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THE FLORIDA SECURITIES ACT: A RE-EXAMINATION

WALTER H. ROBINTON* and HUGH L. SOWARDS**

1 INTRODUCTION

Even the most casual analysis of the American financial picture reveals that, in the last 15 years, Florida has easily outstripped the nation as a whole in corporate and economic growth.

Florida now has in excess of 5000 factories, nearly double the amount in existence just eight years ago. While individual income in the United States as a whole increased approximately 250 per cent in the last 15 years, that of Florida climbed 490 per cent. Since 1940, bank deposits have risen nearly 500 per cent, and currently stand at more than $3 billion.¹

The significance of these statistics and almost countless others which reveal "Florida First" trends has not been overlooked by businessmen and their attorneys. The accompanying influx of new business necessitates acquiring additional capital for that business; that capital must come, in large part, from the investing public. When the public is invited to contribute funds to business enterprises, the Florida Securities Act—"Blue Sky Law"²—frequently comes into play.³ Five years ago the writers compiled an article, the main purpose of which was to present a basic picture of

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2. FLA. STAT. § 517 (1955). From this point on the Act will be referred to merely by indicating the appropriate section number.
3. At a recent session of the Florida Legislative Appropriations Committee, the director of the Florida Securities Commission told members that his agency "is being flooded with applications for securities registrations." Miami Herald, Dec. 20, 1956, p. 3B, col. 3.
the Florida Securities Act from the standpoint of the attorney and his problems.\textsuperscript{4} Since that time numerous developments, both on an administrative and statutory level, coupled with added interest in the Act because of a marked increase in the number of securities offerings, call for a re-examination of this piece of legislation.

\section*{II EXEMPT TRANSACTIONS}

Although the Act in substantially its present form has been in effect for approximately 25 years, considerable confusion still exists among attorneys over the exceedingly practical question of when it is applicable.

The ultimate answer to this question concerns two problems: (1) whether a public offering is involved; (2) whether, assuming a public offering, some statutory exemption is available. By way of illustration, formation of the ordinary closed corporation in no way involves the Act. The incorporators are regarded as subscribers to the corporate charter—a closed group. Thus when A, B and C incorporate there is no public offering and no securities permit of any kind is required. That much is clear. Beyond that point, however, confusion arises. Suppose, for example, that 30 doctors decide to build a private hospital and operate it on a corporate basis. Assuming that there is no solicitation and that these doctors are bona fide incorporators, the Act would not seem to be applicable, just as in the A, B, C situation above. Again, these doctors as incorporators would appear to be merely a closed group and the issue not subject to registration. This view was taken by the writers in their earlier article.\textsuperscript{5} The view stemmed from the fact that the corporate code\textsuperscript{6} requires three or more incorporators. Impliedly, then, it was reasoned that the number in excess of three was immaterial; that as long as the incorporation was actually a voluntary arrangement with no solicitation, no public offering was involved, thus making the Act inapplicable. But some doubt has now been cast on this view.\textsuperscript{7} The doubt arises in connection with the so-called “pre-organization” exemption of the Act,\textsuperscript{8} which provides that, after advance notice to the Florida Securities Commission, an unlimited amount of funds may be solicited and raised, before incorporation, where not more than 25 actual subscriptions are involved. It is to be noted that the exemption referred to contemplates solicitation of subscriptions, while incorporation is a voluntary act. It was thus thought that even though the combined number of incorporators and pre-organization subscribers exceeded 25, the exemption applied only to those persons whose subscriptions were solicited and not to actual incorporators so that the number

\begin{itemize}
\item \textsuperscript{4} Robinton \& Sowards, Florida's Blue Sky Law: The Lawyer's Approach, 6 MIAMI L.Q. 525 (1952).
\item \textsuperscript{5} Id. at 532.
\item \textsuperscript{6} FLA. STAT. § 608.03 (1955).
\item \textsuperscript{7} Release No. 12, Fla. Sec. Comm. (Dec. 15, 1955).
\item \textsuperscript{8} Section 517.06 (10).
\end{itemize}
of bona fide incorporators was immaterial. But a release of the Commission quoting an "informal opinion" of the attorney general, states:

"The total number of subscriptions for shares of capital stock of the proposed corporation cannot exceed twenty-five in number including the original incorporators."

To sum up, the attorney who forms the every-day type of corporation where the number of bona fide incorporators is small, need have no concern with the Act at the time of organization. If, however, there are other persons, not incorporators, whose subscriptions are solicited prior to incorporation, in order to legally avoid conflict with the Act, the total number of incorporators and solicitees who actually contribute funds should be held to a maximum of 25, at least until this question may be further clarified.

The above discussion, of course, relates solely to problems arising before incorporation. Equally practical questions confront the attorney once the organization has reached the going concern stage. The following hypothetical situation illustrates many of the problems that constantly arise:

XYZ, Inc., a Florida corporation, has as its incorporators and only stockholders A, B and C. XYZ, Inc. has an authorized capitalization of 20,000 shares of $1.00 par value common stock, 10,000 shares of which have been issued to A, B and C at par and 10,000 of which are in the corporate treasury. The company is in need of additional capital for expansion. Mr. A, the president, learns that the following persons are willing to buy shares in XYZ, Inc.: (1) R, a blood brother of Mr. A; (2) E, an employee of XYZ, Inc.; (3) C, one of XYZ's customers; (4) B, one of the incorporators.

The first observation to be made here is that no exemption is available for sales from the corporate treasury of XYZ, Inc., stock to any of the above persons except B. Now, the Act contains a post-incorporation exemption for sales out of the treasury provided that the total number of shareholders does not exceed 20 after such sales and the total face amount or total sales price of such shares does not and will not after such sales exceed $10,000. Since $10,000 in stock has already been issued to the incorporators of XYZ, Inc., the exemption is lost. In short, in order for the exemption to be available, the total sales price of all stock issued cannot exceed $10,000.

On the other hand, suppose that XYZ, Inc., the aforementioned Florida corporation, had as its incorporators and only stockholders, M, N and O. Suppose further that XYZ, Inc. had an authorized capitalization of 20,000 shares of $1.00 par value common stock, 3000 shares of which have been

9. See note 7 supra.
10. Section 517.06 (11). It is to be noted that use of this exemption requires
issued at par to M, N and O and 17,000 shares of which are authorized but unissued. Under these circumstances the post-incorporation exemption is available to the limited extent that, upon clearance of a notice of exemption properly filed with the Commission, an additional $7,000 worth of shares may be sold under the exemption to not more than 17 other persons.

The next question for consideration concerns the two previously mentioned problems of whether a public offering is involved, and, whether, assuming a public offering, any exemption is available. First of all, the case of R, Mr. A's blood brother. The important point is that, under the Act, a sale of even one share of stock out of the corporate treasury to an outsider constitutes a "public offering"; unless some exemption is available registration must follow. Unfortunately, no exemption is available in R’s case, for, although he is related to Mr. A, he is still a corporate outsider. The same situation exists with regard to E, the employee, and C, the customer. Much criticism has been voiced with respect to this phase of the Act. Critics point, for example, to the Federal Securities Act of 1933, which specifically exempts "private offerings" by a corporation to a small number of outsiders. The answer, of course, is that, if one sale to an outsider were allowed, then why not two, three, or a dozen? In short, the Act is a registration statute, designed to protect the public from fraud in the sale of unsound or worthless securities. To permit isolated sales of its securities, piecemeal, by a corporation, free of scrutiny of the Commission, would be to frustrate the very purpose of the Act. Yet, the registration process may be unduly burdensome, both from the standpoint of time and money, to the corporation in need of a small amount of funds from a small group of outsiders. A legislative solution to this problem might well be by way of amendment to the post-incorporation exemption provision of the Act so as to increase the present $10,000 limitation to meet more adequately the needs of small business today and at the same time limit the dollar amount to a figure which would reasonably protect the public investor. Meanwhile, however, attorneys should be fully aware that in the typical cases of R, E and C no exemption is available.

With regard to B, since he is already a stockholder of XYZ, Inc., shares may be sold to him or any other stockholder of XYZ, Inc. free of registration.

The XYZ, Inc. situation should not be dismissed without a discussion of some very real trouble spots. Seeking to avoid the registration process, the attorney may advise Mr. A to sell his own shares to outsiders. advance notice to the Commission. § 517.06 (15).
12. See note 10 supra.
13. Section 517.06(4). Here, however, that section of the corporate code dealing with pre-emptive rights should be considered. Fla. Stat. § 608.42 (1955).
This procedure, of course, is in no way violative of the Act. Rather, it comes within the “isolated sale” exemption. But Mr. A replies that such a sale would endanger his political position in the corporation. Unfortunately, the advice is often given in such a situation that Mr. A “replace” his sold shares with unissued shares from the corporate treasury. Result: Mr. A may be subject to severe civil and criminal liability under the Act. The point is that the isolated sale exemption is available only when made “by or on behalf of a vendor not the issuer or underwriter thereof . . . and such sale is not made for the benefit of the issuer . . .” (italics added). Put another way, the test is whether the funds paid for the shares go into Mr. A’s pocket or into the corporate treasury. In the case just discussed the outsider’s money actually goes into the XYZ treasury when Mr. A buys an equal number of shares to replace the ones sold.

A somewhat more subtle but equally illegal device would consist of a sale of a small number of Mr. A’s shares to the outsider. Thus far, all is in order. The outsider is now a stockholder; he is informed that, as such, he may purchase additional shares, this time from XYZ’s treasury, under an exemption freeing from registration securities distributed by a corporation to its own stockholders exclusively. Here again it may well be that the intent of the parties was purely and simply to use the isolated sale exemption coupled with the insider exemption as a scheme for violating the Act, something that is expressly prohibited by the Act itself.

Still another apparently ingenious device consists of borrowing money from the outsider, pledging corporate securities as collateral, and then conveniently forgetting to repay the loan, thus permitting the outsider to become a shareholder of the company by foreclosing on the pledge.

Similar schemes, wittingly or unwittingly, have been contrived. The plain fact of the matter is, however, that any such scheme or combination of schemes spell trouble in large letters for violators.

III EXEMPT SECURITIES

The Act contains eleven different paragraphs listing various securities which are exempt from its operation. What is often not understood in this connection, however, is that even an exempt security is not entirely free of the Act, for even such a security in most instances must be sold by a registered dealer unless sold in an exempt transaction.
A somewhat curious situation exists with respect to the listed securities exemption. Under the provisions of this exemption, a security listed on any recognized and responsible stock exchange which has been previously approved by the Commission is free from registration. In the majority of instances this exemption does not endanger investor protection, for most listed securities are apt to be high-grade. But suppose that such a security does not meet the standards set up by the Act? A recent oil issue offers a case in point. The Commission refused to grant a permit to the oil company to sell its securities in Florida, the refusal being based, among other things, upon the fact that the underwriters had been granted options not available to the public investor. Oddly enough, the day of Commission refusal coincided with clearance by the United States Securities and Exchange Commission and admission to trading privileges by the American Stock Exchange. The following day a Florida investor could purchase these securities through any broker. In effect, then, the securities of the oil company could be sold in Florida just as though the Commission had granted, not refused, the permit. A partial answer to this seemingly puzzling state of affairs lies in the fact that sales of the securities in Florida were on a “secondary” basis, that is, transactions in securities already issued and outstanding. But the rest of the answer is found in the apparent laxity in listing requirements of some stock exchanges. It should be noted here, too, that a safeguard exists by virtue of the fact that the Commission has power to deny the listed securities exemption.

IV REGISTRATION

Once it has been ascertained that a public offering is involved and that no exemption is available, the attorney’s proper advice to his client must be that registration with the Commission is in order.

There are three types of registration provided for in the Act: Qualification, Notification and Announcement. The last two methods of registration are tailored for seasoned issues and over-the-counter secondary offerings. For a detailed discussion of the requirements and technique of registration by Notification and by Announcement, the reader is referred to an earlier discussion. Currently, however, the vast majority of corporate offerings originating in Florida consist of unseasoned issues which must be registered by Qualification.

20. Section 517.05 (6) (7).
21. “A surprising number of the newly listed issues on the American Stock Exchange have been, to say the least, outright speculations . . . ‘listing’ is becoming less and less a symbol of investment quality. What’s in a Listing, Barrons, p. 5 (Jan. 9, 1956).
22. Section 517.05(6)(7).
23. Section 517.07.
The 25 Per Cent Formula

Perhaps the most pertinent question that the attorney should direct to his client in connection with Qualification registrations is whether the promotional group or corporate entity, if such be the case, can show tangible assets in excess of liabilities of at least 25 per cent of the amount sought to be raised in the proposed public offering. The answer to this question will determine in large part the size of the proposed issue, and, indeed, whether there is to be any issue at all. A concrete example will serve to illustrate this point. XYZ, Inc. desires to float a $300,000 stock issue. Its balance sheet reflects tangible assets of $80,000 and liabilities of $21,000. Since XYZ’s net worth is only $59,000, the so-called 25 per cent requirement is not fulfilled; in all probability, then, the size of the XYZ issue will be restricted to a maximum of four times $59,000, or a total of $236,000. Put another way, the registrant must have an excess of tangible assets over liabilities of one-quarter of the total amount to be raised through public subscription. The Commission has adopted this formula as a yardstick, in most instances, to determine whether the business of the registrant is “based upon sound business principles”—one of the standards set up by the Act.25

The reason behind the 25 per cent formula is a valid one; it is to prevent “fly-by-night” schemes and promotions which leave the public holding the bag. If, for example, promoters with little more than an idea and no tangible assets were permitted to solicit public funds, almost invariably financial failure would result. The funds that were raised in such ventures would undoubtedly disappear in the form of organizational expenses, promoters’ fees and the like, leaving the promoters free to walk away from the deal with no scars. On the other hand, if the promotional group itself has a tangible stake in the venture, the promoters will be much more apt to remain on the scene and use conscientious efforts to make it a success.

Several practical aspects of this formula merit the consideration of the attorney prior to processing his client’s registration application. First of all, the word “tangible” is important. In computing the applicant’s total assets for purposes of the 25 per cent formula, intangibles do not count. Accordingly, such assets as patents, copyrights, trade marks, processes, formulae, promotion and good will must be disregarded in the computation. Certain border-line situations are constantly recurring in this connection, one of the most common of which is accounts receivable. The Commission has in some instances taken the position that accounts receivable are tangible assets for purposes of the 25 per cent formula. From a realistic standpoint, however, not all accounts receivable are 100 per cent collectible, so that a reasonable amount, depending upon the nature of the business, should be

25. Section 517.09 (7).
deducted in making the computation. Leases and real estate options present similar problems. Here again, the following realistic questions will be asked by the examiners in arriving at the true value of the option or lease: what was its acquisition cost and what is its current appraised valuation?

But perhaps the most practical of all considerations in connection with the 25 per cent formula concerns brand new ventures and the postponement of incorporation until the last possible moment. Consider the hypothetical situation of A, B and C who have a sound idea requiring approximately $300,000 to finance properly. A, B and C each have $10,000 in tangible assets to contribute to the venture. If they incorporate at this point, the most that can be raised from the public, under the 25 per cent formula, is $120,000. On the other hand, in many instances, A, B and C would be able to raise additional funds before incorporation and thus avail themselves of the pre-organization exemption. Assume, for example, that $50,000 could be raised in this manner. When A, B and C now incorporate, the corporate treasury has assets of $80,000; compliance with the 25 per cent formula has been achieved, while incorporation at the earlier stage might well have doomed the venture through lack of adequate capital.

**Escrow Arrangements**

Frequently the application for registration will disclose that some of the shares issued and outstanding have been issued for services or other intangible assets rather than for actual cash, real estate, equipment or other assets of a tangible nature. Such a disclosure involves nothing illegal, unethical or even out of the ordinary. But the officers, directors or other persons who received such shares for intangible assets should be frankly advised that the Commission will require their share certificates to be delivered in escrow to it until a dividend of six per cent has been actually earned and paid by the company. This provision of the Act is obviously for the protection of those persons who paid in cash or other tangible assets for their shares. While held in escrow, of course, the shares may not be sold, assigned, pledged or encumbered in any manner by their owners. Voting rights, however, are not affected.

Other types of escrow arrangement concern the funds to be raised rather than the shares. First of all, if the pre-organization exemption previously discussed is used, the Act provides for escrow of all funds pending further order of the Commission. In actual practice, a bank is commonly appointed escrow agent; when the total amount sought to be raised under the exemption has been placed on deposit with the bank and the Com-

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26. Section 517.06 (10).
27. Section 517.18.
29. Section 517.06(10).
mission notified of that fact and when the company has been granted its charter, the Commission will authorize release of the funds to the treasurer of the new corporate entity.

A third escrow arrangement not expressly provided for in the Act, has been used by the Commission in an obvious attempt to strengthen investor protection. Such an arrangement may be used when the new company's application reveals no history of earnings. Assume, for example, that the new company qualifies under the previously discussed 25 per cent rule; its tangible assets in excess of liabilities equal one-quarter of the amount it seeks to raise. But the idea, product or service is a new and untried one; management is inexperienced. Although no hard and fast rule can be laid down, in such cases the Commission frequently requires that the funds be escrowed until the entire amount of the offering has been raised. This type of escrow arrangement may work a real hardship on the new company which needs funds and needs them immediately but which, under this arrangement, cannot make use of any part of such funds until the total offering has been subscribed. Again, however, the Commission has taken the position that inasmuch as the new venture is an outright speculation, there is no assurance that all or even a substantial part of the funds necessary for adequate financing will be raised. But the escrow arrangement at least insures that funds of subscribers will not be dissipated in a futile attempt to place the enterprise on its financial feet. In addition, from the standpoint of the company, this type of escrow arrangement may actually be a blessing in disguise, for without it, outright denial of the application may result, on the basis that the venture is based upon unsound business principles.

**Purge Registrations**

It often transpires that, through a misunderstanding, misconstruction or even ignorance of the Act, unregistered securities are sold in a public offering where no exemption is available. When this fact comes to the knowledge of the attorney, he should take immediate steps to remedy the situation. To attempt to conceal or ignore the violation is little short of foolhardy, for severe civil and criminal penalties may result. Happily, there is a solution available. Although there has been a violation of the Act and although there is nothing in the Act expressly providing for registration of unregistered securities already sold in a public offering, the Commission for many years has permitted so-called "purge" registrations, as long as the violation was technical. The technical nature of the violation

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30. Apparently this procedure was adapted from a proposed revision to Regulation A of the Securities Act of 1933. This proposed revision was not adopted; it would have required "promotional" companies to escrow funds until 85 per cent of the total offering was subscribed.
31. See §§ 517.21, 517.22, 517.23, 517.30.
is all-important, the word "technical" connoting no intention or design to violate the Act; no registration is available when the violation is a "willful" one. Moreover, the contention that a violation is technical in no way relieves the violator from the criminal and civil penalties of the act if the circumstances reveal that the true nature of the violation was willful.

The actual purge procedure consists, first, of full compliance with the provisions of section 517.21. This important section of the Act provides that if the seller makes a written offer to the buyer to take back the security and to refund the full amount paid, together with interest, failure on the part of the buyer to accept such an offer within 30 days from its receipt shall cause him to lose his civil remedy as defined by this section. It is therefore common practice in such situations to send all purchasers a bona fide written offer of rescission coupled with a release specifying that the corporation or other issuer and its officers, directors and persons occupying similar positions are released from all claims which might otherwise result from the fact that the securities in question were issued to the buyer without first having been registered. A copy of each release is then submitted as an exhibit in the company's application for registration.33

V BROKERS, DEALERS AND SALESMEN

When the enterprise invites the public to subscribe funds, its securities, as pointed out previously, in most instances must be sold by a registered dealer unless sold in an exempt transaction.

Several alternatives are possible at this point. If the enterprise is a seasoned one with a favorable dividend and earnings history, a so-called "firm commitment" underwriting may be available, wherein the broker-dealer purchases the securities outright from the company at a discount and re-sells them to the public. By far the most common method of distribution of new issues, however, is the "best efforts" type of underwriting. In one sense this is not a true underwriting at all, for instead of buying the securities from the company, the broker-dealer promises to use his best efforts to sell them for the company; there is, of course, no liability for unsold shares under this type of arrangement and no committement to buy any amount of shares. Various combinations of the firm commitment and "best efforts" methods of merchandising securities have been employed, but no matter what the method, the Act provides that total expenses of the public offering cannot exceed 20 per cent of the total aggregate sales price.34 The Act makes it clear that whether such expenses are "in cash

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33. The application should disclose that the issuer is in "technical" violation and request that the violation be purged through the registration.
34. Section 517.09 (5). Although this section refers only to sale of securities registered by Qualification, the Commission has, in practice, adopted a 20% maximum figure in connection with securities registered by Notification, on the basis that the power to fix a maximum commission is necessary to prevent fraud upon purchasers. The use of such power has been approved. Op. Att'y Gen. 055-329 (Dec. 9, 1955).
or otherwise, directly or indirectly”, the expenses must not exceed 20 per cent. It seems apparent, then, that granting of the maximum commission of 20 per cent to the underwriter with the understanding that the company is to bear the burden of other expenses in connection with the sale constitutes a violation of this section.

In some instances the company is unable or unwilling to obtain an underwriting. In this event, the issuing company must register as a dealer. Upon receiving a dealer’s permit, the principal officers of the company may proceed to sell its securities. But this permission to sell applies only to the company’s “principal officers”, not to non-officer directors or ordinary employees of the company.

Perhaps the greatest forward step in recent years from the standpoint of investor protection in Florida is the new examination requirement for brokers, dealers and investment advisers. Prior to adoption of this amendment, obtaining of a securities dealer’s license was simple—much too simple. The $100 annual fee, five letters of recommendation, a surety bond and “good repute” in business were the inadequate requirements. The Commission had long wanted power to examine applicants for the handling of “other people’s money”; the new amendment grants that power. Whether this amendment satisfactorily deals with the situation remains open to question. It should be noted, first, that the Act reads “may also require” an examination. (Italics added). Whether the Commission will turn this “may” into a “must” in every case or only in those cases in which the qualifications of the applicant are in doubt remains to be seen. Furthermore, does the Commission, under the new law, have power to examine one applicant and exempt another? Again, suppose that the applicant is a corporation whose original officers pass the examination but who later resign. Would the new officers be subject to examination? These questions and many others are ably discussed in a current article dealing with this amendment. The point is, however, that for the first time, some tangible requirement concerning the mental qualifications of brokers, dealers and investment advisers has been enacted into Florida law.

VI STOCK OPTIONS

Stock options, because of their increasing popularity in connection with securities issues, merit special treatment, in the opinion of the writers, in any discussion of Blue Sky Law.

Although the Act contains no express prohibition with respect to options or warrants, the Commission has taken the position that applications which disclose that options have been granted to insiders and not

35. Section 517.12.
to the public investor face probable denial except in unusual instances. The burden rests on the applicant to justify the option.37

With respect to options granted to underwriters, the Commission's consistent position has been one of flat denial of the application. There is a sound statutory basis for this position. Maximum commission to underwriters cannot exceed 20 per cent "in cash or otherwise, directly or indirectly."38 For example, suppose that the total offering price of the issue is $300,000 and that the underwriting commission or discount is $45,000, equal to 15 per cent, plus a two year option to purchase the stock at its initial public offering price. It is obvious in such a situation that there is no method of ascertaining the exact amount of gain that might accrue to the underwriter pursuant to exercise of the option. Moreover, this indirect compensation, when added to the 15 per cent figure, might exceed the statutory 20 per cent maximum. It may be stated, then, almost unqualifiedly, that an application disclosing options to underwriters faces denial.

Options to officers or other employees have met with kinder treatment. Even such options, however, if they are for a long term or tend to dilute the interests of the remaining shareholders in any appreciable manner, may precipitate denial of the application on the ground that public sale of securities under such circumstances might "tend to work a fraud upon the purchaser."39 On the other hand, if the applicant can justify issuance of the option as an inducement for its officers or other employees to become associated with the company or to remain with it and if the option is of reasonable duration and on fair terms, there would seem to be no cogent reason for denial. It is dangerous to generalize, however, in this respect; each case will be judged on its own merits. Counsel should by all means consult with the Commission staff prior to actual processing of the application if there is any doubt in his mind with regard to the validity of the option in question.

CONCLUSION

At the present writing there is every indication that the number of Florida public securities offerings will continue to increase at a rapid pace. This fact spells added importance of the Florida Securities Act to attorneys and businessmen. The writers sincerely hope that their article will in some measure contribute to a better understanding of the Act and its practical application to the processing of securities registrations.

38. Section 517.09 (5).
39. Section 517.09 (7).