

Date of Hearing: April 15, 2021

ASSEMBLY COMMITTEE ON BANKING AND FINANCE

Timothy Grayson, Chair

AB 283 (Chen) – As Introduced January 21, 2021

**SUBJECT:** Corporate securities: exemption from requirements

**SUMMARY:** This bill exempts equity-related securities or credits issued by a cooperative corporation as patronage distributions from securities qualification requirements, as specified.

Specifically, **this bill:**

- 1) Exempts from qualification requirements under the Corporate Securities Law of 1968 shares, memberships, or credits to a member's capital as all, or part of, any patronage distributions.

**EXISTING STATE LAW:**

- 1) Provides that it is unlawful for any person to offer or sell any security in this state, unless such offering or sale has been qualified by the commissioner, as specified, or unless the offering or sale is covered by an express exemption (Corporations Code Section 25110).
- 2) Provides under the Corporate Securities Law of 1968 exemptions from qualification for certain securities transactions (Corporations Code Section 25000 et seq). One such exemption includes shares or memberships issued by a corporation organized pursuant to the Cooperative Corporation Law, if the aggregate investment of a shareholder or member in shares or memberships sold does not exceed \$1,000 (Corporations Code Section 25100(r)).
- 3) Establishes the Cooperative Corporation Law (Corporations Code Section 12200 et seq.), which includes the following provisions relevant to this bill:
  - a) If the corporation is organized to provide goods or services to its members, the corporation's "patrons" are those who purchase those types of good from or use those types of services of the corporation (Corporations Code Section 12243).
  - b) If the corporation is organized to market, process, or otherwise handle its members' products or services, the corporation's "patrons" are those persons whose products or services are marketed, processed, or handled by the corporation (Corporations Code Section 12243).
  - c) The patronage of a patron is measured by the volume or value, or both, of a patron's purchases of products from and use of services furnished by the corporation, and by products and services provided by the patron to the corporation for marketing (Corporations Code Section 12243).
  - d) Defines "patronage distribution" as any transfer made to a patron of the corporation the amount of which is computed with reference to the patron's patronage of the corporation (Corporations Code Section 12244).

**EXISTING FEDERAL LAW:**

- 1) Allows a co-op to deduct the amount of patronage dividends from the co-op's gross income (26 U.S.C. Section 1382 (b)).

**FISCAL EFFECT:** Unknown. This bill is keyed fiscal by Legislative Counsel.

**COMMENTS:****1) PURPOSE**

According to the author:

Under current statute, cooperative corporations are unduly burdened by reporting requirements related to disbursements that are made to co-op members. This bill would allow a California cooperative incorporated under the Cooperative Corporation Law an exemption from qualification requirements under California securities law for any equity-related securities it issues as patronage distributions to its members. This bill would also clarify that the existing \$1,000 exemption limit for cooperative equity-related securities applies to each member specifically rather than being inapplicable if any member owns more than \$1,000 in equity-related securities in the cooperative. In doing so, the bill will make clear that each member may directly purchase up to \$1,000 in capital units without the co-op needing a permit related to that member.

**2) BACKGROUND**

A cooperative corporation (or co-op) conducts its business primarily for the mutual benefit of its members as patrons of the corporation. The earnings, savings, or benefits of the co-op are legally required to be used for the general welfare of the members. Whereas a traditional corporation generates earnings for its owners or shareholders, a co-op is required to proportionately and equitably distribute earnings to some or all of its members or its patrons, based upon their patronage of the corporation.

Consumer co-ops and worker co-ops are two general classes of cooperative corporations. A consumer co-op is organized for the benefit of its members who purchase goods or services from the co-op. A worker co-op is organized for the benefit of its members who provide their labor in the production of the good or service sold by the co-op.

Both consumer and worker co-ops are required to distribute their earnings, savings, and benefits to their members. For consumer co-ops, these distributions are based on the amount of money spent by the member at the co-op. The distributions often take the form of an annual dividend, refund, or discount, but may also include property, capital credits (e.g., shares), and other assets or benefits. For worker co-ops, these distributions are based on the amount of hour worked or wages earned and often take the form of a share in year-end profits.

**3) SECURITIES LAW IN CALIFORNIA**

Regulation of the sale and issuance of securities is designed to protect people from fraudulent and excessively speculative investments. Securities regulation began at the state level in the early 20<sup>th</sup> century as investors lost money in fraudulent oil schemes and other exotic investments – lured by promises of incredible returns, but left with the reality of squandered life savings.

From 1911 until 1933, state securities law, known as blue sky laws, developed into a nationwide patchwork with little uniformity between states. Despite their differences, blue sky laws typically share a few common features, including registration requirements for securities. Registration allows state regulators to review a securities offering to ensure that the issuer accurately discloses information about the corporation that will help investors make informed decisions about the security.

As securities were more widely marketed through the 20<sup>th</sup> century, Congress preempted certain blue sky laws to create national standards intended to ease the offering and sale of securities. In 1996 the federal government enacted the National Securities Markets Improvement Act, which exempted certain securities from duplicative state and federal registration requirements. Today, states have limited power to register and review security offerings, but states retain authority over a variety of small or intrastate offerings.

The Corporate Securities Law of 1968 regulates all offers and sales of securities in California. All securities offered or sold must be either qualified with the Department of Financial Protection and Innovation (DFPI) or exempted from qualification. The qualification process requires the issuing corporation to pay a fee to DFPI and may also require the corporation to incur related legal costs.

#### 4) HOW FEDERAL TAX LAW AND STATE SECURITIES LAW AFFECT CO-OPS PAYING PATRONAGE DISTRIBUTIONS

Under federal tax law, a for-profit co-op can deduct the value of patronage distributions made during the tax year from the co-op's gross income, thus reducing the co-op's tax liability. Patronage distributions can take the form of cash, property, debt, capital credits (such as shares in the corporation), memberships, or services. For co-ops with competing cash flow needs (e.g., debt repayment or business expansion), the issuance of capital credits allows the co-op to save cash and use it for other purposes. Under existing state law, however, the co-op may need to obtain a permit from the California Department of Financial Protection and Innovation (DFPI) prior to issuing the capital credits, which requires the co-op to incur legal and permit application costs.

The combination of federal tax law, state securities law, and the business condition of a co-op can create a recipe for countervailing incentives. Because of the favorable tax treatment of patronage distributions, the co-op will likely find that issuing a distribution is in the best interest of its members. The next question to answer is: what form should the distributions take? If the co-op has competing demands for cash, the co-op may be faced with suboptimal options: take out a loan to fund the patronage distributions in cash or pay legal fees and DFPI permit costs to make a portion of patronage distributions in the form of capital credits. Unlike co-ops, traditional corporations do not face this incentive structure as distributions to shareholders do not receive similar favorable tax treatment.

#### 5) HOW THIS BILL PROPOSES TO ADDRESS THE PROBLEM

This bill would make capital credits derived from patronage distributions exempt from the qualification requirements in the Corporate Securities Law of 1968. The bill would also clarify that such capital credits do not count against the existing \$1,000 aggregate investment threshold that exempts certain shares issued by a co-op from qualification requirements. With these two amendments to existing law, co-ops will be able to issue patronage distributions in the form of equity shares without paying for a permit from DFPI.

**REGISTERED SUPPORT / OPPOSITION:**

**Support**

None

**Opposition**

None

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