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Blue Sky Laws in US and India

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The article mainly deals with the major securities laws all over the world, the origin of Blue sky laws, their comparison, and lacunas in-laws. In this research, I have used qualitative research methods to come to the conclusion. Some of the major findings during the research are the difference in the state and federal laws in the USA, the very similar establishment of regulatory bodies in the security market, and their operations all over the world. To conclude I would point out the need for a uniform compliance and regulatory framework so that corporations all over the world can have uniform and quicker compliance and we can have more transparency which shall promote the confidence of investors.

Keywords: *securities law, capital market, blue sky laws, federal law, state laws.*

INTRODUCTION

Investment is one of the major parameters today for the progress and strategic development of any country's economy and industries. Investors of all types are the main source of funds or finance for Companies who want to source their requirement of funding from the public at large. They are the main players in the market and every other player or every law revolves around them. Investor protection is the basic and foremost reason for almost all securities laws. In the US, the security and exchange commission is the main market monitoring body. It is the topmost

authority for the implementation and enforcement of federal and state securities Laws. The main objective of this regulation is the protection of innocent investors and governing the intermediaries and adjudication of fraud activities. Through this article, I will describe certain laws on the above subject of securities law, its origin, history, importance, and comparison to its Indian counterpart.

WHAT ARE BLUE SKY LAWS?

The US states have termed all the laws or statutes which are made about regulations of sale, purchase, or transactions dealing in securities in the capital market. It also includes laws and regulations which give the process of adjudication and punishments of different concerns about any fraudulent activities of offering securities in the public domain.

WHY IT IS CALLED BLUE SKY LAWS?

The genesis of the expression blue sky laws is uncertain, but Supreme Court Justice Joseph McKenna was the earliest to have used this expression in the case *Hall v Geiger-Jones Co. (1917)*. He compared the speculative schemes existing in the market to many feet of blue sky. He further explained that such laws are formulated to prevent and prohibit the sale of such stock which are fly by night concerns or vague oil wells or faraway mines or such other pony's schemes."¹ Before the formation of the SEC in 1934, many fraudsters raised money by making up investment opportunities, only to disappear with the investors' money. In 1956, the Uniform Securities Act provided directions to states to implement their blue sky laws. It also addresses potential differences between state and federal regulations. ² In some of the cases, the court observed that - "The term blue sky laws, in general, initially from various incidents which resulted in many fraudulent securities offerings was so impudent it became very common and mainstream in the US security market that people compared it with companies selling lots of building lots and compared the market to the blue sky".³ Such laws are made for the registration of new securities to be sold in any state and issued

¹ *Hall v Geiger Jones Co.* [1917] 242 U.S. 539

² <https://www.mtsu.edu/first-amendment/article/1170/blue-sky-laws/> > accessed 11 December 2022

³ *Merrick v Halsey* [1917] 61 US 498

by issuing companies, it also enforces licensing and monitoring of market intermediaries like broker-dealers or intermediary managers or advisors.

The major conditions for the registration of securities often consist of a merit review given by the administrative body. This body has the power to implement and prohibit the unfair sale of securities in a particular state. In contrast to such law federal laws majorly depend on the market dynamics to ascertain the fair selling price of securities through full disclosure of information made by the issuing companies. As it implements how to and who can deal in the selling and buying of securities, it also provides for violation of its regulations by the issuers and intermediaries in the market, by imposing fines, bans, and other penal provisions. It also makes provision for the establishment of administrative agencies for law enforcement which imposes liability for false and misleading information relating to securities.

This law provides for establishing an administrative agency that works at the topmost level to regulate the securities market. It shall regulate the securities market players such as brokers, dealers, investment agencies, or advisors. It shall provide for their licensing of such brokers etc. and regulations to impose liability to such market players or middlemen upon their actions which are considered unfair or inequitable. This administrative agency plays a pivotal role in securing the position and safeguarding the confidence of investors in the capital market. However, the methods and regulations will differ in each state in the US.

EVOLUTION OF BLUE SKY LAWS

Investors were seduced by the commitments and false statements stating their stories of getting rich the night. Approximately, fifty million dollars in form of new securities were offered over the decade from which a large part turned worthless due to overselling and unfair practices, as a result in October 1929 the stock market crashed. This resulted in decreasing confidence in the public regarding investing in the US stock market. To control the situation the US government

introduced new regulations for getting back the investors' confidence and protection of them from fraud and misrepresentation by Companies.⁴

In 1931 almost all the states in the US had in place their laws about the regulation of securities. By 1933, when Congress began regulating securities, every state in the US ruling out the state of Nevada had such Laws in place. We can say that the Blue-sky laws precede the Securities Act of 1933⁵ and the Securities Exchange Act of 1934⁶ which count as major statutes governing the capital market in the US. All such laws about securities and investor protection were known as Blue sky laws and these laws were present in most states, these laws were based on the core law that is the Uniform Securities Act (USA) of 1956⁷. This Act provided the basic template to the state lawmakers so they can design their laws of state accordingly. Hence, the state-made laws in variations and their interpretations also differ ever slightly in the different courts of states. Thus, there is a difference in the procedure, and penalties for actions to be considered fraudulent.

To bring about some changes and uniformity in the process and procedures of different states in the US, the US government introduced the National Securities Markets Improvement Act (NSMIA) 1996⁸. The main purpose for the introduction of this Act was first to bring about uniformity in the laws of different states Laws, secondly, it will reduce the major hurdles for issuers, companies, brokers, and other market players in the capital market in the US. The provisions of this act provide for the classification of securities covered or eligible under this act as 'covered securities', or exempted securities, the exemption being from registration with the state and its merit review.

Another Act, namely the Securities Litigation Uniform Standards Act, (SLUSA)⁹ was passed in 1998. This act was made to restrict the jurisdiction of the state and the federal courts in class

⁴ 'What We Do' (US Securities And Exchange Commission) <<https://www.sec.gov/Article/whatwedo.html>> accessed 12 December 2022

⁵ Securities Act 1933

⁶ Securities Exchange Act 1934

⁷ Uniform Securities Act 1956

⁸ National Securities Markets Improvement Act 1996

⁹ Securities Litigation Uniform Standards Act 1988

action suits of fraud, however, this act does not prohibit state courts or the government to take cognizance of claims of fraud about securities. The act requires broadening the jurisdiction of state courts in fraud class action suits in matters of most securities.¹⁰ The government also considered this act to provide equilibrium between the powers of federal and state governments.

US FEDERAL SECURITIES LAWS

The Securities Act of 1933: It introduced and offered broad definitions of securities where I included all types of ownership in a company, and defined the meaning of selling and offering to sell securities.¹¹ It provides for corporate disclosure by the issuer and prohibits any misrepresentation in the registration and financial statements. The Act requires the issuer to attest and make true disclosure which is later made public and before the registration of securities. The act does not cover the registration of every kind of security in its scope, it excludes certain types of offerings such as private offerings (private placement in the case of Indian states) and bonds issued by federal or state governments in small batches.¹²

The Securities Exchange Act of 1934: This Act was made in the synchronicity of the first Act of 1933, its objective is to regulate security transactions uniformly and provide a fair market. Under this Act, SEC was established as a regulatory body.¹³ It provides annual and quarterly reports by the issuer in Form 10-k and Form 10 Q.¹⁴ It prevents fraud through anti-fraud provisions in the secondary market unlike the 1933 Act provided for penalties for matters of IPOs only. The Act also provides for insider trading regulations to build the confidence of investors¹⁵.

¹⁰ *Merrill Lynch, Pierce, Fenner & Smith Inc. v Dabit* [2006] 547 US 71, 78

¹¹ United States Code 2006

¹² 'The Laws that Govern the Securities Industry' (US Securities And Exchange Commission) <<https://www.investor.gov/introduction-investing/investing-basics/role-sec/laws-govern-securities-industry#secact1933>> accessed 13 December 2022

¹³ 'Rulemaking, How It Works' (US Securities And Exchange Commission) <<https://www.investor.gov/introduction-investing/investing-basics/glossary/rulemaking-how-it-works>> accessed 13 December 2022

¹⁴ United States Code, 2006, s 78m

¹⁵ Securities Exchange Act 1934

SUBSEQUENT FEDERAL SECURITIES LEGISLATION

The Investment Advisers Act of 1940: The Act's primary objective was to regulate and register with the SEC, those investment advisers who had hundred million dollars as assets.

The Sarbanes-Oxley Act of 2002: It makes CEOs and CFOs appointed in the issuer company liable for any misstatements or misrepresentation in the financial information given by them by making them attest to such documents. It also established a Public Company Accounting Board for the application of approved accounting principles.

The Investment Company Act of 1940: This Act makes it mandatory for issuing companies to make full disclosure of their investment objectives and financial status to prevent conflicts of interest in mutual funds and index-based products issued in the US stock market.¹⁶

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010: It was introduced for the prevention and protection of whistleblowers and to reward such people who would report violations of regulations to the regulatory body.¹⁷

REGULATORY AUTHORITY

In the USA: In the US the regulatory authority is the Security and Exchange Commission (SEC). The Security Exchange Act of 1934 created the SEC under Section 4¹⁸. SEC is the ultimate body made for regulating securities and for investor protection. SEC is provided with executive legislative as well as judicial powers in various acts to make investing more secure. The main crux of SEC regulation consists of six major Acts namely, the Securities Act of 1933, the Securities Exchange Act of 1934¹⁹, the public utility holding company Act of 1935, the trust indenture Act

¹⁶ 'The Laws that Govern the Securities Industry' (*US Securities And Exchange Commission*) <<https://www.sec.gov/answers/about-lawsshtml.html#secact1933>> accessed 13 December 2022

¹⁷ Adam Hayes, 'Dodd-Frank Act: What It Does, Major Components, Criticisms' (*Investopedia*, 08 September 2022) <<https://www.investopedia.com/terms/d/dodd-frank-financial-regulatory-reform-bill.asp>> accessed 14 December 2022

¹⁸ Security Exchange Act 1934, s 4

¹⁹ Securities Exchange Act 1934

of 1939, the Investment Company Act of 1940²⁰, and the Bankruptcy Act 1938.²¹ The main objective of the SEC is to protect investors, regulate the market, and also to consider capital formation. These are also the same for other countries as in India SEBI performs similar functions. SEC is formed with the appointment of five commissioners by the President, with one of them acting as its Chairperson. It is divided into five different divisions and has headquarters in Washington D.C.

Fundamental powers and functions:-

- SEC is the regulator for the market intermediaries such as brokers, and advisors.
- Enforcement of all laws and regulations about securities.
- It provides for transparency and full disclosure by the issuing Companies before issuing shares or any other kind of securities.
- Adjudication and enforcement of laws for the protection of investors.
- Ensuring that the capital market is fair in competition and the transaction.
- Prevention of fraudulent sales and activities of security trading.
- Granting of licenses to brokerage firms, brokers, and investment advisors.

COMPARISON BETWEEN REGULATORY BODIES OVER THE WORLD

INDIA - SECURITIES EXCHANGE BOARD OF INDIA (SEBI)

The Security and Exchange Board of India Act, 1992²² constituted SEBI in India as the top statutory regulator and monitor for Indian Capital & securities market.

History: before SEBI came into existence the capital market suffered price manipulation which was called price rigging due to the misuse of price-sensitive information. This led to many scams such as Harshad Mehta in 1992. To prevent such scams SEBI was established and this stopped the illegal price rigging and malpractice of the stockbrokers. SEBI's head office is in Mumbai.

²⁰ Investment Company Act 1940

²¹ Bankruptcy Act 1938

²² Security and Exchange Board of India Act 1992

Organizational Structure: SEBI has a wide network and it depends on various strategic departments such as investment management, policy analysis, commodity derivatives regulation, etc. to perform its functions. Its chairman is recommended by the Central government in India. The council consists of two members from the finance ministry from the central government, one officer from RBI, and five members nominated by the central government.²³

Main powers and responsibilities:-

- Just like the SEC, the main function of SEBI is the regulation and monitoring of the capital and securities market in India.
- Protecting and educating the investors.
- Regulating and licensing market intermediaries such as depositories, participants, custodians of securities, foreign portfolio investors, and credit trading agencies.
- Formulation of regulations and rules for issuance and transacting of securities by issuer corporations by making them liable. For transparency and disclosure.
- Making policies and regulations for functions of market intermediaries such as SEBI Merchant Bankers Regulations, SEBI Underwriters Regulations, SEBI Stock Broker Regulations, SEBI Insider Trading Regulations, SEBI Intermediaries Regulations, SEBI Foreign Portfolio Investment Regulations, SEBI Underwriting Regulations, SEBI Investor Protection Regulations, etc.
- It has some semi-legislative, executive, and judicial powers in all matters relating to securities.
- It has its appellate court SAT for proper adjudication about issues of securities.

AUSTRALIAN SECURITIES AND INVESTMENT COMMISSION

The Australian counterpart of the SEC is the Australian Securities and Investment Commission ASIC was established in 1998. ASIC was constituted for the protection of the general public from pension plans in 1998. ASIC like its counterparts has almost the same objectives of regulating

²³ 'About SEBI' (SEBI) <<https://www.sebi.gov.in/about-sebi.html>> accessed 14 December 2022

and monitoring the capital market which includes stocks, bonds, insurance, superannuation, and promoting investors' confidence. ASIC continuously invents creative ways for the development of corporate governance which is how companies are doing business and function in the markets daily. ASIC like SEBI has legislative powers to make regulations regarding the issuance and transactions of different types of securities, it also has investigating powers in case of illegal or malpractices by the corporations or brokers in the market to defraud investors. It is also the licensing authority for intermediaries like brokers etc. Australian Security Exchange (ASX) has an MOU signed with ASIC for major functions and transactions in the security market.²⁴

CANADIAN SECURITIES ADMINISTRATORS (CSA)

Canada is divided into thirteen provinces and each of these provinces has a different and separate regulatory authority that takes care of the regulations of securities law and regulations in the individual state. The CSA is the parent regulatory for these 13 individual state regulators, it gives directions and guidance and can in some cases supersede them. CSA maintains the coordination between state regulatory and intra-state matters and investment. It is responsible for the protection of all the investors, however, each state regulator has its separate mechanism for monitoring fraud and protection of investors in their territory.

Organizational structure: CSA has a chairman and vice chairman appointed for two years. The regulatory body has a permanent secretariat and three committees for Policy, Information technology systems, and projects.²⁵

Functions -

- Maintaining and regulations matters about foreign securities or issuance to other countries.
- Coordinating between two or more state regulations in matters intra-state.

²⁴ 'At the heart of Australia's financial markets' (ASX) <<https://www2.asx.com.au/about>> accessed 14 December 2022

²⁵ 'Protecting investors' (CSA) <<https://www.securities-administrators.ca/about/>> accessed 14 December 2022

- Interstate regulatory meetings for discussions and improvements in the regulations or problem-solving.
- Investor protection and awareness by the CSA and state regulatory.
- Canadian Investor Protection fund is established for educating and making aware new entrants in the market. It provides for a more transparent system and markets to invest in.

BLUE SKY LAWS THEIR APPLICATION

Furthermore, in parallel to the US federal regulations, the presence of individual states' regulations work at a heterogeneous pace in governing securities issued within such individual separate security regulations are known as blue sky laws. It is widely known as precedent in the US that federal laws supersede state securities law which has the same or similar functions, hence the different states have formed their regulatory framework. The 1933 Act (the federal law) provides for the exemption of certain securities from registration and such exempted securities are registered under subsequent state laws; these laws are blue sky laws and such registration provides for a process called qualifying security for sale. State regulatory bodies are empowered with the duty to enforce such a qualification process for the new securities that are offered to the investors. These regulators frame guidelines which are a state-interpreted model of the Uniform Code i.e. Uniform Securities Act of 1956²⁶. One example of such adaptation is California, it has incorporated the basic jargon and regulations of the said Act into its state laws. "The offer for issuance of new securities has to be submitted and approved by the Commissioner of Corporation as per the California Corporation Code".²⁷

Further, the code under section 25019 defines 'security' - it includes an interest in written or not, notes, bonds, debentures, stock, any kind of instrument which is known to be treated as a security, any kind of certificate of interest, etc.²⁸ So, it can be seen from the example of the

²⁶Uniform Securities Act 1956

²⁷ California Corporations Code 2020, ss 25110, 25120

²⁸ California Corporations Code 2020, s 25019

California Corporation Code that many states in the US have modelled their state-specific securities regulations on Federal Law.

THE DIFFERENCE IN THE COURT'S INTERPRETATION OF FEDERAL AND STATE LAWS

In a famous case in 1974, California Supreme Court found that the definition of securities in the state law was modelled after a similar definition given in Federal Laws, hence the Federal cases have an authoritative effect on the state cases. As both Laws have the purpose of protecting innocent investors from fraud schemes.²⁹ The court further investigated if the secured note of the jeweller comes into the definition of securities, the honourable court instead of going by the examples given in the California state law in its S25019, the court applied a risk central test in which the court questioned the Jeweler whether they assumed risk when they purchased the note. Which was altered and found negative and the court said that the purchases were not the notes on a bogus scheme but notes were not worthless and had collateral security.

*SEC v W.J. Howey Co. (1946)*³⁰The US Federal Law, the definition given to securities was much broader under the 1933 Act and SC described securities as any valuable investment which shall give the investor a profit. In this case, the test known as the Howey test is defining security based on the ability of an investment to give a return or profit."Further, the provisions of registration of securities in California are different from federal as in California the qualification for registration of securities can be done by

- (a) Coordination [California Corporations Code Section 25111]
- (b) Notification [Section 25112]
- (c) By permit, [section 25113]

Hence, the state laws in the case of California are way more flexible than that of federal law. So, the eligibility to be considered as security must satisfy the following requirements - firstly the business plan should be just, fair, and equitable, he should transact honestly and the method of

²⁹ *Hamilton Jewelers v Dep't of Corps* [1974] 37 Ca App 3d 330

³⁰ *SEC v W.J. Howey Co* [1946] 328 US 293

issuing securities should not be to defraud the clueless investors. (Section 25140) Even though the approaches are different from state to state, the blue-sky laws share certain basic principles to prevent misrepresentation and lower the risk in the market. For example, the state provides for liability for fraud sales of securities in two ways first, by registration of securities sold or offered within the state with the state regulators, and second transparency by financial disclosures these two methods are also found in the Federal laws.

BLUE-SKY LAWS - INDIAN LEGAL PARLANCE

*Pg. Limited and Others v Union of India (Civil Appeal No. 6572 of 2004)*³¹ Supreme Court of India -Mar 12, 2013 "Reference was made in this case to the Securities laws in the USA, also known as Blue ky laws and its objective to control and monitor unfair practices, fraud done in the securities market, regulations against fraudulent transactions by financiers in agricultural lands and compared the SEBI CIS regulations to such regulations present in the USA. This CIS (Collective Investment Schemes), has the same objective of protecting the interest of investors who are fooled by fraud schemes."

Ds Biotech Ltd. SEBI acclaimed that in the USA the inside trading regulations are a division of their general laws relating to matters of fraud. And in the states all also known as Blue Sky laws provided for anti-fraud provisions for the unfair trading of securities.³²

CONCLUSION

From this article we may conclude that almost all countries have securities laws and regulatory authorities in place, these mechanisms are established to protect investors and provide the public with a fair and efficient securities market. As we all know that a country's economy runs well when the Companies or industrial sectors are working and generating revenue and opportunities for growth and this depends on investment and financial resources placed in the economy and market. India being one of the major developing markets keeps the regulatory

³¹ *Pg. Limited & Ors v Union of India & Anr* C App No. 6572/2004

³² *SEBI v Ds Biotech Ltd* (2003)

authority and mechanism on its toes to check and maintain the inflow of investment in different sectors of its economy.