

INITIAL STATEMENT OF REASONS
FOR RULE CHANGES UNDER THE
CORPORATE SECURITIES LAW OF 1968

Pursuant to section 11346.2 of the Government Code, the California Corporations Commissioner (the "Commissioner") sets forth below the reasons for the proposed adoption of section 260.004.1 to Article 1 of Subchapter 2 of Title 10 of the California Code of Regulations.

The Department of Corporations (the "Department") licenses and regulates broker-dealers pursuant to the Corporate Securities Law of 1968 (CSL), as amended. Corporations Code section 25004 defines the term broker-dealer, in relevant part, as any person engaged in the business of effecting transactions in securities in this state for the account of others or for his own account, but does not include certain persons excluded by statute. In particular, Corporations Code section 25003 excludes "agents" of broker-dealers or issuers from the definition of the term "broker-dealer."

Additionally, Corporations Code section 25210 requires broker-dealers effecting securities transactions in California to obtain a license from the Department. Corporations Code section 25204 authorizes the Commissioner of Corporations to exempt from licensing: (1) any class of persons, unconditionally, or (2) upon specified terms and conditions or for specified periods, as deemed necessary or appropriate in the public interest or for the protection of investors.

In light of a recent California criminal case, *People v. Cole* (2007) 156 Cal.App.4th 452 ("Cole"), the Commissioner proposes to exempt from licensure as broker-dealers, specified associated persons of issuers who do not receive compensation specifically related to purchases or sales of securities, who limit their capital raising activities, and who have not violated either state or federal securities laws. This rulemaking action is based on requests by Gerald V. Niesar, of Niesar & Vestal, LLP, and the Corporations Committee of the Business Law Section of the State Bar of California (the "Committee"). Mr. Niesar's letter dated March 28, 2008, and the Committee's letter dated March 9, 2009, commented on the need to supplement the sections of the Code of Regulations administered by the Commissioner. The Committee provided language to implement the changes, which the Commissioner has incorporated into this rulemaking action.

In *Cole*, the court examined broker-dealer licensure requirements for directors and officers of issuers. The holding of the case, while addressing serious and unscrupulous behavior by its principals, raises significant concerns for the Department, capital markets, and practitioners.

The *Cole* defendants (the "defendants") were officers and/or directors of multiple corporations that sold promissory notes issued by the corporations. Among the many securities law violations committed by the defendants were violations of broker-dealer licensure requirements under the Corporate Securities law of 1968, as amended.¹

¹ The defendants were also convicted of multiple counts of selling securities by means of false statements or omissions in violation of Corporations Code section 25401. Additionally, the evidence would appear to support a charge that the defendants failed to qualify or exempt the securities issued by Document 09/09 C

During the proceedings, the defendants argued that they were not required to be licensed, since they fell within the "agent" exclusion set forth in subdivision (d) of Corporations Code Section 25003. The subdivision excludes from the definition of the term "broker-dealer" certain officers and directors of issuers that receive compensation specifically related to purchases or sales of securities, which includes, but is not limited to, commissions. However, the court held that since the defendants did not receive such compensation for the sale of securities, they were not "agents" of the issuer, and thus were not excluded from the definition of the term "broker-dealer." Consequently, the court found that the defendants should have been licensed as broker-dealers, in violation Corporations Code section 25210.

While the defendants' conduct was egregious, and their convictions justified, *Cole* creates confusion regarding when officers and directors can rely on the agent exclusion set forth in subdivision 25003(d). Generally, officers and directors of start-up companies that otherwise comply with securities laws, are able to engage in limited capital raising activities incidental to their core business, without having to obtain a broker-dealer license. The *Cole* case creates significant capital raising hurdles for start-up companies, by creating uncertainty surrounding licensure requirements and compensation limitations.

Practitioners have commented that *Cole* is creating serious difficulties in advising clients on how to properly comply with broker-dealer licensing requirements.² Moreover, a narrow reading of *Cole* could result in practitioners providing advice to clients fundamentally at odds with the policy aims of state and federal securities laws.³ For example, the Department is concerned that directors and officers of issuers engaged in the business of effecting transactions in securities, may elect to receive commissions, or other compensation specifically related to purchases or sales of securities, in order to avoid licensure requirements.

The receipt of commissions, and other compensation specifically related to purchases or sales of securities, is an important factor in any policy analysis of whether a person should be subject to licensure requirements. As the Securities and Exchange Commission noted when examining these licensure issues, "[c]ompensation based on transactions in securities can induce high pressure sales tactics and other problems of investor protection which require application of broker-dealer regulation..." Securities Exchange Act Release No. 22172 50 FR 27940, (July 9, 1985). The payment of such compensation increases certain risks to investors, and accordingly, any regulatory solution to the issues raised by *Cole* must place strict limitations on the receipt of these types of compensation.

their corporations, in violation of Corporations Code section 25110.

² See Letters from Gerald V. Niesar, (March 28, 2008), and the Corporations Committee of the Business Law Section of the State Bar of California (March 9, 2009). (On file with the Department of Corporations). See generally, Keith P. Bishop, "A Shot Not Heard- The Court of Appeal Holds that an Issuer's Directors and Officers Must be Licensed as Securities Broker-Dealers" California Business Law News Issue No. 3 (2008).

³ See Commissioner's Opinion No. 119-C (2008) (discussing, inter alia, the narrow basis for the *Cole* decision).

The proposed rule, section 260.004.1, would create a non-exclusive "safe harbor", by excluding associated persons of issuers who do not receive compensation specifically related to purchases of sales of securities, who limit their activities as specified in the rule, and who are not subject to federal or state statutory disqualification provisions, from the definition of the term broker-dealer as set forth in Corporations Code section 25004.⁴ The proposed rule applies solely to the associated person's participation in offer and sales of securities of such issuer. The "safe harbor" would incorporate by reference Securities and Exchange Commission rule 3a4-1 (17 CFR 240.3a4-1).

The rule would exclude associated persons of issuers who:

- Have not violated state or federal securities laws.
- Do not receive commissions, or other compensation specifically related to the sale of securities.
- Are not an associated person of another broker-dealer. Such persons would be required to be licensed.
- Restrict their participation in the offering in accordance with rule 3a4-1.
- Are not employees of such issuer.

The proposed rule is reasonably necessary to ensure clarity with regard to California broker-dealer licensure requirement, and, enactment of the proposed rule would:

- Promote California capital markets activity by facilitating capital-raising by issuers, in situations where the imposition of broker-dealer licensure requirements would not provide corresponding investor protection
- Provide added clarity with regard to licensure requirements, in light of a recent California Court of Appeal decision in *People v. Cole*, 156 Cal.App. 4th 452 (2007).
- Protect investors by ensuring that associated persons of issuers that receive commissions for the sale of securities, or have committed acts in violation of the CSL and federal securities laws, are required to be licensed as broker-dealers in California, and thus subject to increased regulatory supervision.
- Expand and clarify the scope of Commissioner's Release No. 119-C (2008).
- Increase consistency with federal SEC licensure requirements.

⁴ We note in passing that the securities issued in any such offerings remain subject to the qualification, or exemption requirements of CSL.

ECONOMIC IMPACT GOVERNMENT CODE SECTION 11346.2(B)(4)

The Commissioner has made an initial determination that the proposed regulatory action will not have a significant adverse impact on business. Moreover, it is anticipated that the proposed regulatory action will promote California capital markets.

FISCAL IMPACT

There is no cost to local agencies and school districts required to be reimbursed under Part 7 (commencing with section 17500) of Division 4 of the Government Code.

No other nondiscriminatory cost or savings are imposed on local agencies.

DETERMINATION GOVERNMENT CODE SECTION 11346.5(a)(8)

The Commissioner has made an initial determination that the proposed regulatory action will not have a significant adverse economic impact on business. It is anticipated that the proposed regulatory action will, in fact, promote California capital markets.

TECHNICAL STUDIES RELIED UPON

The Department did not rely upon any technical, theoretical, or empirical study, report, or other similar document in proposing this regulatory action.

ALTERNATIVES CONSIDERED

Under Government Code Section 11342.610(b), a broker-dealer is not a small business, and therefore no alternatives would lessen the impact of this rulemaking action on small business.