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MASSACHUSETTS SECURITIES REGULATION: IN SEARCH OF THE FULCRUM

Stephen M. Honig†

The Massachusetts Securities Division and representatives of the Massachusetts Securities Bar are currently reevaluating Massachusetts blue sky regulation. In this article, the author reviews the existing practices, and concludes that the Division has wavered between adopting a merit review or disclosure approach to regulation of registered and exempt offerings. The author concludes that vigorous merit review is unjustified under the Massachusetts statute, and advocates fundamental reform of existing practices to ensure certainty in regulation and national uniformity.

I. INTRODUCTION

Massachusetts securities regulation currently reflects, in a microcosm, competing extremes of regulatory philosophy. At present, it is unclear whether Massachusetts is a disclosure jurisdiction, a merit review jurisdiction,¹ or a jurisdiction insistent on applying *sui generis* standards of review. The competition between disclosure and merit review has left practitioners confused, and has given the commonwealth a reputation for unpredictability. Until the dominant regulatory fulcrum is identified, the confusion and unpredictability is likely to continue.

This article identifies and evaluates the regulatory bases, current practices, and possible trends in Massachusetts regulation of both registered and exempt offerings of securities. Accordingly, this article will not survey all aspects of Massachusetts securities regulation, but will concentrate on the philosophical and practical problems with Massachusetts regulation of these important types of offerings.

The article provides some essential background to this discussion by explaining how recent changes in the organization and staffing of the Massachusetts Securities Division (Division) have influenced the present form of regulation.² The current pattern of Massachusetts reg-

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1. Merit review of securities offerings requires the state securities administrator to determine whether the substantive terms of the offering are "fair, just, and equitable" to the investor. If the offering fails to meet the standards of substantive fairness, the administrator may deny registration, even if the prospectus adequately discloses all material information. For a defense of merit regulation, see Tyler, *More About Blue Sky*, 39 WASH. & LEE L. REV. 899 (1982).
2. See *infra* notes 5-10 and accompanying text.

ulation of registered public offerings, as well as some current proposals for reform, are discussed.³ In addition, the article describes the Massachusetts treatment of exempt offerings, identifies some serious legal and practical problems, and discusses proposed changes in this area.⁴ The article concludes that fundamental reform of both the philosophy and practice of Massachusetts securities regulation is needed.

These discussions could not come at a more difficult time in the history of Massachusetts securities regulation. This article will serve more as a historical benchmark than a long term guide to Massachusetts practice, because significant changes concerning the philosophical and technical underpinnings of the regulatory scheme are imminent.

II. BACKGROUND

The flavor of Massachusetts practice cannot be appreciated without a historical perspective. At least in the memory of active practitioners, the 1932 Massachusetts blue sky law⁵ presented a relaxed and uneventful regulatory context throughout its forty year existence. The Division enforced this law in a manner consistent with a disclosure philosophy. Although it was frequently difficult to find a Massachusetts exemption applicable to federally exempt private placements,⁶ it was often possible to negotiate a discretionary exemption or to register on a disclosure basis.

Even after the 1972 adoption of the Massachusetts Uniform Securities Act (Massachusetts Act),⁷ a slightly modified version of the Uniform Securities Act (Uniform Act),⁸ Massachusetts practice did not vary greatly. The early years of the enforcement of the Massachusetts Act seldom gave rise to debates over the nature of merit review, or the propriety of particular regulations in light of a presumed philosophy of disclosure regulation. The Division did not undertake extensive substantive review of publicly or privately offered issues, and it was not difficult to obtain administrative expansion of the statutorily available exemptions. Although many of the restrictions on cheap stock that appear in the present Massachusetts regulations⁹ were first applied by the Division in 1973,¹⁰ practitioners at least initially found that the Divi-

3. *See infra* notes 11-56 and accompanying text.

4. *See infra* notes 56-147 and accompanying text.

5. 1932 Mass. Acts ch. 290, §§ 1-21 (repealed 1972).

6. Indeed, the principal limited offering exemption was measured only in terms of 25 or less shareholders at the offering's conclusion, but was only available to corporations organized within Massachusetts. *Id.* § 3(f).

7. MASS. GEN. LAWS ANN. ch. 110A, §§ 101-417 (West Supp. 1983).

8. UNIF. SEC. ACT §§ 101-419, 7A U.L.A. 567-707 (1958), reprinted in 1 BLUE SKY L. REP. (CCH) ¶¶ 5501-5573 (1983).

9. MASS. ADMIN. CODE tit. 950, § 13.305 (1978), reprinted in 1A BLUE SKY L. REP. (CCH) ¶ 31,465 (1983). For a discussion of cheap or insider stock, see *infra* text accompanying notes 22-35.

10. MASS. ADMIN. CODE tit. 950, §§ 10.00-14.00 (1978) (proposed May 17, 1973).

sion was willing to make reasonable accommodation upon request of counsel if adequate disclosure had been made.

After the 1972 reassignment of the Division from the Department of Public Utilities to the Office of the Secretary of the Commonwealth, and the 1979 appointment of Michael Unger as Director of the Division, however, Massachusetts practice was radically altered. As this article will demonstrate, a consumer protection orientation expressed through rigorous merit regulation replaced the disclosure philosophy, and, to the surprise of both the Massachusetts securities bar and out of state practitioners, the Massachusetts Act came to be enforced as a merit review statute for both public and private offerings. At present the merit review philosophy seems firmly entrenched. Although both the organized bar and a series of formal committees established by the Secretary of State are working toward greater clarity and predictability in the regulatory scheme, some element of merit review clearly will continue to be a hallmark of Massachusetts securities regulation. The precise degree to which merit review standards will prevail is a matter of current debate, and practitioners reading this article should take great care to update its contents.

III. MASSACHUSETTS REGULATION OF PUBLIC OFFERINGS

A. *The Regulatory Context*

The Massachusetts Act makes it unlawful to offer or sell any security in the commonwealth, unless the security is registered in accordance with the Act's provisions or the security or transaction in which it is issued is exempt from registration.¹¹ Registration may be obtained by coordination with a filing under the Securities Act of 1933¹² or by qualification.¹³

Until the Division clarifies its policies, counsel should assume that Massachusetts is a full merit review state. Although a detailed review may not be applied in every case, the assumption will avoid unfortunate surprises. The purported statutory bases for merit review appear in section 305 of the Massachusetts Act.¹⁴ Under this section, the Secretary may issue a stop order denying, suspending, or revoking effectiveness of an offering if: (1) "the offering has worked or tended to work a fraud upon purchasers or would so operate,"¹⁵ or (2) the offering involves "unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, or promoters' profits or

11. MASS. GEN. LAWS ANN. ch. 110A, § 301 (West Supp. 1983).

12. *Id.* § 302; *see* Securities Act of 1933 § 6, 15 U.S.C. § 77f (1982).

13. MASS. GEN. LAWS ANN. ch. 110A, § 303 (West Supp. 1983).

14. *Id.* § 305.

15. *Id.* § 305(a)(E).

participation, or unreasonable amounts or kinds of options."¹⁶

The Massachusetts regulations (regulations) contain the formal articulation of substantive standards derived from these general statutory provisions. Specifically, the regulations provide that unless an issuer has been in business for two years it may not use more than ten percent of the net proceeds to repay loans made by promoters, finders, controlling stockholders, officers, or directors.¹⁷ No offering, whether by coordination or qualification, may result in the book value of common stock being less than twenty percent of its public offering price.¹⁸ In addition, the regulations provide that an offering involves unreasonable underwriter and promoter profits if the aggregate of underwriter discounts, commissions, profits, participations, options, or other consideration exceeds eighteen percent of the aggregate amount of the public offering actually sold.¹⁹

Finally, the regulations provide that, for corporate issuers, a public offering of equity securities will be deemed to work a fraud upon purchasers when it is preceded by the issuance of "an unreasonable amount of promotional or cheap stock."²⁰ The regulations include provisions defining "promotional or cheap stock"²¹ and establish several safe harbors useful for avoiding insider stock problems. Strict compliance with these regulations, however, does not necessarily satisfy Massachusetts merit review.²² The Division today neither systematically takes action against transactions that violate the provisions, nor consistently clears transactions that comply. Despite this inconsistent practice, the detailed insider stock provisions are instructive and deserve closer examination.

The regulations define promotional or cheap stock (insider stock) to include any equity security issued or sold within eighteen months of the public offering date to underwriters and various insiders at a price

16. *Id.* § 305(a)(F). There are four other instances in which the Secretary may revoke an offering. *See id.* § 305(a)(A)-(D).

17. MASS. ADMIN. CODE tit. 950, § 13.303(b)(9) (1978), *reprinted in* 1A BLUE SKY L. REP. (CCH) ¶ 31,463 (1982).

18. MASS. ADMIN. CODE tit. 950, § 13.304(c) (1978), *reprinted in* 1A BLUE SKY L. REP. (CCH) ¶ 31,464 (1982). Commentators have indicated that this and the prior provision, "because of the regulatory headings under which they fall and because they would otherwise conflict with the statutory scheme, should be interpreted as conditions to effectiveness of registration statements. . . ." J. SMITH & Z. CAVITCH, MASSACHUSETTS CORPORATION LAW 14-34 (1982). In any event, there is no clear statutory basis under § 304(c) of the Massachusetts Act or elsewhere for this blanket requirement.

19. MASS. ADMIN. CODE tit. 950, § 13.305(a)(2)(F) (1978), *reprinted in* 1A BLUE SKY L. REP. (CCH) ¶ 31,465 (1982). Warrants to purchase the security are valued only to the extent that their exercise price is below the offering price. *Id.*

20. MASS. ADMIN. CODE tit. 950, § 13.305(a)(2)(E) (1978), *reprinted in* 1A BLUE SKY L. REP. (CCH) ¶ 31,465 (1982).

21. *Id.* These equity securities will be referred to as "cheap stock" or "insider stock" throughout this article.

22. *See infra* section III B.

lower than and not reasonably related to the public offering price.²³ In measuring the reasonableness of price, the following factors are considered: (1) the nature of restrictions on transfer; (2) the existence of contractual provisions that could cause divestiture of the securities; (3) the extent to which the risk undertaken in the investment is substantially greater than the risk undertaken at the time of the public offering; and (4) with respect to securities issued for consideration other than cash, the opinion of an independent appraiser.²⁴

In addition to defining insider stock, the regulations establish four safe harbors to avoid insider stock problems: (1) for issuers organized within eighteen months of offering and in the promotional stage, insider stock issued early in the history of the issuer, that either does not exceed twenty-five percent of the stock outstanding or is common stock with an average consideration per share equal to at least two-thirds of the public offering price;²⁵ (2) for issuers organized more than eighteen months prior to the public offering date and not in the promotional stage, insider stock that does not exceed ten percent of the shares to be outstanding; (3) when the proposed offering price of an equity security does not exceed twenty-five times the net earnings per share; or (4) when arrangements have been made for escrow of insider stock for a period of one year or longer.²⁶

Those contemplating offerings in Massachusetts should note one further source of "law" concerning public offerings. During 1980 and 1981, and until a lack of funds and time caused its termination, the Division published a series of "Massachusetts Securities Bulletins" that gave practitioners some guidance as to the Division's policy and practice. Although criticized as constituting the issuance of regulations without compliance with statutory procedures,²⁷ the bulletins nonetheless explained the Division's approach. An explanation in one of the bulletins of the Division's approach to insider stock problems deserves detailed description.

The second bulletin issued by the Division made clear that compliance with the terms of the four insider stock safe harbors would not foreclose further inquiry by the Division.²⁸ Rather, the Division will look at all the circumstances of an offering to be reasonably certain that

23. MASS. ADMIN. CODE tit. 950, § 13.305(a)(2)(E) (1978), *reprinted in* 1A BLUE SKY L. REP. (CCH) ¶ 31,465 (1982).

24. MASS. ADMIN. CODE tit. 950, § 13.305(a)(2)(E)(i) (1978), *reprinted in* 1A BLUE SKY L. REP. (CCH) ¶ 31,465 (1982).

25. Options qualified under section 422 of the Internal Revenue Code of 1954, 26 U.S.C. § 422 (1982), and options exercisable in excess of 90% of the public offering price, are excluded. MASS. ADMIN. CODE tit. 950, § 13.305(a)(2)(E)(ii)(a) (1978), *reprinted in* 1A BLUE SKY L. REP. (CCH) ¶ 31,465 (1982).

26. MASS. ADMIN. CODE tit. 950, § 13.305(a)(2)(E)(ii)(b)-(d) (1978), *reprinted in* 1A BLUE SKY L. REP. (CCH) ¶ 31,465 (1982).

27. The formal requisites of rulemaking appear in MASS. GEN. LAWS ANN. ch. 30A, §§ 1-7 (West 1979 & Supp. 1983).

28. MASS. SEC. DIV., 1 MASS. SEC. BULL. NO. 2, at 1-2 (Oct. 1980).

the offering will not work a fraud.²⁹ If the Division determines that an offering will work a fraud, it may require that certain remedial actions be taken as a condition of registration. These actions could include a restructuring of the transaction, a capitalization of insider debt, or the escrow of insider stock.³⁰ Although the regulation refers to escrows running "one year or longer,"³¹ the Division made clear in this bulletin its interpretation of "longer": escrows with a minimum duration of eighteen months, running as long as five years, with insider stock to be released from escrow only if certain earnings requirements are met.³² The bulletin further suggested that in appropriate cases, public shares would be given a liquidating preference over insider stock.³³

Finally, the bulletin noted that the definition of promotional or cheap stock provided in the regulations "is not all encompassing and does not attempt to define every type of cheap or promotional stock," and that "[i]n a number of cases, the Division has determined that previously issued shares should be treated as promotional or cheap stock even though the specific facts do not fall within the definition."³⁴ The bulletin offered an example of this phenomenon: stock issued more than eighteen months prior to the public offering date, but without an intervening change in the affairs of the company so as to justify an increase in price, could constitute insider stock.³⁵ Presumably the Division will determine when intervening changes justify any increase in the price of the shares from the original issuance price.

B. Current Public Offering Practices: Does the Massachusetts Act Permit "Fair and Equitable" Review?

The discussion above should confirm the general impression held by Massachusetts securities practitioners that the Division practices an aggressive form of merit regulation. Indeed, Massachusetts is one of the twenty-seven members of the National Association of Securities Administrators Association, (NASAA) Merit Regulation Committee. In a recent survey³⁶ the Division not only identified Massachusetts as a merit review state,³⁷ but also answered affirmatively that it uses a "fair and equitable test or its equivalent," maintaining that the statutory

29. *Id.* at 16.

30. MASS. SEC. DIV., 1 MASS. SEC. BULL. NO. 1, at 16 (July 1980).

31. MASS. ADMIN. CODE tit. 950, § 13.305(a)(2)(E)(ii)(d) (1978), reprinted in 1A BLUE SKY L. REP. (CCH) ¶ 31,465 (1982).

32. MASS. SEC. DIV., 1 MASS. SEC. BULL. NO. 2, at 17 (Oct. 1980). The earnings requirement is, generally, a five percent return on the offering price. The "standard" escrow agreement given by the Division to unwary counsel has, as recently as late 1983, called for a five year escrow.

33. MASS. SEC. DIV., 1 MASS. SEC. BULL. NO. 2, at 17 (Oct. 1980).

34. *Id.* at 16.

35. *Id.*

36. Empirical Research Project, *Blue Sky Laws and State Takeover Statutes: New Importance for an Old Battleground*, 7 J. CORP. L. 689 (1982).

37. *Id.* at 803-05.

standard authorizing the Division to deny registration to offerings that work or tend to work a fraud³⁸ was the equivalent of a "fair and equitable" test.³⁹

The assumption that the Massachusetts statute and its "work a fraud" language authorizes the use of a "fair and equitable" merit review is highly suspect. The statutory language is taken from section 306(a)(E) of the Uniform Act.⁴⁰ The official comment to that section states that "this clause is not designed to be as broad as the 'sound business principles' standard or the 'fair, just, and equitable' standard found in some statutes."⁴¹ Further, the draftsman's commentary to that section made clear that:

[c]lause (E) is not meant to be as broad as the old "fair, just, and equitable" standard in California. Somewhere between the narrow limitation of common law deceit and the opposite extreme of permitting the Administrator to substitute his business judgment for the registrant's, a degree of flexibility seems to be essential.⁴²

The Division's approach to "work a fraud" as the basis for a broad merit review is inconsistent with both the official and draftsman's commentary to the Uniform Act, and the view of commentators that the work a fraud standard represents the narrowest of possible statutory bases for merit review.⁴³ It is quite ironic that a merit standard, originally derived from Populist economic theory in the western and southern states as a defense against the invasion of eastern interests,⁴⁴ should be flourishing in Massachusetts, a state that views itself as the prototypical eastern money center. Despite this irony, it is clear that Massachusetts has recently undertaken rigorous "fair and equitable" merit review as well as very restrictive interpretations of cheap stock, option

38. See MASS. GEN. LAWS ANN. ch. 110A, § 305(a)(E) (West Supp. 1983).

39. Empirical Research Project, *supra* note 36, at 809.

40. UNIF. SEC. ACT § 306(a)(E), 7A U.L.A. 621 (1958), *reprinted in* 1 BLUE SKY L. REP. (CCH) ¶ 5536 (1980).

41. *Id.* § 306(a)(e) comment.

42. L. LOSS, COMMENTARY ON THE UNIFORM SECURITIES ACT 84-85 (1976). The commentary, however, notes that § 306(a)(F) of the Uniform Act, by calling for substantive inquiry into unreasonable promoter's profits, addresses one area in which the blue sky laws *have* traditionally applied a merit as opposed to a disclosure standard. *Id.* at 85-86.

43. See Bartell, *Merit Regulation and Clearing Strategy*, printed in STATE REGULATION OF CAPITAL FORMATION AND SECURITIES TRANSACTIONS 315, 317-18 (D. Goldwasser & H. Makens, eds. 1983). For an analysis of the meaning of the "work a fraud" language in the Maryland Securities Act, see Sargent, *State Limited and Private Offering Exemptions: The Maryland Experience in a National Perspective*, 13 U. BALT. L. REV. 496, 513-14 n.98 (1984).

44. For an analysis of the historical origins of merit regulation, see Bateman, *State Securities Registration: An Unresolved Dilemma and a Suggestion for the Federal Securities Code*, 27 SW. L.J. 759, 776-79 (1973); see also L. LOSS & E. COWETT, BLUE SKY LAW 3-10 (1958) (discussing history of merit regulation).

and warrant, escrow, underwriting expense, and offering price.⁴⁵ This type of review of public offerings, including offerings of well financed companies underwritten by established firms, has created an astonishing pattern of public offerings that cleared with little difficulty in most states but were delayed or denied effectiveness within the commonwealth. There have been some recent indications of a possible easing of the literal application of existing regulations and a retreat from a subjective review of the risks involved in a particular offering. The Division's continued commitment to a rigid form of consumer protection regulation indicates, however, that until it issues new regulations, Massachusetts merit regulation of public offerings will remain difficult and unpredictable.⁴⁶

C. Current Proposals

In the fall of 1982, the Secretary of State established four committees⁴⁷ to assist the Division in revising the regulations to produce a clearer articulation of the standards used to review both public and private offerings. Although these committees had met on numerous occasions by the end of 1983, no proposed regulations have emanated from this process. It is likely, however, that significant changes in the regulations, as well as the issuance of additional interpretive releases, will soon be forthcoming.

The committee charged with considering regulation of non-tax-advantaged public offerings has addressed two principal concerns: the definition of insider stock, and the terms for escrow of insider stock. The Division's identification of insider stock has been an ad hoc process, and negotiated on a different basis each time the matter presents itself. It is possible that Massachusetts may adopt part of the NASAA

45. See Empirical Research Project, *supra* note 36, at 804-08.

46. During 1982 and the first half of 1983, the statistical experience of public registrations and filed § 402(b)(9) exemptions in the commonwealth indicates that during 1982, consistent with practices during the approximately preceding two years, a significant percentage of filings were withdrawn. Conversely, the statistical experience for the first six months of 1983 indicates that a palpably higher percentage of filings are becoming effective.

Type of Filing	Filed 1982	Withdrawn 1982	Filed 6 months 1983	Withdrawn 6 months 1983
Registration by Coordination or by Qualification	1,954	129	1,513	67
§ 402(b)(9) Exemption	809	139	670	42

The practice of the Division is to suggest withdrawal in advance of taking formal action, so the "withdrawn" category is a catchall both for those transactions that were abandoned and those that were contested by the Division.

47. The committees consist of approximately 35 practitioners and participants in the securities industry.

guidelines concerning cheap stock.⁴⁸ Although the NASAA guidelines represent a rigorous technique of insider stock regulation, they provide a precise definition of cheap stock.⁴⁹ The possibility that the guidelines may be adopted may be increased by the 1983 induction of Division Director Michael Unger to the Presidency of NASAA.

The committee's discussion revealed similar uncertainties about the future of insider stock escrows. Although the committee discussed one to five year escrows and an apparent consensus developed on the general imposition of a three year escrow with releases from escrow based upon earnings or market price, it reached no specific conclusions. Perhaps a disagreement over the purpose of insider stock escrows is at the basis of the indecision. Although some believe that escrow provisions should protect public shareholders from the market impact of blocks of unescrowed shares, the Division seems preoccupied with "unjust enrichment" of promoters holding insider stock.

Similarly, the reasons for placing venture capital shares in escrow is not entirely clear. Whatever the reasons may be for requiring the escrow of shares issued to original promoters who are associated with the early formation of an enterprise, the mandatory escrow of shares sold in true venture capital offerings prior to the public issuance seems highly questionable. Although drawing the line between promoter stock on the one hand and venture capital stock on the other may be difficult in a particular case, reasonable guidelines are possible.

Whether these committee discussions will result in the fine-tuning of the existing scheme under the insider stock regulations,⁵⁰ or in a comprehensive revision of the current regulations, is uncertain. The numerical triggers contained in the current regulations, such as the percentage of insider stock permitted to be outstanding after different kinds of offerings, the ratio of price of prior sales of stock to the offering price, and the multiple of earnings reflected in the pricing of public offerings,⁵¹ appear to be based upon arbitrary figures. The liberalization of these standards awaits the development of a regulatory logic as opposed to the substitution of newer and more liberal, but equally arbitrary, numerical standards. Indeed, the retention by insiders of a very high percentage of stock in a strong first-time registrant is viewed by some Massachusetts committee members as a desirable hallmark of the quality of an offering. The current regulations, however, reflect a policy decision that public offerings are acceptable only when the insiders' retained participation is of a decidedly lesser percentage.⁵²

48. NASAA Statement of Policy on Cheap Stock, 1 BLUE SKY L. REP. (CCH) ¶¶ 5312-5314 (Aug. 1984).

49. *Id.* ¶ 5312.

50. MASS. ADMIN. CODE tit. 950, § 13.305(a)(2)(E) (1978), *reprinted in* 1A BLUE SKY L. REP. (CCH) ¶ 31,465 (Aug. 1982).

51. *See id.*

52. *See id.*

In spite of the current committee discussions, the Division has continued to apply very rigorous escrow standards to pending offerings. These standards have included the imposition of liquidating preferences for publicly issued shares and proposals of five year escrow terms. The Division has resisted attempts to correlate the release of shares from escrow with the safe harbors set forth in the regulations,⁵³ even though presumably falling within those safe harbors might have avoided the necessity of escrowing shares in the first instance.

Discussions concerning the public offering of tax advantaged programs have focused primarily upon the Division's application of the NASAA guidelines for real estate tax shelters and for oil and gas programs.⁵⁴ The relevance of these guidelines to Massachusetts practice is a matter of significant debate by practitioners who view Massachusetts as a disclosure jurisdiction, because the guidelines are premised upon a broad merit review standard. It is unfortunately clear, however, that issues of unreasonable compensation to promoters will be left to significant merit review before the Division will grant effectiveness.

D. A Regulatory Perspective

Unless the Massachusetts Act⁵⁵ is amended, the commonwealth will move toward a middle ground that balances the Division's conviction that "fair and equitable" merit review is both justified under the current statute and essential for consumer protection, and the historical perspective of most practitioners that Massachusetts is, both as a matter of law and policy, primarily a disclosure jurisdiction. The importance of resolving this tension by the generation of a comprehensive, predictable, and clear set of regulations cannot be overemphasized. Many offerings that are routinely cleared in other jurisdictions are not filed in Massachusetts because of the rigidity and unpredictability of the existing regulatory regime. The commonwealth's role as a capital center and its continued viability as one of the nation's centers of high technological enterprises require prompt resolution of these important regulatory issues. While most observers do not question the good intentions of the Division in protecting the public, there is a perception that the Division lacks the time and expertise to identify an offering that is so speculative as to "work a fraud." The "I know one when I see one" mentality⁵⁶ must and presumably will be replaced with the predictability that a well defined regulatory scheme can impart. Only such a

53. See MASS. ADMIN. CODE tit. 950, § 13.305(a)(2)(E)(ii) (1978), *reprinted in* 1A BLUE SKY L. REP. (CCH) ¶ 31,465 (Aug. 1982).

54. NASAA Statement of Policy Regarding Real Estate Programs, 1 BLUE SKY L. REP. (CCH) ¶¶ 5352-5360 (June 1984); NASAA Statement of Policy for Registration of Oil and Gas Programs, 1 BLUE SKY L. REP. (CCH) ¶¶ 5221-5232 (June 1984).

55. MASS. GEN. LAWS ANN. ch. 110A, §§ 101-417 (West Supp. 1983).

56. *Cf. Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964) (Stewart, J., concurring) (describing test to determine whether matter is obscene).

scheme can strike a proper balance between the merit review and the disclosure approaches.

IV. PRIVATE PLACEMENT OF SECURITIES IN MASSACHUSETTS

A. *The Regulatory Context*

The Massachusetts Act contains several securities and transactional exemptions from registration also found in the Uniform Act.⁵⁷ The discussion that follows, however, focuses exclusively upon the exemption in section 402(b)(9) of the Massachusetts Act⁵⁸ and the current proposals for the redefinition of that exemption. The relation of the current exemption and the various proposals to NASAA's proposed Uniform Limited Offering Exemption (ULOE)⁵⁹ will also be discussed.

Section 402(b)(9) provides an exemption from registration⁶⁰ for the following transactions:

[A]ny transaction pursuant to an offer directed by the offeror to not more than twenty five persons other than [institutional purchasers] in the commonwealth during any period of twelve consecutive months, whether or not the offeror or any of the offerees is then present in the commonwealth, if (A) the seller reasonably believes that all the buyers in the commonwealth [other than institutional purchasers] are purchasing for investment, and (B) insofar as an offer involves the payment directly or indirectly of any commission or other remuneration for soliciting any prospective buyer in the commonwealth [other than institutional purchasers] a notice is filed with the secretary at least five full business days before the offer, and the secretary does not by order disallow the exemption within the next five full business days; but, in any event, the secretary may by rule or order, as to any security or transaction, or any type of security or transaction, withdraw or further condition this exemption, or increase or decrease the number of offerees permitted, or waive the conditions in clauses (A) and (B) with or without the substitution of a limitation or remuneration.⁶¹

The Massachusetts Act substantially altered the exemption contained in the Uniform Act by increasing the number of offers within the commonwealth (to other than institutional purchasers) from ten to twenty-five, and by eliminating the Uniform Act's absolute prohibition

57. UNIF. SEC. ACT § 402, 7A U.L.A. 631-42 (1958), *reprinted in* 1 BLUE SKY L. REP. ¶ 5542 (Jan. 1982).

58. MASS. GEN. LAWS ANN. ch. 110A, § 402(b)(9) (West Supp. 1983).

59. UNIFORM LIMITED OFFERING EXEMPTION (N. AM. SEC. ADMIN. ASS'N, INC.) (1983), *reproduced in* 1 BLUE SKY L. REP. (CCH) ¶ 5294 (Oct. 1982).

60. The registration provisions appear at MASS. GEN. LAWS ANN. ch. 110A, §§ 301, 403 (West Supp. 1983).

61. *Id.* § 402(b)(9).

of payments of any commission for solicitation.⁶²

Most practitioners, when the Massachusetts Act was adopted, presumed that the section 402(b)(9) exemption would operate in much the same manner as the private placement exemption under prior law. Section 402(b)(9) was not regarded as embodying any particular concern with payment of indirect commissions or other remuneration for solicitation beyond the requirement of a notice filing. Furthermore, practitioners viewed the exemption as self-executing, provided the Secretary did not affirmatively disallow the exemption within the five days following the filing of the notice.⁶³

Nonetheless, commentators have noted that regulatory developments have substantially eroded the section 402(b)(9) exemption, and have turned the exemption into something of a registration process.⁶⁴ Despite the clear language of the statute, the Division has consistently maintained that it is entitled to apply merit review standards over a broad range of matters whenever a notice is filed under section 402(b)(9). The first issue of the Massachusetts Securities Bulletin explained the Division's rationale:

[B]ecause the language of Section 402(b)(9) must be read and interpreted within the context of the antifraud provisions, its exemption is not self-executing, i.e., simply a notice filing and the passing of the requisite five business days does not automatically bestow exemption status upon the offering.

Therefore, the granting of a 402(b)(9) exemption requires an active response from the Division: a thorough, intensive review of every offering conducted within the statutory time limit defined under the Section.⁶⁵

In conjunction with this announcement of the Division's intention to apply substantive merit review to exempt offerings filed under section 402(b)(9), the Division announced that it would no longer follow the previous practice of liberally granting an expansion of the number of offerees within a twelve month period from twenty-five to some greater number, typically less than fifty.⁶⁶

Given the professed intention of the Division to provide merit review to offerings involving underwriter compensation, it is necessary to determine the existence of underwriter compensation triggering the sec-

62. Compare MASS. GEN. LAWS ANN. ch. 110A, § 402(b)(9) (West Supp. 1983) with UNIF. SEC. ACT § 402(b)(9), 7A U.L.A. 641 (1958), reprinted in 1 BLUE SKY L. REP. (CCH) ¶ 5542 (Jan. 1982).

63. Herwitz & Pokross, *Massachusetts Securities Act*, 1972 ANNUAL SURV. MASS. LAW 521, 528 (1972); see MASS. GEN. LAWS ANN. ch. 110A, § 402(b)(9) (West Supp. 1983).

64. SMITH & CAVITCH, *supra* note 18, at 14-27.

65. MASS. SEC. DIV., 1 MASS. SEC. BULL. NO. 1, at 15 (July 1980).

66. *Id.* at 10.

tion 402(b)(9) filing requirement, and the scope of merit review to be applied if a filing is made.

1. Indirect Remuneration

Section 402(b)(9) requires a notice to be filed if either direct or indirect remuneration is paid.⁶⁷ The Massachusetts Act does not, however, define "indirect remuneration." The Division takes an extremely broad view of what constitutes indirect remuneration for the purposes of section 402(b)(9). Although the statute calls for a filing only if an offering involves payment directly or indirectly of any commission or other remuneration "for soliciting" any prospective purchaser in the commonwealth,⁶⁸ the Division has construed the provision much more broadly.⁶⁹ A recent policy statement issued by the Division's General Counsel indicates that it is the Division's view that "any form of payment received by a seller, sponsor, promoter, or principal of any offering will be considered to be 'indirect remuneration', thereby obliging the offeror to file a notice in accordance with Section 402(b)(9), absent a showing of extraordinary circumstances."⁷⁰ The General Counsel reasoned that because the filing requirement was designed to enable the Division to evaluate the adequacy of disclosure concerning the investment program and to determine the reasonableness of the seller's and promoter's compensation, the words "indirect remuneration" must be interpreted broadly.⁷¹ On that basis, the Division stated that indirect remuneration included (1) *any* profit on the sale or lease of any services; (2) *any* management, consulting or other fees charged at above customary rates; and (3) *any* payment made to any person connected with an offering that is based upon a percentage of the funds to be raised.⁷²

The effect of the General Counsel's position, applied literally, would be to expand the number of situations in which indirect remuneration is involved, thus triggering the section 402(b)(9) filing and merit review process. For example, the payment of a salary to the principal of a corporate issuer, following completion of the offering, and the repayment of a loan out of the proceeds to an insider would both constitute indirect remuneration subject to section 402(b)(9) merit review. In addition, the General Counsel's construction would characterize as indirect remuneration the payment to an affiliate of an issuer for the transfer of property or technology to the issuer, even at fair market value. Further, and perhaps most importantly given the intensity with which the Division focuses on tax advantaged offerings, the General

67. MASS. GEN. LAWS ANN. ch. 110A, § 402(b)(9) (West Supp. 1983).

68. *Id.* (emphasis supplied).

69. MASS. SEC. DIV., 2 MASS. SEC. BULL. NO. 2, at 9 (Nov. 1981).

70. *Id.* at 8.

71. *Id.* at 9.

72. *Id.*

Counsel's interpretation of indirect remuneration would include certain payments to a general partner of a tax shelter partnership. Specifically, the following payments would be included: a rent-up fee upon the rental of real estate, a fee in exchange for the guaranteeing of debt or the completion of a project, a management or consulting fee, the retention of a wrap mortgage on the transfer of real property to the program, and the retention of an interest in the value of capital transactions that the Division considers disproportionate to the cash investment of the general partner, even when this interest arises only after recovery of all of the participants' investment.

Because the Division's position requires filing of a section 402(b)(9) notice with respect to most, if not all, private placements within the commonwealth, the General Counsel's interpretation has been the subject of intense and continuing debate within Massachusetts.

Several factors indicate that the Division's position is not justified under the Massachusetts statute. First, such an all inclusive interpretation is not justified by the language of section 402(b)(9). Had the legislature intended a virtually universal filing it would have so stated in clear language.

Second, although the Uniform Act differs from the Massachusetts Act in that the former absolutely prohibits sales remuneration, the official commentary to the Uniform Act on this topic is instructive. The official comment to section 402(b)(9) of the Uniform Act indicates that the drafter did not intend to preclude all solicitation by directors, officers, or employees of the issuer. Solicitation is permissible:

so long as it is only an incidental function of their regular duties and they receive no additional compensation. It is also relevant whether persons are specially hired in connection with the offering, particularly if they have a background in the securities business either as professional promoters or otherwise.⁷³

This official commentary suggests that benefits accruing to affiliates of the issuer, in contrast to payments directly related to a professional solicitation effort, are not intended to be included in the ambit of the phrase "commission or other remuneration [given directly or indirectly] *for soliciting* any prospective buyer."⁷⁴

Third, an analysis of the three cases cited by the General Counsel as authority for his interpretation of the broad scope of "indirect remuneration" does not support his conclusion. To support the Division's

73. UNIF. SEC. ACT § 402(b)(9) comment, 7A U.L.A. 641 (1958), *reprinted in* 1 BLUE SKY L. REP. (CCH) ¶ 5542 (Jan. 1982).

74. MASS. GEN. LAWS ANN. ch. 110A, § 402(b)(9) (West Supp. 1983) (emphasis supplied); *see* UNIF. SEC. ACT § 402(b)(9) comment, 7A U.L.A. 641 (1958), *reprinted in* 1 BLUE SKY L. REP. (CCH) ¶ 5542 (Jan. 1982).

interpretation, the General Counsel relied upon *Schultz v. Rector-Phillips-Morse, Inc.*,⁷⁵ *Petroleum Resource Development Corp. v. State*,⁷⁶ and *Upton v. Trinidad Petroleum Corp.*⁷⁷ A brief review of these cases gives some insight into the willingness of the Division to extend the Massachusetts practice to, and perhaps beyond, its statutorily justifiable limits.

In *Schultz v. Rector-Phillips-Morse, Inc.*,⁷⁸ the Supreme Court of Arkansas held that an initial consultation fee given to a promoter was indirect remuneration. The promoter, Rector-Phillips-Morse (RPM), sold ten percent interests in an apartment complex venture for \$23,500 each. After receiving \$235,000 and before the actual construction of the complex, RPM paid itself a \$28,000 "consultation fee." No explanation was given as to what services were compensated by this fee. In addition, each investor was to pay RPM an annual consultation fee of \$100, and a separate trustee was to manage the apartment complex for \$1200 per month.⁷⁹ The limited offering exemption provided by the Arkansas statute⁸⁰ contained the Uniform Act's absolute prohibition on remuneration.⁸¹ Even though RPM disclosed its consultation fee to potential investors,⁸² the *Schultz* court concluded that the initial consultation fee was remuneration for the solicitation and sale of the interests to the investors.⁸³ In reaching this conclusion, the court stressed that RPM's fee for consulting services was derived from the "proceeds of the joint venture units sold to the investors" and was paid when liquid assets first became available.⁸⁴ Apparently, the court viewed this arrangement as the equivalent of the payment of a sales commission to RPM, thus making the exemption from registration unavailable.

*Petroleum Resource Development Corp. v. State*⁸⁵ involved the offering of fractional interests in oil and gas leases, with Petroleum Resource Development Corporation (PRDC) as the promoter. Originally, PRDC used commissioned salesmen in its promotion. The Oklahoma Securities Commission (Oklahoma Commission) requested that PRDC discontinue this practice because PRDC had not registered the securities with the Oklahoma Commission and the payment of commissions to the salesmen would make the statutory limited offering exemption

75. 261 Ark. 769, 552 S.W.2d 4 (1977).

76. 585 P.2d 346 (Okla. 1978).

77. 652 F.2d 424 (5th Cir. 1981).

78. 261 Ark. 769, 552 S.W.2d 4 (1977).

79. *Id.* at 774-75, 552 S.W.2d at 6-7.

80. ARK. STAT. ANN. § 67-1248(b)(9) (Supp. 1975) (current version at *id.* (1980)).

81. UNIF. SEC. ACT § 402(b)(9), 7A U.L.A. 641 (1958), reprinted in 1 BLUE SKY L. REP. (CCH) ¶ 5542 (Jan. 1982).

82. RPM disclosed a consultation fee of \$48,000 when it actually received only \$28,000. *Schultz*, 261 Ark. at 784, 552 S.W.2d at 12.

83. *Id.* at 785, 552 S.W.2d at 12.

84. *Id.* at 784, 552 S.W.2d at 12.

85. 585 P.2d 346 (Okla. 1978).

unavailable to PRDC.⁸⁶ PRDC amended its offering to provide that the company would drill, and "if appropriate" would complete and equip the wells from the sales revenues. The cost for drilling the well was estimated at \$28,280 and the cost of completing and equipping the well was estimated at \$47,158. PRDC projected that the revenues would be \$63,404.22 to drill the well and \$68,496.95 to complete and equip the well. Any costs in excess of the estimated amounts to be raised from investors were to be paid by PRDC, but PRDC was allowed to retain any surplus remaining from the drilling revenues after the well was drilled and any surplus remaining from the completing and equipping revenues after the well was finished. In addition, PRDC retained a 23.5% working interest, although it contributed no capital.⁸⁷ PRDC then applied for a prospective exemption under the limited offering provision. The Oklahoma Commission denied the application because the "proceeds retained by [PRDC] in excess of the direct and indirect costs allocated to the exploration project are in fact, a form of indirect remuneration for the solicitation of sales within the meaning of [the Oklahoma exemption]."⁸⁸ PRDC subsequently sued, seeking a reversal of the Oklahoma Commission's decision and a confirmation of its right to sell the interests without registering the offering. The Supreme Court of Oklahoma rejected PRDC's argument that the indirect remuneration limitation on the exemption was meant only to prohibit the use of paid professional salesmen.⁸⁹ The *Petroleum Resource* court stressed that PRDC could not circumvent the statute merely by calling the surplus a "supervisory fee" because the Oklahoma legislature "specifically included *indirect remuneration* in the limitation, wisely foreseeing a possibility, such as present here, that a company might attempt to circumvent the limitation."⁹⁰ The possible retention by PRDC of any surplus in the sales proceeds, the court concluded, constituted indirect remuneration for the solicitation of buyers within the meaning of the exemption.⁹¹

Petroleum Resource has been criticized for suggesting that *any* sum received by a promoter not directly attributable to costs of the venture, such as legitimate management or supervisory fees, might be considered indirect remuneration and thereby defeat the use of the exemption.⁹² The decision provides no guidance for distinguishing between these payments and remuneration for solicitation.

The third decision relied upon by the Division, *Upton v. Trinidad*

86. See OKLA. STAT. ANN. tit. 71, § 401(b)(15) (West Supp. 1983).

87. *Petroleum Resource*, 585 P.2d at 347.

88. *Id.*

89. *Id.* at 348.

90. *Id.* (emphasis supplied).

91. *Id.*

92. Note, *Securities Regulation: Hidden Danger of Indirect Remuneration and the Limited Offering Exception in Oklahoma*, 32 OKLA. L. REV. 924, 929 (1979).

Petroleum Corp.,⁹³ involved the promotion of interests in an oil and gas operation by Charles Beard, the sole shareholder in Trinidad, the issuer. Beard was also the sole shareholder of Beard & Associates, which owned a seventy-five percent interest in the lease on the land where the well subject to the offering was located. Beard & Associates sold the lease interest to Trinidad for a \$3,500 profit. Trinidad then signed a "turnkey" contract with a drilling company for drilling the well, resulting in total project expense to Trinidad of about \$81,500. Trinidad, while retaining a twenty-five percent interest, collected \$147,000 from the investors, each of whom had a contract that specified that his money was to be applied to drilling costs only. After the well proved to be dry, Trinidad did not refund any of the excess money; rather, it used the surplus for normal operating expenses.⁹⁴

The United States Court of Appeals for the Fifth Circuit found two possible sources from which Beard and Trinidad could have received "indirect remuneration," thereby preventing Trinidad's offerings from qualifying for the Alabama limited offer exemption: (1) Beard's \$3,500 profit on the sale of the leasehold interests to Trinidad; and (2) the funds that Beard and Trinidad collected that greatly exceeded the actual costs of drilling the well.⁹⁵

With respect to the latter, Trinidad contended that the amount, which totaled over \$65,000, was "the type of profit to which any business corporation is entitled."⁹⁶ The *Upton* court disagreed, stating that "the money retained by Trinidad was not a profit in the ordinary sense in that it was not derived from the operation of the business. It flowed directly from the investors to Trinidad as a consequence of Beard's efforts to solicit purchasers of interests in [the well]."⁹⁷

Trinidad also argued that the excess was not remuneration but was a "reserve for contingency." The *Upton* court suggested that this reserve could be maintained and not constitute remuneration if it bore a "logical relation to the actual risks involved," which would have been over one million dollars if a major "blow-out" had occurred.⁹⁸ The court also noted that any such reserve should contain "some mechanism for returning the excess to the investors on a pro rata basis in cases where, as here, the contemplated contingencies do not materialize."⁹⁹ Trinidad, as offeror, did not return the excess, using it to cover not only the drilling costs of the well, but also the overhead expenses of its entire corporate operation.¹⁰⁰

In evaluating the importance of these cases, it should be noted that

93. 652 F.2d 424 (5th Cir. 1981).

94. *Id.* at 425-26.

95. *Id.* at 426.

96. *Id.*

97. *Id.*

98. *Id.* at 427.

99. *Id.*

100. *Id.*

all of the three cited cases are from jurisdictions other than Massachusetts and not from major securities law courts. Each of the three cases involves a tax shelter program and, perhaps by current standards, an abusive tax shelter program.¹⁰¹ In addition, all of these cases represent examples of extreme fact patterns from which general rules should not be derived. These examples of promoter profiteering cannot support the General Counsel's apparent position that virtually every section 402(b)(9) transaction contains indirect remuneration requiring merit review. Finally, the Division's construction of the "indirect remuneration" provisions is not in accord with the understanding of the Massachusetts securities bar at the time of the adoption of the Massachusetts Act that the section 402(b)(9) exemption would not be restrictively applied. Most practitioners are thus of the view that neither the Massachusetts statute nor the authorities cited by the General Counsel justify the broad scope given to the phrase "indirect remuneration" by the Division.¹⁰²

2. Scope of Review of Section 402(b)(9) Offerings

As explained above, the Division undertakes a merit review of private placement offerings for which filings must be made under section 402(b)(9).¹⁰³ This review is as comprehensive as the Division's review of registered public offerings. The basis for this review can be found in the regulations and in an informal policy statement issued by the Division.

Under the Massachusetts regulations, the section 402(b)(9) notice must contain "[i]nformation from which the Director can determine the commission or other remuneration which will be paid."¹⁰⁴ After the Division determines the amount and nature of the commission or other remuneration, it evaluates the payment in terms of the standards applied to the payment of remuneration in registered public offerings.¹⁰⁵ The Division has expressed the policy that:

[t]he standards of Section 305 of the Act [allowing the issuance of stop orders]¹⁰⁶ apply to all offerings made in Massa-

101. See 49 Fed. Reg. 6719-24 (1984) (to be codified at 31 C.F.R. Part 10) (Internal Revenue Service (IRS) abusive tax shelter regulations). Although the position of the Division is that indirect remuneration arises in its most pernicious form in tax shelters, the Division's stated position is that indirect remuneration issues also are presented in corporate offerings.

102. *But see* Prince v. Heritage Oil Co., 109 Mich. App. 189, 311 N.W.2d 741 (1981) (retention by sellers of leasehold interests in gas and oil wells without contributing proportionate share of capital to the venture was "remuneration" within Michigan's version of the Uniform Act).

103. See *supra* notes 64-72 and accompanying text.

104. MASS. ADMIN. CODE tit. 950, § 14.402(b)(11)(F) (1978), *reprinted in* 1A BLUE SKY L. REP. (CCH) ¶ 31,472 (Sept. 1984).

105. See MASS. ADMIN. CODE tit. 950, § 13.305 (1978), *reprinted in* 1A BLUE SKY L. REP. (CCH) ¶ 31,465 (Aug. 1982) (governing registered public offerings).

106. MASS. GEN. LAWS ANN. ch. 110A, § 305 (West Supp. 1983).

chusetts, whether registered or exempt. The primary concern of the Division is protection of public investors with respect to all securities offerings, and especially with regard to highly speculative and start-up ventures.¹⁰⁷

No current issue in Massachusetts securities practice is more hotly contested as the scope of review permitted the Division in section 402(b)(9) offerings. The Division imports on a wholesale basis the regulatory scheme for public offerings,¹⁰⁸ which consists of several complex rules governing insider stock, price-earnings ratios, the price of an offering, underwriter compensation, and remuneration of sellers, and other issues. In addition, the Division will occasionally review a private placement offering on a "fair and equitable" standard and will either enter a stop order¹⁰⁹ to prevent the effectiveness of the section 402(b)(9) exemption, or will advise counsel of the desirability of withdrawing the filing lest a stop order be instituted. Although most members of the Massachusetts securities bar are of the view that section 402(b)(9) permits a far narrower review than does section 305,¹¹⁰ the Division has continued to engage in comprehensive merit review of section 402(b)(9) offerings.

The Division's merit review of section 402(b)(9) offerings is not justified. Section 402(b)(9) requires a filing only when the transaction involves the payment of commissions and other remuneration for the solicitation of prospective purchasers.¹¹¹ If the Division is to undertake any merit inquiry, it would seem logical that it should be restricted to the issue of remuneration, and only with the remuneration that arises in connection with the solicitation of investors. Given the language of section 402(b)(9),¹¹² it is virtually incomprehensible that the section should be construed to justify a broad merit review inquiry. There appears to be no statutory basis for applying all of the insider stock regulations,¹¹³ issued under section 305,¹¹⁴ to the review of section 402(b)(9) offerings; section 305 relates to registered offerings that work or tend to work a fraud upon purchasers. It cannot even be said that the section 305 regulation governing compensation of underwriters and promoters¹¹⁵ applies to a section 402(b)(9) exempt offering. The section 305 standard includes consideration of *promoters'* profits and participa-

107. MASS. SEC. DIV., 1 MASS. SEC. BULL. No. 1, at 16 (July 1980) (footnote added).

108. See *supra* text accompanying notes 11-45 (describing regulation of registered offerings).

109. See MASS. GEN. LAWS ANN. ch. 110A, § 305 (West Supp. 1983) (authorizing Division to issue stop orders).

110. Compare *id.* § 402 (private offerings) with *id.* § 305 (public offerings).

111. *Id.* § 402(b)(9); see *supra* text at note 61.

112. See *supra* text at note 61.

113. MASS. ADMIN. CODE tit. 950, § 13.305 (1978), *reprinted in* 1A BLUE SKY L. REP. (CCH) ¶ 31,465 (Aug. 1982).

114. MASS. GEN. LAWS ANN. ch. 110A, § 305(a)(E) (West Supp. 1983).

115. MASS. ADMIN. CODE tit. 950, § 13.305(a)(2)(F) (1978), *reprinted in* 1A BLUE SKY L. REP. (CCH) ¶ 31,465 (Aug. 1982).

tions, neither of which is the proper subject matter for inquiry under section 402(b)(9), which speaks only of sales remuneration and not promoter's profits or participation.

B. Current Private Placement Practices: Merit Review of Exempt Offerings

Current use of the section 402(b)(9) exemption must be analyzed from the different vantage points of the corporate offering and the tax shelter offering. The Division has stated that it actually receives few section 402(b)(9) notices for corporate issuances of shares of stock or debt and that it encounters few, if any, abuses or frauds in this area. This observation seems to make only two conclusions possible: either both thieves and poor businessmen are irresistably attracted to tax shelter programs and never to corporate investments, or the level of legal practice within the commonwealth varies radically. Experience suggests that the latter conclusion is correct. It is likely that some practitioners simply do not file section 402(b)(9) notices if a corporate offering is not formally underwritten. Some practitioners representing small and unsophisticated corporate issuers may conclude from a cursory examination of section 402(b)(9) and the regulations¹¹⁶ that a filing is not necessary because no underwriter or broker-dealer is involved in the transaction. A direct placement of stock to a few investors without the participation of a broker-dealer, an underwriter, or a finder¹¹⁷ might well strike the practitioner as falling outside of the filing requirements. At the other extreme, the experienced practitioner may well reject the Division's claims to the contrary and conclude that section 402(b)(9) in fact does *not* require a notice even if an affiliate of the corporate issuer will receive a salary, or will convey property to the issuer in exchange for part of the proceeds of an offering, or will have his loan repaid from the proceeds.

Indeed, it may be that many practitioners remain unaware of the Division's position that any payments to attorneys or accountants by the promoter or offeror in connection with the evaluation of a private placement constitutes indirect remuneration within section 402(b)(9).¹¹⁸ This position is especially questionable when a sophisticated group of venture capitalists purchases the stock of a corporate issuer and the

116. MASS. ADMIN. CODE tit. 950, § 14.402(b)(9) (1978), *reprinted in* 1A BLUE SKY L. REP. (CCH) ¶ 31,472 (Sept. 1984).

117. A finder is a "person who, for consideration, participates in the offer to sell, sale, or purchase of securities or commodities by locating, introducing, or referring potential purchasers or sellers." Michigan Uniform Securities Act, MICH. COMP. LAWS ANN. § 451.802(u) (Supp. 1982). Michigan is the only state that formally distinguishes the finding function from the brokerage function. *See* Hampton, *Broker Dealers*, in MICHIGAN SECURITIES REGULATION, A BLUE SKY LAW COMPENDIUM 65, 88-89 (1983) (C. Moscow & H. Makens, eds.).

118. *See* MASS. SEC. DIV., 2 MASS. SEC. BULL. No. 2, at 8-9 (Nov. 1981); *see supra* notes 67-72.

corporate issuer pays the fees of the attorney representing the investor group. This type of arrangement does not present the opportunity for abuse that the notice procedure under section 402(b)(9) was designed to prevent.

The greatest current activity in section 402(b)(9) filing arises in connection with tax sheltered programs. The intensity may result in part from the vitality of today's tax shelter market and in part from the sophistication of counsel to these types of offerings. No easy generalization can be made concerning the current treatment of these programs.

As a starting point, an issuer must understand that each program is likely to be subject to merit review in great detail. The Division has, in the private placement context, directly¹¹⁹ or indirectly¹²⁰ barred the offering of tax advantaged programs involving promoters with disciplinary records, highly speculative programs, programs that might be deemed under current Internal Revenue Service regulations to be abusive tax shelters,¹²¹ programs that are not supported by sufficient legal opinions, and programs presenting "excessive" direct and indirect remuneration as the Division defines those phrases. It is not unusual, in a section 402(b)(9) filing of a tax shelter program, for counsel to engage in intensive negotiation with the Division concerning the method of calculating the amount of indirect remuneration involved. The Division will tend to include any compensation paid to a finder or brokerage house, any remuneration paid by the offeror to offeree attorneys, accountants, or other representatives, and many forms of consideration received by general partners or their affiliates. Examples of this type of consideration are expense reimbursements to the general partner, payments of fees to general partners for past or future services, any appropriation by the promoters of proceeds remaining after required expenses are covered, and equity positions held or retained by general partners or affiliates that are disproportionate to their capital investment.

Another example is the retention of residuary interest by general partners or affiliates after the sale and refinancing or other capital transaction involving the subject property. The Division will treat these retained interests as remuneration even if they only arise after the other investors have recovered their investment. Also included are markups in price or any profit incidental to the use of wrap mortgages in conjunction with the transfer of property from the general partner or

119. The Division may directly bar the offering by issuing a cease and desist order, MASS. GEN. LAWS ANN. ch. 110A, § 407A (West Supp. 1983), or by seeking an injunction, *id.* § 408.

120. The Division often suggests that an offering be withdrawn before taking formal action. *See supra* note 46.

121. *See* 49 Fed. Reg. 6719-24 (1984) (to be codified at 31 C.F.R. Part 10); *supra* note 101.

his affiliates to the program, and any other present or future payments to the general partner or his affiliates. The negotiation of the value of these payments to the general partner, and their relation to the eighteen percent maximum imported from the public offering regulations,¹²² sometimes involves more ad hoc negotiation than the application of identifiable standards.¹²³

C. Current Proposals

As in the public offering area, the Secretary of State has designated two committees to work with the Division in revising the regulations governing the private placement of securities. These committees have addressed both corporate offerings and tax advantaged offerings, and have focused their attention on the operation of section 402(b)(9) and the possible addition of a Massachusetts version of the ULOE.¹²⁴

Without tracing in detail the tortuous path of these discussions between the Division and the private sector, it now appears that after NASAA's adoption of a final ULOE at its September 1983 meeting,¹²⁵ the Division will push for the adoption of something akin to that ULOE provision within the Commonwealth of Massachusetts. To advance the policy of national uniformity, that provision should closely follow the NASAA text. Discussions with the Division concerning the ULOE, however, have revealed its unfortunate enthusiasm for innovation, despite the national thrust toward uniformity. Consequently, there seems to be a great risk that any Massachusetts provision will alter the ULOE.

A careful study of the debates over the ULOE discloses in clear terms the tension in the search for an appropriate regulatory fulcrum; the debate between disclosure review and merit review has continued. The Division is struggling with the fact that, basically, the ULOE makes applicable to the states the federal exemptive scheme embodied in Regulation D of the General Rules and Regulations of the Securities and Exchange Commission (Regulation D),¹²⁶ which is a disclosure approach to securities issuances.

Regulation D approaches issuances in tiers based upon the size of an offering. Offerings at or below five hundred thousand dollars are not regulated by federal law.¹²⁷ Offerings at or below five million dollars are limited to thirty-five purchasers plus an unlimited number of institutional or "accredited" (wealthy) investors, wherein nonac-

122. See MASS. ADMIN. CODE tit. 950, § 13.305 (a)(2)(F) (1978), reprinted in 1A BLUE SKY L. REP. (CCH) ¶ 31,465 (Aug. 1982).

123. For a statistical summary of the recent private placement experience, see *supra* note 46.

124. UNIFORM LIMITED OFFERING EXEMPTION (N. AM. SEC. ADMIN. ASS'N, INC.) (1983) (reproduced at 1 BLUE SKY L. REP. (CCH) ¶ 5294 (Oct. 1982)).

125. *Id.*

126. Regulation D, 17 C.F.R. §§ 230.501 to .506 (1983).

127. Rule 504 of Regulation D, 17 C.F.R. § 230.504(b)(2) (1983).

credited investors receive disclosure comparable to that required by SEC Form S-18.¹²⁸ Regulation D also provides that for offerings over five million dollars, nonaccredited investors must also meet sophistication standards, and a higher level of disclosure, as provided in SEC Form S-1, is required for these investors.¹²⁹

The threshold ULOE issue to be considered by the Division is whether ULOE replaces, or only supplements, the section 402(b)(9) exemption. The most recent position of the Division is that ULOE should replace at least section 402(b)(9)(B),¹³⁰ which applies in instances where a commission or indirect remuneration is paid so that filing a five day letter is required. This conclusion is indeed unfortunate. In many cases, a commission is paid, or a participant receives something that the Division would consider to be indirect remuneration under its broad definitions, and yet the transaction will not, for example, comply with the federal disclosure requirement for offerings at or below five million dollars.¹³¹ An offering to a modest number of nonaccredited persons, friendly to the offeror or introduced by a finder, might well not involve written disclosure complying with S-18 standards, and yet would be exempt under the Securities Act of 1933.¹³² A similar exemption should be available under Massachusetts law, and indeed *is* available today. The addition of the ULOE should not eliminate that Massachusetts exemption, because in fact numerous legitimate private placements, involving commissions, cannot support the cost or effort of a SEC Form S-18 disclosure document.

The Division's response is that the continuation of section 402(b)(9) would create a "loophole," because ULOE is unavailable to persons who, generally, are subject to orders or rulings involving fraud,¹³³ but no such prohibition applies to section 402(b)(9) offerings. Although the issue presented could be remedied both today and under ULOE by making section 402(b)(9)(B) unavailable to certain undesirable persons, the Division's position is illustrative of its perception that any exemption presents an opportunity to perpetuate fraud by avoiding merit review.

The Division, at least to date, has been willing to include larger offerings that comply with the federal provisions¹³⁴ into the Massachusetts ULOE, thus adopting the more liberal option of the ULOE official draft. Although a conservative approach to the rest of ULOE mitigates much of the progress this inclusion promises, the election to exempt

128. Rule 505 of Regulation D, 17 C.F.R. § 230.505(b)(2)(ii) (1983).

129. Rule 506 of Regulation D, 17 C.F.R. § 230.506(b)(2)(ii) (1983).

130. MASS. GEN. LAWS ANN. ch. 110A, § 402(b)(9)(B) (West Supp. 1983).

131. Rule 505 of Regulation D, 17 C.F.R. § 230.505 (1983).

132. Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(4) (1982).

133. UNIFORM LIMITED OFFERING EXEMPTION (N. AM. SEC. ADMIN. ASS'N, INC.) (1983) (reproduced in 1 BLUE SKY L. REP. (CCH) ¶ 5294 (Oct. 1982)).

134. Specifically, it has indicated a willingness to include Rule 505 and Rule 506 offerings in the Massachusetts ULOE. *See* 17 C.F.R. §§ 230.505, .506 (1983).

transactions over five million dollars that comply with federal law¹³⁵ is a clear acknowledgement by the Division of the realities of raising capital in today's environment.

The Division presently proposes to adopt footnote one of the ULOE, which discusses the increased risk of fraud in tax shelter offerings and requires, for direct participation offerings only, the preparation of a written disclosure document for individuals who are "accredited" under Regulation D.¹³⁶ The Massachusetts Securities Bar (Bar) has objected, suggesting that the footnote's gratuitous discussion concerning the risks of shelters is inappropriate for inclusion in governmental regulations, and has suggested that a possible compromise might be to limit the disclosure obligation to tax shelter deals only, rather than to all direct-participation transactions.

Indeed, the Division's lack of faith in the SEC's approach to disclosure review is carried further by the Division's refusal to permit the Massachusetts ULOE automatically to reflect the nature of the Regulation D exemption. The Division claims that, because that exemption may be amended by the SEC in the future, this agreement would constitute an abrogation of the Division's responsibility, even if the commonwealth were to retain an express right to reject any particular Regulation D amendment by specific action.

Rule 1A of ULOE¹³⁷ permits fees in connection with the offering to be paid only to persons who are "appropriately registered" under state law. The Massachusetts version proposes to add an exemption for a general partner who, without a broker, sells not more than one program each year. In light of this additional exemption, Massachusetts proposes to eliminate the provisions of the ULOE that provide for a simplified broker registration for persons who become brokers only by reason of the offering of new issues while not conducting a general brokerage business. The Bar has urged a reversal of the Division's position to permit a limited registration, noting that otherwise the Massachusetts statute requires a fully registered broker to be registered with the SEC.¹³⁸ Even the most prudent of general partners is unlikely to undertake this obligation. The Division claims that a full registration is required for investor protection, but suggests the issuance of an interpretive release stating that a bona fide general partner is *not* a broker-dealer, requiring *any* registration, because he is not *in the business*

135. Rule 506 of Regulation D, 17 C.F.R. § 230.506 (1983).

136. UNIFORM LIMITED OFFERING EXEMPTION (N. AM. SEC. ADMIN. ASS'N, INC.) note 1 (1983) (reproduced in 1 BLUE SKY L. REP. (CCH) ¶ 5294 (Oct. 1982)). Footnote one of the ULOE states that a written disclosure document must be provided to accredited persons who, by reason of their status, would otherwise not necessarily receive a formal document. *Id.*

137. UNIFORM LIMITED OFFERING EXEMPTION (N. AM. SEC. ADMIN. ASS'N, INC.) rule 1A (1983) (reproduced in 1 BLUE SKY L. REP. (CCH) ¶ 5294 (Oct. 1982)).

138. For the SEC broker registration provisions, see 17 C.F.R. §§ 249.501 to .510 (1983).

of brokerage. This release would be welcomed by the Bar, although it is analytically inconsistent with the provision of an express exemption for a general partner selling a single program each year, since that general partner theoretically will be exempt by the definitional release.

The Division proposes, with general assent of the Bar, to adopt rule 1B of ULOE,¹³⁹ making the exemption unavailable to so-called "bad boys," who are persons involved in an offering who have had recent involvement in fraud, suspension or other disciplinary action in the securities, or similar fields. Similarly, there is little resistance to the adoption of rule 1D of ULOE,¹⁴⁰ which adds to Regulation D a suitability requirement to individual nonaccredited investors, which can be met generally either by financial status or investor knowledgeability.

Perhaps the two most hotly contested areas are those of a numerical limit on the number of permitted investors in a ULOE exempt transaction, and the nature and timing of the filing to be made with the Division. Regulation D permits an unlimited number of accredited purchasers, plus thirty-five purchasers nationally.¹⁴¹ The Division proposes an absolute maximum of thirty-five purchasers within Massachusetts, both accredited and nonaccredited. Although this proposal represents some progress conceptually from the current limit of twenty-five offers,¹⁴² it is inconsistent with national ULOE uniformity and appears to be an arbitrary mathematical limitation without any functional rationality.

The question of timing of filings highlights the Division's resistance to surrendering its ability to conduct substantive review. ULOE contains options for filings prior to sale, or afterwards.¹⁴³ Under Regulation D, the SEC filing generally is due after the sale.¹⁴⁴ The Division has proposed a filing, in all cases, ten days before the sale.¹⁴⁵

Further, the Division seeks filing of all offering materials. This requirement is inconsistent with the Division's expressed positions that it does not want to conduct merit review under ULOE, that it does not require any review of corporate offerings because of an historical absence of abuse in corporate private placements, and that it does not have sufficient staff to process any more paperwork. In addition, the Secretary's committee expected that some mechanism probably would be provided for post-sale filing, without inclusion of offering materials,

139. UNIFORM LIMITED OFFERING EXEMPTION (N. AM. SEC. ADMIN. ASS'N, INC.) rule 1B (1983) (reproduced in 1 BLUE SKY L. REP. (CCH) ¶ 5294 (Oct. 1982)).

140. *Id.* rule 1D.

141. Regulation D, 17 C.F.R. §§ 230.505(b)(2)(ii), -.506(b)(2)(i) (1983); *see id.* § 230.508(e)(1)(iv).

142. MASS. GEN. LAWS ANN. ch. 110A, § 402(b)(9) (West Supp. 1983).

143. UNIFORM LIMITED OFFERING EXEMPTION (N. AM. SEC. ADMIN. ASS'N, INC.) note 4 (1983) (reproduced in 1 BLUE SKY L. REP. (CCH) ¶ 5294 (Oct. 1982)).

144. Rule 503 of Regulation D, 17 C.F.R. § 230.503(a)(1), (3) (1983).

145. Under the Division's proposal, it would add a clarification that the holding of funds in escrow is not the equivalent of a sale.

at least for corporate offerings and perhaps for all except tax shelters.¹⁴⁶

There is indeed the possibility that the Massachusetts ULOE will not be available for tax-shelter offerings that fall within certain IRS standards of abusiveness¹⁴⁷ or for which there exists no supporting authority for the availability of the posited tax benefits. Presumably, this program could be filed under section 402(b)(9) if that statutory exemption remains unaltered. The nature of the review to be given an offering under section 402(b)(9), which fails to meet standards for even a pre-filing review under a ULOE procedure, should not make the sponsor of the program optimistic about prospects for clearance.

The Division's decision to seek pre-sale filing for *all* types of offerings, *with* offering materials, represents a retreat in concept that has left the Secretary's committee unclear as to whether the Division is serious about its promised reorientation of regulatory thinking. If a ULOE that is to contribute to regulatory uniformity, and that is to constitute a departure from merit review, the resolution of this issue is perhaps the litmus test. The Division's view that uniformity justifies requiring *pre*-filing in *all* cases is not persuasive. The Division's assertion that pre-filing will facilitate a "substantive" review that is somehow less than a "fairness" or "merit" review remains an encouraging but untested regulatory promise.

The Division will soon formally issue its new private offering regulations, affecting among other things both section 402(b)(9) offerings and ULOE. There will follow an opportunity for discussion and testimony. Given the philosophical ambivalence of the Division, only the conclusion of that process will disclose the shape of Massachusetts regulation. A regulatory fulcrum, either disclosure or substantive review, must soon be selected in Massachusetts.

V. CONCLUSION

Massachusetts securities regulation presently is in a state of flux. Beginning with a statute that is, in essence, the Uniform Act, the Division by enforcing the statute and issuing regulations has expanded the statute so that current practice is often indistinguishable from open-ended "fair and equitable" merit review.

Although recent developments, including the operation of several appointed committees and general pronouncements by the Division of an intention to reform its practices, at least outside of the abusive tax

146. It has always been clear, if not desirable, that tax shelter offerings would be subject to pre-sale filing together with the offering materials. Some Massachusetts practitioners believe that at least these offerings will be given merit review in spite of the prohibition of such review by footnote 5 of the ULOE. *See* UNIFORM LIMITED OFFERING EXEMPTION (N. AMER. SEC. ADMIN. ASS'N, INC.) note 5 (1983) (reproduced in 1 BLUE SKY L. REP. (CCH) ¶ 5294 (Oct. 1982)).

147. *See* 49 Fed. Reg. 6719-24 (1984) (to be codified at 31 C.F.R. Part 10) (IRS abusive tax shelter regulations).

shelter area, must be taken as constructive indications for the future, nonetheless current Massachusetts practice is slow and unpredictable and suffers from an inability fairly to identify the degree to which merit review will be applied to both public and private offerings.

Unless and until the Division, the practicing Bar, and the securities industry reach some sort of an accommodation so that a comprehensive and predictable set of regulations can be issued, Massachusetts will continue in its current and unenviable position as an enigma to the uninitiated, and as a frustration even to those who practice in the commonwealth. This reevaluation of policy will perhaps result not only in clear regulation, but also regulation that is reasonably uniform with the rest of the country.

ADDENDUM

As this issue went to press, the Division amended section 14.402(b)(13) of title 950 of the Massachusetts Administrative Code to provide a "Massachusetts Uniform Limited Offering Exemption" (MULOE) for use in connection with offerings under Rules 505 and 506 of Regulation D. The amended rule became effective September 14, 1984. MULOE is a significantly broader exemption than that available under section 402(b)(9) of the Massachusetts Securities Act, and as such represents a positive recognition of the kinds of problems discussed in this article. This new rule, however, imposes certain exemptive conditions additional to or different from those already imposed by Regulation D. It is anticipated, furthermore, that some kinds of MULOE transactions will be subjected to a still unspecified degree of substantive review by the Division staff, despite their exempt status. In addition, offerings exempted from federal registration by means other than Rules 505 or 506 will remain subject to pre-commencement notice filing and substantive review under section 402(b)(9), which remains in effect. The private placement of securities in Massachusetts, therefore, will continue to generate questions of policy and practice similar to those discussed in this article.

The adoption of MULOE, furthermore, does not address the problem of defining the role of merit regulation in Massachusetts, except insofar as it will allow a somewhat greater number of transactions to proceed on an exempt basis without merit review. MULOE thus represents some progress, but Massachusetts remains in search of a regulatory fulcrum.