

Date of Hearing: April 23, 2012

ASSEMBLY COMMITTEE ON BANKING AND FINANCE

Mike Eng, Chair

AB 2081 (Allen) – As Amended: April 11, 2012

SUBJECT: Securities transactions: qualification requirements: exemptions.

SUMMARY: Provides that an issuer can offer or sell securities using any form of general solicitation or general advertising. Specifically, this bill:

- 1) Prohibits unsolicited telephone calls to a person's residence or cellular telephone unless the issuer and the caller reasonably believes after reasonable inquiry, prior to the unsolicited telephone call, that the person is an accredited investor.
- 2) Provides that the sales of securities shall be made only to a person who is or whom the issuer reasonably believes after reasonable inquiry to be an accredited investor immediately prior to the sale.
- 3) Provides that the issuer must show that the offering is suitable for the person based on the person's financial status, objectives, investment experience, time horizon, risk tolerance and any other information the issuer deems relevant. The information showing suitability must be kept for four years.
- 4) Establishes if a person is a natural person, the amount of consideration paid by the purchaser does not exceed 10% of his or her net worth.
- 5) Defines "net worth" as the terms used in the definition of an accredited investor described below.
- 6) Allows the issuer to assume that the person has the capacity to protect his or her interests in connection with the offering due to his or her business or financial experience or the business or financial experience of his or her professional adviser.
- 7) Requires the issuer to specify in all advertisements, communications, sales literature or other information that is publicly disseminated in connection with the offering, that the securities will be sold to accredited investors only.
- 8) Requires the issuer to believe in good faith that the offer and sale are exempt from registration under Section 5 of the Securities Act of 1933.
- 9) Defines "publicly disseminated" as communicated to 100 or more persons or otherwise communicated, used, or circulated in a public manner.
- 10) Requires a legend to be on the cover page of each disclosure document advising that the securities described in the disclosure document or subscription agreement will be sold to accredited investors only.

- 11) Provides that dissemination of information regarding the proposed offering to a person who is not an accredited investor shall not disqualify the offering from exemption under this subdivision.
- 12) Requires the issuer to file with Commissioner of the Department of Corporations (DOC) a notice and pay the fee within 15 days after the first sale of the securities in this state.
- 13) Prohibits the offering by an issuer who is an investment company or a development stage company.
- 14) Provides that a person who purchases securities in an offering that fails to meet all of the terms of this bill can bring action for rescission of the purchase. Also provides for attorney's fees and costs to a prevailing purchaser in any such action.
- 15) Prohibits the exemption:
 - a) If within five years immediately prior the first offer of the security the person has filed a registration statement that is the subject of a currently effective stop order entered by any state securities administrator or the Securities and Exchange Commission.
 - b) If within five years immediately prior to the first offer of the security the person has been convicted of any criminal offense involving fraud, deceit, or any offense concerning the offer, purchase, or sale of any security.
 - c) If the person is subject to a state or federal administrative enforcement order or judgment entered within the five years immediately prior to the first offer of the security finding fraud or deceit in connection with the purchase or sale of any security.
 - d) If the person is subject to any order, judgment or decree of any court of competent jurisdiction.
- 16) Provides that the issuer has the opportunity to clear themselves of a-d listed above.

EXISTING FEDERAL LAW:

- 1) Establishes the Securities Act of 1933 and the Securities and Exchange Act of 1934 administered by the Securities and Exchange Commission.
- 2) Establishes the National Association of Security Dealers that helps define the national behavior standards for member and minimum standards for listed securities which is regulated by the Securities and Exchange Commission.
- 3) Prohibits, Except as provided in Rule 504(b)(1), neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:
 - a) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and

- b) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising. [Rule 502(c) of Regulation D]
- 4) Defines an "accredited investor" as any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person:
- a) Any bank or any savings and loan association or other institution whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any insurance company, any investment company registered under the Investment Company Act of 1940 or a business development company, any Small Business Investment Company licensed by the U.S. Small Business Administration, any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of \$5,000,000; any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such act, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of \$5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;
 - b) Any private business development company;
 - c) Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of \$5,000,000;
 - d) Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;
 - e) Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds \$1,000,000;
 - f) Any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;
 - g) Any trust, with total assets in excess of \$5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person, and;
 - h) Any entity in which all of the equity owners are accredited investors. [17 C.F.R. 230.501] [Rule 501, Regulation D]

EXISTING STATE LAW

- 1) Establishes the Corporate Securities Law of 1968 provides for exemptions from qualification for certain securities transactions. [Corporations Code, commencing with Section 25000]
- 2) Provides that the Commissioner of the DOC to approve all securities offered or sold in California. [Corporation Code, Section 25100]
- 3) Prohibits any person to offer or sell in this state any security in an issuer transaction whether or not by or through underwriters, unless such sale has been qualified under Section 25111, 25112 or 25113 or unless such security or transaction is exempted or not subject to qualification. The offer or sale of such a security in a manner that varies or differs from, exceeds the scope of, or fails to conform with either a material term or material condition of qualification of the offering as set forth in the permit or qualification order, or a material representation as to the manner of offering which is set forth in the application for qualification, shall be an unqualified offer or sale. [Corporations Code, Section 25110]
- 4) Requires all purchasers to have either have a preexisting personal or business relationship with the offeror or any of its partners, officers, directors or controlling persons, or managers (as appointed or elected by the members) if the offeror is a limited liability company, or by reason of their business or financial experience or the business or financial experience of their professional advisers who are unaffiliated with and who are not compensated by the issuer or any affiliate or selling agent of the issuer, directly or indirectly, could be reasonably assumed to have the capacity to protect their own interests in connection with the transaction. [Corporations Code, Section 25102 (f)]
- 5) Defines "issuer" as any person who issues or proposes to issue any security, except that:
 - a) With respect to certificates of deposit, voting trust certificates or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors or persons performing similar functions or of the fixed, restricted management or unit type, "issuer" means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which the security is issued. However, with respect to equipment-trust certificates or like securities, "issuer" means the person by whom the equipment or property is or is to be used.
 - b) With respect to certificates of interest or participation in oil, gas or mining titles or leases or in payments out of production under those titles or leases, "issuer" means the person or persons in active control of the exploration or development of the property who sell those interests or participations or payments or any person or persons who subdivide and sell those interests or participations or payments. The determination of the person or persons in active control of the exploration or development of the property shall be made on the basis of the actual relationship of the parties and not on the basis of the legal designation of a person's interest.
 - c) With respect to a fractional or pooled interest in a viatical or life settlement contract, "issuer" means the person who creates, for the purposes of sale, the fractional or pooled interest. In the case of a viatical or life settlement contract that is not fractionalized or

pooled, "issuer" means the person effecting the transactions with the investors in those contracts.

- d) In the case of an unincorporated association which provides by its articles for limited liability of any or all of its members, or in the case of a trust, committee, or other legal entity, the trustees or members thereof shall not be individually liable as issuers of any security issued by the association, trust, committee, or other legal entity. [Corporations Code, Section 25010]

FISCAL EFFECT: Unknown.

COMMENTS:

Currently, small businesses may be constrained from finding other sources of capital because of the requirement that issuers have a pre-existing relationship. This measure attempts to expand opportunities for small businesses by allowing them to use forms of general solicitation or general advertising. General solicitation would allow issuers to reach out to the "public" if an issuer reasonably believes that the person is an accredited investor. An issuer could use means of advertising through the telephone or internet.

THE JOBS ACT- GENERAL SOLICITATION & GENERAL ADVERTISING

On April 5, 2012, President Obama signed landmark legislation, H.R. 3606, the Jumpstart Our Business Startups Act (the "JOBS Act"). The JOBS Act makes it easier for startups and small businesses to raise funds. This legislation passed Congress through a 73-26 Senate vote and a 380-41 House vote. While the JOBS Act makes various changes, the most important as to the relation of this bill is allowing for general solicitation and general advertising. The passage of this legislation makes AB 2081 unnecessary and duplicative to actions taken at the Federal level. While the SEC does have 90 days from April 5, to change its rules, this would also deem this measure premature considering the finality of the Rules are not in print yet. It is clear with the passage of the JOBS Act that general solicitation and general advertising will be permitted.

Private investment funds generally rely on Rule 506 under Regulation D to issue their securities in the United States without being required to register the securities under the Securities Act. Rule 506 permits a private fund to raise virtually unlimited amounts of U.S. domestic capital so long as the investors are all accredited investors. However, private investment funds and their sponsors still have to find a way to reach accredited investors. Prior to the JOBS Act, Issuers relying on Rule 506 have been prohibited by Rule 502(c) from engaging in any form of "general solicitation or advertising" to attract investors. The SEC has never precisely specified what constitutes a "general solicitation," although a number of no action letters have set out guidance on the "manner of offering" restrictions of Rule 502(c). Issuers have often been cautioned that to avoid a general solicitation, an issuer must approach only offerees with whom the issuer has a "preexisting substantive relationship." Over the last several years, many commentators have noted the deleterious effects on private investment funds' capital raising created both by this "general solicitation" limitation and by the vagueness and apparent internal contradiction in its interpretation.

Title II of the JOBS Act amends Section 4 of the Securities Act to state specifically that a Rule 506 private placement shall not be deemed a public offering solely as a result of general

solicitation or general advertising. It also orders the SEC to modify Rule 506 within 90 days of enactment of the JOBS Act to eliminate its prohibition against general solicitation or general advertising for offers and sales of securities so long as all purchasers of the relevant securities are accredited investors.

The Model Accredited Investor Exemption

The North American Securities Administrators Association (NASAA), the association of state securities regulators, drafted and approved a "Model Accredited Investor Exemption" during its 1997 Spring Conference. When adopted by individual states, the Model Exemption provides a new exemption from registration of securities at the state level for small companies that offer and sell their securities exclusively to "accredited investors." The Model Exemption is based on the premise that accredited investors are capable of undertaking their own due diligence and gauging the risk factors before making any investments in small companies. California adopted a version of the Model Accredited Investor Exemption in 1997. California, at that time, decided to not explicitly allow for general solicitation and general advertising. The model itself also did not explicitly use the terminology of "general solicitation and general advertising."

NEED FOR THE BILL:

According to the Author, "AB 2081 is needed to effectively reverse its severe economic and unemployment downturns, it is imperative that the state takes serious measures, such as enacting AB 2081, that will facilitate access to capital for the small business community so that they can obtain the capital to expand, provide jobs and restart our economy. AB 2081 is designed to allow start-up and emerging growth companies to find sophisticated affluent investors who can provide the fuel for start-ups that have the capacity to grow fast and create jobs, and to develop innovative new technologies that will make our state more competitive in the global economy."

FEDERAL ACITIVITY

The SEC established the Advisory Committee on Small and Emerging Companies (ACSEC) 2011 to seek advice on its rules, regulations and policies, as they relate to emerging companies or privately-held small businesses and publicly traded companies with less than \$250 million in public market capitalization in the areas of:

- 1) Raising capital through securities offerings, including private and limited offerings and initial and other public offerings;
- 2) Trading in the securities of emerging and smaller public companies; and
- 3) Public reporting and corporate governance requirements of emerging and smaller public companies.

On January 6, 2012, ACSEC made its first recommendation: "that the SEC take immediate action to relax or modify the restrictions on general solicitation and general advertising to permit general solicitation and general advertising in private offerings of securities under Rule 506 where securities are sold only to accredited investors." The ACSEC also stated that is their view that those investor protections afforded by the existing restrictions on general solicitation and

general advertising are not necessary in private offerings of securities whereby the securities are sold solely to accredited investors.

In November of 2011, the House passed the "Access to Capital for Job Creators Act" (H.R. 2940) by a large and bi-partisan majority of 413-11. If the bill becomes law, the Securities and Exchange Commission (SEC) would be required within 90 days to revise Rule 506 of Regulation D to permit general solicitation and general advertising for a private offering, as long as all purchasers are accredited investors. Rule 506, which contains no limits on offering size, is the most widely relied upon rule used for private offerings that are exempt from registration under Section 4(2) of the Securities Act.

CONCERNS

The Consumer Attorneys of California have concerns with AB 2081. Their concerns "*stem from the foreseeable consequences of misuse of the proposed exemption. We believe the bill could benefit from a closer look at foreseeable consequences including harm to seniors who qualify as "accredited investors" based on their assets but do not have the financial sophistication to protect their life savings.*

Elderly retirees make up a disproportionately large percentage of people who meet the definition of accredited investors simply because their houses have had longer to appreciate, their savings have had longer to accumulate, they may have taken lump-sum payouts on their pensions and, sadly, many are widowed and hold the proceeds of their spouses' life insurance policies. The funds they stand to lose cannot be replaced. We think a closer look at this issue warrants attention."

QUESTIONS:

In light of the massive changes to federal law from the JOBS Act that permits general solicitation and general advertising, why is this bill necessary?

While the SEC does have 90 days from enactment of the JOBS Act to changes its rules, why would the legislature want to move a bill forward that may differ/counter from federal law? Would it be better to wait and see the final changes and then make changes if necessary?

The DOC is going to have to digest all the changes in the JOBS Act and implement them at the state level, is it necessary to also burden the DOC with another level of changes that may not be necessary and then have DOC determine whether or not AB 2081 is preempted?

RELATED FEDERAL LEGISLATION:

HR 2940 (Rep. Kevin McCarthy CA-22) creates the "Access to Capitol for Job Creators Act" which would remove the restriction on Section 4(2) of the Securities Act of 1933 (15 U.S.C. 77d (2)) by adding before the period the following: “, whether or not such transactions involve general solicitation or general advertising.”

S. 1831 (Thune R-SD) creates the "Access to Capitol for Job Creators Act" to direct the Securities and Exchange Commission to eliminate the prohibition against general solicitation as a requirement for a certain exemption under Regulation D.

HR 2930 (Rep. Patrick McHenry NC-10) creates the "Entrepreneur Access to Capital Act" which would amend the Securities Act of 1933 to exempt from its registration requirements and prohibitions any transactions involving the offer or sale of (crowd funded) securities by an issuer if the aggregate amount sold within the previous 12-month period in reliance upon the exemption is: (1) \$1 million, adjusted for inflation, or less; or (2) \$2 million, adjusted for inflation, or less if the issuer provides potential investors with audited financial statements. Requires the aggregate amount sold to any investor in reliance on this exemption within the previous 12-month period, in either case, not to exceed the lesser of \$10,000, adjusted for inflation, or 10% of the investor's annual income. (Crowd funding is a method of capital formation where groups of people pool money, typically composed of very small individual contributions, and often via internet platforms, to invest in a company or otherwise support an effort by others to accomplish a specific goal.)

RELATED LEGISLATION:

SB 978 (Vargas & Price) (2012 Legislative Session) makes several changes including requiring the commissioner to require the issuer to file a notice of transactions. The failure to file the notice or the failure to file the notice within the time specified by the rule of the commissioner shall not affect the availability of the exemption. Any issuer that fails to file the notice as provided by rule of the commissioner shall, within 15 business days after discovery of the failure to file the notice or after demand by the commissioner, whichever occurs first, file the notice and pay to the commissioner a fee equal to the fee payable had the transaction been qualified under Section 25110. Neither the filing of the notice nor the failure by the commissioner to comment thereon precludes the commissioner from taking any action that the commissioner deems necessary or appropriate under this division with respect to the offer and sale of the securities.

PREVIOUS LEGISLATION:

SB 875 (Price) (2010 Legislative Session) would have exempted from qualification offerings or sales of securities using a general solicitation or general advertising, provided the transaction meets specified requirements, including a requirement that the sales are made to accredited investors. Senate Banking and Financial Institutions.

AB 1644 (Campbell & Briggs) (2001 Legislative Session) would have exempted from qualification offerings or sales of securities using a general solicitation or general advertising, provided the transaction meets specified requirements, including a requirement that the sales are made to accredited investors. Failed passage in Assembly Banking and Finance Committee.

REGISTERED SUPPORT / OPPOSITION:

Support

Small Business California (Sponsor)
California Association of Microenterprise Opportunity (CAMEO)

Opposition

AARP

Concerns

Consumer Attorneys of California

Analysis Prepared by: Kathleen O'Malley / B. & F. / (916) 319-3081