms. At the same time, these remedies are clearly the most limited in scope. In general, each administrative remedy is directed to a particular abuse and does not have general application. Those few administrative remedies which are broad in scope are available only where the person against whom enforcement is sought is willing to submit to administrative jurisdiction.

Probably the most important administrative enforcement device is the Securities Administrator's power under section 306 of the Uniform Act to refuse the effectiveness of a registration sought or to suspend a registration which has become effective.[7] In order to exercise this power, the Ad-

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in the three year period ending September 30, 1978, in 95 cases investigated by the SEC, 30,000 investors lost $255 million. The Wall Street Journal, May 1, 1980, at 5, col. 3 (southwest ed.).

[3] The only general works in the area of blue sky regulation are L. Loss & E. Cowett, Blue Sky Law (1958), presently out of print, and H. Sowards & N. Hirsch, Blue Sky Regulation (1977), published as volume 11C, Parts 1 and 2 of the Matthew Bender Business Organization series.

[4] This Uniform Securities Act (Uniform Act or Act) is reprinted in Uniform Laws Annotated (master ed. 1979).

[5] *See* 1 H. Sowards & N. Hirsch, Blue Sky Regulation § 1.03 n. 13 (Supp. 1978).

[6] Some states have altered the language of the Uniform Act. Local customs and procedures, especially in the areas of criminal law and administrative procedure, also have impinged upon the Uniform Act. The reader should consult the statute and case law of the particular jurisdiction.

[7] *See* Uniform Securities Act § 306(a) (1957)[hereinafter cited as U.S.A.].

ministrator must make two findings. First, he must determine that it is in the public interest to deny a tendered registration or to suspend an effective one. Second, he must find that any one or more of the nine specified grounds for refusal, revocation, or suspension exists.[8] The nine enumerated grounds for denial or suspension of securities registration are: (1) that the registration statement is or was materially incomplete or contained misrepresentations of material facts;[9] (2) that there has been a willful violation, in connection with the offering, of the Act, any rule or order of the Administrator,[10] or any condition lawfully imposed under the Act on this particular registration;[11] (3) that the security involved is the subject of a stop order or temporary or permanent injunction from another jurisdiction;[12] (4) that the issuer's enterprise or method of doing business is illegal;[13] (5) that the offering would work or would tend to

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[8] *Id. See In re* Wesley Karban Wyatt, 3 BLUE SKY L. REP. (CCH)(Okla. Sec. Adm. Jan. 9, 1979), *aff'd*, (Okla. Sec. Comm'n March 16, 1979).

[9] *See, e.g., In re* Oriole Land & Dev. Corp., (Okla. Sec. Comm'n Sept. 15, 1970)(order denying registration); *In re* American Engraving, Inc., (Okla. Sec. Comm'n Dec. 31, 1970) (order revoking registration with prejudice).

[10] *See In re* American Engraving, Inc., (Okla. Sec. Comm'n Dec. 31, 1970) (order revoking registration with prejudice).

[11] The Administrator can impose certain conditions on a particular registration which are not imposed on registrations in general. For example, U.S.A. § 305(g) allows the impounding of cheap stock and the escrowing of funds received in connection with sales under the registration. *See, e.g.*, Oklahoma Securities Commission, Statements of Policy Concerning Cheap Stock; Warrants, Options and Cheap Stock; and Impounding Agreements, 2 BLUE SKY L. REP. (CCH) ¶¶ 39,705 & 39,707, *applied in, In re* Frontier Int'l Raceways, Inc., (Okla. Sec. Comm'n July 31, 1970)(order revoking securities registration). Similarly, U.S.A. § 305(h) allows the Administrator to require the use of a particular type of sales contract or subscription form.

[12] The Official Comments indicate that the stop order or injunction from another jurisdiction must be currently in force to be the basis of the denial of suspension of a securities registration. *See* L. LOSS, COMMENTARY TO THE UNIFORM SECURITIES ACT 82 (1976)(official comment to § 306(a)(c)) [hereinafter cited as Loss]. Further, the action must be taken within one year of the original stop order or injunction. *See* U.S.A. § 306(a)(c). Thus, the provision does not permanently bar a security from registration. An Administrator can act only if the reason for the stop order or injunction in the foreign jurisdiction is grounds for such action under the local statute. In addition, the wording of U.S.A. § 306 implies that it is not necessary that the particular block of securities which is the subject of the registration statement also be the subject of the stop order or injunction; the provision merely requires that the securities be of the same class as those that are subject to the stop order or injunction.

[13] The power to deny or suspend a securities registration because the enterprise or method of doing business is illegal is very broad, but one which the state agencies have not extensively used in recent years. Clearly the use of this power would be appropriate to prevent the registration by a corporation wanting to operate a bawdy house in those states where prostitution is illegal. Similarly, this power could properly prohibit the sale of limited partnership interests where the limited partnership was organized under the laws of a state which prohibits a corporation from serving as a partner and the general partner of the limited partnership is a corporation. Oklahoma was such a state until recently. Further, the agency might inquire whether the issuer's business violates the state or federal antitrust statute.

During the early days of securities regulation before 1930, securities agencies used the work a fraud upon the purchaser;[14] (6) that the offering contains unreasonable amounts of underwriters', promoters', or sellers' profits, commissions, discounts, or options;[15] (7) that securities sought to be registered by notification are not entitled to such registration;[16] (8) that the person seeking a co-ordination registration has not forwarded all amendments to its federal registration; (9) that the registrant has not paid the registration fee imposed.[17]

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power to deny registration based on the illegality of the issuer's business to determine the legality of many corporate practices under the state corporation statutes. Today the state commissions, unfortunately, are more apt to limit their inquiry to a determination of whether the issuer complies with the federal securities laws. The official comments, however, do provide two notes of caution to the state agencies. *See* Loss, *supra* note 12, at 82 (official comments to U.S.A. § 306(a)(d)). First, the public interest standards must be met. As a result, the comments suggest that it would not be in the public interest to deny a registration based upon a department store issuer violating fair trade or minimum wage and hour laws. *Id.* Second, the comments make clear that an agency cannot bar an issuer simply because the activity is illegal in the state where the registration is sought if the activity is legal in the state where the issuer intends to conduct its business. *Id.* Thus, the shares of a corporation seeking to operate a bawdy house in Nevada could be sold in Iowa, even though prostitution is legal in Nevada.

[14] *See, e.g., In re* Frontier Int'l Raceways, Inc., (Okla. Sec. Comm'n July 31, 1970)(order revoking securities registration); *In re* R. P. Company, Inc., (Okla. Sec. Comm'n Oct. 15, 1969)(order affirming order of administrator). The power to deny or suspend a securities registration because the offering works a fraud on the purchaser gives the Administrator in a non-fair, just, and equitable state some of the discretion enjoyed by his fair, just, and equitable brethren. The comments, however, make clear that this power is not as broad as the "sound business principles" standard found in many of the early securities acts or the undefined standard of fair, just, and equitable found in many mid-western acts. *See* Loss, *supra* note 12, at 82 (official comments to U.S.A. § 306(a)(e)). The draftsmen's commentary, however, makes clear that this power is the place where the Uniform Act departs from the pure disclosure format found under the federal act. *Id.* at 84-85 (draftsmen's commentary to U.S.A. § 306(a)(e)).

[15] *See, e.g., In re* Houston Science & Medical Corp., (Okla. Sec. Comm'n Dec. 8, 1970) (order denying registration); *In re* The Time Plan Artesian Corp., (Okla. Sec. Comm'n Dec. 1, 1970)(order denying registration). Again, the power to deny or suspend a securities registration because the offering contains unreasonable profits, commissions, discounts, or options is an obvious departure from the full disclosure concept under the federal laws and enters the realm normally reserved for the fair, just, and equitable regulators. Under this provision, many states have adopted rather specific substantive rules. *See, e.g.*, Oklahoma Securities Commission, Statements of Policies Concerning Cheap Stock; Warrants, Options, and Cheap Stock, 2 BLUE SKY L. REP. (CCH) ¶¶ 39,705 & 39,707.

[16] *See, e.g., In re* National Funding Corp., (Okla. Sec. Comm Aug 14, 1969). The Uniform Act authorizes notification registration only for secondary trading in U.S.A. § 302. This type of registration is virtually unused today. The Oklahoma Commission, for example, has not had more than one or two notification registrations in over ten years. As a result, some states delete this procedure when adopting the Uniform Act. Notification registration, however, could be an effective means of distribution of a control block of stock to the general public.

[17] If the Administrator denies or suspends registration because the registrant fails to pay the registration fee, and the registrant subsequently pays the required registration fee, then U.S.A. § 306 indicates that the Administrator must reinstate the registration if the failure to pay was the only grounds for denial or suspension. Further, the last paragraph of U.S.A. § 306(a) indicates that an Administrator may intentionally allow a registration which

The second area where the Administrator has authority to act administratively is in connection with the exemptions from securities registration. Under section 402(c) of the Uniform Act, the Administrator can revoke both the transactional exemptions found in section 402(b)[18] and the securities exemptions for non-profit charitable institutions and employee benefit plans.[19] The Administrator's authority, however, is limited. He may only revoke these exemptions as to a particular security or transaction and does not have authority to withdraw any exemption generally.[20]

Undoubtedly, the draftsmen intended the limitation on the Administrator's authority to protect the public against arbitrary action by the Administrator. In practice, however, this limitation severely hampers the Administrator's ability to protect the public in three specific areas. First, because the Administrator can only revoke exemptions as to a particular class of securities, there is nothing to prevent the offending issuer from simply creating and offering a new class of securities which are not subject to the withdrawal order. Second, the Administrator can only direct the withdrawal order toward the issuer or seller of the securities, and not toward their officers, directors, or promoters. As a consequence, a group of shady promoters whose corporation loses its exemptions may simply organize a new corporation and begin offering similar securities.[21] Finally,

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he knows is defective in some respect to become effective. He then has 30 days after the effective date to commence stop-order proceedings on this defect. This power allows the Administrator to secure jurisdiction over a registrant and to determine whether he wishes to take action without holding up the registration.

[18] *See, e.g., In re* Discount Mart Corp., [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,003 (Okla. Sec. Comm'n Oct. 28 1970)(withdrawing all exemptions); *In re* Financial Reserve, Inc., (Okla. Sec. Comm'n Aug. 6, 1969)(withdrawing all exemptions from past and present officers and directors of issuer and affiliate companies); *In re* Community Nat'l Life Ins. Co., (Okla. Sec. Comm'n Jan. 15, 1969) (withdrawing the manual exemption of U.S.A. § 402(b)(2)); *In re* Provident Fin. Corp., (N.J. Sec. Bur. March 26, 1976)(withdrawing the commercial paper exemption).

[19] U.S.A. §§ 402(a)(9) & (11).

[20] *See* Loss, *supra* note 12, at 136 (official comment to U.S.A. § 403(c)). The Administrator may withdraw a single exemption. For example, he could withdraw the U.S.A. § 402(a)(11) exemption and prohibit a particular company from selling additional securities to its existing securities holders or the Administrator can issue an order containing a blanket withdrawal of all the exemptions. Administrators often employ this latter approach in conjunction with a summary cease and desist order.

[21] U.S.A. § 402(c) talks in terms of withdrawing or denying an exemption "with respect to a specific security or transaction." The official comments expand on this by saying that this authority applies only with respect to a specific case and that the Administrator has no authority by rule or otherwise to revoke any statutory exemption generally. Both the Oklahoma and Wisconsin Commissions avoid this single case limitation to a certain extent by naming the officers, directors, and promoters as parties to the original revocation action and then withdrawing the exemptions as to all the named parties and their affiliates or successors as well as any business enterprise owned, operated, or directly or indirectly controlled by any of the parties. *See, e.g., In re* International Mining Exchange, No. X-1555(E) (Wis. Sec. Comm'n Dec. 18, 1979); *In re* Fine Arts Investment Group, Inc., No. X-1464(E) (Wis. Sec. Comm'n Sept. 28, 1979); *In re* Financial Reserve, Inc. (Okla. Sec. Comm'n Aug. 6, 1969).

the Administrator cannot withdraw the exemptions from particular types of securities which are causing him substantial problems. Thus, the Administrator may not withdraw the exemptions as to investment contracts involving exotic investments such as worm farms,[22] commodity forward contracts,[23] or vending machine franchises.[24] Of course, in all these cases, the Administrator can withdraw the exemptions on an individual basis as the new offerings appear. Before the Administrator can take such action, however, he must first learn of the offering. Often the Administrator is one of the last to learn of such offerings and cannot act until after there is substantial harm to the investing public.[25]

The Administrator may summarily withdraw the exemptions, but he must subsequently give all interested parties an opportunity for hearing. Further, section 402(c) indicates that a person is not subject to either civil or criminal liability for non-registration of securities where the person is relying on an exemption which the Administrator revokes if the non-registrant can show that he did not know or with the exercise of reasonable care could not have found out about the revocation order. A summary suspension order is frequently joined with a cease and desist order. This joining of orders may be effective means of acquiring administrative jurisdiction where the parties otherwise might not be willing to submit, preferring rather to test the Administrator's cease and desist order in court. The withdrawal of exemption order is a valid administrative order which an issuer can challenge only through the administrative appellate process.[26] Hence, an issuer must submit to administrative jurisdiction to challenge a withdrawal of an exemption which an administrator couples with a cease and desist order.

Unfortunately, the Act is silent in one major detail. The Act provides no standard which the Administrator must meet before revoking an ex-

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[22] *See, e.g., In re* Long's Long Life Wormery, Inc., 3 BLUE SKY L. REP. (CCH) ¶ 71,441 (Iowa Ins. Comm'n Mar. 22, 1978); *In re* Worm World, Inc., 3 BLUE SKY L. REP. (CCH) ¶71,414 (S.D. Sec. Div. April 20, 1978), *aff'd*, 3 BLUE SKY L. REP. (CCH) ¶ 71,419 (S.D. Bd. Rev. June 8, 1978). *See also In re* International Plant Growers, 3 BLUE SKY L. REP. (CCH) ¶ 71,490 (Ariz. Sec. Div. Aug. 11, 1978).

[23] State v. Forbes and Bradstreet, Inc., 3 BLUE SKY L. REP. (CCH) ¶ 71,541 (D. Mont. Mar. 24, 1980); Pierce Worcester v. State, 3 BLUE SKY L. REP. (CCH) ¶ 71,530 (D. Hawaii, Oct. 10, 1979); Commonwealth v. Ramco Petroleum, Inc., 3 BLUE SKY L. REP. (CCH) ¶ 71,525 (Mass. Super. Ct. Jan. 4, 1980); *In re* Attorney General (American Petroleum Exchange Corp.), 3 BLUE SKY L. REP. (CCH) ¶ 71,544 (N.Y. Sup. Ct. Jan. 5, 1980).

[24] *In re* Uniserv., Inc., 3 BLUE SKY L. REP. ¶ 71,501 (S.D. Sec. Div. April 19, 1979); *In re* CAB Enterprises, Inc., 3 BLUE SKY L. REP. (CCH) ¶ 71,509 (Ga. Sec. Comm'n Dec. 20, 1978).

[25] In one Oklahoma case the judge enjoined a particular offering and required the promoters to make restitution to the original purchasers. To the chagrin of the Commission and the judge, the promoters were raising the money to make restitution by selling stock in a newly organized corporation, not covered by the injunction, in violation of the Oklahoma Securities Act.

[26] *See In re* Atomite Corp., 29 Dauph. Co. Rep. 113, *subsequent consideration*, 29 Dauph. Co. Rep. 195 (1926) (decisions of Administrator immune from declaratory judgment attack).

emption. If a hearing is requested, however, the Administrator must enter findings of fact and conclusions of law.[27] The Administrator's discretion, therefore, is not totally unbridled and may be reviewed for abuse.[28] At a minimum, the Administrator must find that it is in the public interest to require the selling of the securities, if at all, through the registration process rather than under an exemption.

The last provision giving the Administrator specific authority to take administrative action is section 204(a), authorizing the Administrator to deny, revoke, or suspend the registration of broker-dealers and agents. Similar to the procedures under section 306 dealing with the suspension of registrations, the Administrator must meet two standards before he can act. First, the Administrator must find that it is in the public interest to deny, suspend, or revoke the registration. Second, he must find that one of the eleven grounds specified in the statute for denial, revocation, or suspension exists. These grounds range from filing a false, misleading, or incomplete application to being denied, suspended, or enjoined by another jurisdiction.[29] Probably, the single most important ground is that the defendant is engaging in dishonest or unethical practices in the securities business.[30] A number of states use this requirement as a statutory basis for the adoption of a code of professional conduct,[31] the violation of which will subject the violator to both civil[32] and criminal liability.[33]

In addition to these specific enforcements powers, the Administrator has two other broad general enforcement tools at his disposal. Under section 407(a) the Administrator may conduct investigative hearings to determine whether there has been a violation of the Act. These hearings may either be open to the public, *i.e.*, subject to press coverage and public inspection of the information compiled,[34] or may be held in private, in

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[27] U.S.A. § 402(a).

[28] *Cf.* Doble Steam Motors Corp. v. Daugherty, 195 Cal. 158, 232 P. 140 (1924)(denial of permit appropriate exercise of jurisdiction).

[29] *See* U.S.A. § 204(a). The Oklahoma Administrator recently denied registration based upon a consent injunction under the federal securities act. *See In re* Wesley Karban Wyatt, (Okla. Sec. Adm. Jan. 9, 1979), *aff'd*, (Okla. Sec. Comm'n March 16, 1979).

[30] *See* U.S.A. § 204(a)(2)(G); *see, e.g.*, Selig v. Novak, 256 Ark. 278, 506 S.W.2d 825 (1974).

[31] *See, e.g.*, Okla. Sec. Comm'n Rule R-204(G), 2 BLUE SKY L. REP. (CCH) ¶ 46,406 (1980); Wis. Sec. Comm'n, Statement of Policy: Interpretation of Suitability Rule, 3 BLUE SKY L. REP. (CCH) ¶ 52,741 (1971). *See also In re* Hunt & Fitzgerald, Inc. [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,004 (Okla. Sec. Comm'n June 9, 1971).

[32] U.S.A. § 410. An investor will also have a cause of action against the broker-dealer's or agent's bond under U.S.A. § 202(e). *See, e.g.*, Farmers & Merchants Bank v. George W. Stone Co., 27 Ohio N.P. (n.s.) 529 (C.P. 1929). Recently, a court held that the state administrator might also bring suit under this bond. *See* State v. Maryland Cas. Co., 27 Or. App. 735, 557 P.2d 258 (1976).

[33] U.S.A. § 409.

[34] Most states now have public information statutes similar to the federal Freedom of Information Act, 5 U.S.C. §§ 552-552g (1976). These state statutes will generally control the provisions of the relevant securities act unless the securities act provides access not available under the general information statute. The Uniform Act does contain one rather limited

which case there is no right of inspection or coverage.[35] Further, section 407(a) specifically authorizes the Administrator to publish information concerning violations of the Act.[36] The use of the section 407(a) powers raises obvious problems where such use is not the first step in some other administrative or judicial action by the Administrator.[37] A public investigation with press coverage and no restriction on the admission of hearsay evidence can become a circus and has overtones of McCarthyism. On the other hand, present indications are that these unfair public hearings are not unconstitutional as a *per se* deprivation of due process.[38] The person investigated, however, must be given certain rights, including the right to cross-examine and the right to present rebuttal evidence.[39]

Hearings conducted pursuant to section 407(a) and the resulting publication of findings appear to be very appropriate for making the public aware of a general practice or type of offering which the Administrator feels is new and in violation of the Act. Thus, in the mid-1970's a number of commissions appropriately used hearings to warn the public against the commodity option schemes which were sweeping the country.[40] Due to the possibility of abuse, however, an Administrator should not use hearings as an alternative to other administrative or judicial enforcement mechanisms in connection with particular cases or individuals.[41]

The second broad enforcement tool is the cease and desist order. His-

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access provision. *See* U.S.A. § 413(c). While there is some authority to the contrary, *see, e.g.*, Koch v. Department of Justice, 376 F. Supp. 313, 315 (D.D.C. 1974), courts generally indicate that the federal act allows public inspection of inactive investigatory files.

[35] The best way to initiate investigative hearings under U.S.A. § 407(a) is for the Administrator to issue a formal order of investigation. In this order the Administrator should state whether the investigation will be public or private.

[36] *See* U.S.A. § 407(a)(3). The basis of the power to publish information concerning violations of the Act is similar to authority given the SEC. *See* 15 U.S.C. § 78u(a)-(d) (1976). The SEC has, on certain occasions, used this authority to publish findings where it did not think that the violation warranted further enforcement action but where it wished to point out that the practices were improper. *See, e.g.*, *In re* Greater Washington Investors, Inc., [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,032 (SEC Mar. 22, 1979); *In re* Spartek, SEC Securities Exchange Act Release No. 15567 (Feb. 14, 1979), 491 SEC. REG. & L. REP. (BNA) E-1 (1979); *In re* Ward La France Truck Corp., 13 S.E.C. 73 (1943).

[37] *See In re* Spartek, SEC Securities Exchange Act Release No. 15567 (Feb. 14, 1979), 491 SEC. REG. & L. REP. (BNA) E-4, E-6 (1979)(Karmel, Commissioner, dissenting).

[38] *See* Paul v. Davis, 424 U.S. 693, 700-01 (1976); Hannah v. Larche, 363 U.S. 420, 442-43 (1959).

[39] *See* Jenkins v. McKeithen, 395 U.S. 411, 428 (1969).

[40] *See, e.g.*, *In re* Commodity Options, 1 BLUE SKY L. REP. (CCH) ¶ 9722 (Colo. Sec. Comm'n 1973); *In re* Commodity Options, Notice and Order, 3 BLUE SKY L. REP. ¶ 57,456 (Utah Sec. Comm'n Mar. 2, 1973). Because of his specific statutory authority it may be desirable for the Administrator, rather than other police or law enforcement agencies, to use investigative hearings to warn the public of securities violations.

[41] *See In re* Marine Protein Corp. Indus. Revenue Bonds, SEC Securities Exchange Act Release No. 15567 (Apr. 11, 1979), 499 SEC. REG. & L. REP. (BNA) E-1, E-3 (1979)(Karmel, Commissioner, dissenting); *In re* Spartek, SEC Securities Exchange Act Release No. 15567 (Feb. 14, 1979), 491 SEC. REG. & L. REP. (BNA) E-4, E-6 (1979)(Karmel, Commissioner, dissenting).

torically, state administrators have relied heavily on cease and desist orders. Present research indicates that the practice began in Missouri as early as 1923.[42] Oklahoma began issuing such orders in 1936,[43] while Virginia was issuing such orders by 1948.[44] Other states issued such orders as early as the 1960's and early 1970's.[45] Today, the practice is widespread. In the fall of 1979, the Oklahoma Securities Commission conducted a survey of the members of the North American Securities Administrators Association. Of the fifty-two American jurisdictions, thirty-nine responded,[46] of which twenty-seven were Uniform Act jurisdictions[47] and twelve were not.[48] Of those responding, thirty-six of thirty-nine presently issue cease and desist orders. Of the Uniform Act states, only the District of Columbia[49] does not presently issue such orders.[50]

While the practice of issuing such orders appears both wide-spread and long-standing, its legal basis under the present Uniform Act is not as clear. The Uniform Act does not grant the Administrator specific power to issue cease and desist orders. Section 412(a), however, does authorize

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[42] *Cf. In re* Hermann Helioplane Co., *In re* Bankers' Security Co. and *In re* Bownam & Co., 4 United States Daily 2297, col. 1 (1929)(summarization).

[43] Okla. Sec. Comm'n Order of Sept. 10, 1936. *See In re* Quebec Bond & Share Corp., (Okla. Sec. Adm. Apr. 26, 1954).

[44] Commonwealth v. Travelers Health Ass'n, 46 Va. Corp. Comm'n Rep. 69 (1948), *aff'd,* 188 Va. 877, 51 S.E.2d 263 (1949), *aff'd,* 339 U.S. 643 (1950).

[45] *See, e.g., In re* Raymond Lee Organization, Inc., (Colo. Sec. Comm'n Apr. 18, 1972), *partially aff'd and partially rev'd,* 36 Colo. App. 417, 543 P.2d 75, *rev'd,* 192 Colo. 112, 556 P.2d 1209 (1976); Securities Comm'n v. Holovachka, 234 Ind. 135, 124 N.E.2d 380 (1955); *In re* Jacobs, (Ohio Sec. Div. May 8, 1961); *In re* Golden Circle Gospel Foundation, Inc., (Tex. Sec. Bd. Feb. 21, 1966). *See also* Parnall & Ticer, *A Survey Of The Securities Act Of New Mexico,* 2 N. MEX. L. REV. 1, 43 (1972) [hereinafter cited as Parnall & Ticer] (indicates that four other jurisdictions, the District of Columbia, Missouri, New Mexico, and South Carolina, reported that their administrators issued such orders).

[46] The responses to the survey conducted by the Oklahoma Securities Commission are on file in the records of the Oklahoma Commission.

[47] The Uniform Act jurisdictions are Alaska, Colorado, Connecticut, Delaware, District of Columbia, Hawaii, Iowa, Kansas, Kentucky, Massachusetts, Minnesota, Missouri, Montana, Nebraska, Nevada, New Jersey, New Mexico, North Carolina, Oklahoma, Oregon, South Carolina, Washington, West Virginia, Wisconsin, and Wyoming.

[48] The responding states that are not Uniform Act jurisdictions are Arizona, California, Florida, Georgia, Illinois, New Hampshire, New York, Ohio, Rhode Island, South Dakota, Texas.

[49] District of Columbia officials have indicated that they do issue cease and desist orrders. *See* Parnall & Ticer, *supra* note 45, at 43. The response to the Oklahoma survey did not report this change in position or offer any explanation of it.

[50] The non-uniform states which do not presently issue cease and desist orders are New Hampshire and New York. Eight Uniform Act jurisdictions—Alabama, Arkansas, Idaho, Maryland, Michigan, Pennsylvania, Puerto Rico, and Utah— did not respond to the survey. Two of these states, Arkansas and Michigan, had a specific statutory authorization for the issuance of cease and desist orders, and two others, Pennsylvania and Utah, appear to issue such orders or their equivalent. *See, e.g., In re* Sherry and Rob Farms, Inc., (Pa. Sec. Comm'n Sept. 6, 1978)(summary notification to cease advertising and order), *summarized in,* PA. SEC. COMM'N BULL. 12 (Sept.-Oct. 1978); *In re* Kaylar Dev. Corp. (Pa. Sec. Comm'n Sept. 2, 1977), *summarized in,* PA. SEC. COMM'N BULL. 10 (Jan.-Feb. 1978).

the Administrator to "from time to time make, amend, and rescind such rules, forms, and orders as are necessary to carry out the provisions of this act." The Uniform Act Administrators traditionally point to this provision as authorizing the issuance of cease and desist orders.[51] Cases involving cease and desist orders issued under section 412(a) have been before the appellate courts of a number of states without challenge to the authority of the Administrator to issue cease and desist orders.[52]

The interpretation of section 412(a) to give the Administrator authority to issue cease and desist orders is correct.[53] Certainly such orders are necessary and appropriate to carry out the mandate given the Administrator to enforce compliance with the substantive provisions of the Act. Moreover, a cease and desist order is clearly an "order" within the meaning of section 412(a) and is not an injunction. The Administrator lacks the enforcement power of a court so that the cease and desist order does not carry the weight of a judicial injunction.[54]

The only case which the author has been able to find which addresses the question of whether general order authority is broad enough to encompass the issuance of cease and desist orders also supports the Administrator's position.[55] Motor Transport Co. was operating a bus line between Los Angeles and Santa Ana, California. The carrier boarded and discharged passengers at intermediate points between the two cities. Motor Transport, however, had never sought authority from the Railroad Commission to carry these passengers solely between intermediate points. A competitor who had sought and received authority to carry local passengers on this route objected and the Railroad Commission issued a summary cease and desist order. The summary order was upheld by the Commission in a hearing in which Motor Transport participated. Motor Transport then sought review of the order before the California Supreme Court, claiming that the Commission did not have subject matter jurisdiction and also that the Commission lacked the authority to issue the cease and desist order. The court rejected both contentions.

The court first noted that the regulation of routes was a matter within the jurisdiction of the Railroad Commission in the same way that the sale of securities within a particular state is within the jurisdiction of the se-

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[51] *See* Parnall & Ticer, *supra* note 45, at 42-43 (Oklahoma, New Mexico, Missouri, South Carolina, and the District of Columbia, all Uniform Act states, rely upon the general order authority in U.S.A. § 412(a)). *See also* text accompanying notes 46-50 *supra*.

[52] *See* Allstate Ind. Loan Plan, Inc. v. Mihalek, 555 S.W.2d 585 (Ky. 1977); Raymond Lee Organization, Inv. v. Division of Securities, 556 P.2d 1209 (Colo. 1976); Scholarship Counselors Inc. v. Waddle, 507 S.W.2d 138 (Ky. 1974); Data Access Sys., Inc., v. State, 63 N.J. 158, 305 A.2d 427 (1973); AMR Realty Co. v. State, 149 N.J. Super. 329, 373 A.2d 1002 (1977); Pioneer Finance Co. v. Pennsylvania Sec. Comm'n, 21 Pa. Commw. Ct. 447, 346 A.2d 890 (1975). *See also* Securities Comm'r v. Holovachka, 234 Ind. 135, 124 N.E.2d 380 (1955).

[53] *See* Parnall & Ticer, *supra* note 45, at 42-43.

[54] *See* Travelers Health Ass'n v. Virginia, 339 U.S. 643, 655-656 (1950) (Minton, J., dissenting); Motor Transport Co. v. Railroad Comm'n, 189 Cal. 573, 209 P. 586 (1922).

[55] *See* Motor Transport Co. v. Railroad Comm'n, 189 Cal. 573, 209 P. 586 (1922).

curities administrator.[56] It then held that the Commission had authority over those operating in violation of the law in the same way that it had authority over those who were operating within it. To hold otherwise, according to the court, would give the violator an undue advantage over the person who was trying to compete legally.[57] This same rationale supports the Administrator's jurisdiction over unregistered broker-dealers and agents and the illegal sale of unregistered securities.

Turning to the question of whether the Commission had the authority to issue the cease and desist order, the court held that while the statute did not specifically grant such authority to the Commission, it was not unfair to imply this authority from a reading of the Commission's general order authority. Moreover, the court stated that this implied authority was not inconsistent with the Commission's authority to seek injunctive relief. The court stated that the general order authority authorizes the Commission to issue any order necessary in the exercise of its jurisdiction.[58]

Traditionally, an administrator issues a cease and desist order either summarily[59] or after a full administrative hearing.[60] Experience shows that these orders can be an effective enforcement tool in three distinct situations. First, in the case of a clear violation which the Administrator believes to be either technical or inadvertent, the issuance of a summary cease and desist order provides a quick, inexpensive, and uncomplicated way to bring the infraction to the attention of the violator without resorting to more formal court proceedings under section 408.[61] Normally, because the violation is technical or inadvertant and the violator is a legitimate business person attempting to act in good faith, the issuance of the

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[56] *See id.* at ___, 209 P. at 589. *See also* D & S Inv., Inc. v. Moore, 521 S.W.2d 118 (Tex. Ct. App. 1975).

[57] 189 Cal. at ___, 209 P. at 589.

[58] *Id.* at ___, 209 P. at 590. Notwithstanding the general language of U.S.A. § 412(a), a court may conclude that an Administrator does not have the authority to issue a cease and desist order. *See* Consumer Companies of America v. Williams, No. 78 CI0961 (Ky. Cir. Ct., Franklin County 1978), *subsequently vacated as moot. See also* Marley v. Lentz and Assoc., No. CJ-79-2625 (Okla. Dist. Ct., Okla. County, June 29, 1979), *appeal pending*, Okla. Sup. Ct., No. 53,991. The uncertainty surrounding the ability of the Administrator to issue cease and desist orders has led an increasing number of Administrators to seek clarifying amendments to their Uniform Act to specifically authorize such orders. *See, e.g.*, ALASKA STAT. § 45.55.200 (1962); ARK. STAT. ANN. § 67-1254 (1966); KAN. STAT. § 17-1266a (1979 Supp.) The amendments often insert a provision in U.S.A. § 408 of the Uniform Act giving the Administrator the choice of issuing a cease and desist order or going directly into court for an injunction.

[59] *See, e.g., In re* Inspirational Family Reading Center, (Okla. Sec. Comm'n Jan. 9, 1979)(summary cease and desist order); *In re* Jacobs, (Ohio Sec. Div. May 8, 1961)(letter cease and desist order).

[60] *See, e.g., In re* Economou, 3 BLUE SKY L. REP. (CCH) ¶ 71,515 (Iowa Ins. Comm'n Apr. 24, 1979).

[61] *See, e.g., In re* Jacobs, (Ohio Sec. Div. May 8, 1961)(letter cease and desist order); *In re* Quebec Bond & Share Corp. (Okla. Sec. Comm'n Apr. 26, 1954)(letter cease and desist order).

order is all that is necessary to bring about compliance with the Act. This procedure is also advantageous to the person who is the subject of the order. By issuing the order in letter rather than formal form and by restricting the publicity which is given its issuance, the Administrator may largely avoid the disruptive and injurious impact that more formal proceedings might have upon the violator's business.

Second, where the infraction is clear-cut and the individuals involved are known securities violators or con artists, the Administrator may use the summary cease and desist order as a quick and inexpensive way of informing the general public of the illegal activities and thereby attempt to avoid further loss. The use of such an order, however, is not a panacea in all such cases. While such action, especially if given wide publicity, will educate the public, it also will tip the Administrator's hand that he is aware of the illegal activity. Most known securities violators or con artists are not interested in contesting the legality of their activities. They are fully aware that they are violating the law. Therefore, when the administrator exposes their scheme by the issuance of the summary cease and desist order, they will immediately cease their activities and either go underground or move on to greener pastures in other states. In one sense this is exactly what the Administrator wants. On the other hand, by driving the violator underground or out of the state, the Administrator makes it much more difficult to give service of process or personal jurisdiction[62] over the violator to pursue either criminal or civil remedies. Therefore, the Administrator must carefully weigh the immediate advantage of instant publicity against the increased difficulty that such action will cause him in seeking a more permanent halt to the illegal activity through a civil injunction or criminal prosecution.

Finally, where the violation is less clear, the use of the cease and desist process provides both the Administrator and the alleged violator with an administrative alternative to the more traditional judicial procedure for initiating and resolving a disputed interpretation of the Act. The Administrator can initiate this procedure in either of two ways. If the Administrator feels that the disputed practice is sufficiently injurious to the public that it should be stopped pending resolution of the issue, he will issue a summary cease and desist order giving the violator the opportu-

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[62] While extradition for criminal violation of the securities acts appears to be increasing, such procedure is still not widespread. Research reveals only a few reported cases involving extradition for securities violations. *See* Lewis v. Commissioner of Corrections, 181 N.Y.L.J. 11, col. 4M (N.Y. Sup. Ct. Apr. 3, 1979)(involving extradition to Alabama for acts committed in Alabama); Greenbaum v. Darr, 220 Kan. 525, 552 P.2d 993 (1976)(involving extradition of Kansas resident who performed acts in Kansas which constituted violation of the Texas Securities Act because effect of his act occurred in Texas); Cope v. State, 402 P.2d 970 (Idaho 1965)(extradition to Washington for acts committed in Washington). *See also* Long, *The Conflict of Laws Provisions of the Uniform Securities Act, or When Does A Transaction "Take Place In This State" — Part I*, 31 OKLA. L. REV. 781, 812-15 (1978)[hereinafter cited as Long, *Conflict*] (general discussion of extradition in connection with securities violations).

nity for a subsequent full administrative hearing as to whether the summary order ought to be made permanent.[63] If the alleged violator is a legitimate businessman he normally will honor such an order, if he elects to pursue the issue administratively,[64] until such time as there can be a full investigation of the matter and final resolution in an administrative hearing. If the practice does not create a sufficiently dangerous threat to the public, or the jurisdiction of the Administrator over the practice in question is sufficiently tenuous, *i.e.*, if there is a substantial question whether the interests sold are securities, the Administrator often will forego the issuance of the summary cease and desist order and will merely issue a "show cause" order requiring the alleged violator to appear and show cause why the Administrator should not enter a permanent cease and desist order.[65]

While only the Administrator may institute these cease and desist actions,[66] participation is elective on the part of both parties. The Act clearly does not require the Administrator to use the cease and desist order as the first step in any civil injunctive or criminal action. The Administrator may file these actions under sections 408 and 409 directly if

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[63] *See, e.g., In re* Economou, 3 BLUE SKY L. REP. (CCH) ¶ 71,515 (Iowa Ins. Comm'n Apr. 24, 1979).

[64] The alleged violator must make a critical decision when the Administrator issues a summary cease and desist order against him. The alleged violator must decide whether he is willing to submit to an administrative resolution of the issue or whether he wishes to resort to a judicial forum in the first instance. If he desires the latter he should ignore the summary order and not request a hearing. If he requests such a hearing and begins to participate in the administrative process, then the doctrine of exhaustion of administrative remedies suggests that he cannot seek judicial resolution through an injunctive proceeding to prevent the Administrator from continuing the administrative process. *See, e.g.*, First Jersey Sec., Inc. v. Bergen, 605 F.2d 690 (3d Cir. 1979), *cert. denied*, 100 S.Ct. 1020 (1980); Marshall v. Burlington Northern, Inc., 595 F.2d 511 (9th Cir. 1979); California v. FTC, 549 F.2d 1321 (9th Cir.), *cert. denied*, 434 U.S. 876 (1977). *But see* Consumer Companies of America v. Williams, No. 78C10961 (Ky. Cir. Ct., Franklin County 1978); Lentz and Assoc. v. Marley, No. CJ-79-2625 (Okla. Dist. Ct., Okla. County June 29, 1979), *writ of prohibition and appeal filed*, No. 53928 (Okla. July 11, 1979). If the alleged violator does not like the decision of the Administrator he may seek judicial review of the decision under U.S.A. § 411. *See, e.g.*, Raymond Lee Organization, Inc. v. Division of Sec., 192 Colo. 112, 556 P.2d 1209 (1976). When the alleged violator exhausts his appellate rights under U.S.A. § 411 the matter becomes res judicata and he may not relitigate the issue when the Administrator seeks judicial enforcement of the order. *See, e.g.*, Public Serv. Comm'n v. International Ry. Co., 106 Misc. 364, 174 N.Y.S. 708 (Sup. Ct. 1919); Public Serv. Comm'n v. New York & Queens Gas Co., 103 Misc. 703, 170 N.Y.S. 1009 (Sup. Ct. 1918).

[65] *See In re* Goldstein, Samuelson, Inc., [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,095 (Okla. Sec. Adm. Feb. 23, 1973); *In re* Discount Mart Corp., [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,003 (Okla. Sec. Adm. 1970). Again, the alleged violator is put to the choice of electing an administrative resolution by appearing and participating in the administrative hearing or ignoring the hearing and forcing a judicial resolution.

[66] Though the Administrator is the only one that can institute a cease and desist action, some states have a procedure whereby others may initiate administrative proceedings seeking declaratory rulings. *See* MODEL STATE ADMINISTRATIVE PROCEDURE ACT § 306, 13 UNIFORM LAWS ANN. 46 (master ed. 1980)(pamphlet).

he feels that the violations are severe enough to warrant immediate judicial action. The violator also does not have to submit to an administrative resolution of the dispute. It is clear under the Uniform Act that the Administrator does not have the power to punish for contempt of his order.[67] If the violator continues to act in the face of the cease and desist order, the Administrator, if he wishes to pursue the matter further, has no choice but to go into court to seek an injunction under section 408. In so doing, the Administrator will have to rely on the conduct covered by the cease and desist order rather than the violation of the cease and desist order itself.[68] By simply ignoring the Administrator's order, the alleged violator will get the opportunity to have the dispute heard by a court in the first instance.[69]

Thus, the issuance of a cease and desist order may be of limited legal effect. The order is merely an indication that the Administrator questions the legality of the alleged violator's practice. The order also contains an invitation to resolve the dispute by the more informal administrative pro-

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[67] The Administrator does not have the power to punish for contempt of the cease and desist order under either the uniform or non-uniform acts. The one exception to this rule appears to be the Virginia Corporation Commission. Under the Virginia act, the Corporation Commission is a court of record with the authority to issue injunctions and to punish for violation of those injunctions in the same way that a court of equity can. *See* VA. CODE § 13.1-519 (1978).

[68] Theoretically, the Administrator can claim that he has the power to issue an injunction based upon the violation of the cease and desist order alone. U.S.A. § 408 indicates that grounds for an injunction include not only violation of the provisions of the Act but also any rule or order entered thereunder. Clearly a cease and desist order is such an order. As a practical matter, however, it is believed that few courts will issue an order enforcing a cease and desist order without inquiring into the substantive basis for such order where the violator raises that issue. Thus, the violator will have his day in court on the merits of the dispute. *But see* State v. Werner Pet. Corp. (S.C. Cir. Ct., Richland County June 28, 1976)(unreported)(criminal liability for violation of a cease and desist order). Nor will the concept of res judicata, *see* note 64 *supra*, come into play because the Administrator will not have reached a decision on the merits of the dispute. It is not clear, however, whether res judicata is a factor where the Administrator, on his own motion, sets the case for administrative hearing, takes testimoney, and enters a decision on the merits in default when the violator does not appear. *See, e.g., In re* Playtime Marketing Mfg. Co. (Okla. Sec. Adm. May 31, 1978); *In re* Western Pacific Coin and Silver Exch., [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,203 (Iowa Ins. Comm'n Jan. 23, 1975).

[69] There is substantial question whether the alleged violator can have the dispute heard by a court in the first instance by filing a suit for declaratory judgment or for an injunction to prohibit the Administrator from continuing with the administrative process. D & S Inv., Inc. v. Mouer, 521 S.W.2d 118 (Tex. Ct. App. 1975), held that it was error for the trial court to entertain a declaratory judgment suit to determine whether something is a security. The court indicated that the question should have been presented to the Securities Commissioner. *See also In re* Atomite Corp. 29 Dauph. Co. Rep. 113 (Pa. C.P. 1926), *opinion on further consideration*, 29 Dauph. Co. Rep. 195 (Pa. C.P. 1926). In other legal areas, the federal courts of appeal hold it to be error for the federal district court to enjoin a federal agency from proceeding with an administrative hearing. *See, e.g.*, First Jersey Sec. Inc. v. Bergen, 605 F.2d 690 (3d Cir. 1979), *cert. denied*, 100 S.Ct. 1020 (1980) (disciplinary action of the NASD); Marshall v. Burlington Northern, Inc., 595 F.2d 511 (9th Cir. 1979)(jurisdiction of OSHA over railroad yards).

cess. Moreover, implicit in the issuance of a cease and desist order, is the idea that if the practice continues, or there is not administrative resolution, more formal enforcement action through a civil injunctive proceeding or criminal action will follow.

There are a number of advantages, both to the Administrator and the alleged violator, resulting from the use of the informal administrative process rather than the more formal civil injunctive or criminal actions. The most obvious is that the administrative agency can bring its own expertise to bear on the question while the violator retains his protection against agency bias or abuse through judicial review of the agency decision.[70] Also, of course, there is the speed and informality of the administrative process over the more cumbersome and formal judicial approach. Normally an administrative action will not draw the attention from the media that a judicial proceeding will. Therefore, damage to the alleged violator's business and reputation should be correspondingly reduced if he prevails at the administrative hearing and on review. Further, there is less stigma attached to an adverse administrative ruling than a judicial ruling;[71] therefore, there is less long-term impact on the violator, his business, or his reputation.

There is one other major advantage to the alleged violator which flows from the administrative process which is not available under the judicial approach. Section 412(e) provides that the civil liability provisions of the Act will not attach to transactions entered into by any person based upon a good faith reliance on an order of the Administrator. This protection exists even if the Administrator's order is later amended, rescinded, or judicially determined to be invalid.[72] Thus, if the alleged violator is able

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[70] U.S.A. § 411 provides for judicial review of the Administrator's decisions. Such review is not *de novo*. The findings of the Administrator, to the extent supported by the record, are binding upon the reviewing court. Either party, however, may petition the reviewing court to order the taking of additional evidence by the Administrator. *See* Western Air Lines, Inc. v. Stephenson, [1954-1961 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 70,396 (Cal. Super. Ct., Los Angeles County July 17, 1958), *rev'd sub nom.* Western Air Lines, Inc. v. Sobieski, 191 Cal. App. 2d 399, 12 Cal. Reptr. 719 (1961).

[71] Under most federal securities provisions the entry of a state administrative order, unlike a similar judicial order, is not grounds for denial or revocation of a registration or denial or withdrawal of an exemption. *See, e.g.*, 15 U.S.C. § 780(a)(4)(C) (1976)(broker-dealer registration); 17 C.F.R. §§ 230.252(c) & (d) (1980) (Regulation A is not available or may not be withdrawn if issuer or any officer, director, principal shareholder, or promoter thereof is subject to injunction by any state or federal court). On the other hand, the Uniform Act authorizes the refusal or withdrawal of both broker-dealer and securities registration on the basis of such orders. *See* U.S.A. §§ 204(a)(f) & 306(a)(2)(c). Under the Uniform Act provisions, a consent or default injunction is sufficient. *See In re* Wesley Karban Wyatt, (Okla. Sec. Adm. Jan. 9, 1979)(findings of fact, conclusions of law, and memorandum order denying agent's registration).

[72] The protection given by U.S.A. § 412(e) does not extend to a "no-action" letter issued by the Administrator under U.S.A. § 413(e) since the Administrator does not issue such opinions in the form of an order and they are not subject to judicial review. Loss, *supra* note 12, at 400-01 (official comments to U.S.A. § 413(e)). The protection of U.S.A. § 412(e) only extends to actions taken in reliance on a "rule, order, or form." *Id.* at 155 (offi-

to sustain his position at the administrative hearing, he will be free to continue the practice without further challenge or fear of the imposition of civil liability.[73] This protection flows from the apparent inability of the staff of the securities commission to take an appeal from an unfavorable decision of the Administrator.[74] Section 411 allows "any person aggrieved by a final order of the Administrator" to appeal or seek review of that order. It is not clear, however, whether the staff of the securities commission can qualify as an aggrieved person under section 411.

The Uniform Commissioners indicate that the drafters of section 411 patterned this section's language after that found in the Model Administrative Procedure Act.[75] A majority of the cases under this, and similar state administrative procedure acts, hold that a subordinate officer does not have the authority to appeal an adverse administrative ruling of a superior.[76] The basis for these decisions is that a subordinate and superior represent the same interest and the superior has the authority and responsibility to make the final administrative decision on matters affect-

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cial comments to U.S.A. § 412(e)). The same is true under the federal statutes. *See* Greene v. Dietz, 247 F.2d 689, 695 (2d Cir. 1957). This protection, however, is available if the issuer seeks a formal declaratory determination by the Administrator as is authorized by some administrative procedure acts. *See* Clayton Brokerage Co., Inc. v. Mouer, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,132 (Tex. Dist. Ct. Apr. 18, 1974), *aff'd*, 520 S.W.2d 802 (Tex. Ct. App.), *dismissed*, 531 S.W.2d 805 (Tex. 1975).

[73] U.S.A. § 412(e) does not protect the violator from the imposition of criminal liability for continued conduct in good faith reliance on an order of the Administrator. The sale of unregistered securities is a *malum prohibitum* crime which does not require any malice or evil state of mind. Therefore, a person may be guilty of selling unregistered securities even though he does not know that he must register the securities or that he is even selling securities. In United States v. Anzelmo, 319 F.Supp. 1106 (E.D. La. 1970), the court held that receiving an opinion from the SEC that the selling of certain securities without registration was permissible did not insulate the defendant from prosecution for the sale of unregistered securities. *But see* People v. Ferguson, 133 Cal. App. 41, 24 P.2d 965 (1933). It is doubtful, however, except in the extreme case, that a prosecutor will seek a criminal conviction for the sale of unregistered securities where the Administrator has held the interests sold not to be a security.

[74] In some states, such as Oklahoma, the administrative process involves two levels. The case is first heard by the Administrator. The violator may then request a *de novo* hearing before the Commission *en banc*. OKLA. STAT. tit. 71, § 409 (1965). Under this procedure, the violator gets two bites at the apple. If he convinces the Administrator of his position, the staff cannot appeal to the Commission. If he does not convince the Administrator, but does convince the Commission, then the staff or the Administrator may not appeal. Of course the violator, if he fails to convince either, may still take a judicial appeal.

[75] *See* Loss, *supra* note 12, at 152 (official comments to U.S.A. § 411). *See also* 54 HANDBOOK OF NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS 334 (1944). The Model Administrative Procedure Act has since been withdrawn and replaced with the Model State Administrative Procedure Act of 1961. *See* MODEL STATE ADMINISTRATIVE PROCEDURES ACT, 13 Uniform Laws Ann. 467 (master ed. 1980)(pamphlet). The language of § 15 of the 1961 Act closely parallels the language of U.S.A. § 411. Therefore, the annotations to § 15 are helpful in construing the Uniform Act.

[76] It is unclear whether a distinction should not be drawn between the superior acting in a legislative or policy-making function and the superior acting in a judicial or quasi-judicial function.

ing that interest.[77] There are, however, a number of decisions which take a minority position and allow the subordinate to appeal.[78] These decisions emphasize the fact that a challenged practice should not escape judicial review and take on a conclusive character by giving immunity to the alleged violator.[79] While this latter rationale is more appealing, especially because the administrative decision is given conclusive effect under section 412(e), this position still remains a definite minority view.[80]

B. *Enforcement by Civil Injunction*

The second major enforcement tool available to the Administrator is the ability to bring suit for civil injunctions under section 408 of the Act.[81] Such actions can prevent further violation of the Act or force com-

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[77] *See* Iowa Dept. of Rev. v. Iowa St. Bd. of Tax Review, 267 N.W.2d 675, 678 (Iowa 1978); Davis, *Standing of a Public Official to Challenge Agency Decisions: A Unique Problem of State Administrative Law*, 16 AD. L. REV. 163 (1964)(discussing rule and cases that forbid subordinate from appealing a superior's decision). The rationale preventing a subordinate from appealing a superior's decision is compelling when the superior is acting in a legislative or policy-making capacity. This rationale, however, is less compelling when the superior is acting in a judicial or quasi-judicial function. The rule may be a function of the Administrator's dual role as administrative head of the agency as well as judge in a particular administrative proceeding. The Administrator, acting as the administrative head of the agency, has the final authority to determine whether there will be an action. By deciding as a judge in a particular case that the staff position has no merit, the Administrator may also be making a decision as the administrative head of the agency that the agency should not pursue the matter further.

[78] *See, e.g.*, Altman v. School Comm. of Scituate, 115 R.I. 399, 347 A.2d 37 (1975); *In re* Halifax Paper Co., Inc., 259 N.C. 589, 131 S.E.2d 441 (1963); Elizabeth Fed. Sav. & Loan Ass'n v. Howell, 24 N.J. 488, 132 A.2d 779 (1957).

[79] *See* Altman v. School Comm. of Scituate, 115 R.I. 399, 347 A.2d 37 (1975).

[80] While at one time it was thought that anyone who was not a party to the administrative hearing could not seek an appeal or review of that decision, *see, e.g., In re* Atomite Corp., 29 Dauph. Co. Rep. 113 (Pa. C.P. 1926), *opinion on further consideration*, 29 Dauph. Co. Rep. 195 (Pa. C.P. 1926), it is now clear that the concept of "aggrieved persons" includes people who are not parties. *See, e.g.*, Reagles v. Simpson, 72 Wash. 2d 577, 434 P.2d 559 (1967); Local 1344, Council No. 4, Am. Fed. of State, County, and Mun. Employees v. Connecticut State Bd. of Labor Relations, 30 Conn. Supp. 259, 309 A.2d 696 (1973). Enlarging the number of "aggrieved persons" will allow at least limited appeals from a favorable ruling by the Administrator for the alleged violator. It is clear that the attorney general or chief legal officer of the state may bring such an appeal where there is a matter of public policy involved. *See, e.g.*, Mondale v. Commissioner of Taxation, 263 Minn. 121, 116 N.W.2d 82 (1962); *In re* Pub. Serv. Coordinated Transport, 5 N.J. 196, 74 A.2d 580 (1950). It is doubtful, however, that any private party can come within the concept of an "aggrieved person" where the ruling is favorable to the alleged violator. If the dispute involves determining whether something is a security the ruling of the Administrator will not bar the rights of those who have already purchased. They may file their own suits under the Act and the only effect upon their rights is the persuasive impact that the Administrator's opinion might have upon the court. Parties who have not yet purchased clearly would be "aggrieved persons" since the adjudication involves their rights. Normally at this point, however, these potential purchasers are not identified or interested in pursuing the matter becase if they do not agree with the Administrator they will simply refrain from buying the interest.

[81] The civil injunction is specifically available either to prevent an existing violation

pliance with the Act or any rules or orders thereunder when there is a threatened violation. All parts of the Act are subject to injunctive enforcement. Thus, an action can be brought to enjoin further violation of the antifraud provisions of section 101,[82] the securities registration provisions of section 301[83] or the broker-dealer, agent registration provisions of section 201.[84]

In many states, such as Oklahoma, these injunctive actions can be brought by the enforcement staff of the securities agency without the consent or help of the state attorney general or local district attorney. In a number of states, however, such as Texas, such actions may be brought only by the state attorney general at the request of the securities agency.[85]

In most states, the case law suggests that nothing more is necessary to secure a prohibitory injunction against further violation of the Act than a showing that there has been a violation of the Act.[86] Certainly there is no requirement, as in the case of a private litigant seeking an injunction, that the Administrator show irreparable harm.[87] The federal courts, however, are indicating that the injunctive provisions of the federal acts, the basis of the Uniform Act, are not punitive in nature but rather equitable and prophylactic for the protection of the public.[88] As a result, the federal courts frequently require the Securities and Exchange Commission [SEC]

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from continuing or re-occurring, or in the case of a potential or threatened violation to prevent it from taking place in the first instance. U.S.A. § 408 provides that the Administrator may seek a civil injunction "[w]henever it appears to the Administrator that any person has engaged or is about to engage in any act or practice constituting a violation of any provision of this act or any rule or order thereunder. . . . " Further, of course, if there is an actual violation, the violator is subject to civil liability under U.S.A. § 410 to the purchaser of the securities.

[82] *See, e.g.*, State v. Ford, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,299 (Alas. Super. Ct. June 28, 1976); Tower Credit Corp. v. State, 187 So. 2d 923 (Fla. Dist. Ct. App. 1966).

[83] *See, e.g.*, Securities Comm'r v. McGovern, 3 BLUE SKY L. REP. (CCH) ¶ 71,438 (N.D. Dist. Ct. 1978); Wee Mac Corp. v. State, 301 So. 2d 101 (Fla. Dist. Ct. App. 1974).

[84] *See, e.g.*, Baldwin v. Oklahoma Sec. Comm., [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,007 (Okla. Ct. App. 1971).

[85] The requirement that only the state attorney general can bring an action for a civil injunction becomes extremely cumbersome when coupled with the requirement that only an assistant attorney general may make the court presentation. In such situations, unless there is an assistant attorney general assigned to the securities agency on a full or substantially fulltime basis, the presentation will be inferior to one made by staff attorneys from the securities agency. Some agencies have been successful in getting the attorney general to appoint a member of the securities staff as a special attorney general for the sole purpose of presenting a particular securities case.

[86] *See, e.g.*, Securities Comm'r v. McGovern, 3 BLUE SKY L. REP. (CCH) ¶ 71,438 (N.D. Dist. Ct. May 30, 1978); State v. Creative Products, Inc., [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,056 (Okla. Dist. Ct. Nov. 17, 1972).

[87] *See* Bradford v. SEC, 278 F.2d 566 (9th Cir. 1960); SEC v. Torr, 87 F.2d 446 (2d Cir. 1937); 3 L. Loss, SECURITIES REGULATION 1979-80 (2d ed. 1961).

[88] *See, e.g.*, SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963); SEC v. Paro, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,816 (N.D.N.Y. March 28, 1979).

to establish that there is a reasonable likelihood that future violations will occur.[89] This can be done not only by showing prior violations, but also that these prior violations were knowingly and willfully done.[90] Other factors which a court will consider in ruling on the issuance of an injunction are the magnitude and frequency of the violations, whether the violator continues to maintain that his past conduct was blameless, whether the violator voluntarily ceases the questioned practice, whether his assurances that he will not repeat such conduct are sincere, and whether it is reasonable to expect further violations to occur in light of the violator's professional standing.[91] This stricter standard can now be found in some state cases,[92] and it is reasonable to expect that state courts will increasingly require this showing in the future.

One other major question in connection with prohibitory injunctions under the Uniform Act concerns the standard of conduct necessary to show a violation of the anti-fraud provisions of section 101. Section 101 patterns the language of section 17(a) of the Securities Act of 1933 ('33 Act)[93] and Rule 10b-5.[94] In the landmark case of *Ernst & Ernst v. Hochfelder*,[95] the Supreme Court held that a private litigant must prove scienter in order to be able to recover under Rule 10b-5. While it is not entirely clear whether the Court meant scienter in the common law sense of not only an intentional act, but also one done with the intent to cause injury, or merely a knowing act, the lower federal courts have been virtually unanimous in holding that scienter means only a knowing act or one done in total disregard for the truth.[96]

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[89] *See, e.g.*, SEC v. Commonwealth Chemical Sec., Inc., 574 F.2d 90 (2d Cir. 1978); SEC v. Paro, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,816 (N.D.N.Y. March 28, 1979). The injunctive provisions are really not punitive in nature, but rather equitable and prophylactic in order to protect the public. The flexible nature of the injunctive provisions creates a need for a procedure at both the state and federal level for determining whether a particular practice or the sale of a particular interest violates the securities acts without the stigma of an injunction. This can, in part, be done at the state level through the use of the cease and desist power discussed in the previous section. *See* text accompanying notes 42-80 *supra*. Yet, the administrative route is often unacceptable to the person whose conduct is called into question. The Act needs to be amended to include a procedure similar to the declaratory judgment arrangement where the Administrator alone, or either the Administrator or the challenged party, can have a court determine the validity of the practice without necessarily seeking an injunction.

[90] *See* SEC v. Paro, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,816 (N.D.N.Y. March 28, 1979).

[91] *See, e.g.*, SEC v. Universal Major Ind. Corp., 546 F.2d 1044 (2d Cir. 1976); SEC v. Paro, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,816 (N.D.N.Y. March 28, 1979).

[92] *See, e.g.*, Shaul v. Crofters, Inc., [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,049 (Ohio C.P. Sept. 19, 1972); State v. Cathedral of Tomorrow, Inc., [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,052 (Ore. Cir. Ct. Oct. 9, 1972).

[93] 15 U.S.C. § 77q(a) (1976).

[94] 17 C.F.R. § 240.10b-5 (1979).

[95] 425 U.S. 185 (1976).

[96] *See, e.g.*, Sanders v. John Nuveen & Co., 554 F.2d 790 (7th Cir. 1977). The present standard for reckless disregard appears to be a highly unreasonable omission involving an

The Court, however, specifically left open two very important questions. First, is the standard under section 17(a) of the '33 Act the same as that under Rule 10b-5? Second, is scienter required in SEC enforcement actions under either Rule 10b-5 or section 17(a)?[97] The lower federal courts have split as to the answer to these major questions. Some courts, arguing that the standard ought to be the same whether the plaintiff is the SEC or a private litigant, hold that scienter is necessary for SEC injunctive actions under Rule 10b-5.[98] Other courts, including the Second Circuit, hold that negligence rather than scienter is the standard for SEC injunctive actions based upon the idea that the SEC injunctive actions are prophylactic in nature and are for the protection of the public.[99]

On the other hand, the vast majority of courts hold that negligence rather than scienter is the appropriate standard for SEC injunctive actions based upon section 17(a) of the '33 Act.[100] The difference in treatment between injunctive actions under section 17(a) and Rule 10b-5 lies in the fact that Rule 10b-5 has its statutory authorization in section 10(b) of the Securities Exchange Act of 1934 ('34 Act). As the Second Circuit in *SEC v. Coven*[101] pointed out, the Supreme Court in *Hochfelder* looked at the language of section 10(b), which talks in terms of manipulative or deceptive devices, and concluded that this language demanded a scienter standard. Therefore, the scienter standard of the statute naturally overrides and controls the parameters of the more liberal language of the Rule. The *Coven* court also pointed out that the language of section 17(a) is not subject to any controlling statutory provision. Section 17(a) is not an administrative rule that is bound by statutory guidelines. Therefore, there is no reason to deny the language of section 17(a) its natural meaning which does not impose a scienter requirement.[102]

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extreme departure from the standards of ordinary care which presents a danger of misleading buyers or sellers that is known to the defendant or is so obvious that he must have been aware of it. *See* Franke v. Midwestern Okla. Dev. Auth., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,786 at 90,850 (W.D. Okla. Oct. 8, 1976), *quoted with approval in*, Sanders v. John Nueveen & Co., Inc., 554 F.2d 790, 793 (7th Cir. 1977).

[97] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976).

[98] *See* SEC v. Blatt, 583 F.2d 1325 (5th Cir. 1978); SEC v. Wills, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,712 (D.D.C. Dec. 14, 1978).

[99] *See, e.g.*, SEC v. Aaron, [1979 Transfer Binder] FED. SEC. L. REP. ¶ 96,800 (2d Cir. 1979), *vacated*, 100 S.Ct. 1945 (1980).

[100] *See* SEC v. Blazon Corp., 609 F.2d 960 (9th Cir. 1979); SEC v. American Realty Trust, 586 F.2d 1001 (4th Cir. 1978); SEC v. Coven, 581 F.2d 1020 (2d Cir. 1978); SEC v. World Radio Mission, Inc., 544 F.2d 535 (1st Cir. 1976); SEC v. Shiell, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,190 (N.D. Fla. Sept. 27, 1977); SEC v. Southwestern Coal & Energy Co., 439 F. Supp. 820 (W.D. La. 1977); SEC v. Geotek, 426 F. Supp. 715 (N.D. Cal. 1976). *But see* SEC v. Cenco Inc., 436 F. Supp. 193 (N.D. Ill. 1977). Several courts take the position that an implied civil cause of action under § 17(a) of the '33 Act requires a showing of scienter in the same way as the Court required scienter for civil recovery under Rule 10b-5 in *Hochfelder*. *See, e.g.*, Sanders v. John Nuveen & Co., 554 F.2d 790 (7th Cir. 1977).

[101] 581 F.2d 1020 (2d Cir. 1978).

[102] *See* SEC v. Coven, 581 F.2d at 1026-28. The Ninth Circuit adopted the rationale of

The Supreme Court has resolved the dispute at the federal level in *Aaron v. SEC.*[103] The Court first rejected the idea that there should be a different standard under Rule 10b-5 for agency actions and private litigation. It held that the *Hochfelder* standard should apply to both. It then concluded, as had the Second Circuit in *Coven,* that *Hochfelder* does not automatically control section 17(a). The Court undertook an analysis of section 17(a) and concluded that subsection (1) requires proof of scienter because the *Hochfelder* reasoning applies equally to the language "to employ, any device, scheme, or artifice to defraud." The Court, however, then held that the SEC need not prove scienter in enforcement actions under either section 17(a)(2) or (3).

Administrators, in bringing a suit for an injunction under section 101, should learn from these decisions and not assume or concede that it is necessary to prove scienter in order to obtain the injunction. They should vigorously advocate that their actions are prophylactic in nature and, therefore, a negligence standard is more in line with the Act's purpose of protecting the public. Further, under section 101, there is not the embarrassing problem of a double standard, one for enforcement actions and another for civil recovery, because the Uniform Act specifically prohibits implied causes of action.[104] Thus, the Administrators should impress upon the state courts that, like section 17(a), section 101 is the statutory enactment rather than an administrative rule and, therefore, a court must interpret the statute as it stands rather than in conjunction with the language of a controlling statutory provision.[105]

To date, the author knows of no state enforcement cases[106] considering the liability standard under section 101 since the *Hochfelder* decision. Courts have considered the issue in both the civil and criminal context,

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Coven in SEC v. Blazon Corp., 609 F.2d 960, 965-66 (9th Cir. 1979). The *Coven* court goes on to point out that the legislative history of § 17(a) suggests that Congress intentionally omitted a scienter requirement. Section 17(a) was originally introduced in Congress as § 13 of S. 875 (73d Cong., 1st Sess.). Section 13, as originally written, was framed in terms of "willfully" employing a scheme to defraud and "with the intent to defraud." The House dropped this language from the final bill.

[103] [Current] FED. SEC. L. REP. (CCH) ¶ 97,511 (U.S. June 2, 1980).

[104] *See* U.S.A. § 410(h). *See also* Loss, *supra* note 12, at 151 (official comment to U.S.A. § 410(h)).

[105] The Administrator should argue that, consistent with U.S.A. § 101, no scienter need be shown when there is a broker-dealer or agent's license revocation under U.S.A. § 204(a). Support for such a position lies in the fact that the SEC consistently holds that scienter has no place in an administrative action based upon either § 17(a) or Rule 10b-5. *See In re* Irwin, Adm. Proc. File No. 3-4726 (Feb. 22, 1977), *summarized in,* [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,982; *In re* Steadman, 411 SEC. REG. & L. REP. (BNA) A-8 (June 29, 1977).

[106] The New York Martin Act served as one of the foundations for the language of § 17(a) of the '33 Act. There are several New York cases, one of which pre-dates the '33 Act, suggesting that the attorney general does not need to show scienter to obtain an injunction. *See* People v. Royal Sec. Corp., 5 Misc., 2d 907, 165 N.Y.S.2d 945 (Sup. Ct. 1955); People v. Federated Radio Corp., 244 N.Y. 33, 154 N.E. 655 (1926). *See also* People v. Barysh, 3 BLUE SKY L. REP. (CCH) ¶ 71,431 (N.Y. Sup. Ct. 1978).

and, while it is still too early to be sure, it appears that the state courts will not follow *Hochfelder*. In a recently reported decision, *Kittilson v. Ford*,[107] the Washington Supreme Court, in a civil suit,[108] rejected *Hochfelder* and specifically overruled a 1977 Washington decision which had accepted it.[109] The court relied on several of the rationales outlined above. First, it pointed out that the "manipulative and deceptive" language of section 10(b) of the '34 Act relied on so heavily by the Supreme Court in *Hochfelder* was not included in the Washington act, and therefore, as the Supreme Court itself had noted, the operative language could be read as not requiring scienter or intentional conduct.[110] Second, the court noted that the operative language in Washington was part of the securities act itself rather than in a rule adopted under the statute and controlled thereby. Finally, the court pointed out that there was no legislative history behind the Washington act as the Supreme Court found behind the federal provision requiring scienter. Therefore, the court elected to follow pre-*Hochfelder* precedent in both Washington and under other state acts and not require scienter.[111] Similar reasoning caused the Arizona court of appeals in *State v. Gunnison*[112] to reject *Hochfelder* and hold, following earlier precedent,[113] that a criminal violation of the Arizona equivalent of section 101 is a *malum prohibitum* offense which did not require scienter.[114]

In addition to being able to obtain a prohibitory injunction, section 408 specifically authorizes the Administrator to seek the appointment of a

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[107] 93 Wash. 2d 210, 608 P.2d 264 (1980).

[108] Washington did not adopt U.S.A. § 410(h) prohibiting implied causes of action. Earlier, in the case of Shermer v. Baker, 2 Wash. App. 845, 472 P.2d 589 (1970), the court held that § 101 of the Washington Act would support an implied cause of action.

[109] *See* Ludwig v. Mutual Real Estate Inv., 18 Wash. App. 33, 567 P.2d 658 (1977); Note, *Unlawful Securities Transactions and Scienter; An Emasculating Requirement*, 1 U. PUGET SOUND L. REV. 366 (1978); Comment, *Securities Fraud Under the Blue Sky of Washington*, 53 WASH. L. REV. 279 (1978)(both criticizing the *Ludwig* decision).

[110] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212 (1976).

[111] *See* Treider v. Doherty & Co., 86 N.M. 735, 527 P.2d 498 (Ct. App. 1974); Shermer v. Baker, 2 Wash. App. 845, 472 P.2d 589 (1970). *See also* Merrill, Lynch, Pierce, Fenner & Smith v. Byrne, 320 So. 2d 436 (Fla. Dist. Ct. App. 1975); State v. Gunnison, No. 2 CA-CR 1700 (Ariz. Ct. App. Oct. 24, 1979). It is not totally clear whether the *Kittilson* court intended to adopt a negligence standard or an absolute duty standard. Both *Treider* and *Shermer* contain language which suggests the absolute duty standard, following the Ninth Circuit decision in Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961). *Shermer*, however, which the *Kittilson* court specifically adopted, talks also in terms of breach of fiduciary duty. To the extent that a breach of fiduciary duty gives rise to negligent liability rather than absolute liability the court may have adopted a negligence standard.

[112] No. 2 CA-CR 1700 (Ariz. Ct. App. Oct. 24, 1979).

[113] *See* State v. Burrow, 13 Ariz. App. 130, 474 P.2d 849 (1970)(non-registration of securities and non-registration as a dealer).

[114] *But see* Greenfield v. Cheek, 122 Ariz. 57, 593 P.2d 281 (1979)(civil recovery requires proof of scienter under the Arizona equivalent of U.S.A. § 101). Because *Gunnison* has not been officially reported, the matter will probably go on to the Arizona Supreme Court and that court will either reconsider *Greenfield* or reverse *Gunnison*.

receiver or conservator for any violator or his assets.[115] This power is extremely important in those cases involving known securities violators, con-men, or willful violations of the Act. It allows the Administrator to freeze and preserve the assets of the violator which the violator will otherwise quickly dissipate. Action by the Administrator will give the injured purchasers time to bring their actions for civil damages and a pool of assets from which to get satisfaction.

There is one very important statement in the Draftsmen's Commentary concerning the power of the court to appoint receivers. Professor Loss indicates that he believes that the court has the power to appoint a receiver without the language of the statute under its general equitable powers to grant ancillary relief in a suit for an injunction.[116] The significance of this statement lies in the draftsmen's recognition that section 408 does not limit the remedies available to the Administrator to those specifically spelled out, but allows all other types of remedies which the court can grant under its general equitable jurisdiction.

The United States Supreme Court recognizes that the federal courts, as part of their general equitable jurisdiction, have authority to grant remedial as well as prohibitory injunctions.[117] One type of such injunction that a federal court can order is that a statutory violator surrender into the treasury of the court, for disposition as the court in its discretion may order, any profits that the violator has made in the course of his violation. The rationale for this order is that the violator should not profit from his violation. Denying the violator the fruits of his violation will make crime not pay and will discourage violations.[118]

Building upon decisions under other statutes, the SEC in recent years has been quite successful in pursuading courts, in connection with injunctive actions under the federal act, to order disgorgement of profits.[119] The SEC has accomplished this success in spite of the absence in the enforcement provisions of either the '33 or '34 Acts of authority for the SEC to seek such action, or the courts to grant it.[120] Further, a court has even awarded the Commission disgorgement where the court refused to grant the prohibitory injunction also sought.[121]

In spite of the Uniform Act's silence on the ability of the Administra-

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[115] *See, e.g.*, Huff v. Sioux Options Ltd., [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,197 (Iowa Dist. Ct. April 7, 1975).

[116] *See* Loss, *supra* note 12, at 143 (draftsmen's comment to U.S.A. § 408).

[117] *See* Mitchell v. Robert Demario Jewelry, Inc., 361 U.S. 288 (1960); Porter v. Warner Holding Co., 328 U.S. 395 (1946).

[118] *See* United States v. Moore, 340 U.S. 616 (1951); Porter v. Warner Holding Co., 328 U.S. 395 (1946).

[119] *See, e.g.*, SEC v. Shapiro, 494 F.2d 1301 (2d Cir. 1974); SEC v. General Refractories Co., 400 F. Supp. 1248 (D.D.C. 1975); SEC v. R.J. Allen & Associates, 386 F. Supp. 866 (S.D. Fla. 1974).

[120] *See* 15 U.S.C. §§ 77u, 78v (1976).

[121] *See* SEC v. Penn Central Co., 425 F. Supp. 593 (E.D. Pa. 1976). *See also* United States v. Moore, 340 U.S. 616 (1951).

tor to seek disgorgement under section 408, based upon the Draftsmen's Commentary and the SEC experience, such recovery should be available under the state acts, and Administrators should seek such relief as an effective enforcement tool. In two lower court cases[122] the courts refused such claims without adequate discussion. More recently, the Ohio Supreme Court in *State v. Buckeye Finance Corp.*,[123] held that the Ohio Commission could not sue for rescission or restitution.

Buckeye Finance illustrates the misconception under which all three courts which refused disgorgement were apparently suffering. An action in disgorgement is not an action for rescission or restitution brought by the state on behalf of the injured purchaser; instead, an action for disgorgement is strictly a remedial enforcement tool of the Administrator to deny the securities violator any rewards that he might receive as a result of his violation.[124] It is true that in the vast majority of cases the court will order the funds paid into the treasury of the court for distribution to those individuals injured by the securities violation rather than permitting the funds to inure to the benefit of the state.[125] As recently pointed out in connection with an SEC settlement with some of the Penn Central defendants, however, the SEC action for disgorgement does not in any way impair or infringe upon the rights of the injured individuals to bring a private civil suit to recover for their individual injuries.[126] Further, to the extent that recovery is made under these private suits, the disgorgement amount is reduced.[127] Thus, the SEC action is merely an attempt to recover the violator's profits to the extent those profits are not claimed by injured individuals in private suits.[128]

Further, the two types of actions have different measures of recovery. Under the theory of disgorgement, the Administrator may only recover the profits which the defendant made in connection with the violation.[129] On the other hand, under section 410, the measure of civil recovery by

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[122] *See* Wee Mac Corp. v. State, 301 So. 2d 101 (Fla. Dist. Ct. App. 1974); State v. Dare to Be Great, Inc., [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,096 (Utah Dist. Ct. 1972). *See also* State v. Moore, No. CD77-512 (Okla. Dist. Ct., Okla County Mar. 29, 1978).

[123] 54 Ohio St. 2d 407, 377 N.E.2d 502 (1978).

[124] *See, e.g.*, SEC v. Penn Central Co., 425 F. Supp. 593, 595 (E.D. Pa. 1976).

[125] *Id.*

[126] *See* SEC v. Penn Central Co., [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,809 (E.D. Pa. Mar. 21, 1979).

[127] *See* SEC v. Penn Central Co., 425 F. Supp. 593 (E.D. Pa. 1976).

[128] *Id.*

[129] *See, e.g.*, SEC v. Shapiro, 349 F. Supp. 46 (S.D.N.Y. 1972), *aff'd*, 494 F.2d 1301 (2d Cir. 1974). In *Shapiro*, the defendants traded on inside information. The *Shapiro* court ordered them to disgorge the profits made on such trading with the profits based on the difference between the price the defendants paid and the price after the information became public. The court imposed this measure in spite of the fact that the defendants did not sell at this time, but waited until later when the sale price of the securities had declined from the high attained immediately after the inside information became public. Thus, the court made them disgorge the potential profits from insider trading, and not their actual profits.

the injured purchaser is the consideration he gave for the securities, less any profits received, plus interest from the date of sale and attorney's fees.[130] In addition, civil recovery is a legal issue which a court must submit to a jury while disgorgement is purely equitable and must be tried to the court.[131] Finally, it appears that the running of the statute of limitations under the civil recovery section does not bar SEC disgorgement.[132]

Recently, an excellent decision by an Oklahoma court in *Day v. Southwest Mineral Energy, Inc.*,[133] reversed the trend against recognizing the right of state administrators to seek disgorgement under the Uniform Act. In this case, both the trial and appellate court examined in detail the federal precedent. Both courts elected to follow this federal precedent rather than *Buckeye Finance* and the other state cases rejecting the Administrator's authority to seek disgorgement. The *Southwest Mineral* opinion is far superior to the earlier state decisions and should provide strong precedent for other courts to follow.

One final word should be said about injunctive enforcement actions. Presently, most Administrators are not seeking to recover the costs they incur in bringing enforcement actions. This is a mistake. As part of the ancillary relief granted in connection with an injunctive suit, the Administrator ought to be able to recover his attorney's fees and costs. To date, the author is aware of only two actions, both uncontested, where the Administrator has sought and recovered his costs.[134] Again, with increasing inflation and the tendency to hold the line on agency budgets, Administrators should give more consideration to this method of alleviating some of the costs of litigation.

C. *Criminal Enforcement*

The last of the enforcement tools available to the Administrator is criminal prosecution under the Act. Section 409 contains the criminal liability provisions. That section makes it a felony, punishable by up to a $5,000 fine and three years in prison, to willfully violate any provision of the Act other than section 404. Violation of section 404 which deals with false filings with the Administrator is also a felony. To obtain a convic-

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[130] The *Shapiro* case, *see* note 129 *supra*, well illustrates the difference between civil recovery and disgorgement because that case involved defrauded sellers rather than purchasers. U.S.A. § 410 does not give a cause of action to defrauded purchasers. Therefore, while the Administrator is able to secure disgorgement for violation of U.S.A. § 101, no direct civil recovery is possible under U.S.A. § 410.

[131] *See* SEC v. Wills, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,321 (D.D.C. Feb. 11, 1978).

[132] *See* SEC v. Continental Advisors [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,489 (D.D.C. June 29, 1978).

[133] 51 OKLA. BAR J. 1911 (Okla. July 23, 1980), *aff'g* 3 BLUE SKY L. REP. (CCH) ¶ 71,548 (Okla. Dist. Ct., Okla. County 1979).

[134] *See* Securities Commissioner v. Brenden, 3 BLUE SKY L. REP. (CCH) ¶ 71,471 (N.D. Dist. Ct. Dec. 17, 1978); State v. Pacific Mortgage Co., No. 90736 (Ore. Cir. Ct., Marion County). *See also* State v. Maryland Cas. Co., 27 Or. App. 735, 557 P.2d 258 (1976).

tion for a section 404 violation, however, there is an additional requirement that the prosecutor establish that the defendant making the false filing not only did the act willfully, *i.e.*, knew that he was filing something with the Administrator, but also knowingly in the sense of knowing that the document or statement was false or misleading.[135]

Section 409 also makes the violation of any rule or order promulgated by the Administrator under the Act a felony. The section, however, grants the defendant a partial affirmative defense in connection with a rule or order violation. If the defendant commits the violation with knowledge of the rule or order, then the penalty is the same as for a violation of the Act itself. If, on the other hand, the defendant is able to establish that he did not know of the rule or order at the time he acted, then the court may impose a fine of up to $5000, but there can be no incarceration.[136]

The Uniform Act follows the practice of most statutes creating administrative agencies and only allows criminal prosecutions by the regularly appointed or elected law enforcement officials, *i.e.*, the local district attorneys or the attorney general.[137] As a result, the Administrator or his staff must refer criminal prosecutions to the appropriate officials. There is a growing practice in many states, however, for the local prosecutor to rely upon the expertise of the Administrator or his staff in presenting the case. The local prosecutor may even appoint the Administrator or an agency staff member as a special prosecutor to handle the case in its entirety. This practice allows the best of both worlds by giving the local prosecutor control over the cases which are brought in his jurisdiction, but making available to him the expertise in securities matters which he will often lack.

While the violation of any section of the Act can be the basis for the imposition of criminal liability,[138] as a practical matter virtually all criminal cases will arise from the violation of one of three sections: section 201 for failure to register as either a broker-dealer or agent; section 301 for failure to register securites offered or sold; or section 101 for the commission of fraud. It is not unusual for the same transaction to involve the

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[135] *See* State v. Woodington, 31 Wis. 2d 151, 142 N.W.2d 810 (1966), *cert. denied*, 386 U.S. 9 (1967).

[136] *See* Loss, *supra* note 12, at 145 (draftsmen's comment to U.S.A. § 409). The draftsmen's comment to U.S.A. § 409 suggests that the requirement is actual knowledge as opposed to constructive knowledge. Constructive knowledge would result from the publication of the rules and orders in the official state publication organ, *i.e.*, the *Oklahoma Gazette* in the case of Oklahoma. Because many states do not publish their agency rules and orders in an accessible form such as the *Federal Register* and *Code of Federal Regulations*, a constructive knowledge requirement is not workable. *See* People v. Murphy, 11 Cal. Rptr. 295 (Dist. Ct. App. 1973) (involves a violation of the restrictions included in registration order).

[137] *See* U.S.A. § 409(b).

[138] *See* State v. Woodington, 31 Wis. 2d 151, 142 N.W.2d 810 (1966), *cert. denied*, 386 U.S. 9 (1967) (U.S.A. § 404 violated by filing false statements with the Administrator); Curtis v. State, 99 Ga. App. 732, 109 S.E.2d 868 (1959), *subsequent appeal*, 102 Ga. App. 790, 118 S.E.2d 264 (1960)(U.S.A. § 405 violated by representing that Administrator had approved securities).

violation of two or more of these provisions, *i.e.*, the person selling unregistered securities frequently will be unregistered as an agent or broker-dealer and often will commit fraud in his sales pitch. In such a case, unless general criminal law in the jurisdiction prohibits the joining of counts or the conviction on multiple counts, the prosecutor should allege violations of each section and have the court submit each violation to the jury.[139] It is normally a good trial tactic to couple a violation of the anti-fraud provisions with any non-registration count where the facts will support such a charge. This procedure allows the prosecutor a great deal more leeway as to the evidence that he can introduce. Further, even if the jury is not willing to convict on the fraud charge, the evidence may have a psychological impact on the jury members so that they may be more willing to convict on a non-registration count which the jury may otherwise treat as merely a technical violation. A separate examination of each of the three most common violations is helpful in gaining a more complete understanding of criminal enforcement of the state securities laws.

1. *Non-Registration of Securities*

Non-registration of securities is a very easy criminal case to prove under the Uniform Act. First, of course, the prosecution will have to prove that an offer or sale of the items in question took place. It is important to note that the making of an offer for the sale of unregistered securities is as much a violation of the Act as is the completed sale of such securities. Normally, the prosecutor can establish the offer or sale of non-registered securities through the testimony of the victim.

Second, the state will have to prove that the item sold was a security. There will be no difficulty where the items are of the regular type of securities such as stocks, bonds, or debentures. There may be some difficulty, however, where the items constitute one of the more exotic securities that fall within the definition of "evidences of indebtedness" or "investment contract."[140] While there appears to be some disagreement in the cases,[141] it seems that the question of whether a security exists in a

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[139] It is the author's understanding that in Texas, for example, it is possible to allege the violation of multiple sections of the securities act, but that local law requires the state to select a single count to submit to the jury for its determination. Oklahoma also has an unusual arrangement. Unlike the federal procedure which requires the prosecution to charge the defendant with all violations known at the time, Oklahoma allows the court to try an individual on a single count. Thus if X fraudulently sold unregistered securities to Y and Z and was not registered as an agent, X would go on trial six times. Obviously, the Administrator and the prosecutor will have to be aware of the local practice and procedure.

[140] *See* Long, *Introduction to Student Symposium - Interpreting the Statutory Definition of a Security: Some Pragmatic Considerations*, 6 St. Mary L. J. 95, 96 (1974) [hereinafter cited as Long, *Introduction*]; Long, *Mainstream, supra note 2.*

[141] *Compare* Roe v. United States, 287 F.2d 435 (5th Cir. 1961); State v. Franks, 262 N.C. 94, 136 S.E.2d 623 (1964); State v. Geary, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) ¶ 71,192 (Iowa Dist. Ct. 1975) *with* United States v. Austin, 462 F.2d 724 (10th Cir. 1972); Commonwealth v. Queen, 434 S.W.2d 318 (Ky. 1968).

criminal case is a mixed question of fact and law. As such, the court must submit the issue to the jury for determination. For example, if the state claims that the relevant transaction involves an investment contract the judge must determine which of the several tests for investment contracts is applicable under local law.[142] The judge would then instruct the jury as to the elements of the test adopted and leave it to the jury to determine if there are facts necessary to meet the test. In a civil case, if the court feels that reasonable people would not differ, the judge can withdraw a fact question from the jury and rule on it as a matter of law. Such a procedure, however, is not available in a criminal case. A criminal court cannot withdraw a fact issue, no matter how obvious the answer, from the jury. To do so would direct a verdict against the defendant.[143]

The inability of the criminal judge to rule on a factual issue complicates the case from the prosecutor's point of view. The prosecutor would rather have the judge determine whether a security is involved as a matter of law. On the other hand, there is one counter-balancing factor. Because the question of whether there is a security is a question of fact, it should be permissible to use an expert witness to aid the jury in its determination of this issue. Obviously, this is the ultimate question of fact for the jury to decide, but most states now allow expert testimony on the ultimate question.

The prosecutor should first establish the test the court will adopt and the elements of this test. It is improper for the expert witness to testify as to which test the court should adopt because that is clearly a question of law for the court to determine on the basis of argument of counsel. The prosecutor should then, through a series of hypothetical questions, establish the facts of the case. He should then ask the expert witness, in the hypothetical case, whether there is a security present and why. The latter part is very important. The bare testimony by an expert that a security is present, without accompanying analysis of the hypothetical facts and the relevant test for a security, is worthless, and the trial judge should instruct the jury to disregard it. When the expert witness outlines why the facts present in the case before the jury satisfy the relevant test as defined by the court, his testimony is proper and can be a great deal of help to the jury. The states of Texas and Alaska have used this technique successfully on a number of occasions. The author has served as such an expert several different times.

The last thing that the prosecution must establish in a criminal nonregistration of securities case is that there was no registration of the securities. This can be done in either of two ways. The Administrator, or the person in his office who is designated as the custodian of the agency's

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[142] *See* SEC v. W.J. Howey Co., 328 U.S. 293 (1946); State v. Hawaii Market Center, Inc., 52 Haw. 642, 485 P.2d 105 (1971). *See generally* Long, *State Securities Regulation - An Overview*, 32 OKLA. L. REV. 541 (1979); Long, *Introduction*, *supra* note 140.

[143] *See, e.g.*, Roe v. United States 287 F.2d 435 (5th Cir. 1961); Miller v. State, 285 So.2d 41 (Ga. App. 1973).

records, may testify that he has searched the records of the agency and finds no effective registration for the securities in question at the time of their offer or sale. In the alternative, the prosecution may offer a certificate from the Administrator to the same effect.[144]

It is important to note what the prosecutor does not have to prove in a non-registration of securities case. Under the Uniform Act the prosecutor does not have to prove that the securities were not exempt from registration. Thus, he does not have to negate the some 25 securities and transactional exemptions in sections 402(a) and (b). Section 401(d) of the Uniform Act specifically indicates that the burden of proof shall be upon any person claiming such exemption. Section 402(d) applies in both civil injunctive and criminal cases[145] and does not place an unconstitutional burden on the defendant.[146] The state, of course, still must bear the burden of proof beyond a reasonable doubt on all other elements.[147]

The prosecution should be aware that there is some question over the element of intent. The question centers on whether the prosecution must prove that the defendant knew that he was selling an unregistered security in order to convict. The corollary to that is whether the defendant can escape liability by affirmatively proving that he did not know that the thing sold was a security or that the law required registration. The problem centers on the language of section 409 which requires that the violation of the Act be "willful." A court could interpret this to mean that the defendant must know that he is selling a security and that the law requires registration of that security.

Most cases under the Uniform Act, however, hold that knowledge is totally irrelevant. There is a "willful" violation of the Act according to these decisions, when the act of selling something is a volitional act on the part of the defendant. The defendant does not need to know that he is selling a security or that the law requires registration.[148] As a result, it

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[144] Worsley v. State, 162 Ind. App. 34, 317 N.E.2d 908 (1974)(certificate); State v. Fraks, 262 N.C. 94, 136 S.E.2d 623 (1964)(testimony).

[145] *See, e.g.*, Baldwin v. Oklahoma Sec. Comm. [1971-1978 Transfer Binder] BLUE SKY L. REP. ¶ 71,007 (Okla. App. 1972) (civil injunction); Sessions v. State, 404 P.2d 55 (Okla. Crim. App. 1965); Buchanan v. State, 171 So. 2d 186 (Fla. App. 1965); Nelson v. State, 355 P.2d 413 (Okla. Crim. App. 1960).

[146] *See, e.g.*, State v. Frost, 57 Ohio St.2d 121, 387 N.E.2d 235 (1979); State v. Buchanan, 361 So.2d 692 (Fla. 1978); People v. Dempster, 51 Mich. App. 612, 216 N.W.2d 81 (1974), *rev'd on other grounds*, 242 N.W.2d 381 (Mich. 1976). *But see* State v. Driver, 598 S.W.2d 774 (Tenn. 1980)(holding unconstitutional statute requiring defendant to prove he did not know or in exercise of reasonable care could not discover material misstatement or omission in order to avoid criminal fraud liability).

[147] *See* State v. Frost, 57 Ohio St.2d 121, 387 N.E.2d 235 (1979); State v. Goodman, 21 Ariz. App. 252, 517 P.2d 1299, *opinion vacated on other grounds*, 110 Ariz. 524, 521 P.2d 611 (1974).

[148] *See* State v. Hodge, 204 Kan. 98, 460 P.2d 596 (1969); Commonwealth v. Jones, 3 BLUE SKY L. REP. (CCH) ¶ 71,550 (C.P. Alleghany County April 24, 1980). People v. Terranova, 563 P.2d 363 (Colo. Ct. App. 1977); State v. Russell, 119 N.J. Super. 344, 291 A.2d 583 (1973).

is not an affirmative defense to criminal liability to establish that legal counsel advised the defendant that the items were not securities and did not require registration.[149] Nor is it a defense that the Administrator advised the defendant that there need not be registration.[150]

While the issue of intent appears to be clearly settled under the Uniform Act, the prosecutor should expect the defense to raise the issue and he should be prepared to counter it. The federal cases dealing with nonregistration violations are split over the intent question. The Second Circuit holds that the prosecution must prove intent.[151] The Ninth and Fourth Circuits, however, hold that proof of intent is unnecessary.[152]

There also appears to be two state cases which suggest that knowledge is an element for the prosecution to prove. In *State v. Georgia*,[153] the court first held that the defendant's scheme involved an investment contract. The court then reversed the defendant's criminal conviction because the decision declaring such schemes to be within the securities law was decided shortly before the defendant's case and the court could not charge the defendant with knowledge of it. This case is obviously wrong. If followed, the promoters of no new scheme are subject to criminal prosecution until after a court in the state declares the scheme to involve a security. Certainly such a position does not serve the purpose of the securities laws to protect the general public from these types of schemes.

The second case is *People v. Dempster*,[154] which involves the interpretation of the commercial paper exemption. Again, the court held that the items sold were not within the exemption and that there was a registration violation. The court, however, then reversed the defendant's conviction. It held that the definition of "commercial paper," as used within the statutory exemption, was sufficiently vague prior to the court's decision that the defendant's conviction could not stand.[155] These two decisions

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[149] *See* State v. Witeaker, 118 Or. 656, 247 P. 1077 (1926); People v. McCalla, 63 Cal. App. 183, 220 P. 436 (1923); People v. Clem, 39 Cal. App.3d 539, 114 Cal. Rptr. 359 (1974); People v. Aresen, 91 Cal. App.2d 26, 204 P.2d 389 (1949).

[150] *See* United States v. Anzelmo, 319 F. Supp. 1106 (E.D. La. 1970). *But see* People v. Ferguson, 134 Cal. App. 41, 24 P.2d 965 (1933).

[151] *See* United States v. Tortorello, 480 F.2d 764 (2d Cir. 1973); United States v. Crosby, 294 F.2d 928 (2d Cir. 1961), *cert. denied*, 368 U.S. 984 (1962).

[152] *See* United States v. Brown, 578 F.2d 1280 (9th Cir. 1978); United States v. Custer Channel Wing Corp., 376 F.2d 675 (4th Cir.), *cert. denied*, 389 U.S. 850 (1967). *See also* United States v. Sussman, 37 F. Supp. 294 (E.D. Pa. 1941); Note, *Securities Regulation: Criminal Liability Under the Oklahoma Securities Act—The Willfulness Requirement*, 31 OKLA. L. REV. 486 (1978) [hereinafter cited as *Criminal Liability*].

[153] 50 Ohio App. 2d 297, 362 N.E.2d 1223 (1975).

[154] 396 Mich. 723, 242 N.W.2d 381 (1976).

[155] *Dempster* may well be a case where the prosecutor should have used his discretion not to prosecute because he felt that the defendant was claiming the exemption in good faith. The discretion, however, is the prosecutor's and not the court's. Regardless of the defendant's knowledge, a crime occurred under the statute. As the court indicated in State v. Burrow, 13 Ariz. App. 130, ___, 474 P.2d 849, 851 (1970), violation of the securities act is essentially a *malum prohibitum* or *malum in se* crime.

seem inconsistent with the idea that knowledge of the statute is irrelevant.

There is one further problem in the intent area. Many states are beginning to consider the new Model Penal Code. One of the provisions of this Code provides that a court may not convict a person of a felony without proof of criminal intent unless the statute authorizing such conviction specifically negates the need for proof of criminal intent. Oregon has adopted the Model Penal Code and has language in its securities act similar to section 409. Recently, in *State v. Pierre*,[156] the court held that the language of the securities act was not sufficiently specific to authorize a felony conviction for non-registration of securities without criminal intent. Therefore, the court reduced the defendant's conviction to a misdemeanor. Administrators and prosecutors in those states considering the Model Code should take steps to see that the securities law is exempt from this provision. In the alternative there should be an amendment to the securities law to make clear that intent is not an element of a non-registration violation.

2. *Non-registration as Broker-dealer or Agent*

The elements of a criminal case for non-registration as a broker-dealer or agent will be very similar to those for non-régistration of a security. The prosecutor will have to show that there was an offer or sale. Further, he will have to show that the item offered or sold is a security. He will then have to allege and prove that the person charged is either an agent or a broker-dealer. Section 401(c) defines a "broker-dealer" as "any person engaged in the business of effecting transactions in securities for the account of others or for his own account." The key here is the words "engaged in the business." While a person may be a broker-dealer where he is handling nothing but his own transactions, the vast majority of traders will not be "in the business." Section 401(b) defines an "agent" as "any individual other than a broker-dealer who represents a broker-dealer or issuer in effecting or attempting to effect purchases or sales of securities." In most cases there will be little question that the person is an agent or a broker-dealer. One's status, however, is a fact question and there is little case law dealing with the question.

The prosecutor also must establish that the defendant did not register. This can be done in the same way as outlined above for showing that there was no registration of securities. Sections 401(b) and (c) contain certain exclusions from the definition of "agent" or "broker-dealer." Again, however, the prosecutor does not have to negate these.[157] Section 402(d) covers both exemptions and exclusions from definitions and places

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[156] 30 Or. App. 81, 566 P.2d 534 (1977).

[157] *See* Hohensee v. State, 42 Md. App. 329, 400 A.2d 455 (1979); State v. Frost, 57 Ohio St. 2d 121, 387 N.E.2d 235 (1979); Worsley v. State, 162 Ind. App. 34, 317 N.E.2d 908 (1974). *See also* State v. Hayes, 317 So. 2d 764 (Fla. App. 1975) (involving an exemption).

the burden on the person claiming such exemption or exclusion.[158] As in the case of non-registered securities, the prosecutor does not need to show specific intent to violate the statute. Thus, it is not necessary to show that the defendant knew that he needed to secure a license before making the offers or sales.[159] The prosecution normally will couple violations of agent or broker-dealer registration provisions with violations of the antifraud or securities registration provisions.[160] The latter, however, is a totally independent ground for criminal liability.[161]

3. *Securities Fraud*

The most difficult criminal prosecution under the Uniform Act is that for securities fraud. This difficulty, in large measure, stems from the fact that a criminal prosecution for securities fraud requires the reading of section 409, the criminal liability section, in conjunction with section 101, the antifraud provision. When a criminal prosecution is sought under section 409 of the Uniform Act for violation of section 101, the prosecutor must show conduct which violates section 101. Second, because the criminal charge is under section 409 rather than under section 101, the prosecution must show that the defendant acted "willfully." Third, the prosecutor must prove that the conduct occurred in connection with the offer, sale, or purchase of a security. Conspicuously absent from the elements of a criminal prosecution is the need for the prosecutor to show either reliance by the victim or injury to him.

The first element that the prosecutor must prove is that there has been a violation of the substantive provisions of section 101.[162] There are

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[158] It is not clear whether the language in U.S.A. § 402(d) is also applicable when a person claims that what he is selling is not a security even though it would clearly fit within the definition. An example is a promissory note.

[159] *See* State v. Kreminski, 3 BLUE SKY L. REP. (CCH) ¶ 71,506 (Conn. June 26, 1979); State v. Nagel, 279 N.W.2d 911 (S.D. 1979); Commonwealth v. David, 309 N.E.2d 484 (Mass. 1974); State v. Marsh, 428 P.2d 896 (Ore. 1967).

[160] *See, e.g.*, State v. Nagel, 279 N.W.2d 911 (S.D. 1979); Commonwealth v. Bomersbach, 393 A.2d 995 (Pa. Super. Ct. 1978); Worsley v. State, 162 Ind. App. 34, 317 N.E.2d 908 (1974).

[161] *See* State v. Henderson, 156 N.W.2d 700 (N.D. 1968); State v. Hirsch, 101 Ohio App. 425, 131 N.E.2d 419 (1956). It might be appropriate to bring an action for non-registration as a broker-dealer or agent independent of a fraud or securities registration violation when a broker-dealer located outside the state has consistently made offers into the state without qualifying under the local act. See Long, *Conflict*, *supra* note 62.

[162] U.S.A. § 101 provides:

> It is unlawful for any person in connection with the offer, sale, or purchase of any security, directly or indirectly
>
> (1) to employ any device, scheme, or artifice to defraud;
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading; or
>
> (3) to engage in any act, practice, or course of business which operates as a fraud or deceit upon any person.

three operative subsections within this section. The first prohibits the employment of any device, scheme, or artifice to defraud. This language suggests that the subsection is little more than a codification of the common law concept of fraud.[163] As a result, few criminal prosecutions come under this subsection[164] because the prosecutor must prove scienter. Even with its scienter requirement,[165] however, this subsection presents several major advantages over its more widely used counterparts, theft by fraud or obtaining money by fraud or under false pretenses. These latter crimes clearly require the prosecutor to prove both that the victim parted with money in reliance upon the fraudulent scheme and that the defendant intended to defraud.[166] The prosecutor need prove neither of these elements under section 101.

This point was made in the recent case of *Van Duyse v. Israel*,[167] where the defendant sought a discharge from custody through a writ of habeas corpus. The defendant was charged in state court with both securities fraud and theft by fraud. The jury found him innocent of the theft by fraud charges and guilty of the securities fraud counts. One of the grounds for his writ was that the jury verdicts were inconsistent. The court rejected this claim saying:

> A verdict is inconsistent when the defendant is charged with two offenses having identical elements and the jury acquits him of one offense and convicts him of the other. In order to have convicted petitioner of theft by fraud, the jury would have had to find that petitioner obtained property by making false presentations "made with intent to defraud." § 943.20(1) (d) Wis. Stats. In order to convict petitioner of fraud in the sale of securities, the jury was only required to find that his conduct was willful.[168]

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[163] The conclusion that the first subsection to U.S.A. § 101 is little more than a codification of the common law concept of fraud is supported by those courts which require a jury instruction as to what constitutes a device, scheme, or artifice to defraud. Invariably, the court borrows these instructions from situations involving common law fraud. *See, e.g., State v. Homewood*, 241 S.C. 231, 128 S.E.2d 98 (1962).

[164] *See* Commonwealth v. Wells, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,387 (Pa. C.P. June 27, 1977); Laveranz v. State, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,313 (Ga. Ct. App. Nov. 19, 1976); People v. Messer, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,133 (Cal. App. 1973).

[165] The scienter requirement in the first subsection of U.S.A. § 101 only means that the prosecutor must show that the act was knowingly done or done with reckless disregard. It does not require the showing of an evil mind or intent to defraud.

[166] *See, e.g., State v. Layman*, 357 P.2d 1022 (Okla. Crim. App. 1962)(elements of crime of obtaining money by false pretenses are a false representation of past existing fact, made by or at the direction of the defendant, with the intent to deceive or defraud, with reliance by the person who the defendant intended to defraud, and the obtaining of something of value by the defendant as a result thereof).

[167] 486 F. Supp. 1382 (E.D. Wis. 1980).

[168] *Id.* at 1387-88. A similar distinction to that in *Van Duyse* was made in Curtis v. State, 99 Ga. App. 732, ___, 109 S.E.2d 868, 872 (1959), *subsequent appeal*, 102 Ga. App. 790, 118 S.E.2d 264 (1961), where the court said:

What constitutes a device, scheme, or artifice to defraud is obviously a question of fact which the court will submit to the jury. The type of scheme most frequently charged under this provision involves the conversion of investor money to private use.[169]

One final point should be made about this subsection. There is some dispute as to whether the charge should encompass the scheme as a whole or whether the prosecution should allege each offer or sale in connection with the scheme as a separate offense. In *Queen v. Commonwealth*,[170] the court concluded that each offer or sale employing the scheme was a separate offense.[171] A New York trial court, however, recently reached the opposite conclusion in *People v. Paar*.[172] The latter court refused to dismiss several counts when the conduct was alleged as having taken place between two dates and not identified as having occurred in connection with any particular offer or sale. The former approach appears to be the better and safer way to handle the problem. It does, however, result in the defendant having a great deal more criminal liability exposure than might be thought on first glance.

The second subsection of section 101 prohibits the making of untrue statements of material fact or the making of material omissions which make the information conveyed false or inaccurate. This is the subsection under which the vast majority of criminal securities fraud cases are brought.[173] While it is often stated, in a short-hand way, that this section prohibits the making of material misstatements and omissions, this is not technically true. The subsection does prohibit the making of any misstatement. The section, however, only prohibits those omissions which cause the information conveyed to be either false or misleading. There-

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> A scheme to defraud is such a scheme as is initiated by the perpetrator with an intent to defraud another and cause him to suffer a pecuniary loss, but the intent, not the loss, is the subject matter of the crime. Under Code § 26-7410 [theft by deceit] it must be shown that the victim has been defrauded as a result thereof. Under Code § 97-112 [securities fraud] the existence of the scheme, device or artifice, and its use with an intent to defraud [*i. e.*, scienter], regardless of outcome, constitutes the inhibited act.

See also Queen v. Commonwealth, 434 S.W.2d 318 (Ky. 1968).

[169] *See* Commonwealth v. Wells, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,287 (Pa. C.P. June 27, 1977); Laveranz v. State, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,313 (Ga. Ct. App. Nov. 19, 1976). *See also* Queen v. Commonwealth, 434 S.W.2d 318 (Ky. 1968).

[170] 434 S.W.2d 318 (Ky. 1968). *See also* United States v. Naftalin, 606 F.2d 809 (8th Cir. 1979)(reaching the same conclusion under § 17(a) of '34 Act).

[171] *See* State v. Stith, No. 48726 (Minn. April 11, 1980)(each misrepresentation constitutes a separate offense). *See also* People v. Witzerman, 29 Cal. App.3d 169, 105 Cal. Reptr. 284 (1979)(each misrepresentation constitutes a separate offense in a civil injunction case).

[172] 3 BLUE SKY L. REP. (CCH) ¶ 71,406 (N.Y. Sup. Ct. 1977). *See also* United States v. Amick, 439 F.2d 351 (7th Cir.), *cert. denied*, 404 U.S. 823 (1971); United States v. Birrell, 266 F.Supp. 539 (S.D.N.Y. 1967).

[173] *See, e.g.*, State v. Gunnison, No. 2 CA-CR 1700 (Ariz. App. Oct. 24, 1979); State v. Williams, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,280 (Wash. Super. Ct. Apr. 16, 1975), *aff'd*, 563 P.2d 1220 (Wash. App. 1976).

fore, as the courts occasionally point out in connection with Rule 10b-5, part of the basis for section 101, a "pure" omission is not actionable.[174] Such a distinction, in most cases, is more academic than real because most omissions will have the effect of making the information given misleading. Thus, the omission of a footnote to a balance sheet disclosing that the corporation is subject to substantial contingent liabilities is actionable, not because of the failure to disclose the contingent liabilities, but because the omission makes the balance sheet an inaccurate picture of the corporation's financial condition.

Not all misstatements or omissions impose criminal liability. Liability only results from those misstatements and omissions which are material.[175] Until recently there was a substantial debate as to what should be the legal definition of "material."[176] The Supreme Court settled this debate with their decision in *TSC Industries Inc. v. Northway, Inc.*[177] In the context of a purchase or sale, the test provides:

> [A misstatement or] omitted fact is material if there is a substantial likelihood that a reasonable [purchaser or seller] would consider it important in deciding [whether or not to purchase or sell]. . . Put another way, there must be a substantial likelihood that the disclosure of the [misstatement or the] omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of the information made available.[178]

The state courts have shown the same confusion as the federal courts.[179]

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[174] *See, e.g.*, Evmar Oil Corp. v. Getty Oil Co., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,358 (C.D. Cal. March 17, 1978).

[175] Courts often hold that statements of opinion are not the same as statements of fact for the purpose of determining materiality. While cases can be found in the securities area with this same holding, the vast majority of cases recognize that the purpose of the securities laws is to reverse the concept of *caveat emptor* so that statements of opinion are actionable as facts. A similar problem arises with respect to promises made which subsequently are not kept. As the court pointed out in State v. Brill [1961-1971 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 70,918 (Wis. Cir. Ct. 1971), unfulfilled promises do not rise to the level of a misstatement of fact unless there is no intent at the time to fulfill them or the defendant has no reasonable grounds upon which he can believe in his ability to perform them. In *Brill*, the defendant was held liable where he promised a fixed return when he knew at the time he accepted the payment that he was insolvent and could not meet his obligations to repay, much less pay the promised return. *See also* People v. Carmichael, 106 Cal. App.3d 124, 164 Cal. Rptr. 872 (1980).

[176] The debate over the legal definition of "material" centered around whether the purchaser or seller would or merely might consider the misstatement or omission as important. *Compare* Kohn v. American Metal Climax, Inc., 458 F.2d 255 (3d Cir. 1972)(might) *with* Smallwood v. Pearl Brewing Co., 489 F.2d 579 (5th Cir. 1974) and Grestle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973)(would).

[177] 426 U.S. 438 (1976).

[178] *Id.* at 449.

[179] *Compare* Shermer v. Baker, 2 Wash. App. 33, 472 P.2d 589 (1970)(would) *with* People v. Cook, 89 Mich. App. 72, 279 N.W.2d 579 (1979)(might). *See also* Bayne v. Jenkins,

It is believed, however, that state courts will adopt the *TSC Industries* test as they become aware of it.

Within this legal definition it is obviously a question of fact as to whether, under a particular factual circumstance, something is material. The test, however, is objective rather than subjective. The question is not whether this particular purchaser or seller considers the fact material, but whether the *reasonable* purchaser or seller would do so. It is obviously beyond the scope of this article to attempt to outline all of the bits of information that are material.[180] Two examples, however, might be useful.

In *State v. Williams*,[181] the court, sitting without a jury, found it material that the defendant did not reveal that he had sold fractional interests in the patent he was marketing in an amount exceeding 100 percent. The fractional interests were the securities. Further, the court held material his misstatements concerning when he was going to begin production under the patent and that the Weyerhauser Corporation and the Washington State Patrol had placed an order for goods manufactured under the patent. In *State v. Rutherford*,[182] the court held that the failure to disclose the issuance of a stop order by the Washington Securities Commission against further sale of the securities was a material omission.

The Administrator and prosecutor should be alert to two other things which courts have held to be material. First, the failure to disclose a previous conviction or injunction in connection with the sale of securities or in a related field, *i.e.*, consumer protection, is a material omission.[183] Second, it is a material omission to fail to disclose that the securities sold were unregistered under either the state or federal securities act, if there is a requirement of registration.[184] The significance of this latter point is two-fold. First, it allows the charging of a non-registration violation in the alternative as an antifraud violation. Second, it allows a court to try a violation of the federal securites act as a violation of the state securities act antifraud provisions.

The third subsection of section 101 prohibits any act, practice, or course of business which operates or would operate as a fraud or deceit.[185]

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593 S.W.2d 519 (Mo. 1980); Gerber Prod. Co. v. Anderson, Clayton & Co., 76 Mich. App. 410, 256 N.W.2d 754 (1977).

[180] *See* 1 A. Jacobs, The Impact of Rule 10b-5 (3 Clark Bondman Securities Series) 3-94-3-119 (rev. ed. 1977)(list of items which plaintiffs allege to be material under Rule 10b-5).

[181] [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) ¶ 71,280 (Wash. Super. 1975), *aff'd*, 563 P.2d 1220 (Wash. App. 1976).

[182] 166 Wash. 837, 405 P.2d 719 (1965).

[183] *See* Securities Commissioner v. McGovern, 3 Blue Sky L. Rep. (CCH) ¶ 71,438 (N.D. Dist. Ct May 30, 1978).

[184] *See, e.g.*, SEC v. Pearson, 426 F.2d 1339 (10th Cir. 1970); Securities Commissioner v. McGovern, 3 Blue Sky L. Rep. (CCH) ¶ 71,438 (N.D. Dist. Ct. May 30, 1978); Levan v. Legarra, No. 542,309, Los Angeles Daily Journal, p. 1, col. 1 (Cal. Super Ct. Dec. 23, 1949).

[185] The third subsection of U.S.A. § 101 prevents fraud or deceit on any person. Thus, while in the vast majority of cases the fraud or deceit will be on the person to whom the defendant makes the offer or sale, such does not have to be the case. In Curtis v. State, 102 Ga. App. 790, 118 S.E.2d 264 (1960), the court pointed this out and indicated that the fraud

The major difference between this subsection and subsection one, discussed above, appears to be its focus. Subsection one focuses on the intent or state of mind of the defendant. Subsection three appears to focus on the effect of the conduct upon the victim rather than the state of mind with which the defendant does the act. A number of courts recognize this distinction under section 17(a) of the '33 Act.[186]

The second requirement for a criminal antifraud prosecution requires the violation of section 101 to be "willfully" done. This requirement raises what is believed to be the single most perplexing problem in connection with securities fraud prosecutions. What does "willfully" mean in this context? Does it mean that the act has to be done with scienter? Or does it mean merely that the act has to be a volitional act on the part of the defendant without regard to the state of mind giving rise to the doing of the act?

As noted at the beginning of this section, the "willfulness" requirement stems not from section 101, but rather from section 409. A reading of section 409 reveals that the same language, including the requirement that the violation be "willful," governs both the non-registration violations under sections 201 and 301, discussed in the previous two sections, as well as those violations of the antifraud provisions of section 101. It therefore seems reasonable to interpret the "willfulness" requirement in the same manner under both contexts.[187] As noted in the previous sections, the overwhelming weight of authority holds that "willfulness" in the non-registration context means only that the person charged engage in a volitional, as opposed to a coerced, act without regard to whether he realizes that such conduct is in violation of the registration requirements. Applying this standard to the antifraud violations, it means that the defendant is liable if he voluntarily engages in conduct which violates section 101 without regard to his understanding that his conduct violates that section.

Unfortunately, the court decisions at both the state and federal level are in total confusion. Some federal cases hold that mere negligent or reckless conduct is sufficient to impose liability.[188] Others require proof of

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was not only perpetrated on the securities purchasers, but also upon the existing sharholders of the corporation. More recently, in Reid v. Madison, 438 F. Supp. 332 (E.D. Va. 1977), the court allowed a non-purchaser to maintain an action under § 17(a) of the '33 Act for civil recovery. In *In re* Daniel S. Brier & Co. [1961-1971 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 70,917 (N.J. Sec. Bir. 1970), the New Jersey Administrator took the novel position that the fraud could be perpetrated on the securities commission.

[186] 15 U.S.C. § 77q(a) (1976). *See, e.g.*, Aaron v. SEC, 100 S. Ct. 1945 (1980); SEC v. Blazon Corp., 609 F.2d 960 (9th Cir. 1979); SEC v. Coven, 581 F.2d 1020 (2d Cir. 1978). In *Coven*, the court stated that subsection three of § 17(a) focuses "attention on the *effect* of potentially misleading conduct on the public, not on the culpability of the person responsible." 581 F.2d at 1026 (emphasis in original).

[187] *See, e.g.*, People v. Terranova, 563 P.2d 363 (Colo. Ct. App. 1977); State v. Cox, 17 Wash. App. 896, 566 P.2d 935 (1977); Commonwealth v. Jones, 3 BLUE SKY L. REP. (CCH) ¶ 71,550 (Pa. C.P. 1980).

[188] *See, e.g.*, United States v. Meyer, 359 F.2d 837 (7th Cir. 1966); United States v.

knowing conduct in the sense that the defendant know that the statements made were either false or did not tell the entire story.[189] The majority of state cases appear to follow this latter position.[190]

The confusion stems from the failure of the courts to properly distinguish between the "willfulness" requirement of section 409 and the substantive provisions of section 101. The "willfulness" requirement, in the antifraud context, should not require proof that the violation of section 101 was both "willful and knowing."[191] Rather, "willfulness" should have the same interpretation as in the non-registration context and merely require the act or conduct to be violational rather than coerced.[192] Such an interpretation, however, does not mean that a criminal conviction will automatically follow without proof of scienter. It simply means that the "willfulness" requirement of section 409 does not impose such a requirement. There must be an examination of the substantive provisions of section 101 to see whether they include such a scienter requirement.

As noted earlier in discussing civil injunctions under section 101,[193] there is a growing difference of opinion on this point. It appears, however,

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Schaefer, 299 F.2d 625 (7th Cir. 1962); Stone v. United States, 113 F.2d 70 (6th Cir. 1940). *See also* Annot., 20 A.L.R. Fed. (1974) (general discussion of federal cases).

[189] *See, e.g.*, United States v. Charnay, 537 F.2d 341 (9th Cir. 1976); Elbel v. United States, 364 F.2d 127 (10th Cir. 1966); United States v. Hill, 298 F. Supp. 1221 (D. Conn. 1969). One of the things which causes confusion in the federal cases is the fact that securities fraud is often charged along with mail or wire fraud. There is no question that a conviction requires proof of scienter under the mail fraud statute. Therefore, the courts tend to treat the two statutes together and impose the higher requirements of the mail fraud statute. *See* State v. Cox, 17 Wash. App. 896, 566 P.2d 935 (1977)(illustrates the distinction between the two statutes).

[190] *See, e.g.*, Van Antwerp v. State, 358 So.2d 782 (Ala. App. 1978); People v. Blair, 195 Colo. 462, 579 P.2d 1133 (1978); State v. Hynds, 84 Wash.2d 657, 529 P.2d 829 (1974); People v. Cook, 89 Mich. App. 72, 279 N.W.2d 579 (1979). The author has only found two cases which reach a contrary position. *See* State v. Gunnison, No. 2 CA-CR 1700 (Ariz. App. Oct. 24, 1979); People v. Barysh, 3 BLUE SKY L. REP. (CCH) ¶ 71,431 (N.Y. Sup. Ct. August 1978). *See also Criminal Liability, supra* note 152.

[191] Some courts do hold that in the antifraud context, the willfulness requirement requires proof that the violation was both knowing and willful. *See, e.g.*, People v. Blair, 195 Colo. 462, 579 P.2d 1133 (1978); State v. Hynds, 84 Wash.2d 657, 529 P.2d 829 (1974); People v. Cook, 89 Mich. App. 72, 279 N.W.2d 579 (1979).

[192] The official comments to U.S.A. § 409, *see* Loss, *supra* note 12, at 144, on the "willfulness" issue, refer to their comment under U.S.A. § 204(a)(2)(B). That comment reads:

> As the federal courts and the SEC have construed the term "willfully" in § 15(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(b), all that is required is proof that the person acted intentionally in the sense that he was aware of what he was doing. *Proof of evil motive or intent to violate the law*, or *knowledge that the law was being violated, is not required.*

Id. at 29. This comment was quoted in People v. Blair, 195 Colo. 462, 579 P.2d 113, 118 (1978), as support for the conclusion that willfulness means knowing. This holding is incorrect. All that U.S.A. § 101(2) requires is that the person know that he is making a statement and that this statement is voluntarily made. This comment makes crystal clear that intent to deceive or defraud is not an element. *See* State v. Gunnison, No. 2-CA-CR 1700 (Ariz. App. Oct. 24, 1979). *But see* State v. Hynds, 84 Wash.2d 657, 529 P.2d 829 (1974)(dicta).

[193] *See* text accompanying notes 81-114 *supra*.

that the majority hold that scienter, in the sense of knowing conduct,[194] is not a requirement under subsections (2) or (3) of either section 17(a) of the '33 Act[195] or section 101 of the Uniform Act.[196] There was a recent application of this idea to criminal prosecutions under the Arizona equivalent of section 101(2) in *State v. Gunnison*.[197] The court, after reviewing federal developments rejecting the application of *Ernst & Ernst*[198] to section 17(a) of the '33 Act, concluded that the rationale of *Ernst & Ernst* had no application under the Arizona state law. The court then concluded that violation of the statute was a *malum prohibitum* offense for which there is no requirement of knowledge. The court cited earlier cases reaching a similar conclusion under the registration provisions.[199]

More recently, in *Van Duyse v. Israel*,[200] the court held that the prosecution need not prove scienter in an action brought under section 101(3). The defendant was convicted in a state court jury trial of violating section 101(3) of the Wisconsin Securities Act. He sought a writ of habeas corpus from the federal district court on the ground, *inter alia*, that the evidence was not sufficient to support his conviction because he claimed that the state had to prove that he engaged in the prohibited conduct with scienter. The court rejected Van Duyse's contention saying:

> While the Wisconsin courts have not addressed the intent question, the language of the statutory provisions at issue supports the state's interpretation. Section 551.41(3) speaks of conduct which *operates* or would *operate* as a fraud or deceit upon

[194] The lower federal courts do not interpret Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), to require intent to deceive or cause injury and have extended the concept of knowing conduct to embrace reckless conduct as well. *See, e.g.*, Sanders v. John Nuveen & Co., 554 F.2d 790 (7th Cir. 1977); Sunstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033 (7th Cir. 1977).

[195] *See, e.g.*, Aaron v. SEC, 100 S.Ct. 1945 (1980); SEC v. Blazon Corp. 609 F.2d 960 (9th Cir. 1979); SEC v. American Realty Trust, 586 F.2d 1001 (4th Cir. 1978); SEC v. Coven, 581 F.2d 1020 (2d Cir. 1978).

[196] *See* Kittilson v. Ford, 93 Wash. 223, 608 P.2d 264 (1980). *See, e.g.*, State v. Gunnison, No. 2 CA-CR 1700 (Ariz. App. Oct. 24, 1979).

[197] No. 2 CA-CR 1700 (Ariz. App. Oct. 24, 1979). It appears that State v. Cox, 17 Wash. App. 896, 566 P.2d 935 (1977), is consistent with the *Gunnison* decision. In the *Cox* case, however, the court talks in terms of subsection two not requiring intent to deceive. Therefore, it is not clear whether the court is merely saying that the prosecution does not have to show that the defendant intended to deceive the victim or cause him injury or whether it is taking the position that subsection two does not require the act to be knowingly done in the sense of knowing that the statement is false or misleading. The court does say that the making of an untrue statement is sufficient for a violation. *Id.* at ___, 566 P.2d at 939. This statement suggests that the latter interpretation is correct. This is consistent with the position subsequently taken by the Washington Supreme Court in Kittilson v. Ford, 93 Wash. 2d 223, 608 P.2d 264 (1980).

[198] 425 U.S. 185 (1976); *see* Aaron v. SEC, 100 S.Ct. 1945 (1980).

[199] *See* State v. Russell, 119 N.J. Super. 344, 291 A.2d 583 (1972); State v. Burrows, 13 Ariz. App. 130, 474 P.2d 849 (1970).

[200] 486 F. Supp. 1382 (E.D. Wis. 1980).

> any person. Section 551.58 imposes criminal liability on any person who "wilfully" violates any provision of the act. Taken together, the plain meaning of the statutory provisions indicates that the State need only prove that the accused wilfully engaged in conduct which operates or would operate as a fraud or deceit upon any person. It is the nature of the act which is dispositive, not the state of mind of the actor. In this sense, the statute imposes a form of strict liability. Once the seller has wilfully engaged in conduct which operates or would operate as a fraud or deceit, he will not be heard to argue that he did not intend the consequences of his acts.
>
> Accordingly, the State was only required to prove that petitioner wilfully engaged in the type of conduct prohibited by the act.[201]

The *Gunnison* and *Van Duyse* cases are correct. Adoption of the rationale used in these cases will go a long way to alleviate the present confusion in the prosecution of securities fraud cases and will harmonize the results, if not the reasoning, of the outstanding cases. If courts adopt the rationale of the *Gunnison* and *Van Duyse* decisions prosecutions under section 101(1) will continue to require the proof of scienter, but prosecutions under either section 101(2) or (3) will not.[202] The major impact of the two decisions on state securities fraud prosecutions results from the fact that present case law shows that prosecutors bring more cases under subsections (2) and (3) than under subsection (1).[203]

The final requirement for a criminal fraud prosecution is that the substantive violation of section 101 take place "in connection with the offer, sale, or purchase of a security." Quite obviously, the prosecutor is going to have to establish that what the defendant offered, sold, or puchased was a security.[204] The same basic standards apply here as in a prosecution for the non-registration violations. The defendant does not need to know

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[201] *Id.* at 1387 (emphasis in original).

[202] That the prosecution must prove scienter under U.S.A. § 101(1) but not under U.S.A. 101(2) and (3) finds confirmation in Aaron v. SEC, 100 S.Ct. 1945 (1980), where the Supreme Court reached the same holding under § 17(a).

[203] *See, e.g.*, Boggess v. Commonwealth, 447 S.W. 2d 88 (Ky. 1969)(subsection three only); State v. Gunnison, No. 2 CA-CR 1700 (Ariz. App. Oct. 24, 1979); People v. Cook, 89 Mich. App. 72, 279 N.W.2d 579 (1979)(both subsections two and three); People v. Blair, 195 Colo. 462, 579 P.2d 1663 (Colo. App. 1977); State v. Williams, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,280 (Wash. Super. Ct. April 16, 1975), *aff'd*, 563 P.2d 1220 (1976)(subsection two only). In many cases, the charges appear to be generally under U.S.A. § 101 without attempting to specify any particular subsection. *See, e.g.*, Queen v. Commonwealth, 434 S.W.2d 318 (Ky. 1968); People v. Terranova, 563 P.2d 363 (Colo. App. 1977); State v. Hynds, 84 Wash. App.2d 675, 529 P.2d 829 (1974). If courts adopt the *Gunnison* and *Van Duyse* rule, the prosecutor should not bring a general charge as he will then have to prove the most stringent requirement imposed. This means proving scienter since subsection one requires such proof.

[204] *See, e.g.*, State v. Brewer, 26 Ariz. App. 408, 549 P.2d 188 (1976).

that what he is selling through fraud or misrepresentation is a security;[205] nor is the advise of counsel or of the securities officials a defense. Thus, as was made clear in *United States v. Brown*,[206] whatever the scienter standard the prosecution must establish to show a substantive violation of section 101, no scienter standard carries over into this branch of the case.

Second, the prosecutor also must show, as in the non-registration violations, that there was an offer, sale, or purchase of these securities. Little need be said about this requirement other than to remind the reader of the broad definition of these terms found in the Uniform Act.[207] There are many cases which discuss the concepts of offer, purchase, and sale in conjunction with both section 17(a) of the '33 Act and Rule 10b-5. By and large these cases are equally applicable under the Uniform Act with the notable exception of those items excluded from the definition by the Uniform Act. Section 401(j)(6) of the Uniform Act excludes from the definition of sale bona fide pledges or loans, stock dividends, mergers, consolidations, and reclassifications,[208] and a judicially approved reorganization.[209]

The major problem is in determining whether the fraud, deceit, or misrepresentation took place "in connection with" the offer, sale or purchase of the securities. In the simple case this requirement may pose no problem because there will be a direct link between the conduct and the offer, sale, or purchase. In the more difficult cases, however, especially those involving corporate mismanagement, the connection between the two may be less obvious. Nevertheless, these latter cases should not go

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[205] *See, e.g.*, United States v. Brown, 578 F.2d 1280 (9th Cir. 1978).

[206] 578 F.2d 1280 (9th Cir. 1978).

[207] *See* U.S.A. § 401(j).

[208] The mergers, consolidations, and reclassifications excluded from the definition of sale by U.S.A. § 401(j)(6) must take place pursuant to a class vote, and the controlling corporate statute or the corporation's articles of incorporation must require this class vote. If there is no required vote, but it is voluntarily taken or the shareholders are individually approached, then the exclusion does not apply. Further, Type B reorganizations under the Internal Revenue Code, *see* I.R.C. § 368 (a)(1)(B), involving a stock for stock exchange where both corporations continue to exist, one merely becoming the subsidiary of the other, are not covered even though a vote is taken pursuant to the controlling statute or articles of incorporation. Such a reorganization is simply not a merger, consolidation, or reclassification as these terms are traditionally defined. *See, e.g.*, Heard v. Savage, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,787 (W.D. Okla. Oct. 12, 1978); Dyer v. Eastern Trust and Banking Co., 336 F. Supp. 890 (D. Me. 1971); Emmi v. First-Manufacturers Nat'l Bank, 336 F.Supp. 629 (D. Me. 1971). Such reorganizations are currently very popular in connection with the organization of bank and insurance holding companies. Banking and insurance corporation statutes often authorize such reorganizations.

[209] Since U.S.A. § 401(j)(6) excludes certain transactions from the definition of sale, the antifraud, as well as the registration provisions, do not apply. Because this creates an obvious gap in the antifraud coverage of the statute, many states alter the Uniform Act to make these exclusions merely exemptions from the registration requirements. *See, e.g.*, ALA. CODE tit. 8, § 8-6-11(a)(13) & (14) (1975); KAN. STAT. § 17-1262(k) & (l) (supp. 1979). The defendant has the burden of proving that he comes within any of these exclusions. *See also* U.S.A. § 402 (d) (covering both claims to exemptions and exclusions from definition).

unprosecuted.

Again, because there is little guidance under the Uniform Act, there must be reference to the experience under the federal acts. The federal courts originally took a rather narrow view of whether something occurred in connection with an offer or sale.[210] The Supreme Court has rejected this narrow interpretation.[211] As a result, the lower federal courts have adopted a much broader "nexus" test for defining "in connection with." The Fifth Circuit recently summarized this test as follows:

> The "in connection with" requirement of Rule 10b-5 is flexibly applied to require that there be a nexus between the defendant's fraud and the plaintiff's sale of securities. The plaintiff in a Rule 10b-5 case need not establish a direct or close relationship between the fraudulent transaction and the purchase or sale, but only that the transaction involving the sale "touch" the transaction involving the defendant's fraud. This Court has held that the "in connection with" test of *Superintendent of Insurance*" is satisfied where the prescribed conduct and the sale are part of the same fraudulent scheme.[212]

The nexus test obviously gives the prosecutor very wide latitude in attempting to connect the alleged fraud or misrepresentation with some offer, sale, or purchase of a security. There clearly are some limitations, however, on this latitude. The courts hold that conduct which takes place at a time before and remote from the present transaction will not qualify.[213] This becomes very important when assessing the liability of professionals such as lawyers and accountants who render professional opinions. The watershed of liability for these people appears to be whether they can reasonably foresee the use of their opinions in connection with the sale.[214] If use is foreseeable, their actions are covered by section 101. The courts also hold that conduct which takes place after the purchase or sale, and which is not a part of a continuing scheme to defraud, is not covered.[215] Finally, the courts hold that the "in connection with" requirement excludes those cases where the conduct leads the victim to retain his securities rather than sell them.[216] The basis of the latter holding is

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[210] *See, e.g.*, Superintendent of Ins. v. Bankers Life & Cas. Co., 300 F. Supp. 1083, 1101-1102 (S.D.N.Y. 1969), *rev'd*, 404 U.S. 6 (1971).

[211] *See* Superintendent of Ins. v. Banker Life & Cas. Co., 404 U.S. 6, 12-13 (1971).

[212] Alley v. Miramon, 614 F.2d 1372, 1378 n.11 (5th Cir. 1980).

[213] *Compare* Darrell v. Goodson, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,349 (S.D.N.Y. Apr. 10, 1980)(conduct held too remote) *with* Horst v. W.T. Cabe & Co., [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,213 (E.D.N.Y. Oct. 31, 1977)(conduct during pendency of executory contract held to be in connection with transaction).

[214] *See* Competitive Associates, Inc. v. Howath & Howath, 516 F.2d 811 (2d Cir. 1975); Sharp v. Coopers & Lybrand, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,612 (E.D. Pa. Sept. 27, 1978).

[215] *See, e.g.*, Wittenberg v. Continental Real Estate Partners, Ltd. 478 F. Supp. 504 (D. Mass 1979).

[216] *See, e.g.*, Troyer v. Karcagi, 476 F. Supp. 1142 (S.D.N.Y. 1979). U.S.A. § 101, how-

that Rule 10b-5 covers only purchases and sales of securities. Section 101 and section 17(a) of the '33 Act, however, also cover "offers."

Conclusion

As can be seen from the foregoing discussion there are many questions, but as yet few answers, concerning the administrative, injunctive, and penal provisions of the Uniform Securities Act. Yet, because of the increased activity and interest in state securities laws, there is a desperate need for some guidance in these areas for the securities administrators and their staffs, the prosecutors who must enforce the Act, and the practicing bar that must deal with the Act. This article attempts to provide some aid toward this end. The article is not a substitute for in-depth research by the person facing a particular problem. Rather, it is an attempt to give the reader a broad overview of the Act and its provisions, to outline some of the obvious questions raised by the provisions, and to answer those questions to the best of the author's ability based upon the case law, state and federal, presently available.

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ever, unlike Rule 10b-5, covers violations that cause the victim to reject an offer that he might otherwise accept. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). The relatively narrow scope of Rule 10b-5 results from the fact that it only encompasses purchases and sales of securities while U.S.A. § 101 and § 17(a) of the '33 Act both cover "offers."