Registration Exemptions for Securities Issued by Eleemosynary Organizations

Dwayne L. Burton

Traditionally, a person consigned his soul to his religion and entrusted his health to the hospital. Now he can invest cash in either institution. "Earn 7% just for doing your Christian duty"[1] or, if you prefer, receive both a heart and portfolio transplant during one trip to your favorite medical facility.[2] In a nation which thrives on transfusions of credit, eleemosynary organizations naturally would be expected to enter the public money market to finance their expanding public services. Issuing half a billion dollars of unregistered securities each year, however, exceeds all expectations.[3]

Every state except Delaware monitors the sale of securities[4] through a combination of antifraud and registration laws. The antifraud provisions generally authorize state administrative agencies to investigate and to seek injunctive action against the sale or proposed sale of fraudulent securities.[5] The registration provisions attempt to prevent fraudulent or unqualified issuers from entering the money market by requiring varying degrees of disclosure of information to purchasers or regulatory agencies by issuers and sellers of securities.[6] Most state legislatures, however, have found that regulation of certain segments of the securities market is unnecessary, either because other governmental control is available[7] or because the nature of the issuer or the transac-

1. *Church Bond Blues,* Wall St. J., Nov. 8, 1967, at 1, col. 1. The quote is from sales material for securities "issued" by Bethel Baptist University of Colgate, Oklahoma, a non-existent university.

2. *See Ziegler Company Grows by Getting Individuals, Rather Than Institutions, to Buy Bonds,* Wall St. J., May 15, 1972, at 12, col. 1 [hereinafter referred to as *Ziegler Company Grows*], for a description of the sale of bonds in a hospital lounge.

3. *See Church Bond Blues, supra* note 1.

4. Although the term "securities" is usually technically defined by statute, the statutory definitions are not only vague but have been judicially expanded. It is sufficient for present purposes to view securities as investments in common enterprises, with profits resulting solely from the efforts of others. See Sire Plan Portfolios, Inc. v. Carpentier, 8 Ill. App. 2d 354, 132 N.E.2d 78 (1956). Generally, the securities issued by nonprofit organizations are limited to bonds.

5. *See* L. Loss & E. Cowett, Blue Sky Law 21-26 (1958).

6. *Id.* at 26-42.

7. Lane, *Securities Exemptions for Small Corporations,* 8 Clev.-Mar. L. Rev. 152,

tion is such that regulation would be inappropriate.[8] Therefore, they have provided broad exemptions in the registration scheme to minimize regulatory burdens in those instances.[9] One such extrication exempts securities issued by nonprofit organizations.

Although the nonprofit or eleemosynary[10] exemption has been present in blue sky law almost since the inception of state regulation, there have been few attempts to evaluate its utility. Such an inquiry has become particularly important in light of the relatively recent proliferation of institutional securities. This discussion will analyze problems occasioned by the exemption and recommend appropriate adjustments to the *Arizona Securities Act of 1951*. Developments in the financing patterns of nonprofit organizations will be examined to determine whether the current form of exemption is warranted. The conclusion is reached that some form of investor protection has become necessary. Then, after assessing the extent of control which is practical, blue sky laws will be surveyed to summarize trends in the regulation of the securities issues of nonprofit organizations. Finally, Arizona's securities laws will be examined and amendments proposed.

Developments in Institutional Financing

Institutional financing during the first third of this century remained private and conventional. Investments in eleemosynary organizations were infrequent and insubstantial; most often the investors were local banks or philanthropists.[11] Since the depression, however, nonprofit institutions have significantly altered their financing patterns

169 (1959). See ARIZ. REV. STAT. ANN. §§ 44-1843(1)-(5) (Supp. 1972-73), exempting securities issued by the United States or its political subdivisions, banks, building and loan associations, insurance companies and public utilities if such issuers are regulated by federal or state agencies.

8. For examples of exempted issues, see ARIZ. REV. STAT. ANN. §§ 44-1843(6)-(10) (1967), exempting eleemosynary securities, securities listed on specified stock exchanges, negotiable instruments, foreign securities and certain secured debts. For a variety of exempted transactions, see *id.* § 44-1844. *See also* UNIFORM SECURITIES ACT, § 402; 15 U.S.C. §§ 77(c), (d) (1970).

9. *Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 1st Sess. 96 (1933).

10. The terms "eleemosynary," "charitable," "institutional" and "nonprofit" are used interchangeably. Unless otherwise noted, the terms "exemption" and "exempt" are used throughout the discussion in reference to registration by description and registration by qualification, both of which require detailed disclosure, and not to registration by notification which entails only a notice of intent to sell. See LOSS, SECURITIES REGULATION 54-61 (2d ed. 1961). *Compare* ARIZ. REV. STAT. ANN. §§ 44-1871 to -1878 (1967) (registration by description) *and id.* §§ 44-1891 to -1900 (registration by qualification) *with* ME. REV. STAT. ANN. tit. 32, § 871 (Supp. 1972) (registration by notification).

11. For an analysis of the decline of American philanthropy after 1930, see JENKINS, PHILANTHROPY IN AMERICA 137-41 (1950); THE YEARBOOK OF PHILANTHROPY (J. Jones ed. 1950). These authorities attribute the decline to the depression and World War II. The current shortage of capital, however, appears to have been caused by expanded services.

and have entered the public money market. By 1967, they were issuing securities at an estimated rate of almost $500 million each year.[12] There is evidence that the rate has and will continue to increase rapidly,[13] especially since these securities fulfill a demand for short term bond investments yielding returns comparable to returns on corporate bonds.[14]

With the increase in the quantity and dollar value of institutional securities came the trend of the small, individual purchaser buying such securities. In fact, the typical "investor" in this emerging segment of the securities market has been described as follows:

> Our typical customer lives in rural America. . . . He's at least 55 years old, the mortgage is paid off, and the kids are gone. And he has maybe $2,000 to $5,000 to invest. He's not rich, so he's not worrying about income taxes . . . but he is interested in income. So he buys an 8% bond from us. That's the kind of individual that is the backbone of our business.[15]

According to this description, the purchasers are neither experienced nor trained investors; a typical purchaser is likely to be a laborer who wants to see a local hospital built for his family, or a devout individual who believes that he is performing a religious duty. Such investors frequently fail to separate the value of the eleemosynary organization from the financial merits of the proffered securities. Moreover, with the small amount of investment capital that they have available, these

---

12. *Church Bond Blues, supra* note 1.

13. During the first half of 1971, the Ziegler Company, the leading institutional underwriter, sold around $124 million in bonds issued by nonprofit organizations. That amount was more than their total bond sales for each year throughout the late 1960's. Robert W. Baird & Co., The Ziegler Company, Inc. at 12, Dec. 7, 1971 (prospectus). In fact, Ziegler's volume of hospital bonds has increased 250 percent in the past 10 years. Cherry, *Many Hospitals, Hard Pressed for Funds, Find Relief in Tax-Exempt Bond Market,* Wall St. J., Sep. 7, 1972, at 30, col. 2 [hereinafter referred to as *Many Hospitals*]. *See also* FORTUNE, Apr. 1972, at 22; *Ziegler Company Grows, supra* note 2.

The increase in the volume of securities sold has not been the only development in the nonprofit organization financing pattern. In the past two years an increasing number of "quasi-municipal" nonprofit-hospital organizations have appeared. Local and state authorities form hospital authorities to issue the securities, to construct the facilities and to lease the facilities to the nonprofit organizations. The two major advantages are a tax exempt status (and consequently a lower debt service) for the bonds and an exemption from securities registration under the governmental exemption. See *Many Hospitals, supra* note 13. In addition, these hospital authorities are usually exempted or able to avoid debt limitations imposed upon municipal corporations by state laws. See "Bonded Indebtedness: Local Government Finance," 14 ARIZ. L. REV. 409, 575 (1972).

14. *See* text accompanying note 15 *infra.* For examples of securities issued by nonprofit organizations, see Wall St. J., Mar. 22, 1972, at 21, col. 4 (Piedmont Hospital, Inc.); Wall St. J., Sept. 27, 1967, at 22, col. 3 (Montreal Catholic School Commission); Wall St. J., Sept. 19, 1967, at 30, col. 3 (Sisters of St. Joseph of Nazareth); Wall St. J., Sept. 28, 1965, at 24, col. 4 (Sisters of St. Dominic); Wall St. J., Dec. 6, 1963, at 17, col. 1 (School Sisters of Notre Dame of Dallas).

15. *Ziegler Company Grows, supra* note 2.

purchasers are unable to diversify their portfolios, and a single unsuccessful investment can cancel a lifetime of saving.

The disadvantageous position of these purchasers in securities transactions is compounded by the distribution procedures utilized by the issuing institutions. The procedures tend to isolate the purchasers from analysis of the securities by disinterested parties. Approximately 65 percent of the eleemosynary securities issued are sold directly to the public through underwriters who earn sales commissions from the issuers.[16] While no disclosure of information is required by law for such sales, these issues are usually accompanied by circulars which resemble a prospectus.[17] These brochures, however, are usually written more for promotional purposes than for informative disclosure.[18] Solely on the basis of the information in these circulars, small, individual investors have purchased between 70 and 80 percent of the underwritten institutional securities issued in recent years.[19] The only protection for investors comes from the self-regulation of underwriters,[20] who have been extremely reluctant to underwrite questionable issues. Consequently, underwritten issues have seldom been in default[21] and are almost never questioned by securities regulators.[22]

The distribution procedure for non-underwritten institutional securities represents a clearer case of isolating investors from independent opinions regarding the advisability of the investment. These issues are usually distributed under the direction of "financial program supervisors" who act as consultants to the issuers by providing organizational and legal services, printed certificates and sales brochures.[23] The securities are sold directly to the public by the issuers;[24] no one stands between the issuers' representations and the potential investors. This system has become suspect since the result is a high rate of purchase by

16. *See Church Bond Blues, supra* note 1.
17. *Id.*; *see, e.g.*, B.C. Ziegler & Co., Sun Coast Hospital, Inc., Feb. 1, 1972 (prospectus); B.C. Ziegler & Co., John F. Kennedy Memorial Hospital, Feb. 1, 1972 (prospectus); B.C. Ziegler & Co., Women's Hospital Foundation, Feb. 15, 1972 (prospectus).
18. The circulars not only contain much less information, but explanations of the risks involved in the investment are conspicuously absent. Other unusual features include photographs on the covers and warnings of non-registration on the last page.
19. Robert W. Baird & Co., *supra* note 13, at 12. *See also Ziegler Company Grows, supra* note 2.
20. The underwriters have attempted to establish self-regulation by proposing the adoption of an underwriters' code. This proposal has been rejected by securities regulators. See *Church Bond Blues, supra* note 1, at 21, col. 3.
21. The Ziegler Company recently stated that none of the 758 hospital issues it has underwritten has ever defaulted. Similarly, as of late in 1971, 99.998 percent of its total underwritten issues since 1913, which include an occasional profit-making corporation, have a similar record. Robert W. Baird & Co., *supra* note 13, at 11.
22. *Church Bond Blues, supra* note 1, at 21, col. 4.
23. *Id.* at 1.
24. *Id.*

small, individual purchasers[25] of securities which, overall, have a higher rate of default than underwritten securities.[26] Despite these trends, however, securities regulators generally agree that eleemosynary securities have presented no widespread problems of default.[27]

The recent popularity of institutional issues among small investors and the increased volume of sales, however, have prompted numerous fraudulent operations. Those who contemplate engaging in securities fraud look to that area of the market offering a maximum return at a minimum risk.[28] Because nonprofit organizations are exempted not only from registering their securities, but also from notifying the state of impending issuance,[29] this area has proved a boon to con-artists.

The most common fraudulent scheme involving eleemosynary securities victimizes the weakest prey—the unsophisticated individual investor[30]—through the sale of securities of non-existent organizations. This tactic generally centers around phony religious associations since the aged and devout are often willing to do their "Christian duty" by purchasing institutional securities without inquiry into their legitimacy.[31] Unsophisticated investors are not the only victims, though, as other schemes also defraud legitimate organizations.[32] Once promoters have persuaded a reputable organization to sponsor an issue, they exploit its name to establish two additional markets: the members of the organization itself and sophisticated investors. The operators then either sell more securities than authorized[33] or pay only a small fraction of the proceeds to the organization while retaining an exorbitant "commission."[34] Multimillion dollar frauds have become increasingly common in this area and schemes exceeding $10 million are not un-

25. Although there are no statistics available, there are several factors that indicate that the rate of purchase by small, individual purchasers is higher for non-underwritten securities than for underwritten securities. Most importantly, the former are distributed locally and the class of large investors is limited. Second, the unit price of the securities is usually decreased to promote sales among the members of the organization. The local goals of the organization also contribute to the purchase by small investors. *See generally id.*

26. Again, there are no statistics available, but one Securities and Exchange Commission investigator has stated that he could recall more than a dozen issues of religious organizations in New Mexico and Texas which had defaulted. *Id.* at 21, col. 4. Arizona investors experienced a similar series of defaulting bonds which were issued by nonprofit institutions to finance hospital facilities during the 1960's. Letter from Claude D. Keller, Arizona Director of Securities, Mar. 3, 1972, on file in the *Arizona Law Review* offices.

27. *See Church Bond Blues, supra* note 1, at 21, col. 4.

28. *See Hearings on H.R. 4314, supra* note 8, at 99.

29. *See* text accompanying notes 70-74 *infra.*

30. *See generally Church Bond Blues, supra* note 1, at 21, col. 3.

31. *Id.* at 1, col. 1.

32. *See, e.g.,* Wall St. J., Oct. 29, 1970, at 8, col. 2; Wall St. J., Sept. 16, 1968, at 8, col. 2; Wall St. J., Nov. 13, 1967, at 30, col. 2.

33. *Church Bond Blues, supra* note 1, at 21, col. 3.

34. *See* Wall St. J., Sept. 16, 1968, at 8, col. 2.

known.[35] The problem became so acute in certain "Bible-belt" states that several of them have altered their exemption procedures to protect people from naivete caused at least in part by their own religious zeal.[36]

It has thus become necessary to check the rising trend of fraudulent practices in the institutional securities area. Any regulation, however, should be exercised carefully to avoid unduly hindering legitimate nonprofit organizations. The burden imposed upon an issuer of securities under blue sky registration laws can be great indeed.[37] Undoubtedly, a requirement that all nonprofit organizations meet the rigorous registration and disclosure requirements imposed upon other issuers would obtund their efforts to benefit the community. Therefore, a modified form of regulation, to be exerted only when and to the extent necessary to protect the public interest, must be developed. Although balancing these goals is difficult, an analysis in terms of weighing the benefits and burdens of governmental regulation[38] will aid in developing appropriate remedies. Until these countervailing factors have been evaluated, regulation should not be extended.

Extent of Protection Necessary

Once it has been decided that the sale of institutional securities should be regulated, it must be determined what type of control would be most appropriate.[39] There is a continuing debate among securities-

35. Most of the large frauds have been effected by preying upon legitimate organizations. The recent crisis with the Baptist Foundation of America is an excellent example of the ineptness of present laws for protecting investors and organizations. Since the foundation was not required to register the issues, the Securities and Exchange Commission (SEC) was limited to injunctive action. Consequently, the foundation was able to "underwrite" securities for legitimate organizations and to delay SEC action until after it had defaulted on approximately $14 million worth of securities. Wall St. J., Dec. 22, 1970, at 4, col. 2; Wall St. J., Oct. 29, 1970, at 8, col. 2. Fortunately, the Commission has been able to gather evidence of fraud prior to the sale in other cases. See Wall St. J., Mar. 31, 1966, at 10, col. 1.

36. *See* text accompanying notes 52-63 *infra.*

37. *See* text and notes 48-53 *infra.*

38. *See* Bromberg, *Texas Small Offering Exemptions,* 18 SW. L.J. 537, 559 (1964).

39. Constitutional questions may be raised by the introduction of securities regulation into this area. Since religious organizations constitute a large portion of the nonprofit organizations, any regulation may produce allegations of infringement on the first amendment's freedom of religion clause. Such allegations are unconvincing, however, since it has long been established that freedom of religion embraces two concepts: freedom to believe and freedom to act. While the first may be absolute, the second remains subject to regulation for the protection of society. Cantwell v. Connecticut, 310 U.S. 296, 303-04 (1940). Securities laws do not restrict freedom to believe, but only proscribe that conduct which amounts to unlawful dealings in securities. *Cf.* Taylor v. Knowles, BLUE SKY L. REP., ¶ 70,884 (E.D. Wis. 1970) (freedom of speech). The mere inclusion of religious organizations in state regulation does not constitute a regulation of religious practices. A state may control the disposition or transfer of the property of a religious body without interfering with religious practices so long as the decision is based upon neutral principles of property law applicable to all persons or organizations. Presbyterian Church v. Mary Elizabeth Blue Hull Church, 393 U.S. 440, 449 (1969); Maryland & Virginia Eldership of the Churches of God v. Church of God at Sharpsburg, Inc., 396 U.S. 367, 370 (1970) (Brennan, J.,

law analysts as to whether a "merit" or a "truth" approach is the better system for providing investor protection.[40] One school of thought advocates that the state should require the issuer only to disclose the whole truth and nothing but the truth to the investor.[41] The burden is then on the investor to protect himself by obtaining an accurate evaluation of the disclosed information. Others submit that the state should evaluate the securities before they are offered for sale.[42] Although the standards vary among states, this merit approach usually involves some type of fairness to investors test.[43] An analysis of the two systems reveals that the merit system is the better scheme for regulating institutional securities.

The potential value of the disclosure approach lies in the assumption that once the entire truth is exposed, the investor is capable of making or obtaining a knowledgeable judgment. This assumption has been criticized in regard to investors generally.[44] "[E]ven the whole truth cannot be told in such simple and direct terms as to make investors discriminating. A slow educational process must precede that. Those who need investment guidance will receive small comfort from the balance sheets, statistics, contracts and details which the prospectus reveals."[45] The problem is even more pronounced where typical purchasers of eleemosynary securities are involved. It is probable that they lack the training and experience necessary to decipher such information and arrive at a proper investment decision.[46] Moreover, the distribution procedures used, particularly in the case of financial supervisor-managed issues, have removed the likelihood of professional advice.[47]

---

concurring). Securities laws are neutral principles applicable to all classes of securities. *Cf.* Cantwell v. Connecticut, 310 U.S. 296 (1940).

40. *See* Jennings, *The Role of the State in Corporate Regulation and Investor Protection,* 23 L. & CONTEMP. PROB. 193 (1958). It should be noted that states rarely employ a pure merit or disclosure approach; the two methods are usually combined with the emphasis placed on one or the other. In Arizona, for example, registration by qualification is obtained by complying with the required disclosure under ARIZ. REV. STAT. ANN. § 44-1984 (1967), but the registration is subject to denial or revocation under *id.* § 44-1921, if the sale of the securities would be unfair or inequitable to purchasers.

41. *See* Armstrong, *The Blue Sky Laws,* 44 VA. L. REV. 713 (1958); Bloomenthal, *Blue Sky Regulation and the Theory of Overskill,* 15 WAYNE L. REV. 1447 (1969); Cohen, *Truth in Securities Revisited,* 79 HARV. L. REV. 1340 (1966).

42. *See* Hueni, *Application of Merit Requirements in State Securities Regulation,* 15 WAYNE L. REV. 1417 (1969); Joslin, *Federal Securities Regulation from the Small Investors' Perspective,* 9 J. PUB. L. 219 (1957); Orschel, *Administrative Protection for Shareholders in California Recapitalizations,* 4 STAN. L. REV. 215 (1952).

43. *See* LOSS & COWETT, *supra* note 5, at 67-79.

44. *See, e.g.,* Douglas & Bates, *The Federal Securities Act of 1933,* 43 YALE L.J. 171, 171-72 (1933); Hueni, *supra* note 42, at 1418; Jennings, *supra* note 40, at 210; Joslin, *supra* note 42, at 221.

45. Douglas & Bates, *supra* note 44, at 171-72.

46. *See* text accompanying note 15 *supra.*

47. *See* text accompanying notes 16-27 *supra.*

Even assuming that a disclosure system would provide adequate protection, the cost of disclosing the entire truth is likely to outweigh the benefits to be derived. Experience with the federal securities laws has shown that disclosure is an expensive and time consuming process.[48] If the documents are prepared in accordance with a state disclosure scheme,[49] similar problems may arise.[50] Moreover, the burden of preparing a registration statement or prospectus to comply with disclosure standards is especially onerous to eleemosynary issuers, since many of them offer relatively small issues and the unit overhead cost of an issue increases with the decrease in the size of the issue.[51] Hence, the smaller the issue, the smaller the proportion of the proceeds available for providing services. At some point it becomes unprofitable to issue the securities, and the organization must either forego providing the services which could have been rendered with the funds or obtain conventional financing.[52] It is evident that society has been unwilling to impose the full disclosure requirement on nonprofit organizations, probably because the burdens involved in such a scheme outweigh any possible benefits.[53]

It has been suggested that the key to successful state regulation of all securities lies in the merit approach.[54] This system appears particularly well suited for regulating eleemosynary securities. By requiring

48. It may require over a year and the aid of several professions to comply with the federal disclosure requirements. The time and expense vary, of course, with the size and business structure of the issuer. For a detailed discussion of the federal disclosure requirements, see Heller, *Disclosure Requirements Under Federal Securities Regulation*, 16 BUS. LAW. 300 (1961). *See also* Cohen, *supra* note 41.

49. If a prospectus has been prepared in compliance with federal requirements, it often may be used to satisfy the state requirements as well. See ARIZ. REV. STAT. ANN. § 44-1896 (1967); Loss *supra* note 10, at 54-55. An issuer may qualify for registration under the Arizona act by filing the prospectus, a consent to service of process, an application and filing fees. ARIZ. REV. STAT. ANN. § 44-1892 (1967).

50. Disclosure requirements under blue sky laws are usually much less inclusive than under federal law, but the burden may still be great in some cases. See Loss *supra* note 10, at 54-61. One major reason for the reduced burden under blue sky laws may be the frequent inclusion of merit requirements. See Loss note 10 *supra*, at 54-61. The disclosure requirements under the Arizona Act are set forth in ARIZ. REV. STAT. ANN. § 44-1894 (1967).

51. Bromberg, *supra* note 38, at 564; Jennings, *supra* note 40, at 214 n.130.

52. Nonprofit organizations have the option of securing conventional mortgage financing to obtain funds, but the advantage of the lower debt service which is gained by issuing the securities is then lost. The money that would have been spent to issue the securities would then be spent for increased interest payments. Thus, once the cost of issuance plus the debt service on the securities reaches the equivalent of what many nonprofit organizations consider prohibitive, borrowing the funds becomes infeasible. *See generally Many Hospitals, supra* note 13.

53. Nevada and Oregon are exceptions to the general rule. Under NEV. REV. STAT. § 90.130 (1968), a nonprofit organization is required to disclose any information required by the administrator concerning the form, place, method and qualifications for doing business, financial condition and history. The administrator is apparently given wide discretion. Under ORE. REV. STAT. § 59.065 (1971), the applicant must file a registration statement containing such information and exhibits as the commissioner shall require. Again, the administrator has been delegated wide discretionary authority.

54. Jennings, *supra* note 40, at 212.

a state agency to review the merit of the securities, potential investors are provided with an independent evaluation of the securities by persons who are usually trained and experienced in interpreting the pertinent data. Although the governmental agency cannot guarantee the success of the investment, it can evaluate the fairness of the offer to the potential purchasers.[55] In most cases this would far exceed investor protection under the disclosure procedure.

The merit system has been questioned on the ground that the standards for approval are frequently too vague.[56] If available empirical studies are dependable, however, they indicate that the procedure can be quite effective and practical, especially where there is a special need for investor protection.[57] Not only are the standards functional, but if they are properly applied applicants for registration generally receive fair treatment.[58] The direct cost to the state for such regulation is probably no more than for the disclosure system,[59] and certain indirect costs of regulation are decreased.[60] In addition, the quantity of information necessary to satisfy the merit test is less than that required in a prospectus to be presented to investors.[61] Since the registration statment is for the state agency, it is much simpler than a prospectus and much less costly to prepare.[62] The amount of information necessary to make a determination will, of course, vary with the experience and capabilities of the members of the state agency.

It appears that the solution to providing adequate but justifiable protection for purchasers in the institutional securities market lies somewhere between an uncontrolled exemption and complete disclosure—a merit exemption or a merit registration. The exact procedure must be determined by the inclination of the particular state legislature considering the issue and the context of pre-existing state law.

Development of Current Eleemosynary Exemptions

The diverse philosophies underlying blue sky laws have led to

55. For a review of the various "fairness" standards and their application under blue sky laws, see Loss, *supra* note 10, at 55-56. *See also* Loss & Cowett, *supra* note 5, at 67-79.

56. Jennings, *supra* note 40, at 245.

57. *See* Orschel, *supra* note 42; Zeller, *The Economic Aspects of State Regulation of Securities*, 1942 Wis. L. Rev. 541.

58. Orschel, *supra* note 42, at 235.

59. *Id.*; Zeller, *supra* note 57, at 544.

60. *See* Bromberg, *supra* note 38, at n.111; Zeller, *supra* note 57, at 545. The greatest indirect cost for regulating securities is usually incurred in attempting to correct past fraudulent conduct.

61. Jennings, *supra* note 40, at 214.

62. *Id.*; Orschel, *supra* note 42, at 235, states that the merit proceedings studied did not impose any disproportionate burdens upon the applicants.

varying forms of exemptions among the states. A convenient method of analyzing and summarizing these statutory schemes is to review the three basic factors which all such statutes must encompass: the scope, the invocation and the termination of the eleemosynary exemption.

The initial inquiry is to consider which organizations should qualify for the exemption. The most liberal response has been to exempt all organizations not organized or operated for profit.[63] The majority of states have been more cautious in their approach, however. Realizing the potential for abuse in such a broad exemption, various legislatures have enacted exclusive-purpose clauses in addition to the nonprofit limitation. These clauses commonly require that the organization must be religious, educational, benevolent, fraternal, charitable or reformatory in order to qualify for the registration exemption.[64]

Beyond these basic prerequisites for exemption,[65] there are other qualifications which have been utilized frequently. One is to require that no portion of the organization's net earnings may inure to the benefit of any person, private stockholder or individual.[66] This prevents individuals from deriving private gain through receipt of benefits intended for eleemosynary associations. The phrase "inure to the benefit of" censures inappropriate distributions in any form, while the "net earnings" phraseology allows organizations to incur reasonable operating expenses for both goods and services.[67] A second form of

63. Initially, several states exempted all nonprofit organizations without qualification. See R. REED & L. WASHBURN, BLUE SKY LAWS, at 15 (Florida), 24 (Idaho), 101 (Ohio) and 144 (West Virginia) (1921). Texas is the only state which has retained this broad exemption. TEX. REV. CIV. STAT. art. 581-6(E) (1964).

64. *See, e.g.*, ALA. CODE tit. 53, § 37(h) (Cum. Supp. 1971); MICH. STAT. ANN. § 19.776(402)(8) (Cum. Supp. 1971); NEB. REV. STAT. § 8-1110(8) (1970); WASH. REV. CODE ANN. § 21.20.310(9) (1961).

65. Many state legislatures have amended the blanket exemption by adding qualifications to solve actual or anticipated abuses. These scope qualifications are local in character and reflect policies of individual states rather than broader trends. For example, one type of qualification places a registration requirement upon certain classes of securities, such as evidences of indebtedness, CAL. CORP. CODE § 25100(j) (West Supp. 1971); OHIO REV. CODE ANN. § 1707.02(I) (Page Supp. 1970), or liens upon revenue producing property subject to taxation, ARIZ. REV. STAT. ANN. § 44-1843(6) (Supp. 1972-73); MISS. CODE ANN. § 5384(6) (Cum. Supp. 1971); VT. STAT. ANN. tit. 9, § 4203(5) (1970). Another type of qualification requires specific organizations such as medical organizations, ARIZ. REV. STAT. ANN. § 44-1843(6) (Supp. 1972-73), or foreign agricultural cooperatives, ARK. STAT. ANN. § 67-1248(8) (1966), to register their securities. Several states require registration for all securities issued by non-resident associations. See CONN. GEN. STAT. ANN. § 36-322(a)(7) (1958); TEX. REV. CIV. STAT. ANN. art. 581-6(E) (1964); WIS. STAT. ANN. § 551.22(8) (Special Pamphlet 1970).

66. *See, e.g.*, ARIZ. REV. STAT. ANN. § 44-1843(6) (Supp. 1972-73); ILL. REV. STAT. ch. 121 1/2, § 137.3(H) (1969); OHIO REV. CODE ANN. § 1707.02(I) (Page Supp. 1970); S.D. COMPILED LAWS ANN. § 47-31-76 (1967).

67. California has placed stringent restrictions upon the receipt of association funds by promoters in any capacity. CAL. CORP. CODE § 25100(j) (West Supp. 1971), provides in part: "[t]his exemption does not apply to the securities of any non-profit organization if any promoter thereof expects or intends to make a profit directly or indirectly from any business or activity associated with the organization or from remuneration received from such non-profit organization."

qualification broadens the scope of the basic exemption by including specific organizations which are not created or operated exclusively for the enumerated purposes. These additions reflect a concern that the exclusive-purpose clause forecloses the nonprofit exemption privilege to associations which provide valuable and direct benefits to the public.[68] Although some states have addressed this problem by granting exemptions to specific groups such as chambers of commerce or trade and professional organizations,[69] such specificity does not wholly solve the problem since other equally deserving organizations remain excluded. County fair associations, conservation groups and urban-problem-solving associations are examples of organizations created for direct public benefit, and yet each group might be ineligible under such a statute. If organizations are, in fact, nonprofit and operated for direct public benefit, they should be granted an exemption.

The second factor to be considered in exempting nonprofit organizations from registration is the invocation procedure—the procedure necessary to obtain the privilege. In most states, including Arizona, neither the organization nor the state is required to certify the organization's qualification.[70] The organization simply declares itself as exempt, usually through its articles of incorporation or bylaws. This procedure can cause serious problems. Since the state receives no official notice of the intent to sell or of the sale, it is often relegated to corrective action after a violation of the law occurs. At that point, the state may attempt either to disqualify the security from the definition of "exempt security"[71] or, in a proper case, to invoke the anti-fraud provisions.[72] Such remedial action is of little consequence to the investor who has already been defrauded.[73] Moreover, until the seller or issuer actually commits fraud, the state is powerless to prevent the sale of questionable securities.[74]

68. MARSH & VOLK, PRACTICE UNDER THE CALIFORNIA CORPORATE SECURITIES LAW OF 1968, 150 (1969).

69. *See* note 64 *supra*; UNIFORM SECURITIES ACT § 402(a)(9).

70. Many states provide, however, that if the state challenges the organizations qualification for the exemption, the burden of proving the exemption is on the organization. See ARIZ. REV. STAT. ANN. § 44-2033 (1967); UNIFORM SECURITIES ACT, § 402(d).

71. *See, e.g.*, Securities & Exchange Comm'n v. Universal Services Ass'n, 106 F.2d 232 (7th Cir. 1939); Taylor v. Knowles, BLUE SKY L. REP., ¶ 70,884 (E.D. Wis. 1970); Securities & Exchange Comm'n v. Children's Hosp., 214 F. Supp. 883 (D. Ariz. 1963); Saxon v. Arkansas State Fair Ass'n, 181 Ark. 750, 27 S.W.2d 505 (1930).

72. *See* materials cited in note 32 *supra*.

73. In most instances, the purchaser is also granted civil remedies. See LOSS & COWETT, *supra* note 5, at 129-79. Arizona's civil remedies are contained in ARIZ. REV. STAT. ANN. §§ 44-2001 to -2005 (1956). These remedies have been designed primarily to remedy "technical" fraud, but in cases involving eleemosynary organizations investors may be reluctant to sue the issuer for technical violations. If a blatant case of common law fraud is involved, the purchaser is usually faced with the problem of locating the defrauder and sufficient assets to recover all losses.

74. This problem is not as serious in Arizona as in some states, since ARIZ. REV.

Recognizing these deficiencies, several states have progressed cautiously toward increased regulation of the institutional securities industry. Though the movement remains inconspicuous, it has gained momentum with the increased financing activity of nonprofit organizations. Some states now require charitable organizations issuing securities to file a statement notifying the securities regulation agency of the prospective sale. In effect, these states have created a requirement of registration by notification.[75]

Such a requirement provides minimal investor protection since it only gives the state notice of the sale and of the identity of the issuer.[76] Other states have specifically reserved the right to require the filing of supplemental information.[77] The most stringent requirements are found in the recent amendments to the Kansas and Minnesota securities laws. Minnesota requires all nonprofit issuers to submit a statement that the issuer need not apply for registration by application and a "descriptive circular or statement briefly describing the securities."[78] Kansas requires claims of exemption for the issuance of securities exceeding $25,000 to be accompanied by the statement of a practicing Kansas attorney verifying that the securities are exempt and that they are secured by a trust indenture which is a legal obligation of the issurer.[79] The application for exemption must also be accompanied by "such information . . . as the commissioner shall by rule prescribe."[80]

Requirements such as those found in the Minnesota or Kansas statutes combat two basic problems. First, they operate to place the state on notice so that it may act to prevent fraudulent or unsound securities from reaching the market, without unduly burdening legitimate charitable organizations. Second, they make it more likely that only those entitled to the exemption will be allowed to use it. Any

---

STAT. ANN. § 44-1991(3) (1956), prohibits any transaction "which operates or *would operate* as a fraud or deceit" (emphasis added).

75. The distinction between an exemption and registration by notification is more apparent than real. In most cases, sales are legal upon filing the notice containing the prescribed information and may continue until the securities regulator issues a stop order, either on a fraud or fairness standard. LOSS & COWETT, *supra* note 5, at 34.

76. *E.g.*, IDAHO CODE § 30-1435 (Supp. 1970); LA. REV. STAT. ANN. § 51:704(12) (Supp. 1972).

77. ME. REV. STAT. ANN. tit. 32, § 871 (Supp. 1972); MASS. ANN. LAWS ch. 110A, § 5 (1967). While Florida does not require a notice of intention to sell to be filed, it does require that each offeree receive "a written report as to the feasibility of the project and the full disclosure of the method of financing." FLA. STAT. ANN. § 517.05 (5) (Supp. 1971-72).

78. MINN. STAT. ANN. § 80.09 (Supp. 1972).

79. KAN. STAT. ANN. § 17-1261(h) (Supp. 1971). In addition to requiring action by the organization, Kansas requires the state commissioner to grant a certificate of exemption within 30 days of the application for exemption, unless he has denied the exemption. *Id.*

80. *Id.*

state re-evaluating its eleemosynary exemptions should consider similar provisions.

The final element to be considered is the power of the state administrative agency to deny or revoke the exemption from registration. This power over institutional issuers under blue sky laws was uncommon until it was introduced in section 402(c) of the *Uniform Securities Act.* Although this section has been adopted in a large number of jurisdictions,[81] Arizona is not among them.

Section 402(c) grants the state regulatory agency power to issue an order revoking or denying the exempt status of an individual issuer, but not the power to promulgate rules revoking any class of statutory exemptions.[82] This revocation power includes the right to suspend exemptions pending litigation. The section also provides that the issuer must be given notice and an opportunity for a hearing on all adverse rulings. The greatest flaw within section 402(c) is that it does not specify the grounds for invoking the denial or revocation powers, and states adopting it have consistently failed to remedy the problem. Presumably, this section could be invoked when an organization's activities carried it outside the definition of an exempt organization or when it participated in fraudulent activities. Whether the section can be invoked when the regulatory agency simply finds that such action would be in the interest of preserving fair investments to the public is unknown.[83] Future adoptions of the provision should provide substantive grounds for exemption denial or revocation to avoid forcing the securities regulators to act without guidelines.[84]

By granting to the securities agency the power to deny or revoke an exemption on an individual basis, the scope and invocation provisions of the exemption can be simplified. As expressed by the draftsmen of the *Uniform Securities Act*: "[p]resumably the power granted by [section 402(c)] will be exercised sparingly. But its presence makes it possible to simplify . . . exemptions by omitting some of the conditions which are now commonly found but were obviously inserted only to take care of the unusual case."[85] In other words, the scope of the exemption can be broadened to allow any nonprofit organization operating directly for the public's benefit to apply for the privilege.[86]

81. *See, e.g.*, MICH. STAT. ANN. § 19.776(402)(C) (Supp. 1971); N.J. STAT. ANN. § 49:3-50(C) (1970); P.R. LAWS ANN. tit. 10, § 882(C) (Cum. Supp. 1970); WASH. REV. CODE ANN. § 21.20.325 (Supp. 1971).

82. UNIFORM SECURITIES ACT § 402(c) (draftsmen's commentary).

83. Because Professor Loss failed to include fairness in the *Uniform Securities Act,* it has been argued that he rejected the "fairness" concept. See Jennings, *supra* note 40, at 245.

84. *Cf.* LOSS & COWETT, *supra* note 5, at 63.

85. UNIFORM SECURITIES ACT § 402(c) (draftsmen's commentary).

86. *See id.* § 402(a)(9) (draftsmen's commentary).

The invocation and termination procedures which require all applicants to notify the securities regulators of their intentions completes the scheme by insuring that there is an opportunity to deny the exemption to unqualified issuers on an individual basis. The result is an increased utilization of the privilege by truly eleemosynary organizations and a reduced utilization by organizations which present a danger to the investing public.

As illustrated by the variety of state schemes generally, it is possible to devise any number of procedures for regulating institutional securities which do not unduly interfere with the eleemosynary organization's efforts to serve the community. The remaining problem is to devise a scheme which functions within the context of Arizona's present securities laws.

Proposals for Amending Arizona's Blue Sky Laws

The *Arizona Securities Act of 1951*[87] presents a receptive context and unique structure which will accommodate the proposed innovations with minimal amendment to existing law. Accordingly, the basic proposal is to transfer the eleemosynary exemption from the autogenetic class to a conditional class of exemptions. In addition, the securities commission will be given the power to revoke such exemptions by order upon specified grounds after complying with notice and hearing procedures. Again, the most convenient manner of discussion is the scope, invocation and termination analysis.

Currently, to qualify for the eleemosynary exemption in Arizona an organization must meet six requirements. It must (1) be incorporated; (2) be organized and operated exclusively for religious, educational, benevolent, fraternal, charitable or reformatory purposes; (3) not be for pecuniary profit; (4) not distribute net earnings to shareholders; (5) not pledge revenue producing property subject to taxation; and (6) not be organized for health services.[88] Of these requirements, only the third and fourth should be retained in their present form. The nonprofit requirement remains the vital element of the exemption, and the prohibition against distributing net earnings to shareholders serves to define the term "nonprofit." The remaining prerequisites should be modified or eliminated in order to reflect the policy of providing investor protection without imposing undue burdens on worthy organizations.

87. ARIZ. REV. STAT. ANN. §§ 44-1801 to -2037 (1956 and as amended Supp. 1972-73).
88. *Id.* § 44-1843(6) (Supp. 1972-73).

Limiting the exemption to incorporated organizations discriminates against both associations and individuals that have chosen other forms of organization for any number of valid reasons. For securities regulation purposes, the line between incorporation and a different business structure is arbitrary since it is based neither on considerations of solvency nor of legitimacy. It is the financial stability of the enterprise and not its form of operation which determines these factors. Therefore, Arizona should follow the example of Congress[89] and other states[90] and provide an exemption to all associations which meet the other requisites.

As noted previously, numerous states have found the exclusive-purpose clause overly restrictive.[91] If Arizona's clause is applied literally, organizations such as chambers of commerce, professional and trade organizations, which are often operated for broader public benefit than currently exempted associations, might be ineligible for exemption.[92] A broad exemption for all entities organized and operated exclusively for direct public benefit would ensure the privilege to all those whose function is within the broad policy and spirit behind the exemption.

With the accompanying power to deny or revoke the exemption on a case-by-case basis, the remaining restrictions become superfluous. The prohibition against pledging the securities as liens upon revenue producing property subject to taxation is found in only two other states,[93] indicating that it has very limited use for curing abuses. This factor, coupled with the fact that, under the proposed scheme, the exemption could be denied under invocation procedures if the pledge were subject to abuse, militates in favor of deleting this scope limitation.

Another provision in the Arizona blue sky laws denies the registration exemption to medical service organizations[94] and, like the incorporation requirement and the exclusive purpose clause, should be discarded. The prohibition against exempting organizations providing

89. 15 U.S.C. § 77(c) (1970) was amended in 1934 by substituting the term "person" for "corporation." H.R. REP. No. 1838, 73d Cong., 2d Sess. 40 (1934). *See also* UNIFORM SECURITIES ACT § 402(a)(9).

90. *See, e.g.*, CAL. CORP. CODE § 25100(j) (West Supp. 1971); ILL. REV. STAT. ch. 121½ § 137.3(H) (1969); KAN. STAT. ANN. § 17-1261(h) (Supp. 1971); MINN. STAT. ANN. § 80.09 (Supp. 1972).

91. *See* text accompanying note 46 *supra*.

92. If Arizona presently allows individuals or other unincorporated associations to use the exemption, then the laws should be amended to comply with the established practice. Since issuers are not required to notify the state, it is difficult to ascertain who is taking advantage of the exemption.

93. MISS. CODE ANN. § 5384(6) (Cum. Supp. 1971); VT. STAT. ANN. tit. 9, § 4203 (5) (1970).

94. Ch. 186, [1968] ARIZ. LAWS 641.

health care was added to the statute as an emergency provision in 1968 in response to a series of defaults on bonds issued to raise funds for the construction of hospitals in various Arizona communities.[95] As the experience with underwritten hospital securities has indicated,[96] however, very few health care facilities entail high risk investments. Again, the exemption should be applied according to each fact situation, and categorical denial cannot be justified by a previous bad experience.

While the proposed modification of the scope of the exemption is directed at broadening it to include all deserving issuers, the procedures proposed for invoking the exemption have been designed to prevent financially questionable issuers from selling securities without registration as well as to prevent fraudulent issuers from selling any securities. Thus, the broader scope of the exemption will not result in decreased investor protection.

Arizona's blue sky laws present a receptive context for amendments aimed at accomplishing the objectives discussed above. In addition to the conventional issuer[97] and transaction[98] exemptions, the Arizona statutes allow the securities commission to create exemptions in certain cases by rule[99] or by order.[100] This scheme, hailed as "progressive,"[101] provides a suitable vehicle for transforming the automatic, no-notice, eleemosynary exemption of section 44-1843(6) into a contingent exemption by order under section 44-1846. Section 44-1846 is currently written as a small offering exemption which allows the commission, by special order only, to exempt individual issues of less than $200,000.[102] The applicant must submit a written petition and carry the burden of satisfying the commission as to two important conditions: that "registration is not essential to public interest"[103] and that it is not essential "for the protection of investors."[104] The pro-

95. The amendment was submitted to the legislature following the issuance of bonds with debt services of 8 percent by numerous Arizona nonprofit corporations, "allegedly organized for charitable purposes," to construct hospitals in Maryvale, Scottsdale, Mesa and other Arizona communities. The interest rate appears to have been quite high for that period. Letter, *supra* note 26.

96. *See* statistics cited note 21 *supra.*

97. ARIZ. REV. STAT. ANN. § 44-1843 (Supp. 1972-73).

98. *Id.* § 44-1844.

99. *Id.* § 44-1845 (1967).

100. *Id.* § 44-1846.

101. UNIFORM SECURITIES ACT § 402(c) (draftsmen's commentary).

102. As stated in its annual reports, the Arizona Corporation Commission has been granting approximately 160 exemptions each year under ARIZ. REV. STAT. ANN. § 44-1846 (1967). This number should be decreased by the recent amendment to the Arizona Act, *id.* § 44-1844(1) (Supp. 1972-73), granting private offering exemptions. Interview with Claude D. Keller, Arizona Director of Securities, by telephone, Oct. 26, 1972.

103. ARIZ. REV. STAT. ANN. § 44-1846 (1967).

104. *Id.*

posed change would add the eleemosynary exemption to this section, separately retain the $200,000 individual-issue exemption and retain all of the current procedures and burdens of proof.[105] The only addition to be made to the present procedure is a requirement that the commission be satisfied that the issuer is a proper party for the exemption by reason of coming within the scope provision.[106]

The totality of the amendment, then, would establish a procedure similar to that currently employed in Kansas.[107] The commission would not only have notice of all organizations seeking exemption, but would also have the power to deny the exemption if the petitioner failed to satisfy the commission that the issuer was eligible or that registration of the proferred securities would not be essential for either public or investor protection.[108] Although it is expected that denials will be infrequent, those who are found ineligible may still issue securities by registering them.

Two of the remaining amendments to section 44-1846 would require additional information to be filed with the written petition for exemption. The petitioner would be required to include all information and documents, including sales material, which the commission prescribed by rule.[109] This would not only allow the commission to acquire the information necessary to make an informed decision, but it recognizes that the commission is the best judge of what information is necessary.[110] By limiting the amendment to authority to promul-

105. Subsection (6) would be deleted from ARIZ. REV. STAT. ANN. § 44-1843 (Supp. 1972-73).

106. As the amendments are structured, an issuer applying for a small offering exemption would also be required to establish compliance with the scope of the statute. This would require only a showing that the total amount of the proposed issue did not exceed $200,000.

107. KAN. STAT. ANN. § 17-1261(h) (Supp. 1970).

108. Although such a delegation of power to regulatory agencies has provoked constitutional objections in the past, only three pre-depression cases have held such discretionary powers invalid. See People v. Beekman & Co., 347 Ill. 92, 179 N.E. 435 (1932); People v. Federal Sur. Co., 336 Ill. 472, 168 N.E. 401 (1929); Klein v. Barry, 182 Wis. 255, 196 N.W. 457 (1923). The prevalent view of delegation of administrative discretion was summarized recently by the Supreme Court of Arizona when it noted "a distinct modern tendency to be more liberal in the granting of discretion in the administration of laws in fields where the complexities of economic and governmental conditions have increased, particularly where it is impractical to lay down a comprehensive rule." State v. Arizona Mines Supply Co., 107 Ariz. 199, 484 P.2d 619 (1971). This view, coupled with the observation by Professor Loss that a substantial degree of administrative flexibility is essential in regulating modern business as complex as the securities industry, conveys the notion that it is too late to debate whether there should be administrative discretion in the regulatory agencies. LOSS & COWETT, *supra* note 5, at 63.

109. *See* KAN. STAT. ANN. § 17-1261(h) (Supp. 1970).

110. This rule-making authority, which is comparable to the authority granted securities regulators under most blue sky acts, is almost universal, UNIFORM SECURITIES ACT § 412(a) (draftsmen's commentary), and is intended to reinforce the general rule-making power under ARIZ. REV. STAT. ANN. § 44-1821 (1967). The potential danger of the power in regard to exemptions for nonprofit organizations is that the securities commission could promulgate rules imposing disclosure burdens upon applicants which

gate rules, however, uniformity is ensured among applicants. The second addition would require the petitioner to file a consent to service of process similar to that filed in conjunction with registration of securities. It is just as important to have issuers of exempt securities amenable to the state judicial process as it is in the case of registered issuers.[111]

The remaining amendment to section 44-1846 proposes to modify the revocation procedures by including a suspension procedure and by changing the grounds for exemption revocation from the commission's discretion to specific standards to be applied in accordance with procedural due process.[112] In order to maintain the present structure of the *Arizona Securities Act*, however, it would be necessary to place the grounds and procedures for suspension and revocation with their counterparts for the registration process. Since the sections setting forth the grounds for denial of registration contain material peculiar to registration, this amendment can best be accomplished by creating a new, similar section for exemption revocation. Appropriate grounds for revocation would range from insolvency to dishonesty, and would include prior fraudulent security dealings as well as present transactions. These grounds have proven sufficient for registration revocation and there is no reason why they would not be adequate for exemption revocation.

Conclusion

The present procedures employed by most states for exempting from registration securities issued by nonprofit organizations are outmoded. Because eleemosynary organizations now issue a large number of securities, problems of fraud and insolvency have developed which current Arizona law cannot adequately control. This does not mean, however, that the exemption has lost all utility. Indeed, eliminating the exemption could curtail the beneficial public services rendered by such organizations. What is required are new procedures

would equal or exceed the requirements for registration by qualification. As a matter of experience, this prospect is unlikely. Since 1952, the sole disclosure requirements for applicants for the small offering exemption have been contained in ARIZ. CORP. COMM., RULES AND REGULATIONS GOVERNING ADMINISTRATION OF SECURITIES STATUTES, Order No. S-23 (1972). These standards should be sufficient for disclosure by nonprofit organizations. If so, the basic requirement will be a balance sheet prepared within 90 days of the application and a statement of operations for each of the 3 preceding years.

111. *See* ARIZ. REV. STAT. ANN. § 44-1892(4) (1967).

112. For provisions similar to those proposed in text, see UNIFORM SECURITIES ACT § 402(c). It should be noted that the proposed change would also affect the small offering exemption. If most of the exemptions which are now granted under ARIZ. REV. STAT. ANN. § 44-1846 (1967), are hereafter obtained under *id.* § 44-1844(1) (Supp. 1972-73), then the amendment will have little impact upon this class of exemptions. See note 102 *supra*.

which protect investors without sacrificing the public interests involved. The Arizona legislature can accomplish these goals by amending the law in three respects. It should liberalize the category of organizations eligible for the exemption, condition the exemption upon the securities commissions' approval under a "merit" test, and make the privilege revocable under specific grounds. These proposals are specifically set out in the appendix.

APPENDIX

The following proposed amendments constitute a specific and detailed proposal for adapting Arizona's securities registration exemption for eleemosynary organizations to the recommendations of the foregoing analysis. New words are indicated by italics and proposed deletions have been enclosed in parentheses. The proposed amendments also reflect the suggested structural changes.

Proposed Amendments

§44-1843. [Delete subsection (6) and renumber the remaining subsections.]

§ 44-1846. Power of the commission to exempt certain securities or transactions by special order.

A. The commission may in its discretion by special order exempt from registration under articles 6 and 7 of this chapter

1. Securities in an aggregate amount not exceeding two hundred thousand dollars, *or*
2. Securities issued by *any issuer* organized and operated exclusively[113]
   (a) For religious, educational, benevolent, fraternal, charitable or reformatory purposes, *or*
   (b) *For the direct benefit of public welfare*

   and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any private stockholder or individual, (excluding, however, securities made liens upon revenue producing property subject to taxation and securities issued by a nonprofit organization which is engaged in or intends to engage in the construction, operation, maintenance, or management of a hospital, sanatorium, rest home, clinic, medical hotel, cemetery or mausoleum).

113. The two purpose clauses were set off in subsections to make it explicit that the "organized and operated exclusively" language modifies both clauses.

upon written petition and upon a showing by the issuer satisfactory to the commission that *the issuer or securities qualify for an exemption under subsection 1 or 2 and that* registration is not essential to the public interest or for the protection of investors by reason of the special characteristics of the securities or transactions, or the limited character and duration of the offering, or the special characteristics or limited number of the offerees or investors.

B. Special orders issued under this section shall each relate to a specific issuer and issue and shall not add any class of securities or transactions to those exempt under §§ 44-1843 and 44-1844, shall be (revocable at the discretion of the commission) *subject to suspension or revocation upon one or more of the grounds specified in article 8,* and shall not relieve the issuer from the application of any of the provisions of this chapter except §§ 44-1841 and 44-1842.

C. A petition filed under this section shall be accompanied by

1. *Such information and documents, including sales material, as the commission shall by rule prescribe*;
2. A fee equivalent to one-fiftieth of one percent of the aggregate amount of the offering, but in no instance shall it be less than twenty-five dollars.[114] No fees shall be returnable irrespective of the nature of the action upon the petition to which the fee attaches; *and*
3. *If the issuer who is applying for the exemption is not a registered dealer or is not a corporation organized under the laws of this state, a consent to service of process conforming to the requirements of § 44-1862.*

ARTICLE 8. DENIAL, REVOCATION OR SUSPENSION OF SECURITIES REGISTRATION: AND REVOCATION OR SUSPENSION OF REGISTRATION EXEMPTIONS[115]

§ 44-1923. Revocation of orders of exemption from registration; grounds.

The commission may revoke any order exempting securities from registration under this chapter if, after a hearing or notice and opportunity for hearing as provided by article 11 of this chapter, it finds that:

1. The application for exemption from registration, any financial statement, or any document or exhibit filed with

114. The present fees may be inadequate, and, if so, an adequate fee should be established.

115. The title has been modified to reflect the content of the article.

the application, or any amendment or supplement thereto was inaccurate or misleading.

2. *The issuer or any dealer or salesman designated to engage in the sale of the securities has violated any provision of this chapter, or any rule, regulation or order of the commission thereunder.*
3. *The sale of the securities works or will tend to work a fraud or deceit upon the purchasers thereof, or is or will be unfair or inequitable to the purchasers.*
4. *The issuer is insolvent, or is in an unsound financial condition.*
5. *The issuer has refused to permit the commission to examine into its affairs, or has failed or refused to furnish information required by the provisions of this chapter, or any rule, regulation or order of the commission thereunder.*
6. *The issuer, any officer or director of the issuer, if a corporation or unincorporated association, or any trustee or other fiduciary of the issuer, if a trust, or any partner of the issuer, if a partnership, or any person controlling, controlled by or under common control with the issuer:*
   (a) *Has been convicted of a felony or misdemeanor involving a transaction in securities or of which fraud is an essential element.*
   (b) *Is subject to an order, judgment or decree of a court of competent jurisdiction enjoining or restraining it or him from engaging or in continuing any conduct or practice in connection with the sale or purchase of securities.*
7. *The issuer or securities are no longer entitled to an exemption under subsection A(1) or A(2) of § 44-1846.*

§ 44-(1923) 1924.[116] Order denying or revoking registration *or revoking order of exemption*; notice to issuer and dealers.

A. If, after a hearing or notice and opportunity for hearing as provided by article 11 of this chapter, the commission finds grounds for denying or revoking registration of securities *or for revoking an order of exemption from registration of securities*, it may enter an order denying or revoking the registration *or revoking the order of exemption.* The order shall state specifically the grounds for its issuance.

116. §§ 44-1923 and 1924 were renumbered §§ 44-1924 and 1925 respectively to allow the insertion of a new § 44-1923.

B. Upon the entry of an order denying or revoking the registration of securities *or revoking an order of exemption from registration of securities*, the director shall send notice of the order by registered mail to the issuer of the securities and to all registered dealers engaged in the sale thereof. *No person may be considered to have violated sections 44-1841 or 44-1842 by reason of any offer or sale effected after the entry of an order under this section if he sustains the burden of proof that he did not know, and in the exercise of reasonable care could not have known of the order.*[117]

§ 44-(1924) *1925.* Order suspending registration; *order suspending exemption*; hearing; notice.

A. If the commission has reasonable grounds to believe that the registration of any securities under this chapter should be revoked on any ground specified in §§ 44-1921 or 44-1922 *or that an order of exemption from registration of securities under this chapter should be revoked on any ground specified in § 44-1923* it may enter an order suspending the registration *or the order of exemption from registration* of such securities pending an examination into the affairs of the issuer or pending a hearing or *notice and*[118] opportunity for hearing as provided by article 11 of this chapter. No suspension of registration *or of an order of exemption from registration* shall be effective for more than thirty days, except with the consent of the registrant. The suspension order shall specify the grounds upon which it is issued.

B. Upon entry of an order suspending (1) the registration *or (2) an order of exemption from registration* of any securities, or an order withdrawing a suspension order previously issued, the director shall send notice of the order to the issuer of the securities and to all registered dealers engaged in the sale thereof. *No person may be considered to have violated sections 44-1841 or 44-1842 by reason of any offer or sale effected if he sustains the burden of proof that he did not know, and in*

117. This sentence is added to protect a category of dealers that may not actually exist. Assuming a "dealer," ARIZ. REV. STAT. ANN. § 44-1801(2) (1967), traded solely in exempt securities, he would not have to register under *id.* § 44-1842. *Id.* § 44-1843. If the order of exemption were suspended or revoked, and if the unregistered dealer continued to trade in the now non-exempt security, he would presumably be guilty of a felony under *id.* §§ 44-1842, -1843. Since this dealer is *unregistered*, he would not have received notice of the exemption revocation or suspension because *id.* § 44-1924 (§ 44-1925 of the proposed amendments) requires the director to notify only the issuers and *registered* dealers. This sentence avoids the possibility of such strict liability if the dealer did not know and in the exercise of reasonable care, could not have known, of the exemption, revocation or suspension. This sentence was taken from the UNIFORM SECURITIES ACT § 402(c) (last sentence).

118. This phrase was inserted to repeat the exact phraseology used in the other sections.

the exercise of reasonable care could not have known of the order.[119]

§ 44-1972. Notice of and opportunity for hearing; time of hearing

A. Before entering an order denying or revoking the registration *or revoking an order of exemption from registration* of any securities as provided in article 8 of this chapter the commission shall send to the issuer of the securities, and, if the application for registration of the securities was filed by a registered dealer, to the dealer, a notice of hearing or notice of opportunity for hearing.

119. For an explanation of the reason for this added sentence, see n.117 *supra.*