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California Corporate Securities Law of 1968: The Issue of the Nonissuer

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CALIFORNIA CORPORATE SECURITIES LAW OF 1968: THE ISSUE OF THE NONISSUER

On January 2, 1969, California's new Corporate Securities Law (the "New Law") became effective.[1] The New Law replaces a fifty year old Blue Sky Law (the "Prior Law") which the present Commissioner of Corporations termed a "venerable body of regulation . . . prone to hardening of the arteries."[2] In a published draft of the proposed New Law, the Commissioner stated:

> While the Proposed Act preserves almost intact the powers and purposes of the law which has served California for 50 years, it takes into account administrative experience which has demonstrated that in certain areas extensive regulatory procedures are not necessary for the protection of the investor and shifts the emphasis of the regulatory effort from those areas into areas which, by reason of economic, sociological and technological changes have become areas of potential fraud outside effective regulatory effort under the present law.[3]

Under the Prior Law, the Commissioner had no permit jurisdiction over sales by nonissuers.[4] The New Law provides for qualification of nonissuer transactions unless the security or the transaction is specifically exempted. This article will review and comment on the effect of the new nonissuer provisions in light of the need for investor protection weighed against the burden on the nonissuer and on legitimate business interests in California.

I. Why Regulate the Nonissuer Transaction?

An analysis of the reasons why California has chosen to regulate the nonissuer transaction must be made with regard to the State's parental philosophy of securities regulation. Generally, securities administration emphasizes either a regulatory philosophy or one of full disclosure. The disclosure standard of the Federal Acts is based on the theory that full and adequate disclosure will protect the investor from the flaws or fraud of a proposed offering. California takes the position that disclosure alone is not adequate, that the California investor must be protected notwithstanding his full knowledge of certain situations. The more protective regulatory standard of California utilizes disclosure as a means to furnish the adminis-

1 Cal. Corp. Code §§ 25000-804 (West Supp. 1968-69), *repealing* Cal. Stats. 698, ch. 384, § 1 (Reg. Sess. 1949).

2 Volk, *Fifty Years of Securities Regulation in California*, 42 L.A. Bar Bull. 569 (1967).

3 Corporate Securities Law of 1968 (Proposed), Oct., 1967 (Pamphlet distributed by Commissioner containing New Law, soliciting suggestions and recommendations).

4 Where such sale by a nonissuer, however, was found to be for the "benefit of the issuer," a permit was required. *See* p. 89 *infra*.

trator of the law with sufficient information to determine whether a proposed transaction and plan of business is "fair, just and equitable."[5]

The objectives of securities regulation in California are to prevent fraud, to prohibit the sale of unsound securities, and to afford investors at least a fair chance of realizing their objectives in legitimate ventures. The overwhelming reason for regulating the nonissuer transaction is that these same objectives are applicable to both issuer and nonissuer transactions. In many nonissuer transactions, the dangers are diminished by the presence of either (*i*) adequate information concerning the issuer, (*ii*) securities of a sound financial quality, or (*iii*) a sophisticated investor. As in the case of issuer transactions, the presence of such elements should result in appropriate exemptions from qualification requirements, rather than in the formation of a rationale for complete failure to regulate nonissuer transactions.

The Prior Law discriminated against California issuers by allowing a firmly underwritten offering of a foreign issue in California to be deemed a nonissuer transaction and consequently not subject to the permit jurisdiction of the Prior Law.[6] Paradoxically, where the issuer was a California corporation, it was required to obtain a permit from the Commissioner before selling to the underwriter.[7] Apparently, the Commissioner arrived at this result by viewing a firmly underwritten offering as, first, an issuer transaction, *i.e.*, a "sale" by the issuer to the underwriter, and, second, a nonissuer transaction, *i.e.*, the subsequent sale by the underwriter to the investors. By regulating nonissuer transactions, the New Law has removed the discrimination and placed the California issuer on an equal footing with the foreign issuer.

II. THE NONISSUER TRANSACTION

In a consideration of the application of the New Law, a distinction must be drawn between an issuer and a nonissuer transaction. It was also necessary to draw this distinction under the Prior Law in order to determine the Commissioner's jurisdiction; the test, however, was quite different.

Under the Prior Law the Commissioner had no permit jurisdiction over the nonissuer transaction[8] unless such transaction was in substance an issuer transaction.[9] The primary jurisdictional question was whether or not a transaction was made for the benefit, direct or indirect, of the issuer.[10] It was clear that if the transaction was made for the benefit of the issuer, it was deemed to be an "issuer" transaction for regulatory purposes. Thus,

[5] *See* p. 102 *infra*.

[6] Sterling, *The California Corporate Securities Law of 1968 and the Public Company*, 2 BEV. HILLS BAR J. 25 (Oct., 1968).

[7] Cal. Stats. 707, ch. 384, § 1 (Reg. Sess. 1949) (repealed 1969).

[8] *Id.*

[9] *Id.*

[10] *Id.*

where the sole stockholder of a restaurant agreed to sell all of his stock, to effect the resignation of the officers and directors, and to discharge the corporation's liabilities from the proceeds of the sale, the court held that the vendor was an issuer and not a bona fide owner of the securities.[11] In another case the plaintiff entered into a transaction with the sole shareholder of the issuer corporation wherein plaintiff was to lend money to the issuer and to buy a certain number of shares from the sole shareholder. The transaction was held to have been made for the benefit of the issuer,[12] the court finding that the loan and sale of stock were part of an integrated bargain and that the sale was conditioned on plaintiff's loan to the issuer.

In giving the Commissioner jurisdiction over nonissuer transactions, the New Law provides a specific definition of a "nonissuer transaction":

> . . . any transaction not directly or indirectly for the benefit of the issuer. A transaction is indirectly for the benefit of the issuer if any portion of the purchase price of any securities involved in the transaction will be received indirectly by the issuer.[13]

The rules of the Commissioner (the "Rules") add to the nonissuer definition by limiting the term "purchase price" to "only the specific consideration bargained for in return for the securities (which may include the making of a loan to the issuer)" and excluding any remote, contingent, or incidental benefit which may accrue to the issuer, such as inducing a person to become or to remain an employee of the issuer.[14]

In an opinion of the Attorney General of California rendered prior to the New Law, the following nonissuer situations were found to be sales of securities made for the benefit of the issuer.[15] These situations are examined in light of the effect of the New Law.

(1) *Sale of securities for the purpose of financing the issuer, and investment of the proceeds of sale in the issuer by way of contribution of capital or by way of loan.* This direct monetary benefit to the issuer would be deemed an issuer transaction under both the Prior and New Laws.

(2) *Pledge of securities for a loan to the issuer.* Rule 260.011 states that such a loan may be considered as a part of the purchase price flowing to the issuer. Hence this is deemed to be an issuer transaction.[16] Since a pledge of securities for purposes of a loan is made for the specific purpose of securing such loan, as opposed to a sale of securities where a loan may be an incidental by-product, it is clear that such a bargain would be for the benefit of the issuer. If the transaction were made with a bank or other

[11] Pyle v. Shipman, 251 Cal. App. 2d 913, 60 Cal. Rptr. 46 (1967).

[12] Bellerue v. Business Files Institute, Inc., 61 Cal. 2d 488, 393 P.2d 401, 39 Cal. Rptr. 201 (1964).

[13] CAL. CORP. CODE § 25011 (West Supp. 1968-69).

[14] CAL. ADM. CODE title 10, § 260.011 (1968).

[15] 51 OP. CAL. ATT'Y GEN. 40 (1968).

[16] CAL. ADM. CODE title 10, § 260.011 (1968).

financial institution, however, it would be exempt under the institutional investor exemption.[17]

(3) *Grant of an option to purchase securities for the purpose of inducing the grantee to accept employment with the issuer.* It appears to be the intent of the New Law, as indicated in Rule 260.011, that such a transaction is not for the benefit, direct or indirect, of the issuer.[18] However, would a contractual commitment by the grantee to accept employment with the issuer as consideration for the option be the "specific consideration bargained for" which would result in the issuer's receiving a portion of the purchase price and thus an indirect benefit?

(4) *Grant of an option to purchase securities for the purpose of inducing the grantee to act as an underwriter for an issue of securities by the issuer.* Under the New Law this transaction would not be deemed to be for the direct or indirect benefit of the issuer since the consideration bargained for in return for the securities would be a remote, contingent, or incidental benefit to the issuer.

There are no difficulties where an issuer and a nonissuer are not involved in the same transaction. In contrast, where a transaction involving a nonissuer results in the issuer's receiving a direct benefit (*e.g.*, proceeds of sale paid to issuer) or an indirect benefit (*e.g.*, a loan made to the issuer), the transaction would be an issuer transaction. Between these two extremes are the gray areas—nonissuer transactions where the issuer receives some benefit, monetary or other, which may or may not be too remote, contingent, or incidental to make the entire transaction an issuer transaction.

The New Law has attempted to clarify the gray area. In some instances the attempt has fallen short of the mark. Rule 260.011 limits the definition of purchase price to "only the specific consideration bargained for in return for the securities."[19] The inducement of an investor to become an employee of the issuer is set forth as an example of the type of benefit that is too remote to be part of the purchase price. But if the contract of sale between the nonissuer and the buyer provides that the buyer is obligated to purchase stock from the nonissuer and to work for the issuer, such a legally binding commitment could hardly be considered to be a remote or contingent benefit to the issuer. Thus the thrust of the "benefit" provisions appears to imply an intent by the drafters that a finding of benefit to the issuer should be limited to situations where some type of monetary consideration flows to the issuer.

III. QUALIFICATION

Under the Prior Law qualification was by permit only.[20] The New Law

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[17] *See* p. 97 *infra*.
[18] CAL. ADM. CODE title 10, § 260.011 (1968).
[19] *Id.*
[20] Cal. Stats. 707, ch. 384, § 1 (Reg. Sess. 1949) (repealed 1969).

requires qualification of nonissuer transactions unless specifically exempted by statute. Qualification of issuer and nonissuer transactions may be by notification, coordination, or permit. Notification is the basic procedure for qualification of the nonissuer transaction. Section 25130 states that it is unlawful for any person to offer or sell any security in this state in any nonissuer transaction unless: (*i*) it is qualified by coordination[21] or by notification,[22] or (*ii*) it is specifically exempted.[23]

A. Qualification By Notification

To qualify securities by notification, an application to the Commissioner must be signed and verified by either (*i*) the nonissuer seeking to sell, (*ii*) the issuer, or (*iii*) any broker-dealer.[24] The application must contain such information and exhibits as are prescribed by the Rules,[25] but the information required is limited to that known or available to the applicant without unreasonable effort or expense.[26] It is quite possible that a nonissuer will not have knowledge of, or access to, much of the information required by the Commissioner. Since in a nonissuer situation the Commissioner has no power *per se* to compel disclosure by the issuer, he may lack sufficient information to pass on the merits of the proposed transaction. The Commissioner does have the power, however, to enter an order postponing or suspending effectiveness of qualification.[27] There appears to be a conflict between the Commissioner's power to postpone or suspend, if such were to be used as a lever to require additional information, and the prohibitory provision that information may not be required of a nonissuer unless the information is known or reasonably available to him.[28] The Commissioner also has the power to issue a stop order denying, suspending, or revoking effectiveness of qualification if he finds that the proposed plan of business or the proposed sale of securities is not "fair, just and equitable."[29] If no suspension or stop order is in effect and the application has been on file for ten business days, qualification automatically becomes effective.[30]

Qualification of nonissuer transactions by notification will, in effect, qualify the entire class of securities under application regardless of the number of shares owned by the applicant.[31] Such qualification is effective for twelve

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21 CAL. CORP. CODE § 25111 (West Supp. 1968-69).
22 CAL. CORP. CODE § 25131 (West Supp. 1968-69).
23 CAL. CORP. CODE § 25130 (West Supp. 1968-69).
24 CAL. CORP. CODE § 25131(b) (West Supp. 1968-69).
25 *See* CAL. ADM. CODE title 10, § 260.131 (1968).
26 CAL. CORP. CODE § 25131(d) (West Supp. 1968-69).
27 CAL. CORP. CODE § 25143(a) (West Supp. 1968-69).
28 CAL. CORP. CODE § 25131(d) (West Supp. 1968-69).
29 CAL. CORP. CODE § 25140(a) (West Supp. 1968-69).
30 CAL. CORP. CODE § 25131(c) (West Supp. 1968-69).
31 CAL. CORP. CODE §§ 25130, 25104(h) (West Supp. 1968-69).

months.[32] If securities of the same class have been qualified by notification in the past twelve months, or by coordination or permit in the past eighteen months, they are exempt from qualification by notification.[33]

Nonissuer transactions involving securities registered under section 12 of the Securities Exchange Act of 1934[34] (the "1934 Act") are exempt from qualification by notification.[35] This exemption, however, applies only to notification and does not cover situations where the nonissuer is required to qualify by coordination[36] or by permit.[37]

Although the notification procedure is also available for qualifying an issuer transaction, it will find its greatest utilization in connection with nonissuer transactions. A nonissuer transacton of a security in registration under the Securities Act of 1933[38] (the "1933 Act") is not eligible for qualification by notification, but must be qualified by coordination.[39] The nonissuer qualification requirement thus puts the Commssioner on notice of nonissuer trading in non-section 12 securities of smaller companies, which may not be regulated by the Securities Exchange Commission. An objection to the notification procedure is that the disclosure requirements placed on the issuer may be unduly burdensome. Some states, cognizant of the problem, provide for registration by announcement.[40]

B. *Qualification By Coordination*

Section 25111(a) of the New Law reads:

> Any security for which a registration statement has been filed under the Securities Act of 1933 in connection with the same offering may be qualified by coordination under this section either in an issuer or nonissuer transaction.[41]

Conformity to the coordination requirement is not as discretionary as it appears. The language is not mandatory because the applicant can always choose to qualify by permit,[42] a more burdensome and less efficient procedure. But if the securities are eligible for qualification by coordination,

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32 CAL. CORP. CODE § 25132 (West Supp. 1968-69).

33 CAL. CORP. CODE § 25104(h) (West Supp. 1968-69).

34 15 U.S.C. § 78*l* (1964).

35 CAL. CORP. CODE § 25101(a) (West Supp. 1968-69). *See* p. 95 *infra*.

36 CAL. CORP. CODE § 25111 (West Supp. 1968-69).

37 CAL. CORP. CODE § 25113 (West Supp. 1968-69).

38 15 U.S.C. §§ 77a-77aa (1964), *as amended*, (Supp. II, 1965-66).

39 CAL. CORP. CODE § 25131(a) (West Supp. 1968-69).

40 FLA. STAT. § 517.091 (1962), *as amended*, (Supp. 1969). The statute provides that where a security has been outstanding and publicly held for at least one year, a dealer may register by announcement by sending a telegram to the Commissioner which states: (a) name and location of the issuer; (b) a brief description of the security; and (c) a statement that the securities have been outstanding and publicly held for at least one year.

41 CAL. CORP. CODE § 25111(a) (West Supp. 1968-69).

42 CAL. CORP. CODE § 25113 (West Supp. 1968-69).

they cannot be qualified by notification.[43] By using the words "in connection with the same offering" in section 25111(a), the drafters emphasize that the coordination procedure is limited to the securities which are part of a particular block of securities for which a registration is pending. Regulation A offerings are not part of this registration classification since such offerings are exempted from registration.[44] Regulation A offerings, however, will have to be qualified by notification.

An applicant must comply with the filing requirements of the New Law[45] and the Rules,[46] which require the submission of documents substantially identical to those which the applicant was required to file with the SEC under the 1933 Act. The application to the Commissioner must include a copy of the pending registration statement, together with all exhibits, and an undertaking by the applicant to furnish all amendments thereto.

If the application has been on file with the Commissioner for ten days and if a stop order is not in effect, qualification by coordination of the sale of securities automatically becomes effective the moment the federal registration statement becomes effective.[47] The Commissioner has the same power to issue a stop order or to suspend the effectiveness of qualification as he has under the notification process.[48] Qualification by coordination is effective for twelve months.[49] This more efficient procedure allows the Commissioner to take advantage of the full disclosure standards of the 1933 Act by "coordinating" the federal and state effort.

C. Qualification By Permit

The New Law retains qualification by permit in substantially the same form. The law is unclear as to the availability of the permit procedures for

43 CAL. CORP. CODE § 25131(a) (West Supp. 1968-69).

44 17 C.F.R. §§ 230.251-.262 (1968). Where an offering by the issuer does not exceed $300,000 or where the aggregate price of offerings by the issuer and all of its affiliates does not exceed $300,000 in any one year, the offering or offerings is exempt under Regulation A from registration requirements of the 1933 Act; it is necessary, however, to file offering circulars with the SEC. Any one affiliate may offer securities not to exceed $100,000 in any one year. "An 'affiliate' of an issuer is a person controlling, controlled by or under common control with such issuer." 17 C.F.R. § 230.251 (1968). For further discussion of Regulation A, see 1 L. LOSS, SECURITIES REGULATION 609-734 (2d ed. 1961).

45 CAL. CORP. CODE §§ 25111(b), (c) (West Supp. 1968-69).

46 CAL. ADM. CODE title 10, § 260.111 (1968).

47 CAL. CORP. CODE § 25111(c) (West Supp. 1968-69). An additional condition precedent to effectiveness is that a statement of the maximum and minimum proposed offering prices and the maximum underwriting discounts and commissions has been on file with the Commissioner for two business days or such shorter period as permitted by the Commissioner.

48 CAL. CORP. CODE § 25140(a) (West Supp. 1968-69).

49 CAL. CORP. CODE § 25114 (West Supp. 1968-69).

all types of nonissuer transactions. Section 25113 allows qualification by permit of (*i*) issuer and nonissuer transactions otherwise eligible for qualification by coordination and (*ii*) issuer transactions otherwise eligible for qualification by notification.[50] The section, however, does not permit qualification of nonissuer transactions which are eligible for qualification by notification. There appears to be no sound reason for denying a nonissuer use of the permit provisions if he so desires. The permit procedure is more burdensome than qualification by notification.

D. *Nonissuer Qualification Expenses*

Generally, the issuer is prohibited from paying the expenses of a shareholder selling in a nonissuer transaction.[51] The issuer and the nonissuer, however, may agree at the time of purchase from the issuer that it will pay all expenses of a subsequent resale by the nonissuer.[52] If an issuer and a nonissuer are involved in the same offering, the expenses of the offering must be apportioned between them according to their degree of participation.[53]

IV. SECURITIES EXEMPTIONS

A. *For Issuer and Nonissuer Transactions*

Securities issued by certain municipalities,[54] by institutions of various types subject to regulation of federal or state non-security agencies,[55] or by charitable institutions[56] are deemed to be inherently safe and to present a reduced need for investor protection. Such securities are exempt from all issuer and nonissuer qualification requirements under the New Law.[57] The most significant exemption in this broad category is any security listed or approved for listing on the New York Stock Exchange, and any right to purchase such security.[58] This exemption has been criticized on two counts: (*i*) the failure to exempt securities senior to those listed on the New York

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[50] CAL. CORP. CODE § 25113 (West Supp. 1968-69).

[51] CAL. ADM. CODE title 10, § 260.140.22 (1968).

[52] CAL. ADM. CODE title 10, § 260.140.22(c) (1) (1968).

[53] CAL. ADM. CODE title 10, § 260.140.22 (1968).

[54] CAL. CORP. CODE § 25100 (West Supp. 1968-69).

[55] *Id.* The exemptions of this section include, but are not limited to: securities of Federal or State banks [§ 25100(c)]; securities of Federal or State savings and loan associations [§ 25100(d)]; securities of Federal or State credit unions [§ 25100(h)]; securities subject to jurisdiction of State Insurance, Public Utilities, or Real Estate Commissioners [§ 25100(e)]; securities which are shares, investment certificates, or borrower's membership certificates of State savings and loan associations [§ 25100(g)], or of common carriers or public utilities or public utility holding companies, subject to the jurisdiction of the Interstate Commerce Commission [§ 25100(i)].

[56] CAL. CORP. CODE §§ 25100(j),(k) (West Supp. 1968-69).

[57] CAL. CORP. CODE § 25100 (West Supp. 1968-69).

[58] CAL. CORP. CODE § 25100(o) (West Supp. 1968-69).

Stock Exchange and *(ii)* discrimination against securities listed on other exchanges.[59] Although securities listed on all national security exchanges are required by both their exchanges and the SEC to publicize information similar to that required by the New York Stock Exchange, the frequency and quality of information released by corporations listed on the New York Stock Exchange is much greater.[60]

All states having stock exchange exemptions include an exemption for securities listed on the New York Stock Exchange.[61] Except for California and Michigan, the states which recognize the New York Stock Exchange exemption also recognize an American Stock Exchange exemption.[62] Ironically, thirty-one states provide an exemption for securities listed on the Pacific Coast Stock Exchange.[63] As to securities senior to those listed on the New York Stock Exchange, there appears to be no sound basis for exclusion from the exemption. The rights of senior security holders are prior to those of investors in the listed securities deemed not in need of protection.[64]

B. From Qualification by Notification for Nonissuer Transactions

The New Law has undertaken to regulate the nonissuer transaction, including publicly traded secondary offerings. In this regard, the area most in need of regulation is the sale of securities of the smaller, publicly held company which is not listed on a stock exchange. Thus, the law provides a broad exemption from nonissuer qualification for securities of a company which has securities registered under section 12 or section 12(g) of the 1934 Act (hereinafter referred to as a section 12 company).[65] Registration is required under section 12 if the company has securities listed on a stock exchange or if it has assets of $1,000,000 and more than five hundred shareholders. Periodically, issuers registered under section 12 are required to file financial and other material information which will be made available to the public.[66] Security holders of section 12 companies receive information concerning the interests of management in certain transactions, annual certi-

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[59] Sterling, *The California Corporate Securities Law of 1968 and the Public Company*, 2 BEV. HILLS BAR J. 25 (1968).

[60] *Id.*

[61] The states which have no provisions exempting securities listed on stock exchanges are: Connecticut, Delaware, District of Columbia, Nevada, Pennsylvania, and Wisconsin. For a current state-by-state chart of stock exchange exemptions, see 1 CCH BLUE SKY L. REP. 851-71.

[62] *Id.*

[63] *Id.*

[64] *See* Sterling, *supra* note 59, at 31.

[65] CAL. CORP. CODE § 25101(a) (West Supp. 1968-69). The test to determine whether a corporation meets the requirement of section 12(g) is to be applied on the last day of its fiscal year. 15 U.S.C. § 78*l*(g) (1) (1964).

[66] 15 U.S.C. § 78m(a) (1964).

fied financial statements, and detailed disclosure with regard to proxy statements. The availability of such information is the overriding rationale for the exemption.

A company that fails to meet the asset and shareholder requirements of section 12 may voluntarily become a section 12 company and thereby take advantage of the exemption under the New Law. Considering the expense of registering with the SEC and the strict reporting requirements of the 1934 Act, there appears to be little danger that this exemption will be utilized to circumvent the California law.

Section 25101(a)[67] is an exemption only from the qualification by notification requirement of the nonissuer transaction.[68] The section does not exempt securities of a section 12 company in registration under the 1933 Act; such securities must be qualified by coordination[69] or by permit.[70] In addition, the section does not exempt secondary offerings under Regulation A of the 1933 Act if the aggregate offering price of the secondary exceeds fifty thousand dollars.[71]

There is no duplication between the New York Stock Exchange exemption,[72] which applies to companies that are by definition section 12 companies, and the section 12 exemption.[73] Whereas the section 12 company which has securities in registration under the 1933 Act must qualify by coordination or permit, securities of a company listed on the New York Stock Exchange, whether or not such securities are in registration under the 1933 Act, are completely exempt. The following overlap, however, exists between these two exemptions: Securities of a company listed on the New York Stock Exchange which are not in registration under the 1933 Act are exempt from qualification by notification under both the New York Stock Exchange exemption and the section 12 company exemption. The exemption for securities of a section 12 company is justified by the quantity and quality of information available to the public and by the generally higher investment quality of the securities.

V. TRANSACTION EXEMPTIONS

The exemptions discussed above are based on the character of the securities. Although a security may be nonexempt under the law, the nature of the transaction may demand a separate exemption. The following nonissuer transactions are exempt from the qualification by notification require-

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67 CAL. CORP. CODE § 25101(a) (West Supp. 1968-69).
68 CAL. CORP. CODE § 25130 (West Supp. 1968-69).
69 CAL. CORP. CODE § 25111 (West Supp. 1968-69).
70 CAL. CORP. CODE § 25113 (West Supp. 1968-69).
71 CAL. CORP. CODE § 25101(a) (West Supp. 1968-69).
72 CAL. CORP. CODE § 25100(o) (West Supp. 1968-69).
73 CAL. CORP. CODE § 25101(a) (West Supp. 1968-69).

ments of the New Law.[74] These transaction exemptions and the securities exemptions previously discussed operate independently of one another.

A. *Sale to Certain Financial Institutions*

Under the Prior Law, an offer or sale by a foreign issuer to certain sophisticated financial institutions such as banks and insurance companies was exempt. The exemption was not available to California issuers engaged in similar transactions. California issuers have been put on an equal footing under the New Law[75] and the same exemption has been extended to a nonissuer transaction.[76] The exemption is conditioned upon a representation by the financial institution that it is taking for investment and not with a view towards distribution.[77] This representation appears to be overly protective, for it is not likely that a financial institution will allow itself to be utilized as a vehicle for a public distribution of securities. The Rules[78] have expanded the class of sophisticated institutions to include certain colleges and universities, municipalities, and any corporation with a net worth of not less than $14,000,000, provided that the securities being acquired either are senior securities or, if they are common stock, will not represent more than five per cent of the aggregate of outstanding shares of common stock of the issuer. The intent of this exemption is to establish a class of investors who, because of their size or investment experience, do not require the protection of the law.

B. *Sale by Creditors and Judicial Sales*

The New Law retains certain exemptions for issuer transactions allowed under the Prior Law: *(i)* the offer or sale of a security by a bona fide secured party who sells such security in the ordinary course of business to liquidate a bona fide debt and *(ii)* a judicial sale.[79] Traditionally, buyers at judicial sales purchase at their own risk.

C. *Firmly Underwritten Secondary Offerings*

In order to provide the necessary mechanics for public distribution of a firmly underwritten secondary offering, the New Law provides specific exemptions for certain transactions which occur prior to the ultimate public sale. Any transaction or agreement involving underwriters, whether among underwriters or between the nonissuer and an underwriter, is exempt if the sale is qualified prior to distribution in California.[80] This exemption per-

74 CAL. CORP. CODE § 25104 (West Supp. 1968-69).
75 CAL. CORP. CODE § 25102(i) (West Supp. 1968-69).
76 CAL. CORP. CODE § 25104(c) (West Supp. 1968-69).
77 *Id.*
78 CAL. ADM. CODE title 10, §§ 260.104.1, 260.102.10 (1968).
79 CAL. CORP. CODE § 25104(e) (West Supp. 1968-69).
80 CAL. CORP. CODE § 25104(d) (West Supp. 1968-69).

mits an unfettered atmosphere for the vital underwriting dealings—the underwriting agreement and the agreement among underwriters.

With the exception of securities listed on the New York Stock Exchange, a nonissuer sale of a security of a company which has filed a registration statement under the 1933 Act must qualify by coordination.[81] Must the offer of a security in registration be qualified prior to sale? Section 25130, the basic nonissuer notification section, begins, "It is unlawful for any person to offer or sell . . . ."[82] But an offer of a security in registration under the 1933 Act is specifically exempt from the notification requirements.[83] However, the ultimate sale of the securities must be qualified by coordination.[84]

D. *Prior Qualification*

After an issuer transaction is qualified, secondary trading in any security of the same class is exempt for an eighteen month period.[85] Once trading has begun, and after the expiration of the initial eighteen month period, the security of a non-section 12 company is exempt if the security has been qualified by notification within the past twelve months. Thus, for trading to continue in a security of a non-section 12 company, the security must be qualified by notification every twelve months. The rationale for this exemption is that once the Commissioner has passed on the merits of a security, there is no sound basis for him to consider the particular security again within a relatively short period of time.

E. *Effective Date of Requirement of Qualification by Notification*

Although the New Law became effective January 2, 1969, the Rules exempted any nonissuer offer or sale of a security made by or through a broker-dealer prior to May 1, 1969.[86] The rationale behind the deferred starting date was a concession to practicality to allow for the necessary processing time required after the opening January 2, 1969, filing date.[87]

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81 CAL. CORP. CODE § 25111(a) (West Supp. 1968-69).

82 CAL. CORP. CODE § 25130 (West Supp. 1968-69).

83 CAL. CORP. CODE § 25104(g) (West Supp. 1968-69). If the offer is made through an advertisement, such an advertisement is exempt from the advertising provisions of the law. CAL. CORP. CODE § 25300(b)(3) (West Supp. 1968-69).

84 CAL. CORP. CODE § 25111(a) (West Supp. 1968-69).

85 CAL. CORP. CODE § 25104(h) (West Supp. 1968-69). The eighteen month period is apparently determined by the maximum length of time that registration under section 12(g) of the 1934 Act may be delayed. Section 12(g) provides for a maximum filing date of 120 days after the end of the first fiscal year, and a maximum date of effectiveness sixty days after the filing date.

86 CAL. ADM. CODE title 10, § 260.105.3 (1968).

87 H. Marsh, The New California Corporate Securities Law of 1968 (Syllabus of lecture delivered at U.C.L.A., Aug., 1968).

F. Sale by Bona Fide Owner

The New Law exempts:

> Any offer or sale of a security by the bona fide owner thereof for his own account if the sale (1) is not accompanied by the publication of any advertisement and (2) is not affected [*sic*] by or through a broker-dealer in a public offering.[88]

This exemption applies essentially to private transactions, whether they be face-to-face or private placements through a broker-dealer. Where the sale is not accompanied by any advertisement and the seller is dealing directly with the buyer, the personal nature of the transaction obviates the need for protection of the law. The exemption allows broker-dealers to effectuate private placements (limited to less than twenty-five offerees and ten purchasers) where such purchasers are assumed to have the capacity to protect their own interests.[89]

In drafting the exemption, the authors appear to have overlooked one common type of commercial transaction. Suppose the owner of an incorporated (close corporation) retail store wishes to sell his business. The owner proceeds to list the stock of the business with a business broker, who advertises the sale in a newspaper. This transaction apparently fails to satisfy either condition of section 25104, and the exemption is lost. A broker-dealer is defined as a person engaged in the business of effecting transactions in securities in California for the account of others or for his own account.[90] The sale of the retail business by a business broker would be effected "through a broker-dealer in a public offering," and the sale-by-owner exemptions would appear to be lost. Such a transaction, however, was probably not intended to be within the jurisdiction of the Commissioner.

Section 25104(a) provides that the sale by the bona fide owner must be "for his own account."[91] What effect would this provision have on a sale of trust securities by a trustee? As the legal owner, the trustee would satisfy the requirement of "bona fide owner." But is the trustee selling "for his own account"? If not, the trustee would be required to qualify any such transaction by notification. It seems unlikely that this was the intent of the drafters.

G. Unsolicited Broker Transactions

If a transaction is effected by or through a licensed broker-dealer pursuant to an unsolicited order or offer to buy, it is exempt.[92] Traditionally, securities regulation has not been concerned with a sale of securities which is initiated by a buyer and not solicited by a broker-dealer.[93] Clearly, where

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88 CAL. CORP. CODE § 25104(a) (West Supp. 1968-69).

89 CAL. ADM. CODE title 10, § 260.102.2 (1968).

90 CAL. CORP. CODE § 25004 (West Supp. 1968-69).

91 CAL. CORP. CODE § 25104(a) (West Supp. 1968-69).

92 CAL. CORP. CODE § 25104(b) (West Supp. 1968-69).

93 15 U.S.C. § 77d(2) (1964). *See* 1 L. LOSS, SECURITIES REGULATION 697-700 (2d ed. 1961).

the buyer initiates the transaction and the buyer's broker effectuates the sale by soliciting the seller directly, the transaction is exempt. But what if the transaction is effected by or through a broker-dealer who is making a market in the securities? In exempting the broker-dealer who acts pursuant to an unsolicited buy order, section 25104(b) is clear in its intent not to exempt the acts of the broker-dealer who makes a market and actively solicits its buy orders by its listings in the "pink sheets." The Code specifically exempts an inquiry regarding the written bid in the "pink sheets" made by one broker-dealer to another broker-dealer who is making the market.[94] Thus, the failure, and resultant liability, of the market maker to qualify these securities will not affect the validity of the acts of another inquiring broker-dealer who has not solicited the buy order. The question of the market maker's liability to the buyer and related issues of contract and privity should be noted, but are not the subject of this discussion. Section 25104(b) would also exempt a transaction where the broker-dealer acting at the initiation of the buyer effectuates a transaction through another broker-dealer who is making a market outside of California.

H. Broker-Dealer Sales to Non-Residents

A sale of securities by a broker-dealer licensed in California to a resident of a foreign state is exempt from the qualification requirements of the New Law if the security (*i*) is qualified for sale under the law of the purchaser's residence or (*ii*) is exempt from such qualification under that law.[95] Regulation of such sales is not considered to be necessary for the protection of California investors.

VI. MARKET MAKERS

A broker-dealer who wishes to make a market in securities of a non-section 12 company must qualify the securities by nonissuer notification[96] and must renew such qualification every twelve months.[97] None of the exemptions heretofore discussed insulate a broker-dealer who makes a market in such securities. If the securities are qualified by anyone (a nonissuer, the issuer, or any broker-dealer), they can be sold by any nonissuer, including a broker-dealer, for twelve months from the effective date of such qualification.[98] It is contemplated that the Commissioner will maintain a list of securities registered under section 12 of the 1934 Act. A similar list of all non-section 12 securities qualified by notification within a twelve month period would greatly assist the broker-dealer. The burden of inquiry, of course, would be on the broker-dealer.

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94 CAL. CORP. CODE § 25104(b) (West Supp. 1968-69).

95 CAL. ADM. CODE title 10, § 260.105.2 (1968).

96 CAL. CORP. CODE § 25131 (West Supp. 1968-69).

97 CAL. CORP. CODE § 25132 (West Supp. 1968-69).

98 *Id.*

VII. LEGEND OR ESCROW CONDITION

Under the New Law the Commissioner retains the power to restrict transferability of the securities by imposing a legend or escrow condition.[99] Such restriction, however, may not be imposed as a condition of nonissuer qualification by notification.[100] The Commissioner may impose a legend condition upon a proposed issuance of securities where he determines that there is substantial danger that subsequent transfers of such securities might be unfair, unjust, or inequitable to subsequent purchasers despite the provisions of the Code requiring the qualification of nonissuer transactions.[101] An escrow rather than a legend condition may be required where the Commissioner foresees an unusual danger that promotional shares might be distributed to the public despite the legend.[102] Once an escrow or legend condition is imposed, it will be unlawful to transfer the securities without the prior written consent of the Commissioner.[103] It thus becomes clear that the nonissuer qualification exemptions are meaningless if the subject securities are burdened with an escrow or legend condition. Notwithstanding the availability of an exemption, the Commissioner's consent must be obtained before a valid transfer can be effected.

VIII. EXEMPTIONS RECONSIDERED

There are certain exemptions not contained in the New Law which are worthy of consideration.

A. *Standard Manual Exemption*

Many states have statutes exempting securities listed in certain standard manuals.[104] Among the manuals included are Moody's Industrial Manual and Standard & Poor's manuals.[105] The manuals contain general information about the issuer and customarily include financial statements and a capitalization section. There are no general quality standards required for listing which equal the disclosure requirements under either the 1933 Act or section 12 of the 1934 Act. An example of the uncertain standards of the manuals is presented by a letter from a vice president of Moody's Investors Service to Commerce Clearing House:

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99 CAL. CORP. CODE § 25141 (West Supp. 1968-69).

100 *Id.*

101 CAL. ADM. CODE title 10, § 260.141.10 (1968).

102 CAL. ADM. CODE title 10, § 260.141.3 (1968).

103 CAL. CORP. CODE § 25133 (West Supp. 1968-69). *See also* CAL. ADM. CODE title 10, 260.141.11 (1968).

104 For a current chart on those states which recognize a Standard Manual Exemption, see 1 CCH BLUE SKY L. REP. 831-34.

105 Standard & Poor publishes the following financial manuals: Standard Listed Stock Reports; Over-the-Counter and Regional Exchange Stock Reports; Standard American Stock Exchange Stock Reports; and Standard Convertible Bond Reports.

> There is no fixed requirement or qualification for companies and their securities to be listed in Moody's Manual . . . .
>
> The factor of credit and liability is not a qualification for the inclusion of a company in Moody's factual publications. In other words, it cannot be assumed that because a company appears in the Manuals that [*sic*] it is in sound financial condition and that its credit is good . . . .[106]

An advantage of the manual exemption is that the manuals are readily available to the public, as contrasted, for example, with the difficulty encountered by an investor in securing information filed with the SEC under section 12 of the 1934 Act. The information obtained from the SEC, however, is of much higher quality. With regard to investor protection, availability of information to investors is vital, but reliability cannot be permitted to bow to availability.

B. Isolated Transaction

Based on the theory that an infrequent, isolated transaction cannot cause much harm, many states have adopted an exemption for the isolated transaction. Most states leave the term undefined.[107] A few states have attempted a statutory definition of the isolated transaction.[108] The danger in the exemption is that it limits the frequency of transactions but not the monetary value of any single transaction. Presumably, however, a purchaser of a large block of securities would be an experienced investor not deemed to be in need of the protection of the law. The isolated transaction applies to a sale to one buyer, but the number of offerees may be unlimited.

The isolated transaction exemption would be a useful addition to the New Law. To protect the investing public, the exemption could be drawn to apply to a transaction where the aggregate value of the securities being sold is in excess of a stated dollar value. In addition, the buyer would be required to represent that, based on his financial responsibility and business experience suitable to the investment, he is not in need of the protection of the law.

IX. FAIR, JUST AND EQUITABLE

Under the Prior Law the applicant had the burden of demonstrating that "the proposed plan of business . . . and the proposed issuance of securities [were] fair, just and equitable" and that the securities and the method of issuance were free from fraud.[109] The New Law retains the same burden on

106 1 CCH BLUE SKY L. REP. 833.

107 Comment, *Regulation of Nonissuer Transactions Under Federal and State Securities Registration Laws*, 78 HARV. L. REV. 1635, 1646 (1965).

108 North Dakota limits the "isolated sale" transaction to a sale of securities by an issuer or owner if there have been no more than two other sales of securities of the same issue by such issuer or owner within a twelve month period prior to the date of sale. N.D. CENT. CODE § 10-04-06(3) (1960) *as amended* (Supp. 1967).

109 Cal. Stats. 709, ch. 384, § 1 (Reg. Sess. 1949) (Repealed 1969).

the applicant for qualification by permit.[110] Where a nonissuer is qualifying by coordination or by notification, however, the burden shifts to the Commissioner. He must then find that the proposed plan of business or the proposed issuance of securities is not "fair, just and equitable" in order to deny, suspend, or revoke effectiveness of qualification.[111] On closer examination, this widely acclaimed "shift in the burden" appears to be of greater significance from an administrative rather than a legal aspect. For example, a nonissuer who wishes to sell securities which are in registration under the 1933 Act must qualify by coordination.[112] Qualification of the sale of securities automatically becomes effective at the moment the federal registration statement becomes effective if no stop order has been issued by the Commissioner.[113] Because of this "automatic" procedure, the Commissioner will have to find affirmatively that the transaction or proposed plan of business is not "fair, just and equitable" in order to halt the qualification process. From a practical and procedural standpoint, the Commissioner will be more restrained to find that an offering is not "fair, just and equitable," particularly when the registration under the 1933 Act remains viable.

If the Commissioner does issue a stop order, the applicant could, with the consent of the Commissioner, either amend the application or attempt to qualify by permit.[114] As a final alternative, the applicant could choose to litigate after exhausting his administrative remedies.

If the applicant chooses the latter course, who will have the burden of proving to the court that the plan of business and the issuance or sale of securities are "fair, just and equitable"? The New Law gives no indication of an answer unless it is interpreted to present a rebuttable presumption that the offering eligible for coordination or notification is prima facie "fair, just and equitable." Thus, the burden of overcoming such a presumption would be on the Commissioner. A court may well find, however, that notwithstanding the procedural shift of the burden, the applicant always has the ultimate burden of showing that an offering is "fair, just and equitable."

X. CONCLUSION

The New Law has corrected many deficiencies of a clearly outdated Blue Sky law. The overwhelming impact of the New Law is the weaving together of the regulatory efforts of federal and state agencies. The by-products of this effort are the unfettering of a qualification procedure long bogged down in red tape, the freeing of the Commissioner's office from a

110 CAL. CORP. CODE § 25140(d) (West Supp. 1968-69).

111 CAL. CORP. CODE § 25140(a) (West Supp. 1968-69).

112 CAL. CORP. CODE § 25111(a) (West Supp. 1968-69).

113 *See* p. 93 *supra*.

114 If the order is issued under section 25143(a), the Commissioner's consent is not required to amend the application. The Commissioner's consent would be required, however, if the order is issued under section 25140(a).

morass of detail which either served no useful purpose or duplicated the federal effort, and the accelerating of commercial transactions, particularly public offerings, hopefully with no loss of protection of the public.

In assuming jurisdiction over the nonissuer transactions, the New Law has taken a major step forward in overseeing an area of securities transactions having significant impact on the investment community. For the most part, the exemptions to the nonissuer transactions are keyed to securities and transactions where the investors are thought not to require the protection of the law either because the investor is in a position to fend for himself, or because California's interests in its economy and in legitimate business within the state outweigh the relatively small risk of loss to investors.

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