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Regulation of Securities Offerings In California: Is It Time For a Change After a Century of Merit Regulation?

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REGULATION OF SECURITIES OFFERINGS IN CALIFORNIA: IS IT TIME FOR A CHANGE AFTER A CENTURY OF MERIT REGULATION?

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The California securities law originated in 1913 from a populist movement that embodied a paternalistic attitude toward the protection of investors. It was characterized by the registration of offerings of securities with few exemptions and exclusions, a qualitative review of the merits of those offerings and an administrator with broad authority to implement and enforce the law. While the California securities law is still based on merit review, exclusions and exemptions have been added and expanded over the years by the California legislature and securities regulators. More recently, Congress has preempted state registration and merit review of various securities and transactions and this has been implemented and expanded by administrative action.

These developments raise a question as to whether it is time to consider a change in the method of regulating securities offerings in California and, in that connection, to determine whether the system of merit review has outgrown any usefulness it may have had originally. In my view, addressing this issue requires an empirical analysis of the regulation of securities offerings in California and its evolution over the past century.

The analysis begins in Part II with an overview of the history of the California securities law focused on issuer transactions from 1913 to the comprehensive revision of the law in 1968. This is followed in Part III by a more in-depth review and chronology of changes in the law and practice from 1917 to the present pertaining to each of three types of issuer transactions: private stock offerings, real estate syndications, and public stock offerings. Included are developments in the federal securities law and actions taken by self-regulatory organizations that have had an impact on the regulation of these transactions in California. To put

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this in perspective, the review of each type of issuer transaction is preceded by a brief history of capital formation pertaining to that transaction.

Part IV presents data showing the number and types of securities offerings in California for which notices of exemption or applications for qualification by coordination, notification or permit have been filed with the Department. With this background, the rationale for revisiting the method of regulating the offer and sale of securities and the system of merit review in California is set forth in Part V.

In conclusion, I believe it is time to change the method of regulating the offer and sale of securities in California in a manner that would include eliminating or limiting the system of merit review, with a view to enhancing the antifraud enforcement of the California securities law. Several courses of action are explored to accomplish that result.

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I. INTRODUCTION

For years, virtually every offer, sale, or issuance of securities in California by a corporation or other entity required a permit from the department administering the California securities law ("Department").[1] This is because the securities law in California has been based on merit review[2] that empowers the senior administrator of the Department ("Commissioner")[3] to review and evaluate the merits of proposed offers, sales, and issuances of securities to determine whether the applicable standards have been met.

While still being based on merit review, the California securities law has undergone many changes over the last 107 years in an effort to strike a more reasonable balance between protecting the interests of investors and facilitating the raising of capital. A comprehensive revision of the law occurred in 1968.[4] Since then, key exemptions have been added and, more recently, Congress has passed legislation to preempt state registration and merit review with respect to various securities and transactions, which has been implemented and expanded by administrative action. While the Department has periodically reviewed and updated portions of its regulations during this period, the

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1. The California securities law at first was administered by the State Corporation Department and later by a division of the Department of Investments. From 1968 to 2013, it was administered by the Department of Corporations. In 2013, the Department of Corporations and the Department of Financial Institutions were combined to form the Department of Business Oversight (DBO). *See* 1 HAROLD MARSH, JR. & ROBERT H. VOLK, PRACTICE UNDER THE CALIFORNIA SECURITIES LAW §§ 1.01, 2.01[1] (Keith Paul Bishop ed., Matthew Bender rev. ed. 2020). Recently, the Department's name was changed to the Department of Financial Protection and Innovation. *See infra* text accompanying notes 7–9.

2. There does not appear to be a widely accepted definition of merit review (sometimes in a broader sense called "merit regulation"). In general, it refers to the discretion of a state securities administrator to make substantive decisions regarding the merits of a proposed offering. The level of merit review will depend on the formulation of the standard. An offering that becomes effective automatically, subject to the issuance of a stop order, will receive less scrutiny than an offering that becomes effective only upon an affirmative finding that the prescribed standard has been met. *See generally* Ad Hoc Subcomm. on Merit Regul. of the State Regul. of Sec. Comm., *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785, 801–09 (1986) [hereinafter *A.B.A. Report*] (an exhaustive study of merit review under state law in the United States).

3. The senior administrator was the Commissioner of Corporations until the DBO was formed, at which time the senior administrator became the Commissioner of Business Oversight. *See* MARSH & VOLK, *supra* note 1, § 2.01[1]. With the recent change in the Department's name, the senior administrator is now the Commissioner of Financial Protection and Innovation. *See infra* text accompanying notes 7–9.

4. *See* MARSH & VOLK, *supra* note 1, § 2.01[1].

California legislature has been slow in making significant changes to the law and these changes have been made only on a piecemeal basis.

The purpose of this Article is to determine whether there should be a change in the method of regulating the offer and sale of securities in California and, in that connection, whether the system of merit review has outgrown any usefulness it may have had originally. This entails describing the evolution of the California securities law in general and as it pertains to certain types of issuer transactions, as well as examining data regarding the extent to which issuers are relying on exemptions or filing applications to qualify offers and sales of securities. With this background, the rationale for revisiting the method of regulating the offer and sale of securities is presented, conclusions are reached, and various courses of action are explored.

This Article is particularly timely for several reasons. First, it has now been over fifty years since the last comprehensive review and revision of the California securities law. Second, the COVID-19 pandemic has significantly impacted the global, U.S. and California economies. Small businesses in particular have been adversely affected by the shutdown and shelter-in-place orders.[5] Their sustainability and return to profitability will depend in part on their ability to obtain sufficient equity capital and credit in the future,[6] a need that could be ameliorated by easing some of the restrictions on capital formation. Finally, the Department will be undergoing a reorganization over the next few years. The California legislature in August 2020 passed the California Consumer Financial Protection Law.[7] This legislation was signed by the Governor in September 2020 and became effective January 1, 2021. It is tied to Governor's 2020–2021 Budget that provides for significant increases in the Department's funding and personnel to expand its authority and capacity to protect consumers of financial products and services.[8] In an effort to better reflect this new role, its

5. *See generally* U.S. SEC. & EXCH. COMM'N, OFF. OF ADVOC. FOR SMALL BUS. CAP. FORMATION, ANNUAL REPORT FOR FISCAL YEAR 2020, at 11 (2020), https://www.sec.gov/files/2020-oasb-annual-report.pdf (highlighting initial reported impacts of COVID-19 and providing data and analysis of demographic trends for crafting policy solutions).

6. *See id.* at 19–35.

7. Act of Aug. 31, 2020, ch. 157, §§ 1–11, 2020 Cal. Legis. Serv. 1, 3–27 (West).

8. *See* Governor's Budget Summary 2020–21, Gavin Newsom, Governor, State of Cal. 173–74 (Jan. 10, 2020), http://www.ebudget.ca.gov/2020-21/pdf/BudgetSummary/FullBudgetSummary.pdf; S.B. 74, 2019–2020 Reg. Sess., at 113 (Cal. 2020); Keith Paul Bishop, *Despite "Massive Job Losses and Revenue Shortfalls," Governor Continues to Propose Large Increase in*

name has been changed to the Department of Financial Protection and Innovation, and it is now headed by the Commissioner of Financial Protection and Innovation.[9]

II. OVERVIEW OF THE CALIFORNIA SECURITIES LAW (1913 TO 1968)

Between 1911 and 1931, forty-seven states had adopted statutes that regulated the sale of securities (commonly called "Blue Sky Laws").[10] The first securities legislation in California, the Investment Companies Act, was enacted in 1913.[11] It was the product of a progressive program launched after the election in 1911 of Governor Hiram W. Johnson.[12] The Investment Companies Act was said to be:

> designed to protect investors from promoters selling stocks and bonds in illegitimate ventures or for prices fraudulently out of proportion to the value of the stocks and bonds so sold. This law is enlightened legislation for the protection of the public against swindlers. It will make the securities of California corporations respected at home and abroad.[13]

The Act required an application only for the original offer or sale of securities by an issuer, focused on public sales, required a finding that the proposed plan of business was not "unfair, unjust, or inequitable," and permitted "investment brokers" to obtain a general permit to sell securities upon a showing of a good business reputation and dealing only in "good" securities.[14]

The Corporate Securities Act[15] was adopted in 1917 to replace the Investment Companies Act. While it was characterized basically as a

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DBO Staffing, ALLEN MATKINS (May 15, 2020), https://www.calcorporatelaw.com/despite-massive-job-losses-and-revenue-shortfalls-governor-continues-to-propose-large-increase-in-dbo-staffing.

9. Act of Sept. 29, 2020, ch. 264, § 6, 2020 Cal. Legis. Serv. 1, 15–16 (West); *see California Consumer Financial Protection Law*, CAL. DEP'T OF FIN. PROT. AND INNOVATION, https://dfpi.ca.gov/california-consumer-financial-protection-law/ (last updated Dec. 3, 2020, 7:02 PM).

10. For a history of the Blue Sky Laws, see Paul G. Mahoney, *The Origins of the Blue-Sky Laws: A Test of Competing Hypotheses*, 46 J. L. & ECON. 229, 229 (2003); Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 348 (1991).

11. Act of May 28, 1913, ch. 353, §§ 1–25, 1913 Cal. Stat. 715, 715–22 (repealed 1917).

12. *See* John G. Sobieski, *Securities Regulation in California: Recent Developments*, 11 UCLA L. REV. 1, 2 (1963). Mr. Sobieski served as Commissioner from 1959 to 1963.

13. *Id.* at 2–3.

14. Act of May 28, 1913 §§ 2(e), 4(a), 4(b), 5, 6.

15. Act of May 18, 1917, ch. 532, §§ 1–29, 1917 Cal. Stat. 672, 673–86 (repealed 1949).

rewrite and reorganization of the Investment Companies Act, it greatly expanded the jurisdiction and regulatory authority of the Commissioner.[16] In 1949, the Corporate Securities Act was codified in the California Corporations Code as the Corporate Securities Law (collectively, with the Corporate Securities Act, the "1917 Act").[17]

The 1917 Act was totally revised and modernized with the adoption of the Corporate Securities Law of 1968 ("1968 Law"),[18] which still governs securities transactions in California.

A. 1917 Act (1917 to 1968)

To highlight the basic differences in approach and to point out the scope and limitations of the various types of state securities laws, Professor Richard W. Jennings divided them into four classes or combinations of classes as follows: "(1) fraud prevention; (2) licensing of broker-dealers; (3) qualification of securities, restricted to fraud prevention by compelling 'full disclosure'; and (4) qualification of securities, with the imposition of varying degrees of substantive regulation of the terms and conditions under which securities may be sold or issued."[19]

The 1917 Act, according to Professor Jennings, "combines broker-dealer regulation, fraud prevention, and disclosure with administrative supervision over sales or issues of new securities in the state by an issuer; alteration of outstanding securities through charter amendments; and exchanges of securities effected through merger, consolidation, or voluntary recapitalization."[20] It was characterized by him as one of the "more far-reaching systems of securities regulation."[21] He

16. *See* MARSH & VOLK, *supra* note 1, § 1.03[1][a].

17. Act of May 23, 1949, ch. 384, § 1, 1949 Cal. Stat. 698, 698–722 (codified as amended at CAL. CORP. CODE §§ 25000–25104).

18. Act of May 9, 1968, ch. 88, § 2, 1968 Cal. Stat. 243, 243–56 (codified as amended at CAL. CORP. CODE §§ 25000–25804).

19. Richard W. Jennings, *The Role of the States in Corporate Regulation and Investor Protection*, 23 L. & CONTEMP. PROBS. 193, 208 (1958). Professor Jennings, an internationally known expert on corporate law and securities regulation, was a faculty member at the University of California, School of Law from 1947 to 1983. Professor Jennings and Professor Harold Marsh, Jr. were the coauthors of the first casebook on securities regulation, RICHARD W. JENNINGS & HAROLD MARSH, JR., SECURITIES REGULATION: CASES AND MATERIALS (1963), and were responsible for later editions and supplements until 1998. *See* David S. Ruder, *A Tribute to Richard W. Jennings*, 88 CALIF. L. REV. 272, 272–73 (2000).

20. Jennings, *supra* note 19, at 213.

21. *Id.* at 212.

wrote further that "the California statute may be regarded as an integral part of a broad scheme for correcting some of the inequities and defects which may otherwise arise in the practices of corporation finance."[22]

The key provision of the 1917 Act was section 3 that read in part as follows: "No company shall sell . . . or offer for sale, negotiate for sale of, or take subscriptions for any security *of its own issue* until it shall have first applied for and secured from the commissioner a permit authorizing it so to do."[23] Section 12 of the 1917 Act then provided that every security issued without a permit or not conforming to the provisions required by a permit shall be void.[24] These sections, in combination, were interpreted to mean that it was the original issuance, not the sale, of securities that was subject to the permit requirements.[25]

Because the trigger was the issuance of securities, the 1917 Act was construed to require a permit for some issuances that arguably might not be considered a sale.[26] For example, the Commissioner took the position that a permit was required for the issuance of securities as a share dividend, in an exchange of securities with existing shareholders, or in a statutory merger or consolidation.[27] The issuance of treasury shares also required a permit since the outstanding shares had been

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22. *Id.* at 213.

23. Act of May 18, 1917, ch. 532, § 3, 1917 Cal. Stat. 672, 673, 675–76 (repealed 1949) (emphasis added); *see* John E. Dalton, *The California Corporate Securities Act—Its Legislative, Administrative and Financial Aspects*, 18 CALIF. L. REV. 115, 130 (1930) [hereinafter Dalton I]. The wording was changed slightly in the 1949 codification to read: "No company shall sell any security of its own issue, . . . or offer for sale, negotiate for the sale of, or take subscriptions for any such security, until it has first applied for and secured from the commissioner a permit authorizing it so to do." Act of May 23, 1949, ch. 384, § 1, 1949 Cal. Stat. 698, 698–722 (codified at CAL. CORP. CODE § 25500); *see* William R. Bickford, *California Corporate Securities Law of 1968: Some Interpretations, Some Problem Areas*, 2 PAC. L.J. 497, 499 (1971).

24. Act of May 18, 1917 § 12. For the legislative history of this provision, see T.W. Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act: III*, 34 CALIF. L. REV. 543, 545 (1946) [hereinafter Dahlquist III]. The words "sold or" had been added before the word "issued" by the time of the 1949 codification. Act of May 23, 1949 § 1; *see also* Bickford, *supra* note 23, at 502 (detailing the evolution of California securities law as to voiding securities issued without a permit).

25. *See* T.W. Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act*, 33 CALIF. L. REV. 343, 350 (1945) [hereinafter Dahlquist I].

26. *See id.* at 351.

27. *See id.*

reacquired and were later reissued.[28] Interestingly, the statute was interpreted to require a permit for the original issuance of securities if the issuer was a California corporation, regardless of where the issuance took place.[29] The Commissioner ultimately took the position that this would also apply to any corporation whose principal place of business activity was located in California, regardless of its state of incorporation.[30] Otherwise, if the securities of a foreign corporation located elsewhere were issued outside California, as in a firm-commitment underwritten offering, no permit would be required for the resale of those securities in California.[31]

Section 3 of the 1917 Act also extended the permit requirements to offers for sale, negotiations for sale, or taking subscriptions for a security.[32] This raised a question as to how these types of preliminary acts of an issuer would be treated short of an actual sale or issuance.[33] The Department was fairly liberal in enforcement when executory contracts were expressly made subject to approval of the Commissioner and a permit was subsequently obtained.[34] However, given the wording of section 3 and the "void" concept in section 12, there was considerable doubt among lawyers as to whether anything could be done to validate a transaction once such a contract had been signed.[35] The Commissioner adopted a practice, which was later authorized by statute, of issuing negotiating or "offering" permits so that issuers could enter into a contract or engage in other preliminary acts without being concerned about violating the law.[36] Eventually, most issuers began applying for negotiating permits before engaging in these

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28. *See* T.W. Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act: II*, 34 CALIF. L. REV. 344, 374 (1946) [hereinafter Dahlquist II]. Treasury shares were eliminated in California effective January 1, 1977. *See* CAL. CORP. CODE § 2309 (Deering 2020).

29. *See* Dahlquist II, *supra* note 28, at 384.

30. *See* MARSH & VOLK, *supra* note 1, § 1.03[2][a].

31. *See infra* text accompanying notes 375–79. The Commissioner had no permit jurisdiction over a nonissuer transaction unless it was in substance an issuer transaction. *See* Marc Levin, Note, *California Corporate Securities Law of 1968: The Issue of the Nonissuer*, 2 LOY. L.A. L. REV. 87, 88 (1969).

32. Act of May 18, 1917, ch. 532, § 3, 1917 Cal. Stat. 672, 673, 675 (repealed 1949).

33. For a discussion of preliminary acts prior to sale, see Dahlquist I, *supra* note 25, at 353–56. MARSH & VOLK, *supra* note 1, § 1.03[3][b].

34. *See* Dahlquist I, *supra* note 25, at 354.

35. *See* MARSH & VOLK, *supra* note 1, § 3.01[3].

36. *See generally id.* § 3.01[2]–[3] (discussing negotiating permits under the 1917 Act).

preliminary acts, especially when any of the negotiations with prospective investors might take place in California.[37]

The definition of "security" in section 2(6) of the 1917 Act enumerated various instruments, including one issued or offered to the public evidencing a right to participate or share in the profits or earnings or distribution of assets, but excepted any security listed in a standard manual upon a finding by the Commissioner that it was accurately described and a sale would not work a fraud upon the purchaser.[38] This definition was amended in 1929 to limit the instruments enumerated, eliminate the reference to instruments issued or offered to the public, and substitute any "beneficial interest in title to property, profits or earnings."[39] Referring to this language, T.W. Dahlquist wrote, "it is clear that there has been an unmistakable trend in the California decisions to interpret the Act liberally and to sweep almost every conceivable sort of interest within the definition."[40] However, its application to offers and sales of partnership interests, particularly limited partnership interests, was subject to some uncertainty, as will be discussed below.[41]

The definition of "sale" in the 1917 Act was fairly straight-forward.[42] It was amended in 1945, to include "any change in the rights, preferences, privileges or restrictions on outstanding securities."[43] This codified a position taken by the Commissioner and the Attorney General with respect to changes in outstanding securities,[44] whether they were adverse or beneficial to security holders.

Unlike the securities laws of many other states, there were no exemptions from the permit requirements for securities listed on a national securities exchange (generally called a "marketplace" exemption) or for some of the most common types of transactions involving

37. *See id.* § 1.03[3][b].

38. Act of May 18, 1917, ch. 532, § 2, 1917 Cal. Stat. 672, 673, 674 (repealed 1949).

39. Act of Aug. 14, 1929, ch. 707, § 2, 1929 Cal. Stat. 1251, 1254–56 (repealed 1949); *see* MARSH & VOLK, *supra* note 1, § 1.03[4].

40. Dahlquist I, *supra* note 25, at 357.

41. *See infra* text accompanying notes 303–06.

42. *See* Act of May 18, 1917 § 2(70).

43. Act of May 18, 1945, ch. 399, § 1, 1945 Cal. Stat. 853, 853–54 (repealed 1949); *see* Marshall L. Small, *Changes in Rights, Preferences, Privileges and Restrictions on Outstanding Securities Under the California Corporate Securities Law*, 14 HASTINGS L.J. 94, 96 (1962); MARSH & VOLK, *supra* note 1, § 1.03[1][d].

44. *See* Small, *supra* note 43, at 95.

the offer, sale, or issuance of securities.[45] The securities laws of other states included, for example, exemptions for securities of corporations that had been in existence for a prescribed number of years and with certain profits earned, securities issued by local companies organized within the state, stock issued to shareholders in connection with a merger or reorganization, and stock sold to existing shareholders.[46]

Except for an exemption for securities issued under a plan confirmed by a court under the federal Bankruptcy Act, there was no exemption for recapitalizations, reorganizations, or other exchanges of securities.[47]

The process of issuing securities usually began with the preparation and filing with the Department of an application for a negotiating or "offering" permit.[48] As discussed later, this posed a dilemma for lawyers because they had to obtain financial and other information to support the sophistication of prospective investors before an application was even filed and a permit issued.[49] An issuer could then file an application for what was called an "open permit" for a public offering or a "closed permit" in which the prospective purchasers were named.[50] This distinction would be used to determine how the applications would be reviewed by the Department.[51] There was no prescribed form for applications for negotiating or definitive permits, and they tended to take somewhat the same form as pleadings in litigation, using legal-sized paper with bluebacks.

The Commissioner was given the power to establish rules and regulations to provide the standards for issuing permits and to authorize the conditions that could be included in permits.[52] Professor Jennings summarized the Commissioner's overriding standard for authorizing and denying permits under the 1917 Act as follows:

> On original issues of securities, the Commissioner is to issue a permit only if he finds "that the proposed plan of

45. *See* Jennings, *supra* note 19, at 216.

46. *See* Dalton I, *supra* note 23, at 132–34; Ronald M. Shapiro & Alan R. Sachs, *Blue Sky Law and Practice: An Overview*, 4 U. BALT. L. REV. 1, 15–19 (1974).

47. *See* Dahlquist II, *supra* note 28, at 350.

48. *See* MARSH & VOLK, *supra* note 1, § 6.05[2].

49. *See infra* text accompanying notes 310–12.

50. *See* MARSH & VOLK, *supra* note 1, § 6.05[3][a].

51. *See id.* § 6.05[3][c].

52. *See* Dalton I, *supra* note 23, at 130.

> business . . . and the proposed issuance of the securities are fair, just, and equitable, that the applicant intends to transact its business fairly and honestly," and that the securities proposed to be issued and the methods of issuing and disposing of them, "are not such as, in his opinion, will work a fraud upon the purchaser"; otherwise, he shall deny the application, refuse the permit, and notify the applicant in writing of his decision.[53]

The specific standards in these rules were generally applied by the staff without granting variances and were interpreted as having the full force and effect of law.[54]

In offerings involving the issuance of promotional shares or shares of highly-speculative ventures, the Commissioner could impose voting switches that entitle a group of shareholders to elect a majority of the board upon a default in the payment of dividends and could require waivers of a promoter's right to receive dividends and liquidating distributions until certain financial or other results were achieved.[55] The Commissioner could also condition the issuance of a permit on the deposit of the securities in escrow, as well as impounding the proceeds and limiting the selling expenses.[56] In the sale of shares to existing shareholders, the Department often required that they first be offered to all shareholders in proportion to the number of shares each held to the total number of new shares to be issued.[57]

The "void" concept also extended to any security sold or issued in nonconformity with any provision in a permit,[58] making compliance

53. Jennings, *supra* note 19, at 214–15 (alteration in original) (quoting Act of July 12, 1965, ch. 1078, § 1, 1965 Cal. Stat. 2727, 2727 (repealed 1968)). Initially, the standard had been worded in the negative, and the Commissioner was authorized to issue a permit on a finding that, among other things, the proposed plan of business was not "unfair, unjust, or inequitable." Act of May 18, 1917, ch. 532, § 4 Cal. Stat. 672, 673, 676–77 (repealed 1949). This was amended in 1947 to the language that was eventually codified at Act of July 12 § 1. *See* Act of May 2, 1947, ch. 130, § 1, 1947 Cal. Stat. 650, 650–51 (repealed 1949); Harriett R. Buhler, *1947 California Corporations Code and Other Corporations Legislation*, 35 CALIF. L. REV. 423, 432 (1947).

54. *See* MARSH & VOLK, *supra* note 1, § 8.01[4][b].

55. *See* Jennings, *supra* note 19, at 215–16; *see also* Charles L. Gladson, Comment, *Securities Regulation: The Voting Switch Condition in a Permit to Issue Securities*, 14 HASTINGS L.J. 169, 169 (1962).

56. *See* Jennings, *supra* note 19, at 215–16; Donald A. Pearce, *Escrows—Burden or Boon?*, 14 HASTINGS L.J. 124, 125 (1962).

57. *See* John E. Dalton, *The California Corporate Securities Act*, 18 CALIF. L. REV. 255, 263 (1930) [hereinafter Dalton II].

58. *See* Dahlquist III, *supra* note 24, at 545–46.

with these conditions more important. Even though the statute provided that securities issued in violation of the permit requirements, or in nonconformity with a permit, were void, this was generally interpreted in the case law as meaning they were voidable whenever necessary for the protection of innocent, original purchasers, or subsequent assignees.[59] A provision was added to the 1917 Act in 1967 allowing an issuer to apply for a curative permit, but the "void" concept remained.[60]

Over the years, the 1917 Act came under increasing criticism. Among the issues cited were the following:

- its discrimination against corporations that were incorporated or had their principal place of business in California,
- overly broad definitions of the terms "security" and "sale,"
- a lack of exemptions for exchange listed securities and for certain limited sales,
- its application to most mergers, recapitalizations, and reorganizations,
- a lack of coordination with the federal securities law,
- the inadequacy of its fraud provisions,
- the overly broad discretion given the Commissioner, and
- the concept that securities issued without, or in nonconformity with, a permit were "void."[61]

The 1917 Act remained in effect for fifty-one years.[62] Although it was amended nearly every year, there had been no substantial modifications.[63] Professor Harold Marsh Jr. and Robert H. Volk, the authors of the leading treatise on California securities regulation, wrote that to understand the 1917 Act one had to put it in perspective.[64] They

59. *See* MARSH & VOLK, *supra* note 1, § 1.03[6][b] (citing Dahlquist III, *supra* note 24, at 553); William A. Dorland, Note, *Noncomplying Securities in California: Judicial Protection of Interests Under Corporations Code § 26100*, 18 STAN. L. REV. 1184, 1184 (1966).

60. Act of Aug. 14, 1967, ch. 1120, § 1.5, 1967 Cal. Stat. 2781, 2781–82 (codified at CAL. CORP. CODE § 25518). The process of applying for a curative permit was carried over to the 1968 Law, *see* Act of May 9, 1968, ch. 88, § 2, 1968 Cal. Stat. 243, 243–56 (codified as amended at CAL. CORP. CODE §§ 25000–25804), but it only applied to securities issued or sold before January 2, 1969, and expired on January 2, 1972. *See* MARSH & VOLK, *supra* note 1, § 1.03[8][g].

61. *See generally* MARSH & VOLK, *supra* note 1, § 1.03[8][a]–[j] (discussing major defects in the 1917 Act).

62. *See id.* § 1.03[1][d].

63. *See id.*

64. *See id.* § 1.03[1][c].

pointed out that because of problems with the securities markets and their structure, as well as the limited communications and transportation facilities of the time, most securities transactions in the early twentieth century were intrastate in nature, involving only the local capital markets.[65] Accordingly, the 1917 Act sought to regulate only issuances of securities by companies within the jurisdiction of the State of California and sales in California by brokers and agents.[66]

Walter G. Olson, who had practiced under the 1917 Act for many years, offered the following comment about the need for a change:

> No one can deny that the old law functioned adequately in the performance of its assigned task of protecting California investors. During those years when it stood alone in providing investor protection, it achieved this protection, for the most part, with reasonable efficiency and without unduly burdening legitimate business processes.
>
> On the other hand, it is equally indisputable that fundamental changes in California's approach to securities regulation were long overdue. A law designed to regulate securities transactions and markets essentially local in character, unassisted by controls at the federal and industry levels, could hardly be expected to function effectively and efficiently when applied to vast interstate securities markets which have been subjected to a major degree of supervision by other regulatory bodies.[67]

While there seemed to be general agreement, with isolated dissents, that a new or substantially revised securities law was desirable, various attempts to obtain major new securities legislation failed.[68] In 1959 and again in 1961, these efforts were directed to adopting the

65. *See id.*
66. *Id.*
67. Walter G. Olson, *The California Corporate Securities Law of 1968*, 9 SANTA CLARA LAW. 75, 75 (1968).
68. *Id.* at 76.

Uniform Securities Act[69] or a modified version of that Act.[70] Assembly Bill (A.B.) 2531, which was introduced in 1959, did not contain the "fair, just, and equitable" standard, but specified other grounds on which the Commissioner was empowered to deny, suspend, or revoke the registration of securities.[71] "These attempts failed and, in 1967, somewhat in desperation, limited amendments to the [1917 Act] were proposed."[72] When the new Commissioner, Robert H. Volk, appointed a committee to undertake a comprehensive reevaluation of securities regulation in California, these proposed amendments were abandoned.[73] This study led to adoption of the 1968 Law by the California legislature in 1968 that replaced the 1917 Act effective January 1, 1969.[74]

B. Adoption of the 1968 Law

While the 1968 Law incorporated some new concepts, the drafting committee and its reporter, Professor Harold Marsh Jr.,[75] also

69. This was the Uniform Securities Act of 1956, which was a product of the National Conference of Commissioners on Uniform State Laws and was designed to guide states in drafting their own securities laws. The Act was revised in 1985 and again in 1988. The latest version is the Uniform Securities Act of 2002, which was last revised in 2005. *See* Joel Seligman, *The New Uniform Securities Act*, 81 WASH. U.L.Q. 243 (2003).

70. *See* Olson, *supra* note 67, at 76. *See generally* Howard C. Ellis & Kenneth D. McCloskey, *The Future of Corporate Securities Regulation in California—Effect of Proposed Uniform Act*, 12 HASTINGS L.J. 256 (1961) (discussing the possible ramifications of adopting the Uniform Securities Act during the 1961 session of the California legislature); Robert H. Edwards, *California Measures the Uniform Securities Act Against its Corporate Securities Law*, 15 BUS. LAW. 814 (1960) (discussing the possible ramifications of adopting the Uniform Securities Act during the 1959 session of the California legislature); Donald A. Pearce, *California Corporate Securities Law vs. Proposed Uniform Securities Law*, 9 HASTINGS L.J. 1 (1957) (discussing the history of the securities law in California and other states and of the Uniform Securities Act).

71. *See* Edwards, *supra* note 70, at 817–21.

72. Olson, *supra* note 67, at 76.

73. *See id.* In addition to Professors Richard W. Jennings and Harold Marsh, Jr., the committee consisted of prominent practitioners, legislators, and then current and prior regulators. *See* Robert H. Volk, *The California Corporate Securities Law of 1968—a Significant Change from Prior Law*, 24 BUS. LAW. 77, 77 n.2 (1968); MARSH & VOLK, *supra* note 1, § 1.05[1][c].

74. Act of May 9, 1968, ch. 88, § 2, 1968 Cal. Stat. 242, 243, 243–56 (codified as amended at CAL. CORP. CODE §§ 25000–25804). For a detailed description of the process that resulted in replacing the 1917 Act, see MARSH & VOLK, *supra* note 1, § 1.05.

75. Professor Marsh was a faculty member at the UCLA School of Law, and an expert on securities and corporate law. *See* MARSH & VOLK, *supra* note 1, at xiii. As the reporter for the committee, he was the principal draftsman of the new securities law. Together with Robert H. Volk, Professor Marsh guided the 1968 Law through the California legislature. *See id.* § 1.05[1][b].

borrowed from the 1917 Act, the Uniform Securities Act, and the federal securities laws.[76]

Several of the criticisms of the 1917 Act were addressed in section 25110 of the 1968 Law.[77] This section provides: "It is unlawful for 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 . . . or unless such security or transaction is exempted or not subject to qualification . . . ."[78] It is the offer or sale of securities, not the issuance, that triggers the need for qualification. In addition, the offer or sale must be made "in this state," which is a new defined term.[79] Under this definition, an offer or sale is deemed to have been made in California if:

- an offer to sell or buy originates from California,
- an offer to sell or buy (wherever originated) is directed to and received in California,
- an offer to sell or buy (wherever originated) is accepted in California or,
- if both the seller and purchaser are domiciled in California, the security is delivered to the purchaser in California.[80]

This was intended to clarify the jurisdictional reach of the California securities law. With this change, the domicile or principal place of business of the issuer and the jurisdiction in which the securities are initially issued were no longer determinative as to whether qualification is required.

While the term "issuer transaction" is not defined, a "nonissuer transaction" is defined in section 25011 as any transaction not directly or indirectly for the benefit of the issuer.[81] This section provides further that a transaction is indirectly for the benefit of the issuer if any portion of the purchase price of any securities involved in the

76. Olson, *supra* note 67, at 77.
77. *See* CAL. CORP. CODE § 25110 (Deering 2020). Unless otherwise indicated, references in the text to sections of the 1968 Law shall be to Title 4, Division 1, of the California Corporations Code and the complete citation will be set forth in the first note citing each section.
78. *Id.*
79. *See id.* § 25008.
80. *Id.*
81. *Id.* § 25011.

transaction will be received indirectly by the issuer.[82] The intent was that any transaction directly or indirectly for the benefit of an issuer is to be treated as an issuer transaction; otherwise it is to be treated as a nonissuer transaction.[83] Qualification of nonissuer transactions was for the first time required by section 25130, subject to the availability of an exemption.[84]

The definitions of "security" and "sale" were also modified. The clause "beneficial interest in title to property, profits, or earnings" was dropped from the definition of "security" in an effort to "curb the tendency of some administrators to find anything and everything to be a 'security.'"[85] Retained in the definition were a "certificate of interest or participation in any profit-sharing agreement" and an "investment contract," which had been interpreted more narrowly.[86]

The revised definition of "sale" requires that a securities transaction be "for value." Section 25017(e) provides that an offer or sale of a warrant or right to subscribe to another security or of a convertible security is deemed to include an offer and sale of the underlying security.[87] Therefore, qualification is required at the time of issuance of options, warrants, rights, or convertible securities, and not when the underlying securities are ultimately issued.[88] The definition also excludes certain stock dividends.[89]

A number of exemptions from qualification were added by the 1968 Law, many of which will be described in detail in Part III. Included are exemptions for securities (including certain listed securities), for transactions by an issuer (including small and limited

82. *Id.*

83. *See* Keith Paul Bishop, *A Taxonomy of Issuer and Nonissuer Transactions*, ALLEN MATKINS (Mar. 4, 2020), https://www.calcorporatelaw.com/a-taxonomy-of-issuer-and-nonissuer-transacations (citing MARSH & VOLK, *supra* note 1, § 10.03[2]).

84. CAL. CORP. CODE § 25130.

85. Olson, *supra* note 67, at 80–81.

86. CAL. CORP. CODE § 25019. For a discussion of how the definition of a "security" has been interpreted by the courts, see generally Georg Behrens, *What Is a Security? The California Synthesis on the 50th Anniversary of the Corporate Securities Act of 1968*, 46 & 47 LINCOLN L. REV. 23 (2019/2020) (discussing the different approaches and tests used to determine what falls within the definition of a security).

87. *See* CAL. CORP. CODE § 25017(e).

88. This is in contrast to the position of the Securities and Exchange Commission (SEC) in not requiring registration of options separate and apart from the underlying shares until the time they become exercisable. *See* Alan H. Hyde, *Employee Stock Plans and the Securities Act of 1933*, 16 CASE W. RSRV. L. REV. 75, 85–86 (1964).

89. *See* CAL. CORP. CODE § 25017(f)(2).

offerings), for reorganizations and recapitalizations, and for nonissuer transactions.[90] The use of negotiating permits was essentially eliminated through the addition of exemptions for offers, negotiations, and agreements for which applications for negotiating permits would otherwise have been required.[91]

The Commissioner was empowered to exempt by rule any transactions as not being comprehended within the purposes of the 1968 Law on a finding that qualification would not be necessary or appropriate in the public interest or for the protection of investors.[92] This authority has been used extensively and provides the Commissioner with considerable flexibility in exempting transactions without having to go through the extensive legislative process that would otherwise be required.[93] Equally important is a provision authorizing the Commissioner to issue interpretative opinions that can be relied upon by the recipient.[94] The Commissioner also issues administrative and interpretative releases to provide guidance under the 1968 Law.[95]

One of the most significant changes in the 1968 Law was to provide for three different procedures for qualification of the offer and sale of securities:

- qualification by coordination[96] applies to offerings for which a registration statement has been filed with the SEC

90. *See* Olson, *supra* note 67, at 82–91; Levin, *supra* note 31, at 94–100.

91. *See* Olson, *supra* note 67, at 87. A definitive permit will normally be issued if a negotiating permit would be issued, except where the material terms of the offering remain to be negotiated. CAL. CODE REGS. tit. 10, § 260.102 (2020). There is no civil liability if a sale is qualified prior to the payment or receipt of any part of the consideration, even though an offer to sell or a contract of sale may have been made or entered into without qualification. CAL. CORP. CODE § 25503.

92. *See* CAL. CORP. CODE § 25105.

93. Olson, *supra* note 67, at 91.

94. *See* CAL. CORP. CODE §§ 25618, 25700; Olson, *supra* note 67, at 91.

95. These releases had been available by mail, but it was not until 1972 that a compilation of releases from 1969 to 1971 was published. *See* CAL. DEP'T OF CORPS., CALIFORNIA COMMISSIONER OF CORPORATIONS OFFICIAL OPINIONS: POLICY LETTERS 1969–1971 (1972). Some of the releases are now available on the Department's website at *Commissioner's Releases, Selected Opinions, Bulletins and Notices*, CAL. DEP'T OF FIN. PROT. AND INNOVATION, https://dfpi.ca.gov/commissioners-releases-selected-opinions-bulletins-and-notices/ (last updated Dec. 11, 2019). The releases can also be found in 3 HAROLD MARSH, JR. & ROBERT H. VOLK, PRACTICE UNDER THE CALIFORNIA SECURITIES LAW app. a-1 (Keith Paul Bishop ed., Matthew Bender rev. ed. 2020) and in LEXISNEXIS, CALIFORNIA CORPORATIONS CODE AND COMMERCIAL CODE WITH SECURITIES RULES AND RELEASES (2021 ed.).

96. CAL. CORP. CODE § 25111.

under the Securities Act of 1933 ("1933 Securities Act"),[97]

- qualification by notification[98] applies to offerings of securities registered under the Securities Exchange Act of 1934 ("1934 Exchange Act"),[99] and
- qualification by permit[100] applies to all other issuer transactions.

Qualification by coordination and notification becomes effective automatically if, in the case of qualification by coordination, certain conditions have been met, and in the case of qualification by notification, the requisite time period has elapsed.[101] Qualification by permit, as before, becomes effective upon the Commissioner issuing a permit authorizing the sale of the securities.[102]

The form for applications became standardized. A facing page was adopted by rule of the Commissioner that requires information about the type of qualification, the applicant, and the offering,[103] and the rules pertaining to each type of qualification contain the information and documents to be included in and to accompany the application.[104]

While the 1968 Law preserves the "fair, just, and equitable" standard, it shifts the burden to the Commissioner in the case of qualification by coordination and notification. The Commissioner may issue a stop order denying, suspending, or revoking effectiveness of qualification by coordination or notification of an underwritten offering on a finding that the order is in the public interest, that the proposed plan of business or issuance or sale is *not* "fair, just, and equitable,"

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97. *See* Securities Act of 1933, Pub. L. No. 111-229, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa).

98. *See* CAL. CORP. CODE § 25112.

99. Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78qq).

100. CAL. CORP. CODE § 25113.

101. *See id.* §§ 25111–25112; Olson, *supra* note 67, at 92–93.

102. *See* CAL. CORP. CODE § 25113; Olson, *supra* note 67, at 93. There is no time limit within which the Commissioner must act, but it has been argued that the Commissioner can be forced to issue or deny a permit within the period required for holding a hearing if it is believed that an unreasonably long delay has occurred. *See* Marc H. Cochran, Comment, *Close Corporation Securities Qualification: A Call for an Extension of Prior Intent*, 19 SANTA CLARA L. REV. 147, 160 (1979).

103. CAL. CODE REGS. tit. 10, § 260.110 (2020).

104. *Id.* §§ 260.111–.113.

that the issuer does not intend to transact its business fairly and honestly, or that the securities proposed to be issued or the method to be used in issuing them will tend to work a fraud upon the purchasers.[105] For qualification by coordination or notification of an offering that is not underwritten, the standard is worded somewhat differently.[106] In addition, the Commissioner's authority to issue a stop order is limited in the case of the qualification by coordination of certain types of registered offerings.[107] In the case of qualification by permit, the Commissioner must make an affirmative finding with respect to these same standards, including that the proposed plan of business and the proposed issuance of securities are "fair, just, and equitable."[108]

The rules adopted by the Commissioner establish standards to evaluate a wide variety of proposed offerings of securities and differ depending upon whether a "limited offering qualification" or an "open qualification" is being sought.[109] They are presented as guidelines in the situations covered for the exercise of the Commissioner's discretion and, unlike the practice under the 1917 Act, are not meant to preclude the application of more liberal or stringent standards if justified by the circumstances.[110] A variation will be granted at the request of an applicant in the case of a limited offering qualification if it is possible to find that the offer and sale will not be "unfair, unjust or inequitable" to the initial purchasers.[111]

Finally, the 1968 Law eliminated the concept that securities issued without a permit or in nonconformity with a permit were "void."[112] This was always a particularly troublesome problem for lawyers and had generated a considerable amount of litigation.[113] Walter G. Olson, commenting on the elimination of the "void" concept, wrote: "A more glaring failure to provide legislative guidance for the courts is difficult to find, and it is no wonder that the result has been

105. *See* CAL. CORP. CODE § 25140(a)(1).
106. *See id.* § 25140(a)(2).
107. *See infra* text accompanying note 412.
108. *See* CAL. CORP. CODE § 25140(b).
109. *See* CAL. CODE REGS. tit. 10, § 260.001(e)–(f). The distinction is whether the offer and sale of the securities is only to persons designated by name or class or is without restriction as to the persons or class of persons.
110. *See id.* § 260.140; MARSH & VOLK, *supra* note 1, § 8.01[4][c].
111. CAL. CODE REGS. tit. 10, § 260.140.
112. *See* MARSH & VOLK, *supra* note 1, § 14.06[1].
113. For a discussion of this litigation up to 1946, see Dahlquist III, *supra* note 24, at 551–54.

irremedial [sic] chaos for the honest issuer and frustrating ineffectiveness for the practitioner seeking proper redress for his injured client."[114] In lieu of this concept, the 1968 Law provides for specific civil remedies and time limits for an investor to make a claim. In the case of a permit violation, it allows an issuer to make a written repurchase offer to cut off an investor's private right of action.[115]

III. CHANGES AFFECTING CERTAIN ISSUER TRANSACTIONS

With this overview, we will now examine how changes in the California securities law over time affected each of three types of issuer transactions: private stock offerings, real estate syndications, and public stock offerings.[116] To put this in perspective, each of these sections begins with a brief history of capital formation pertaining to that type of transaction. This is followed first by a description of practice under the 1917 Act through 1968 and then of practice under the 1968 Law to the present. Included are developments in the federal securities law, as well as actions taken by self-regulatory organizations, that have had an impact on the California securities law as applied to each of these types of issuer transactions. Many of these changes are presented by category (e.g., exemptions and qualification) roughly in chronological order to give a sense of timing and the rate at which they were made.

A. Private Stock Offerings

The discussion begins with private offerings of stock, which for this purpose means the nonpublic offer and sale of stock only to persons designated by name or class.[117]

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114. Olson, *supra* note 67, at 96.

115. *See* CAL. CORP. CODE § 25507(b) (Deering 2020); Olson, *supra* note 67, at 97.

116. These are all issuer transactions and were selected as being those that arguably were impacted the most by the changes in the California securities law. Other transactions that were also impacted include changes in rights, preferences, privileges, and restrictions; mergers and acquisitions; and nonissuer offers and sales of securities.

117. This is taken from CAL. CODE REGS. tit. 10, § 260.001(e) (2020), which defines a "Limited Offering Qualification" as "a qualification which authorizes the offer and sale of securities only to persons designated therein by name or class."

1. Background

During the first part of the twentieth century, merchant banks and the public would buy shares in, or lend money to, companies with tangible assets or recurring revenues.[118] Ventures that fit in neither category presented a greater risk and were forced to rely for capital on wealthy individuals and families.[119] Most of this investment activity originated in the eastern United States. An exception was William H. Crocker, a well-respected San Francisco financier and son of Charles Crocker (one of the "big four" railroad entrepreneurs), who began investing in startups in the early 1900s, including the Federal Telegraph Company.[120]

Another innovator from that era was A.P. Giannini, who through his Bank of Italy, focused on a neglected market, taking deposits from and making loans to small businesses and individuals.[121] The bank spread throughout California in the 1920s by establishing branches and eventually was renamed the Bank of America.[122] By 1921, it had four hundred thousand depositors, the most in the United States, and six years later it surpassed one million depositors and was the nation's third largest bank by assets.[123] It survived the Great Depression and in 1945 became the world's largest bank.

California was spared the full impact of the Great Depression until the early 1930s.[124] Because the California economy was diversified, it was not crippled as much as many of the industrialized states of the Northeast or the Midwestern states whose economies were based on agriculture.[125]

Among the laws enacted by Congress after the stock market crash in 1929 were the following:

- The 1933 Securities Act that requires the registration with the SEC of offers and sales of securities using interstate

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118. *See* Nicolas Colin, *A Brief History of the World (of Venture Capital)*, THE FAMILY (May 4, 2016), https://salon.thefamily.co/a-brief-history-of-the-world-of-venture-capital-65a8610e7dc2.

119. *Id.*

120. *See* TOM NICHOLAS, VC: AN AMERICAN HISTORY 84–85 (2019).

121. *See* Jason Zweig, *An Unlikely Hero for 1906, 1929 . . . and Today*, WALL ST. J. (May 29, 2020, 11:00 AM), https://www.wsj.com/articles/an-unlikely-hero-for-1906-1929-and-today-11590764100; *see also* KEVIN STARR, CALIFORNIA: A HISTORY 187–89 (2005).

122. Zweig, *supra* note 121.

123. *Id.*

124. *Id.*

125. STARR, *supra* note 121, at 193.

transportation, commerce, or the mails absent the availability of an exemption and prohibits misrepresentations and other fraud in the sale of securities.[126]

- The 1934 Exchange Act that empowers the SEC to register, regulate, and oversee brokers, transfer agents, and clearing agencies, as well as self-regulatory organizations such as securities exchanges.[127] It also prohibits certain types of conduct in the securities markets and provides for registration, reporting, and disclosures by companies having publicly-traded securities.
- The Banking Act of 1933 ("1933 Banking Act") (better known as the Glass-Steagall Act)[128] that, in an effort to curb conflicts of interest and excessive risk taking, separated commercial banking from underwriting and securities trading.

The 1933 Securities Act created dual federal and state regulation of securities transactions.[129] Its limitations on the solicitation of investors, together with the requirements imposed by the states, made it more difficult for startups and smaller businesses to raise capital. Consequently, funding usually came from the founders, their families, and others with whom the founders had social or business relationships.

World War II had a significant impact on the California economy. The federal government spent more than $35 billion in California during the war years.[130] This influx of funds multiplied California's manufacturing economy "by a factor of 2.5 and tripled the average

126. Securities Act of 1933, Pub. L. No. 111-229, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa).

127. Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78qq).

128. Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.); *see* JONATHAN BARRON BASKIN & PAUL J. MIRANTI, JR., A HISTORY OF CORPORATE FINANCE 204 (1997). The 1933 Banking Act was largely repealed in 1999 when Congress passed the Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended in scattered sections of 12 U.S.C. and 15 U.S.C.) which allowed commercial banks to again engage in investment banking and securities trading.

129. For an interesting discussion of the scope of the state and the newly-adopted federal securities laws, the extent to which they were concurrently applicable, and the need, if any, for correlation of the regulatory functions of each, see Russell A. Smith, *The Relation of Federal and State Securities Law*, 4 L. & CONTEMP. PROBS. 241 (1937).

130. STARR, *supra* note 121, at 237.

personal income."[131] There was also a huge increase in the population caused in part by the growing economy and the opportunities it presented. The new challenge after World War II was to provide the capital necessary to convert U.S. industry from manufacturing weapons and other military systems to manufacturing consumer goods.[132] In the mid-1940s, a few wealthy individuals and families created their own investment firms to make equity investments.[133] In these firms, professional management teams took responsibility for sourcing opportunities, evaluating risks, and negotiating the terms of the investments.[134] By 1946, several of these firms were based in San Francisco,[135] and later others were established in Southern California. Since these firms did not rely on government support with the attendant regulatory requirements, they were somewhat more attractive to entrepreneurs. The source of equity capital for startups and smaller businesses, however, continued largely unchanged.

The Small Business Act of 1953,[136] enacted by Congress in 1953, created the Small Business Administration (SBA). The authority of the SBA was limited to making direct loans to businesses or arranging for loans to be made by qualified lenders that are partially guaranteed by the federal government.[137] In order to encourage technological advances during the Cold War, Congress passed the Small Business Investment Act of 1958.[138] This Act allowed licensed private firms, known as Small Business Investment Companies (SBICs), to borrow funds from the federal government at below-market rates that could be leveraged against privately-raised funds for investment in debt or equity of entrepreneurial ventures.[139] Over 700 SBICs were in operation by the mid-1960s.[140]

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131. *Id.*

132. Colin, *supra* note 118.

133. *Id.*

134. *Id.*

135. *See* NICHOLAS, *supra* note 120, at 97 tbl.3-1.

136. Small Business Act of 1953, Pub. L. No. 83-163, 67 Stat. 232 (codified as amended at 15 U.S.C. §§ 631–657u).

137. *Id.* at 235–36.

138. Small Business Investment Act of 1958, Pub. L. No. 85-699, 72 Stat. 689 (codified as amended at 15 U.S.C. § 661).

139. *See generally The History of Private Equity*, INVESTMENT U, https://investmentu.com/private-equity-history/ (last visited Oct. 4, 2020); NICHOLAS, *supra* note 120, at 135–42 (discussing the rise and development of SBICs).

140. *See* NICHOLAS, *supra* note 120, at 137 fig.4.5.

By this time, "aspects of the modern [venture capital] investment model had started to be established."[141] Independent venture capital firms were formed with professional managers, many of whom had prior experience with SBICs, to meet the demand that arose from small, newly-created companies with high growth potential.[142] This category of investment was known as risk or venture capital and was a subset of private equity.[143]

When the Employee Retirement Income Security Act of 1974[144] was enacted in 1974, a prudence rule made it uncertain as to whether corporate pension funds could invest in risky investments, including investments in small or new companies. In 1979, an amendment was introduced that made it possible for pension plans to use a total portfolio approach to managing risk exposure, rather than to subject single investments to a risk analysis in isolation.[145] As a result, more institutional investors, such as pension funds, foundations, and endowment funds, made investments in private equity and venture capital firms.[146] An example is the California Public Employees' Retirement System.

Beginning in the 1980s, many large corporations began to sponsor in-house venture capital units for financial gain as well as to expand their technological reach.[147] Outside the formal venture capital investing channel, capital also became available from individuals (called "angel investors"), typically having a net worth in the millions of dollars. It was estimated that by the late 1980s, about 250,000 angel investors existed (roughly 100,000 being active at any point in time), and they collectively accounted for a pool of capital at least twice the size of that managed by organized venture capital firms.[148]

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141. *Id.* at 142–43.

142. *Id.*

143. The other subset of private equity consists of firms that were formed to effect and manage leveraged buyouts of existing companies.

144. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified in scattered sections of 29 U.S.C.).

145. *See* NICHOLAS, *supra* note 120, at 176–77. In 2020, the Department of Labor issued an information letter that allowed investments in private equity as a component of professionally-managed defined contribution plans, such as 401(k) plans. Press Release, U.S. Dep't of Labor, U.S. Department of Labor Issues Information Letter on Private Equity Investments (June 3, 2020), https://www.dol.gov/newsroom/releases/ebsa/ebsa20200603-0.

146. *See* NICHOLAS, *supra* note 120, at 176–77.

147. *Id.* at 243–46.

148. *Id.* at 239.

A major development that had a significant impact on private and public offerings was the enactment by Congress of the National Securities Markets Improvement Act of 1996 (NSMIA).[149] NSMIA expanded the source of private equity and venture capital by increasing the number and type of persons who could invest in private investment companies before they would be required to register under the Investment Company Act of 1940 ("Investment Company Act").[150] The Act added an exclusion from registration allowing private investment companies to sell interests to "qualified purchasers," which include natural persons, family-owned companies, and institutional investors that own not less than a specified dollar amount of investments.[151]

As time went on, the venture capital and private equity firms achieved scale through a combination of government policy and loans from the banking sector, as well as a robust market for initial public offerings (IPOs) that, along with the sale of portfolio companies, created an opportunity for liquidity.[152] In 2019, 10,430 companies received $133 billion in venture capital funding, with California firms accounting for 33.7 percent of the investment in these companies, 49.2 percent of the capital invested, and $257.7 billion of assets under management.[153] It was also estimated that the number of active angel investors reached over 330,000 and the amount invested exceeded $23 billion in fiscal 2019.[154]

149. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.).

150. Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1–80a-64).

151. *See* Privately Offered Investment Companies, Investment Companies Act Release No. 22,597, 62 Fed. Reg. 17,512 (Apr. 9, 1997) (codified as amended at 17 C.F.R. pt. 270). The Investment Company Act was amended by the Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, 132 Stat. 1296 (2018), to increase another exclusion from no more than one hundred investors to no more than 250 investors with other limitations.

152. *See* NICHOLAS, *supra* note 120, at 239.

153. *See* Yearbook, NVCA 2020 Yearbook, Nat'l Venture Cap. Ass'n 17, 24, 28 (Mar. 2020), https://nvca.org/wp-content/uploads/2020/04/NVCA-2020-Yearbook.pdf (includes angel investor and corporate venture capital participation). While the number of venture capital transactions declined significantly in the first half of 2020, there was only a small decline in total dollar volume. *See* Yuliya Chernova, *Venture Capital Deals Stay Strong, Despite Pandemic*, WALL ST. J., July 15, 2020, at B4.

154. *See* U.S. SEC. & EXCH. COMM'N, OFF. OF ADVOC. FOR SMALL BUS. CAP. FORMATION, ANNUAL REPORT FOR FISCAL YEAR 2019, at 18 (2020), https://www.sec.gov/files/2019_OASB_Annual%20Report.pdf [U.S. SEC. & EXCH. COMM'N, ANNUAL REPORT FOR FISCAL YEAR 2019].

One cannot overlook, however, the significance of small businesses in the economy, many of which are not dependent on institutional investment sources. It is estimated that in 2019 a majority of the early-stage small businesses relied on personal funds, retained earnings, loans, or credit cards for capital, while only 7 percent relied on equity investments.[155]

While agriculture, entertainment, tourism, manufacturing, and other sectors continue to be important for the growth of the California economy, Silicon Valley has become the leading center for high-tech innovation and development. In 2019, California represented 15 percent of the U.S. economy, and if it had been considered separately, it would have been the fifth largest economy in the world, ranked between Germany and the United Kingdom.[156] This of course does not reflect the impact of the COVID-19 pandemic beginning in 2020. It is still too early to predict how long this condition might last, and what the new "normal" might look like.

2. Practice Under the 1917 Act (1917 to 1968)

Under the 1917 Act, almost every offer, sale, and issuance of stock in a private offering in California had to be qualified by permit. As previously discussed, the exemptions were few in number. Professor Jennings wrote that "the California statute rejects the idea of a small issues exemption of corporate securities, based upon private offers, amount of securities, or the number of offers or sales, the theory being that such exemptions are neither necessary nor advisable," and further that "[a] 'private-offering' exemption when applied to corporate securities has proved to be much too vague and susceptible of evasion."[157] Consequently, issuers were required to obtain permits for the issuance of shares to one person, to existing shareholders, to individuals and their spouses upon the initial organization of a so-called "mom and pop" business, or to a public company in connection with the formation of a wholly-owned subsidiary. In addition, there was no exemption for sales by companies that had securities listed on a national securities exchange, the theory being "that merely listing a

155. *Id.* at 16.
156. *See Best States for Business 2019*, FORBES (Dec. 2019), www.forbes.com/places/ca/.
157. Jennings, *supra* note 19, at 217.

security for trading confers no badge entitling it to immunity from regulation."[158]

The process often began with the filing of an application for a negotiating or "offering" permit.[159] The dilemma for lawyers in applying for these permits is covered later in some detail in the discussion of real estate syndications. To obtain a permit covering the actual issuance, a separate application for a definitive or "closed" permit had to be filed with the Department.[160] Applications for negotiating and definitive permits generated a lot of work for lawyers and were a significant burden in terms of time and expense for issuers, particularly small businesses.

Even in the most straight-forward transactions, it was common for an examiner to send a letter asking questions or pointing out what were viewed as deficiencies in an application. Given the limited methods of communication of the day, the policies adopted by the Department were not widely known. Communications with the examiner were conducted by mail, telephone and, when necessary, personal appearances at the Department. Any deficiencies could be remedied by filing an amended application. Unresolved issues were often appealed to a supervisor or Deputy or Assistant Commissioner. When there were particular issues that lawyers would like to have considered by the Department, it was not unusual for a pre-filing conference to be requested. Most problems tended to be worked out, and there were relatively few denials, abandonments, or withdrawals.

As one of the conditions previously discussed,[161] permits increasingly contained a requirement that the certificates representing the shares be deposited and remain in escrow until released by an order of the Commissioner.[162] In addition, any transfers of the shares held in escrow required the consent of the Commissioner.[163] This condition was initially imposed to maintain control over secondary distributions or resales of the securities and later out of a concern that they might

158. *Id.* at 216–17.
159. *See* MARSH & VOLK, *supra* note 1, § 3.01[2].
160. *See id.* § 6.05[3][a].
161. *See supra* text accompanying note 56.
162. *See* MARSH & VOLK, *supra* note 1, § 1.03[7][d].
163. *See id.*

be transferred to unsophisticated persons who might not have adequate knowledge of the business or affairs of the issuer.[164]

The Commissioner served as the escrow holder unless another person was designated in the permit to act in that capacity.[165] Frequently, lawyers representing the issuers were designated as escrow holders and often handled applications for the transfer or release of shares from escrow.[166]

An application for consent to transfer typically included the name of the applicant and, in most cases, a description of the consideration, as well as an acknowledgment of each proposed purchaser's awareness of the reason for the escrow condition.[167] Statements as to the sophistication of the purchaser and the purchaser's knowledge of the business and affairs of, or positions with, the issuer were later required.[168]

Recognizing the difficulties with escrows, the Commissioner in 1967 adopted rules to include a legend condition in lieu of an escrow in permits for non-promotional securities.[169] It was believed that a legend would also be effective in controlling subsequent transfers and preventing the shares from being distributed or transferred to unsophisticated persons. In purging the escrow files, the Department found that almost 80 percent of the companies with securities held by the Commissioner in escrow were no longer in business and had dissolved or been suspended by the California Secretary of State for nonpayment of taxes.[170]

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164. *See id.*

165. *See id.* § 9.03[2].

166. *Id.*

167. *Id.* § 1.03[7][d].

168. *Id.* For a time, an order permitting the transfer of securities in escrow would only be granted if the transferee met the qualifications for the original issuance of the securities. This sometimes became a problem in obtaining orders for transfers incident to a divorce or the death of an original issuee, whether by name or class.

169. *Id.* § 9.03[2]. The Commissioner still has the authority to require the deposit of securities in escrow as a condition to qualification, specifically in cases where it is determined that there is an unusual danger that promotional shares might be distributed to the public despite a legend on the certificates. CAL. CORP. CODE § 25141 (Deering 2020); CAL. CODE REGS. tit. 10, § 260.141.3 (2020).

170. MARSH & VOLK, *supra* note 1, § 9.03[2].

3. Practice Under the 1968 Law (1969 to the Present)

The 1968 Law was intended to facilitate the raising of capital and to eliminate some of the problems with the 1917 Act. At the outset, the addition of "in this state" as a defined term changed the jurisdictional reach of the securities law and provided some clarification for lawyers in advising their clients as to when the qualification requirements would be applicable.[171] The 1968 Law also makes it clear that the qualification requirements are triggered by the offer and sale, not the issuance, of securities.

A number of exemptions from qualification that apply to the offer and sale of stock in private offerings were added in the 1968 Law. One of the most significant transactional exemptions is section 25102(a), which exempts offers, but not sales, not involving a public offering, and allows issuers to enter into an agreement pursuant to the offer that contains specified language so long as no part of the purchase price is paid, and none of the securities are issued before the sale is qualified unless it is exempt.[172] The Commissioner by rule provided that, for this purpose, no public offering is involved if an offer is made to not more than twenty-five persons, not including certain specified persons.[173] Although this essentially eliminated the need for negotiating permits, the 1968 Law also exempts offers, but not sales, pursuant to a negotiating permit.[174]

The 1968 Law exempts any offer or sale of securities to specified institutional investors and to any corporation with outstanding securities registered under section 12 of the 1934 Exchange Act[175] or any wholly-owned subsidiary that will own directly or indirectly all of the outstanding stock of the issuer, subject to delivery of an investment

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171. Because of the breadth of the definition of "offer" under the 1968 Law, the Commissioner in 1996 issued an order exempting offers on or through the Internet that meet certain conditions. Cal. Dep't of Crops., Offers of Securities Made on the Internet, Commissioner's Release No. 100-C (Nov. 5, 1996), https://dfpi.ca.gov/commissioners-release-100-c/.

172. CAL. CORP. CODE § 25102(a).

173. Cal. Dep't of Corps., Guidelines for Determining When Securities Are Being "Offered to the Public," Commissioner's Release No. 5-C (Jan. 31, 1969), https://dfpi.ca.gov/wp-content/uploads/sites/337/2019/03/5C.pdf. The number of persons was later increased to 35. *See* CAL. CODE REGS. tit. 10, § 260.102.1.

174. *See* CAL. CORP. CODE § 25102(c); CAL. CODE REGS. tit. 10, § 260.102.

175. Securities Exchange Act of 1934, Pub. L. No. 73-291, § 12, 48 Stat. 881, 892–94 (codified as amended at 15 U.S.C. §§ 78a–78qq); *see* 15 U.S.C. § 78*l* (2018).

representation.[176] This, for the first time, allowed public companies and their wholly-owned subsidiaries to form subsidiaries without requiring a permit. The Commissioner, by rule, later added to this list corporations with a consolidated net worth of at least $14 million, subject to nexus and other limitations.[177] Also later exempted by rule were the offer and sale of common shares, or any warrant or right to subscribe to those shares, by an issuer that has securities registered under section 12 of the 1934 Exchange Act, subject to certain listing, financial and other conditions.[178]

For the first time, an exemption was adopted specifically for small offerings. It had been estimated that sales of stock to an individual or an individual and spouse were responsible for almost one third of the workload of the Commissioner's staff and represented in excess of 7,000 of the 22,000 permits issued during the Department's 1968 fiscal year.[179] This exemption was added as section 25102(h),[180] which, as initially adopted, contained the following conditions, all of which were required to be met:

- the issuer is a California corporation,
- having only common stock outstanding,
- which, after giving effect to the proposed sale, is beneficially owned by no more than five persons,
- no advertising is published and no selling expenses are incurred,
- no promotional consideration is involved,
- with certain provisos, the shares are issued for (i) assets (subject to liabilities) of an existing business transferred to the issuer upon its initial organization, or (ii) cash or cancellation of indebtedness for money borrowed, or both, upon initial organization, or (iii) cash following initial

176. *See* CAL. CORP. CODE § 25102(i).

177. *See* CAL. CODE REGS. tit. 10, § 260.102.10(b).

178. *See id.* § 260.105.17(a).

179. MARSH & VOLK, *supra* note 1, § 1.03[8][c]. There was testimony before an Assembly committee in January 1960 to the effect that the amount for new securities cleared for sale in California was approaching $1 billion per month and that every month the Department had issued in excess of 1,800 permits. *See* Edwards, *supra* note 70, at 814 n.1. This was a significant increase from the 477 permits issued by the Department for the sale of securities in 1928. *See* Dalton II, *supra* note 57, at 256.

180. CAL. CORP. CODE § 25102(h).

organization in a sale to existing shareholders, or (iv) any other legal consideration if there is only one shareholder,

- the share certificates have been legended in accordance with the Commissioner's rules,
- a notice is filed with the Commissioner signed by all the officers and directors and the issuees, and
- availability of the exemption is confirmed by an opinion of California counsel.[181]

It is obvious that these conditions were carefully crafted to capture the types of transactions that were thought to be less likely to need regulatory scrutiny.[182] While section 25102(h) certainly reduced the number of permits sought, it was still very narrow, and was considered to be the most restrictive of similar exemptions in other states.[183]

One of the conditions for reliance on this exemption was that the share certificates bear a legend restricting transfer without the consent of the Commissioner.[184] As indicated previously, this had already been adopted by the Commissioner in lieu of an escrow as a condition for permits.[185]

There was a question about what to do with the previous permits that had required an escrow. The Commissioner adopted a rule to the effect that permits, other than those also providing for promotional shares subject to dividend waivers, were deemed amended to delete the escrow condition and to substitute a legend restricting transfer.[186] Escrow holders could stamp or print the legend on the certificates and distribute them to the holders.[187] A release of shares from escrow was only required for those who requested that the certificates be legended or delivered once legended so as to avoid the difficulty of being unable to locate the holders.[188] With thousands of escrows in existence, this required a considerable effort by issuers and escrow holders.

While the change to a restrictive legend was welcomed, it remained a burden because the consent of the Commissioner was still

181. *See* Olson, *supra* note 67, at 86–87.

182. *See generally* Bickford, *supra* note 23, at 510–18 (discussing the restrictive nature of the "small issue" exemption created by section 25102(h)).

183. *See id.* at 511.

184. *Id.* at 512, 515.

185. *See supra* text accompanying note 169.

186. CAL. CODE REGS. tit. 10, § 260.141.13 (2020).

187. *Id.*

188. *See* MARSH & VOLK, *supra* note 1, § 9.04[1].

required for any subsequent sales or transfers of the shares, and an order was required for removal of the legend. It was not unusual for lawyers to discover at the last minute before a proposed sale or transfer of stock that the certificates had been imprinted with a restrictive legend and that consent of the Commissioner would be required before the sale or transfer could be completed.

Eventually, changes were made by the legislature to expand the utility of section 25102(h). In 1973, the number of beneficial owners was increased from five to ten and the exemption was extended to corporations formed in other states.[189] In 1983, the number of beneficial owners was again increased to thirty-five.[190]

The notice condition was also amended to remove the necessity of obtaining the signatures of the officers and directors of the issuer and of the issuees.[191] This had posed a logistical problem for issuers, as well as requiring them to convince these persons to sign the form. However, an opinion of counsel is still required to this day.[192]

Finally, section 25102(h) was amended in 1996 to require that the purchasers provide an investment representation in lieu of imprinting legends on the share certificates.[193] The 1996 amendment also provided that shares that had been issued previously in reliance on section 25102(h) were no longer subject to the restrictions on transfer and issuers could remove the legends without the consent of the Commissioner.[194] This again required that lawyers and their clients make arrangements with the shareholders for the exchange of certificates, but

189. Act of Sept. 5, 1973, ch. 390, § 2, 1973 Cal. Stat. 839, 840 (codified as amended at CAL. CORP. CODE § 25102).

190. Act of July 28, 1983, ch. 442, § 1, 1983 Cal. Stat. 1750, 1750–54 (codified as amended at CAL. CORP. CODE § 25102).

191. *See* MARSH & VOLK, *supra* note 1, § 4.02[12].

192. The purpose of this requirement was said to be that the involvement of a lawyer would not only tend to avoid abuse by persons claiming the exemption when it was inapplicable, but that it would also reduce the possibility of an accidental failure to meet all of its conditions. *See id.* § 4.02[13][c]. Many believed, however, that this requirement was unnecessary, and it was rumored at the time that it was actually imposed in response to a lobbying effort on behalf of general practitioners who insisted on remaining involved in the incorporation process.

193. Act of May 6, 1996, ch. 41, § 1, 1996 Cal. Stat. 154, 154–62 (codified at CAL. CORP. CODE § 25102). This change was consistent with the exemption in CAL. CORP. CODE § 25102(f) (Deering 2020) that had been amended in 1981 to require an investment representation. *See infra* text accompanying note 211.

194. Act of May 6, 1996 § 1.

it had finally eliminated the involvement of the Commissioner in sales and transfers of these shares.

In the 1970s, Congress and the SEC also had been considering adding exemptions to registration for small and limited offerings in order to facilitate the raising of capital. The exemption typically relied on by issuers in private offerings had been section 4(2) of the 1933 Securities Act (later redesignated as section 4(a)(2) by the Jumpstart Our Business Startups Act)[195] that exempts from registration "transactions by an issuer not involving any public offering."[196] The intrastate offering exemption in section 3(a)(11) of the 1933 Securities Act[197] had also been used by some for private offerings, but created some compliance risks.[198] The question of what constitutes a "public offering" was left to judicial and SEC interpretations and created considerable uncertainty for lawyers advising their clients.

To facilitate the raising of capital, the SEC adopted several exemptions and "safe harbors" for certain limited or small offerings.[199] In the process, concepts were introduced that influenced the regulation of securities in California and other states. The rules containing these exemptions and "safe harbors" were the following:[200]

- SEC Rule 146[201] was adopted in 1974 to permit issuers to raise an unlimited amount of capital.[202] Reliance was conditioned on an issuer's reasonable belief as to the requisite

195. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in scattered sections of 15 U.S.C.).

196. Securities Act of 1933, Pub. L. No. 111-229, § 4(2), 48 Stat. 74, 84 (codified as amended at 15 U.S.C. §§ 77a–77aa); 15 U.S.C. § 77d(a)(2) (2018).

197. Securities Act of 1933 § 3(a)(11); 15 U.S.C. § 77c(a)(11).

198. *See* Sidney Sosin, *The Intrastate Exemption: Public Offerings and the Issue Concept*, 16 CASE W. RSRV. L. REV. 110, 112 (1964).

199. For a description of these exemptions, see Symposium, *Recent Developments in Corporate and Securities Law*, 14 LOY. L.A. L. REV. 79, 120–24 (1980).

200. *See generally* U.S. SEC. & EXCH. COMM'N, REPORT ON THE REVIEW OF THE DEFINITION OF "ACCREDITED INVESTOR" 12–14 (2015), https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf (summarizing the small business exemptions prior to Regulation D). For a historical perspective of the limited methods available for raising private capital under the 1933 Securities Act prior to the adoption of SEC Rule 146, see generally Stanley Schwartz, Jr., *Rule 146: The Private Offering Exemption—Historical Perspective and Analysis*, 35 OHIO STATE L.J. 738 (1974); Tom A. Alberg & Martin E. Lybecker, *New SEC Rules 146 and 147: The Nonpublic and Intrastate Offering Exemptions from Registration for the Sale of Securities*, 74 COLUM. L. REV. 622 (1974).

201. 17 C.F.R. § 230.146 (rescinded 1982); *see* Transactions by an Issuer Deemed Not to Involve Any Public Offering, Securities Act Release No. 5487, 39 Fed. Reg. 15,261 (May 2, 1974).

202. 17 C.F.R. § 230.146.

knowledge and experience of offerees in financial matters and their ability to evaluate the risks and merits or bear the economic risk of the prospective investment. In addition, it imposed a ceiling of thirty-five persons who could purchase the securities.

- SEC Rule 240[203] was adopted in 1975 to permit offerings of up to $100,000 for small businesses with no more than 100 beneficial owners.
- SEC Rule 242[204] was adopted in 1980 to provide an exemption under section 3(b) of the 1933 Securities Act[205] for offerings of up to $2 million and, for the first time, introduced an "accredited investor" definition for offerees. Offers could be made to an unlimited number of accredited investors and up to thirty-five nonaccredited investors.

To further facilitate these types of offerings, Congress enacted the Small Business Investment Incentive Act of 1980,[206] the Omnibus Small Business Capital Formation Act of 1980,[207] and the Small Business Issuers' Simplification Act of 1980.[208] These Acts raised the dollar limit for the SEC's authority to create small offering exemptions under section 3(b) of the 1933 Securities Act from $2 million to $5 million, provided an exemption from registration for up to the amount allowed under section 3(b), added an "accredited investor" definition in section 2(a)(15) of the 1933 Securities Act that deferred to the rules of the SEC, provided for a forum to consider small business capital formation, and authorized cooperation to effectuate greater uniformity in federal-state securities matters.[209]

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203. 17 C.F.R. § 230.240 (rescinded 1982); *see* Exemption for Closely Held Issuers, Securities Act Release No. 5560, 40 Fed. Reg. 6484 (Feb. 12, 1975).

204. 17 C.F.R. § 230.242 (rescinded 1982); *see* Exemption of Limited Offers and Sales by Qualified Issuers, Securities Act Release No. 6180, 45 Fed. Reg. 6362 (Jan. 28, 1980).

205. Securities Act of 1933, Pub. L. No. 111-229, § 3(b), 48 Stat. 74, 83 (codified as amended at 15 U.S.C. §§ 77a–77aa); 15 U.S.C. § 77c(b)(1) (2018).

206. Small Business Investment Incentive Act, Pub. L. No. 96-477, 94 Stat. 2275 (codified as amended at 15 U.S.C. §§ 80a–80a-64).

207. Omnibus Small Business Capital Formation Act of 1980, Pub. L. No. 96-477, 94 Stat. 2291 (codified as amended at 15 U.S.C. §§ 80c–80c-3).

208. Small Business Issuers' Simplification Act of 1980, Pub. L. No. 96-477, 94 Stat. 2294 (codified as amended in scattered sections of 15 U.S.C.).

209. Small Business Investment Incentive Act §§ 301, 503, 505, 603.

With all these developments at the federal level, it still took twelve years for the California legislature to adopt a more useful exemption to facilitate raising capital through limited or small offerings. This exemption was adopted in 1981 as an amendment to section 25102(f) that originally had exempted partnership, joint venture, and certain trust interests offered or sold in a transaction not involving a public offering.[210] As amended, it exempted the sale of securities meeting the following conditions:

- sales are not made to more than thirty-five persons, with certain exclusions,
- all purchasers either have a preexisting personal or business relationship with the offeror or certain specified persons or, by reason of their business or financial experience or that of their professional advisors, the purchasers could be reasonably assumed to have the capacity to protect their own interests in connection with the transaction,
- each purchaser represents that the purchase is being made for the purchaser's own account (or trust account) and not with a view to or for sale in connection with any distribution of the security,
- the offer and sale are not accomplished by the publication of any advertisement, and
- a notice must be filed if required by rule of the Commissioner.[211]

This amendment to section 25102(f) was characterized by Professor Marsh and Robert H. Volk in their treatise on California securities regulation as "the most significant change made by the Legislature in the securities law since the enactment of the Corporate Securities Law

210. Act of Oct. 2, 1981, ch. 1120, § 1, 1981 Cal. Stat. 4387, 4387–91 (codified at CAL. CORP. CODE § 25102(f)).

211. *See* William J. Ward, Note, *California Corporate Securities Law: Small Business Capital Formation and Investor Protection*, 13 PAC. L.J. 459, 470–79 (1982); Cal. Dep't of Corps., Limited Offering Exemption Corporations Code Section 25102(f), Commissioner's Release No. 67-C (Oct. 20, 1981), https://dfpi.ca.gov/wp-content/uploads/sites/337/2019/03/67c.pdf. The Commissioner adopted an emergency regulation to take effect the same day requiring the filing of a notice and providing that the availability of the exemption is not conditioned upon the filing. CAL. CODE REGS. tit. 10, § 260.102.14 (2020). A provision to the same effect was later added to CAL. CORP. CODE § 25102(f) (Deering 2020) and eliminated from the regulations.

of 1968 and the most significant single amendment adopted since the original enactment of the Corporate Securities Law in 1917."[212]

This new exemption has a much broader scope than section 25102(h).[213] For example, it is not limited by the type of issuer or securities.[214] It also increased the limit on purchasers to thirty-five, a number that had been used by the SEC in several of the exemptions it had adopted.[215] There were no limitations on the number or qualifications of offerees or the type of consideration that could be received in the transaction.[216] While a notice is required to be filed, no opinion of counsel is required.[217]

A year after the section 25102(f) exemption became effective in California, the SEC adopted Regulation D.[218] This Regulation replaced SEC Rules 146, 240 and 242 and unified much of the SEC's exemption scheme into a single regulation with common definitions, terms, and conditions. The new exemptions and "safe harbors" as adopted under Regulation D were as follows:[219]

- SEC Rule 504[220] permitted the sale of up to $500,000 of securities in a consecutive twelve-month period, had no limit on the number of investors, and did not have any disclosure requirements, thereby shifting the regulation of these smaller offerings to state regulators. SEC Rule 504 imposed restrictions on the manner of offering, but issuers are permitted to use general solicitation and advertising

212. MARSH & VOLK, *supra* note 1, § 4.02A[1][a].

213. For descriptions and comparisons of the exemption in section 25102(h) and the newly adopted exemption in section 25102(f), see Ward, *supra* note 211, at 470–79. For a discussion of the factors as to why an issuer would choose to rely on either exemption, see MARSH & VOLK, *supra* note 1, § 4.02[3].

214. MARSH & VOLK, *supra* note 1, § 4.02A[1][c][4].

215. *Id.* § 4.02A[2][b].

216. *Id.* §§ 4.02A[1][c][1], [1][c][2], [1][c][5].

217. *Id.* § 4.02A[5].

218. 17 C.F.R. §§ 230.500–.508 (2019); *see* Revisions of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, 47 Fed. Reg. 11,251 (Mar. 16, 1982).

219. Revisions of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6839, 47 Fed. Reg. 11,251 (Mar. 16, 1982).

220. 17 C.F.R. § 230.504 (2019). In 1988, the SEC increased the dollar limit to $1 million, Regulation D Revisions, Securities Act Release No. 6758, 53 Fed. Reg. 7,866 (Mar. 10, 1988), and in 2017 again increased it to $5 million, Exemptions to Facilitate Intrastate and Regional Securities Offerings, Securities Act Release No. 10,238A, 82 Fed. Reg. 12,067 (Feb. 28, 2017).

for certain offers and sales registered or exempt from registration under state law.

- SEC Rule 505[221] permitted the sale of up to $5 million of securities in any consecutive twelve-month period to a maximum of thirty-five nonaccredited investors and an unlimited number of accredited investors.
- SEC Rule 506[222] permitted the sale to up to thirty-five nonaccredited investors and an unlimited number of accredited investors, but had no dollar limitation. The nonaccredited investors, alone or with a purchaser representative, must be sophisticated—that is, they must have had sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment.

SEC Rules 504 and 505 were adopted pursuant to section 3(b) and SEC Rule 506 was adopted pursuant to section 4(2) (now section 4(a)(2)) of the 1933 Securities Act. Notices on Form D were required to be filed with the SEC for reliance on each of these Rules. Ultimately, the Commissioner allowed the filing of a copy of a Form D in lieu of the notice required by section 25102(f) for offerings also made in reliance on one of the rules under Regulation D.[223]

In 1990, the SEC adopted Regulation S that provides a safe harbor from the registration requirements under the 1933 Securities Act for offers and sales of securities that occur outside the United States.[224] While this can apply to both private and public offerings, it will be discussed below in connection with public stock offerings.[225]

In 1994, the California legislature added section 25102(n) as another exemption from qualification.[226] Section 25102(n) exempts

221. 17 C.F.R. § 230.505 (rescinded 2017). SEC Rule 505 was rescinded in 2017. *See* Exemptions to Facilitate Intrastate and Regional Securities Offerings, Securities Act Release No. 10,238A, 82 Fed. Reg. 12,067 (Feb. 28, 2017).

222. 17 C.F.R. § 230.506 (2019).

223. *See* Cal. Dep't of Corps., Notice Filing and Fee Payment Requirements for Securities Offerings Under SEC Rule 506, Commissioner's Release No. 103-C (Dec. 12, 1996), https://dfpi.ca.gov/wp-content/uploads/sites/337/2019/03/103c.pdf.

224. Offshore Offers and Sales, Securities Act Release No. 6863, 55 Fed. Reg. 18,306 (May 2, 1990).

225. *See infra* text accompanying notes 438–41.

226. Act of Sept. 27, 1994, ch. 828, § 3, 1994 Cal. Stat. 4097, 4108–09 (codified at CAL. CORP. CODE § 25102(n)).

offers or sales of securities in transactions that generally meet the following requirements:

- the issuer is a California corporation, any other form of business entity organized in California, or a foreign corporation with a specified California nexus,
- sales are made only to "qualified purchasers or other persons the issuer reasonably believes, after reasonable inquiry, to be qualified purchasers," which include specified organizations, entities, and natural persons meeting certain net worth and/or gross income thresholds,
- each purchaser signs an investment representation, and
- a notice is filed with the Commissioner.[227]

This exemption provides no limits on the number of offerees or purchasers and allows publication of a general public announcement of the offering containing specified information.[228] A disclosure statement is also required to be delivered to prospective purchasers and a copy is to be filed with the Department.[229] In an unusual move, the SEC in 1996 adopted SEC Rule 1001[230] under the 1933 Securities Act to provide an exemption from registration of offerings of up to $5 million that comply with section 25102(n).

These exemptions were the most significant for private offerings, but other exemptions were adopted for particular types of transactions. For example, in the 1980s there was a significant increase in the creation of technology companies, many of which were located in California.[231] These companies chose to compensate and incentivize their employees in part through equity awards.[232] Because of the large number of employees receiving these awards, it became difficult to avoid

227. *See* Cal. Dep't of Corps., "Qualified Purchaser" Limited Public Offering Exemption Under Corporations Code Section 25102(n), Commissioner's Release No. 94-C (Sept. 27, 1994), https://dfpi.ca.gov/wp-content/uploads/sites/337/2019/03/94c.pdf. *See generally* Lee R. Petillon, *Designed to Scale: The Ability of Small Companies to Raise Capital Has Been Dramatically Eased by New Federal and State Securities Rules*, 19 L.A. LAW. 31, 34 (1997) (describing the benefits of the section 25102(n) exemption).

228. Cal. Dep't of Corps., "Qualified Purchaser" Limited Public Offering Exemption Under Corporations Code Section 25102(n), Commissioner's Release No. 94-C (Sept. 27, 1994), https://dfpi.ca.gov/wp-content/uploads/sites/337/2019/03/94c.pdf.

229. *Id.*

230. 17 C.F.R. § 230.1001 (2019).

231. *See* NICHOLAS, *supra* note 120, at 7.

232. Mark C. Anderson et al., *Executive Compensation in the Information Technology Industry*, 46 MGMT. SCI. 530, 530 (2000).

registration under the 1933 Securities Act.[233] The SEC addressed this issue in 1988 by adopting SEC Rule 701,[234] which allows companies not subject to the SEC's reporting requirements to offer and sell securities, within limits, to employees and certain others under compensatory benefit plans or agreements.[235]

The California legislature finally dealt with these compensatory offerings in 1996 with the adoption of section 25102(o).[236] This section exempted from the qualification requirements the offer or sale of securities by nonpublic corporations[237] that comply with SEC Rule 701, subject to rules of the Commissioner that impose certain substantive requirements on equity awards under compensatory plans or agreements.[238] Lawyers can now more easily draft plans and agreements for compensatory equity issuances that avoid registration under the 1933 Securities Act and qualification under the 1968 Law.

A development that had a significant impact on private offerings was the enactment by Congress of NSMIA in 1996.[239] This legislation preempts state law to the extent it requires registration, or prohibits, limits, or imposes conditions based on the merits, of the offer or sale of a "covered security."[240] It does not preempt a state's antifraud enforcement authority.[241] Included as a "covered security" are securities

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233. The revised definition of "sale" in the 1968 Law that included an offer or sale of a warrant or right to subscribe to another security also raised an issue as to whether the grant of options to employees might require qualification. *See* Bickford, *supra* note 23, at 524–25.

234. 17 C.F.R. § 230.701 (2019); *see* Compensatory Benefit Plans and Contracts, Securities Act Release No. 6768, 53 Fed. Reg. 12,918 (Apr. 20, 1988).

235. 17 C.F.R. § 230.701.

236. Act of May 6, 1996, ch. 41, § 1, 1996 Cal. Stat. 154, 154–62 (codified at CAL. CORP. CODE § 25102); s*ee also* CAL. CODE REGS. tit. 10, §§ 260.102.10(b), 260.105.8 (2020) (incentive stock options). There were already several exemptions to qualification in California that applied to public companies with securities registered under Securities Exchange Act of 1934, § 12. *See* Securities Exchange Act of 1934, Pub. L. No. 73-291, § 12, 48 Stat. 881, 892–94 (codified as amended at 15 U.S.C. §§ 78a–78qq); 15 U.S.C. § 78*l* (2018).

237. The legislature amended § 25102(o) in 2000 to add limited liability companies to the entities that could rely on the exemption. Act of Sept. 27, 2000, ch. 705, § 4, 2000 Cal. Stat. 4642, 4644–57 (codified at CAL. CORP. CODE § 25102(o)).

238. *See* CAL. CODE REGS. tit. 10, §§ 260.140.41–.42, .45–.46.

239. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.).

240. 15 U.S.C. § 77r(a) (2018). *See generally* Robert N. Rapp & Fritz E. Berckmueller, *Testing the Limits of NSMIA Preemption: State Authority to Determine the Validity of Covered Securities and to Regulate Disclosure*, 63 BUS. LAW. 809 (2008) (discussing how NSMIA's preemption affects state authority over the registration and qualification of securities offerings).

241. Rapp & Berckmueller, *supra* note 240, at 813.

sold in transactions exempt from registration in reliance on SEC rules adopted under section 4(a)(2) of the 1933 Securities Act, which includes securities sold or offered for sale under SEC Rule 506 of Regulation D.[242] In addition to allowing private companies to raise funds without state registration and merit review, it facilitated private placements of equity securities by public companies (PIPEs, for Private Investment in Public Equity) to "accredited investors."[243] Section 25102.1(d) was adopted by the legislature to recognize the preemption of SEC Rule 506 offerings and to provide for the filing with the Department of a copy of the notice filed with the SEC on Form D and the payment of a filing fee, both of which are specifically permitted by NSMIA.[244]

In 1998, section 25102(p)[245] was adopted by the legislature to exempt the offer and sale of securities to those meeting the definition of an "accredited investor" in section 28031[246] by persons licensed under the Capital Access Company Law.[247] The Capital Access Company Law is intended to facilitate California small businesses obtaining financing by enabling certain investment companies to rely on an exemption from registration under the Investment Company Act.[248]

In recent years, there have been several developments that affect private offerings of equity. In April 2012, Congress enacted the Jumpstart Our Business Startups Act (JOBS Act)[249] in support of entrepreneurship and small business growth.[250] "[T]he JOBS Act

242. National Securities Markets Improvement Act of 1996 § 102.

243. *See* Marc I. Steinberg & Emanuel U. Obi, *Examining the Pipeline: A Contemporary Assessment of Private Investment in Public Equity ("PIPEs")*, 11 U. PA. J. BUS. L. 1, 3–4 (2008).

244. Act of Aug. 26, 1997, ch. 391, § 9, 1997 Cal. Stat. 2614, 2632–33 (codified as amended at CAL. CORP. CODE § 25102.1(d)); *see* Cal. Dep't of Corps., New Filing Requirements for Regulation D Offerings, Commissioner's Release No. 120-C (Mar. 24, 2009); Cal. Dep't of Corps., Notice Filings Under the National Securities Markets Improvement Act of 1996 Conforming Amendments to the Corporate Securities Law of 1968, Commissioner's Release No. 109-C (Revised) (Feb. 5, 2007), https://dfpi.ca.gov/wp-content/uploads/sites/337/2019/03/109c.pdf.

245. Act of Sept. 21, 1998, ch. 668, § 1, 1998 Cal. Stat. 4321, 4321–29 (codified at CAL. CORP. CODE § 25102(p)).

246. CAL. CORP. CODE § 28031 (Deering 2020).

247. Act of Sept. 21, 1998 § 3.

248. 15 U.S.C. §§ 80a-1 to -64 (2018).

249. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in scattered sections of 15 U.S.C.).

250. *See generally* Mark Hiraide, *Ready Capital*, 39 L.A. LAW., Dec. 2016, at 18 [hereinafter Hiraide, *Ready Capital Part I*] (discussing how the JOBS Act has enabled businesses to raise capital without registering an offering with the SEC and state securities regulators).

requires the SEC to eliminate the prohibition on using general solicitation under SEC Rule 506 where all purchasers of the securities are accredited investors . . . ."[251] The SEC implemented this legislation by adopting SEC Rule 506(c) in 2013 to permit general solicitation and provide "reasonable steps" to verify the "accredited investor" status of purchasers.[252] The original exemption was redesignated as SEC Rule 506(b) and continues to be available for issuers that do not wish to limit sales to "accredited investors."[253] Offerings made in reliance on SEC Rule 506(b) and (c) are preempted from state registration and merit review.[254]

The JOBS Act also expanded the exemption for Regulation A offerings and exempted equity crowdfunding offerings, subject to implementation by the SEC in what became Regulation Crowdfunding.[255] Although these exemptions may apply as well to private offerings, they will be discussed below in connection with public stock offerings.[256]

Another development during this period related to securities acquired in unregistered, private sales from the issuer or an affiliate of the issuer, such as those acquired in reliance on SEC Rule 506 and are deemed to be "restricted securities" for purposes of the federal securities law.[257] To afford greater liquidity for holders of these securities, Congress in 2015, as part of the Fixing America's Surface Transportation (FAST) Act, added section 4(a)(7) to the 1933 Securities Act to exempt from registration private resales of "restricted securities," provided, among other things, that each purchaser is an "accredited

251. *Eliminating the Prohibition Against General Solicitation and General Advertising in SEC Rule 506 and Rule 144A Offerings*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/info/smallbus/secg/general-solicitation-small-entity-compliance-guide.htm (last modified Sept. 20, 2013).

252. *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9415, 78 Fed. Reg. 44,471 (July 24, 2013).

253. *See* Hiraide, *Ready Capital Part I*, *supra* note 250, at 21.

254. *See Overview of Exemptions*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/smallbusiness/exemptofferings/exemptofferingschart (last modified Feb. 12, 2019).

255. Hiraide, *Ready Capital Part I*, *supra* note 250, at 21; Rutheford B. Campbell, Jr., *Regulation A and the JOBS Act: A Failure to Resuscitate*, 7 OHIO STATE ENTREPREN. BUS. L.J. 317, 319 (2012) [hereinafter Campbell, *Regulation A and the JOBS Act*].

256. *See infra* text accompanying notes 442–59.

257. *See "Restricted" Securities: Removing the Restrictive Legend*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/fast-answers/answersrestrichtm.html (last updated Jan. 16, 2013).

investor" and there is no general solicitation or advertising.[258] The Act also added these securities as "covered securities" so they are preempted from state registration and merit review.[259]

In June 2019, the SEC issued a Concept Release on Harmonization of Securities Offering Exemptions (the "Concept Release") in which it solicited comment "on possible ways to simplify, harmonize, and improve the exempt offering framework to promote capital formation and expand investment opportunities while maintaining appropriate investor protections."[260] The exemptions or "safe harbors" from registration under the 1933 Securities Act for which specific comment was solicited were section 4(a)(2), SEC Rules 504 and 506, Regulation A, Regulation Crowdfunding, and section 3(a)(11) of the 1933 Securities Act and related SEC Rules.[261] Comments were also solicited with respect to the definition of "accredited investor" and the doctrine of "integration" whereby separate securities transactions are considered part of the same offering.[262] The Concept Release appears to have been prompted largely by the concerns about the complexity of the exempt offering framework that had been expressed over time by market participants, as well as by the Government-Business Forums on Small Business Capital Formation.[263] The SEC often has been criticized for its lack of action in addressing issues that tend to inhibit capital formation, particularly as applied to small businesses.[264]

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258. Fixing America's Surface Transportation Act, Pub. L. No. 114-94, § 76,001, 129 Stat. 1312, 1787–88 (2015).

259. *Id.* Earlier, the SEC had provided "safe harbors" in 1972 with the adoption of SEC Rule 144 for resales of restricted securities in the public markets subject to certain conditions, *see* 17 C.F.R. § 230.144 (2019); Definition of Terms "Underwriter" and "Brokers' Transactions," Securities Act Release No. 5223, 37 Fed. Reg. 591 (Jan. 13, 1972), and in 1990 with the adoption of SEC Rule 144A for private resales to "qualified institutional investors," 17 C.F.R. § 230.144A (2019); Resale of Restricted Securities, Securities Act Release No. 6862, 55 Fed. Reg. 17,933 (Apr. 30, 1990).

260. Concept Release on Harmonization of Securities Offering Exemptions, Securities Act Release No. 10,649, 84 Fed. Reg. 30,460, 30,460 (June 26, 2019) [hereinafter Concept Release]. The Concept Release is 211 pages in length and contains 138 requests for comment.

261. *Id.* at 30,485–86, 30,498.

262. *Id.* at 30,469, 30,511.

263. *Id.* at 30,461, 30,461 n.10.

264. *See, e.g.*, Rutheford B. Campbell, Jr., *The New Regulation of Small Business Capital Formation: The Impact—If Any—of the JOBS Act*, 102 KY. L.J. 815, 832–33 (2013/2014); Campbell, *Regulation A and the JOBS Act*, *supra* note 255, at 317; Rutheford B. Campbell, Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcomes of the SEC's Crown Jewel Exemptions*, 66 BUS. LAW. 919, 919 (2011); Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC's*

After allowing a period of time for comments on the issues raised in the Concept Release, the SEC in December 2019 proposed amendments to the "accredited investor" and "qualified institutional buyer" definitions,[265] and in August 2020 proposed amendments to its rules dealing with certain of the exemptions and other aspects of exempt offerings raised in the Concept Release.[266]

In August 2020, the amendments to the "accredited investor" definition in SEC Rule 501(a) and conforming amendments to the "qualified institutional buyer" definition in SEC Rule 144A were adopted by the SEC substantially as they had been proposed.[267] The definition of an "accredited investor" had remained largely unchanged for more than thirty-five years and is based exclusively on a person's income and net worth. Those who do not meet the thresholds, regardless of their financial sophistication, have been denied the opportunity to invest in private companies and certain hedge, private equity and venture capital funds that rely on various exemptions from federal registration. The SEC has now added to the definition new categories of natural persons who have attained specified professional certifications, designations or credentials, as well as a few new categories of entities that meet specified investment requirements.[268] The SEC is also authorized to add other natural persons whose professional certifications, designations or credentials meet the criteria it has established.[269] In amending the definition, the SEC chose not to raise the income and net worth thresholds for natural persons or adjust them for inflation.[270]

Continuing Failure to Address Small Business Financing Concerns, 4 N.Y.U. J.L. & BUS. 1, 3–4 (2007).

265. *See* Amending the "Accredited Investor" Definition, Securities Act Release No. 10,734, 85 Fed. Reg. 2574 (Jan. 15, 2019).

266. *See* Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Securities Act Release No. 10,763, 85 Fed. Reg. 17,956 (Mar. 31, 2020) [hereinafter Private Markets Proposing Release].

267. *See* Accredited Investor Definition, Securities Act Release No. 10,824, 85 Fed. Reg. 64,234 (Oct. 9, 2020) [hereinafter Accredited Investor Release].

268. *Id.* at 64,237, 64,241.

269. *Id.* at 64,241.

270. *See* Public Statement, Jay Clayton, Chairman, Sec. & Exch. Comm'n, Statement on Modernization of the Accredited Investor Definition (Aug. 26. 2020), https://www.sec.gov/news/public-statement/clayton-accredited-investor-2020-08-26. The thresholds for a natural person are an individual net worth, or joint net worth with that person's spouse, exceeding $1 million, exclusive of that person's primary residence, or an individual income exceeding $200,000 in each of the two most recent years or exceeding $300,000 with that person's spouse in each of those years and such

Then in November 2020 the amendments to the rules dealing with certain of the exemptions and other aspects of exempt offerings were adopted by the SEC substantially as they had been proposed.[271] In its initial proposal, the SEC had stated that "[m]any of the proposed amendments are expected to be of greatest benefit to the capital raising efforts of small entities that may lack an existing network of angel and VC funders and appear to face the greatest constraints in obtaining external financing."[272] However, they appear to be more in the nature of changes to the current system rather than new approaches to the framework of exempt offerings that some had anticipated.

The changes affect some of the exemptions previously discussed, including SEC Rules 504 and 506 of Regulation D, and others affect exemptions that are discussed below in the section on public stock offerings.[273] The limit for offerings under SEC Rule 504 was increased from $5 million to $10 million.[274] In addition, the disclosure requirements in SEC Rule 506(b) for nonreporting companies making offers to nonaccredited investors have been aligned with the requirements for Regulation A, and offers could be made to as many as thirty-five sophisticated, nonaccredited investors during any ninety-day period.[275] Changes have also been made in the general solicitation restrictions, including adding examples to include present-day communications and permitting certain events or meetings at which issuers are invited to present their investment opportunities to potential investors (called "demo days").[276] The new rules also add general principles and "safe harbors" for integrating offerings and provide that offers and sales made in compliance with SEC Rule 701, pursuant to an employee benefit plan, or with Regulation S will not be integrated with other offerings.[277]

person has a reasonable expectation of reaching the same income level in the current year. *See* 17 C.F.R. § 230.501(a) (2019).

271. *See* Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Securities Act Release No. 10,884, 86 Fed. Reg. 3496 (Jan. 14, 2021) [hereinafter Private Markets Adopting Release].

272. Private Markets Proposing Release, *supra* note 266, at 18,038.

273. *See infra* text accompanying note 462.

274. Private Markets Adopting Release, *supra* note 271, at 139–40.

275. *Id.* at 217.

276. *Id.* at 77–86.

277. *Id.* at 46–53.

Moving from exemptions to the qualification of offers and sales of securities, several changes were made in the 1990s to reduce the cost and ease the requirements for the qualification of offerings by smaller issuers under the 1968 Law.

The legislature in 1992 authorized the filing of a "small company application" for qualification by permit.[278] The purpose was to allow use of the simple Q&A format of the Small Corporate Offering Registration disclosure document based on Form U-7 adopted by the North American Securities Administrators Association, Inc. (NASAA).[279] A "small company" is a California corporation or a foreign corporation that is a small business concern under federal law, has certain contacts to California, and meets certain other requirements.[280] There are also conditions on the offering, including the type of stock offered and outstanding, the size of the offering, the offering price, and the use of the net proceeds.[281]

In 1995, the Commissioner adopted a series of rules to ease various requirements for qualification of offerings by "small businesses issuers," which are defined generally on the basis of their annual revenues and the relationship of their businesses to California.[282]

B. Real Estate Syndications

Next we turn to the offer and sale of interests in real estate syndications, which are a means by which investors pool their funds for the purchase of real estate, which in some cases is intended for development or renovation, through entities that are managed by others.

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278. Act of Sept. 23, 1992, ch. 884, § 1, 1992 Cal. Stat. 4105, 4105–06 (codified at CAL. CORP. CODE § 25113(b)(2)). Interestingly, an application must be reviewed and signed by each member of the board of directors of the applicant. *See* CAL. CODE REGS. tit. 10, § 260.110.2 (2020). In 2019, only two "small company applications" were filed under section 25113(b)(2) based on spreadsheets provided by the Department that are on file with the author.

279. *See* MARSH & VOLK, *supra* note 1, § 6.05[5]; CAL. CODE REGS. tit. 10, § 260.113.1; Cal. Dep't of Corps., The Small Corporate Offering Registration (SCOR) Application Process and Offerings of Securities Under SEC Regulation A, Commissioner's Release No. 93-C (Oct. 13, 1993), https://dfpi.ca.gov/wp-content/uploads/sites/337/2019/03/93c.pdf.

280. Cal. Dep't of Corps., The Small Corporate Offering Registration (SCOR) Application Process and Offerings of Securities Under SEC Regulation A, Commissioner's Release No. 93-C (Oct. 13, 1993), https://dfpi.ca.gov/wp-content/uploads/sites/337/2019/03/93c.pdf.

281. *Id.*

282. *See* CAL. CODE REGS. tit. 10, § 260.001(i).

1. Background

Real estate syndications had long been popular in the eastern part of the United States.[283] The capital was invested almost entirely by professionals, who were knowledgeable and experienced in real estate, as well as by wealthy individuals.[284] By the late 1940s and 1950s, funds became available from other investors, and real estate was seen as a potentially profitable investment.[285] The history of syndications in California has been described as follows:

> Real estate syndication activity in California began during the land boom of the early 1960's with a group of Southern Californians who specialized in the sale of undeveloped acreage. By the end of the 1960's apartment properties had emerged as the most popular investment for real estate syndicates, although they were also being formed to develop office buildings, resort hotels, medical complexes, industrial parks and other projects which require substantial aggregations of capital.[286]

Real estate syndications could take the form of a general partnership, a corporation, or a trust, but in later years were typically structured as limited partnerships.[287] This structure allowed profits and losses to be passed through directly to the investors in proportion to their interests without exposing them to personal liability, and to take advantage of tax benefits, including prepayment of interest, leveraging the investment through debt, and taking the maximum allowable depreciation.[288]

As this type of investment evolved, the popularity became based largely on the appreciation of real estate and how it holds up in

283. *See* Harry D. Miller, *Real Estate Syndication Under the California Corporate Securities Law of 1968*, 16 UCLA L. REV. 371, 371 (1969).

284. *Id.*

285. *See id.* at 371–72.

286. Jane W. Hall, Comment, *Investor Suitability Standards in Real Estate Syndication: California's Procrustean Bed Approach*, 63 CALIF. L. REV. 471, 476–77 (1975) (citing Stephen E. Roulac, *Syndication: Past, Present & Future*, REAL EST. TODAY, Nov. 1972, at 24–27).

287. *See* Stephen B. Hazard, Comment, *Regulation of Real Estate Syndications: An Overview*, 49 WASH. L. REV. 137, 140 (1973). These syndications are to be distinguished from real estate investment trusts (REITs) that were created by Congress . REITs must meet certain requirements and distribute at least ninety percent of their taxable income to investors. *See What's a REIT (Real Estate Investment Trust)?*, NAREIT, https://www.reit.com/what-reit (last visited Jan 4, 2021).

288. *See* Paul E. Dorroh, Comment, *SEC Regulation of California Real Estate Syndicates*, 61 CALIF. L. REV. 205, 206–07 (1973).

comparison to other asset classes, the use of leverage and significant cash flow, as well as the advantages afforded investors by the federal tax law.[289] In most syndicates, the funds invested were spread over a number of properties, often on a blind pool basis whereby the properties were identified after the investment.[290] They are typically diversified by geography and type of property. In others, the funds were committed to one specific, identified property.[291] The investment can be "value added" in the sense that renovation or construction are anticipated.[292]

The tax advantages fluctuated through the years with changes in policy made by the various administrations. The Tax Reform Act of 1969[293] added a 10 percent minimum tax, a limitation on the deduction of investment income, and a maximum tax on earned income, but it did not seem to adversely impact tax-sheltered investments.[294] The tax advantages became more attractive with the enactment of the Economic Recovery Tax Act in 1981.[295] High-income investors could quickly write off expenses and losses against income earned from other sources, and profits were taxed at a lower capital gains rate.[296] The Tax Reform Act of 1986,[297] however, severely reduced the advantages of real estate tax shelters, largely due to the elimination of the capital gains tax differential, an increase in the period for writing off depreciation, and a limitation on passive investment losses.[298] These tax changes, together with a period of overbuilding, caused a

289. Miller, *supra* note 283, at 371–72.

290. Dorroh, *supra* note 288, at 208–09.

291. *Id.*

292. *Id.*

293. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (codified as amended in scattered sections of 26 U.S.C.).

294. *See* Leo J. Pircher, *Tax Sheltered Investments: What, Who, When and Which?*, 28 BUS. LAW. 897, 914 (1973).

295. *See* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (codified as amended in scattered sections of 26 U.S.C.).

296. Kirstin Downey, *Millions Burned as Real Estate Partnerships Fizzle: Investment: All Those People Who Benefited from Depreciation Now Find Those Huge Write-Offs Coming Back to Haunt Them in the Form of Higher Taxes.*, L.A. TIMES (Oct. 29, 1989, 12:00 AM), https://www.latimes.com/archives/la-xpm-1989-10-29-fi-568-story.html.

297. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.).

298. *See* Roy E. Cordato, *Destroying Real Estate Through the Tax Code. (Tax Reform Act of 1986)*, CPA J. ONLINE (June 1991), http://archives.cpajournal.com/old/10917112.htm; Leslie Berkman, *Tax Law Puts Real Estate Syndication in New Light*, L.A. TIMES (Dec. 7, 1986, 12:00 AM), https://www.latimes.com/archives/la-xpm-1986-12-07-fi-1548-story.html.

significant downturn in property values in the late 1980s and early 1990s that adversely affected the real estate market.[299] Some benefits to investors in real estate partnerships were provided by the Tax Cuts and Jobs Act of 2017,[300] including special deductions and ways to eliminate certain other limitations on deductibility.[301] While the syndication of real property continues to be popular, the tax advantages are no longer as favorable as they once were.

2. Practice Under the 1917 Act (1917 to 1968)

The applicability of the 1917 Act to the offer and sale of partnership interests depended on whether they fell within the definition of a "security." The term "security" had been amended in 1929 to include any "beneficial interest in title to property, profits or earnings."[302]

T.W. Dahlquist wrote in 1945 that, despite the literal wording of the 1917 Act, there had been a consistent administrative interpretation to the effect that bona fide general and limited partnership memberships did not constitute "securities" requiring a permit.[303] He added that, owing to the publication of an article by a senior administrator, doubt had been raised among some practitioners as to whether a permit was required for the offer and sale of partnership interests, particularly limited partnership interests to which the comments in the article were confined.[304] This caused a statewide debate among lawyers, leading to the legislature's addition in 1945 of an exemption for partnership interests in section 2(b)(12) of the 1917 Act.[305] It applied to the offer or sale of interests in general partnerships, or in limited partnerships where certificates are filed and recorded as required by the California Civil Code, except when offered to the public.[306]

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299. *See* Downey, *supra* note 296.

300. Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017) (codified as amended in scattered sections of 26 U.S.C.).

301. *See* Bobby Burch, *How Will the New Tax Law Affect Real Estate Investors?*, THINK REALTY (Feb. 20, 2019), https://thinkrealty.com/new-tax-law-will-affect-real-estate-investors/.

302. Act of Aug. 14, 1929, ch. 707, § 2, 1929 Cal. Stat. 1251, 1254–56 (repealed 1949).

303. Dahlquist I, *supra* note 25, at 361.

304. *Id.*

305. Act of May 18, 1945, ch. 399, § 1, 1945 Cal. Stat. 853, 853 (repealed 1949). Because this was an exemption from the permit requirements, some thought that it supported the position that partnership interests came within the definition of "securities." *See* Dahlquist I, *supra* note 25, at 361–62.

306. Act of May 18, 1945 § 1.

With the adoption of this exemption, the question became whether these partnership interests were being offered to the public.[307] In many real estate syndications, it was difficult to establish that a public offering was not involved. However, some syndicators, particularly those coming from a real estate background, continued to avoid the permit requirements by claiming that these interests were not "securities" or by taking a much broader view of what would constitute an offering to the public.[308] Beginning in the 1960s, it became generally accepted that when the investors had limited control over partnership affairs and were at risk in the investment, the partnership interests were securities and in most cases were being offered to the public.[309]

As discussed previously with respect to private stock offerings, an issuer could apply for a negotiating or "offering" permit for preliminary acts (i.e., offers, negotiations, or subscriptions) to insure compliance with the 1917 Act.[310] To obtain a negotiating permit, syndicators had to satisfy the Department as to the sophistication of the offerees.[311] This was somewhat of a catch-22, in that offers or negotiations were not permitted without a permit, but in order to get the requisite information, the syndicators invariably had to discuss the nature and terms of the investment opportunity with the prospective investors.

To support sophistication, the applications normally included the names of the offerees and their occupations, annual income, net worth,

307. *See generally* Lindell L. Marsh, Note, *The Availability to the Syndicator of the Private Offering Exemption to the California Corporate Securities Law*, 17 HASTINGS L.J. 792 (1966) (discussing the requirements of the private offering exemption and the availability of the exemption to a syndicator). Similar issues were presented in determining whether real estate syndications were subject to registration under the 1933 Securities Act. If the offer and sale of the interests came within the definition of a "security" under section 2(a)(1) of the 1933 Securities Act, 15 U.S.C. § 77b(a)(1) (2012), registration would be required unless an exemption was available. The exemption most relied upon was section 4(2) (now section 4(a)(2)) of the 1933 Securities Act, *id.* § 77d(a)(2), that exempts from registration "transactions by an issuer not involving any public offering," followed by section 3(a)(11) of the 1933 Securities Act, *id.* § 77c(a)(11), that exempts intrastate offerings. *See* Linda A. Wertheimer & Stephen S. Mark, *Special Problems of Unregistered Real Estate Securities*, 22 UCLA L. REV. 1219, 1221–25 (1975).

308. Noncompliance with the registration requirements of the 1933 Securities Act was also prevalent. This was attributed to a combination of factors: the question of whether the interests were "securities"; the availability, real and illusory, of statutory exemptions; the apparent aversion of most syndicate promotors to registration; and the SEC's failure to inject itself more positively into syndications. *See* Curtis J. Berger, *Real Estate Syndication: Property, Promotion, and the Need for Protection*, 69 YALE L.J. 725, 760 (1960).

309. Dahlquist I, *supra* note 25, at 358–59.

310. *See* Hall, *supra* note 286, at 478.

311. *See id.*

and investment and business experience.[312] A significant annual income or net worth was usually deemed to be sufficient on the assumption that these offerees were able to bear the financial risk of the investment and therefore did not need the protection afforded by the securities law. Amendments to these applications had to be filed with some regularity as new prospective investors were identified.

To keep this personal information out of the public records, lawyers had to request that it be afforded confidential treatment. This was also required for applications for definitive permits, as well as pre- or post-effective amendments. Since many of these offerings were tax oriented, particularly those involving undeveloped real estate, the Department was flooded with applications toward the end of a year. In many cases, this required that the lawyers appear in person before a supervisor to make a request for priority. It was awkward when they had to request several priorities from the same supervisor in a short period of time. Much of this activity centered in Southern California causing a backlog in the Department's Los Angeles office, which was alleviated to some extent by filing applications in the Department's San Francisco and San Diego offices.

This procedure became unworkable with the substantial increase in the number of applications. Lawyers engaged in this practice ultimately prevailed upon the Department to issue negotiating permits where the applications set forth the financial and other criteria that offerees had to meet as a class, without having to disclose the names of the potential investors, their net worth or income, or other information supporting their sophistication.

3. Practice Under the 1968 Law (1969 to the Present)

Although the clause "beneficial interest in title to property, profits, or earnings" was dropped from the definition of "security" in the 1968 Law,[313] the uncertainty over the treatment of limited partnership interests continued, and the courts used a number of tests to determine

312. *See id.*
313. Act of May 9, 1968, ch. 88, § 2, 1968 Cal. Stat. 242, 243–56 (codified as amended at CAL. CORP. CODE §§ 25000–25804).

whether the offer and sale of a particular investment vehicle involved a security.[314]

However, the 1968 Law had a significant effect on the process for dealing with real estate syndicates. For example, it eliminated the requirement for a negotiating permit for any offer (but not a sale) of securities not involving a public offering and permitted entering into any agreement for a sale of securities conditioned on qualification being obtained.[315] The Commissioner also adopted a rule providing that, for this purpose, no public offering is involved if an offer is made to not more than twenty-five potential investors, exclusive of certain specified persons.[316]

Section 25102(f) had exempted partnership, joint venture, and certain trust interests offered or sold in a transaction not involving a public offering.[317] Along with a release providing guidelines for when securities are being offered to the public, the Commissioner adopted a rule to the effect that offers and sales of partnership interests do not involve a public offering if offers are not made to more than twenty-five persons and sales are not consummated to more than ten such persons, if all the offerees meet certain suitability standards.[318] In another release, the Department stated that in appropriate cases it would accept, in lieu of a condition in a permit, that the issuer limit the offering to persons whom it had reasonable grounds to believe were suitable

314. *See* Daniel B. Higgins, Comment, *Is a Limited Partnership Interest a "Security"?: The Current State of the California and Federal Definitions Add a Legal Dimension to Economic Speculation*, 16 SANTA CLARA L. REV. 311, 316–27 (1976). There has been a belief in some quarters that if, for example, a real estate syndicate invests in existing income property acquired when the investors release their funds (and place them at risk of loss), that is an economic, not a securities, risk because the earnings are dependent on market conditions in the future. This differs from an investment in property that will be improved by construction or development by the syndicator—a promise of added value—that is a security. *See Real Estate Syndication and Securities Law*, FIRST TUESDAY J. (Oct. 17, 2016), https://journal.firsttuesday.us/real-estate-syndication-and-securities-law/55096/. For an earlier variation of this interpretation, see Miller, *supra* note 283, at 384.

315. *See* CAL. CORP. CODE § 25102(a) (Deering 2020).

316. See CAL. CODE REGS. tit. 10, § 260.102.1 (2020), which reflects that the number of persons was later increased to thirty-five.

317. *See generally* Sherman S.M. Wong, Comment, *Limited Partnerships and the California Securities Law: Restricting the Public Sale of Limited Partnership Interests*, 13 U.C. DAVIS L. REV. 618 (1980) (examining the treatment of limited partnerships under the California securities law and proposing limiting restrictions on the public sale of limited partnership interests).

318. *See* CAL. CODE REGS. tit. 10, § 260.102.2; Cal. Dep't of Corps., Guidelines for Determining When Securities Are Being "Offered to the Public," Commissioner's Release No. 5-C (Jan. 31, 1969), https://dfpi.ca.gov/wp-content/uploads/sites/337/2019/03/5C.pdf. This rule was made inapplicable to section 25102(f) upon its amendment in 1981.

investors, and that it would give instructions to the same effect to any broker-dealer employed to assist in the distribution.[319] These releases and rules brought greater clarity for lawyers and their clients, particularly for those involved with the smaller syndications.[320] The amendment of section 25102(f) in 1981, however, was even more helpful in avoiding qualification for the offer and sale of partnership interests.

The Commissioner adopted rules under the 1968 Law to establish standards of presumptive fairness to serve as guidelines to syndicators.[321] The standards pertaining to granting permits for real estate programs are quite extensive.[322] They cover such matters as presumptive suitability, compensation and fees, conflicts of interest, rights and obligations of participants, and disclosures.[323] For those syndications in which the general partner was an affiliate of a broker-dealer, clearance with the National Association of Securities Dealers, Inc. (NASD) was required, in which case its regulation of underwriting compensation also became an issue.[324]

Dissatisfaction of the real estate industry with the standards imposed by the Commissioner for real estate syndications led to the passage of the Real Estate Syndicate Act in 1969.[325] Jurisdiction was transferred to the Real Estate Commissioner for smaller real estate syndicates, being those with no more than one hundred beneficial

319. Cal. Dep't of Corps., Suitability of Securities, Commissioner's Release No. 8-C (Feb. 27, 1969), https://dfpi.ca.gov/wp-content/uploads/sites/296/2019/03/8C.pdf.

320. In 1974, the Department considered whether to adopt an exemption similar to SEC Rule 146 and determined that it would not be appropriate, citing the state's keen interests in local securities transactions and the fundamental differences between a disclosure standard and a fair, just, and equitable standard. Report, *Regulation of Real Estate Securities, Including the Applicability of Federal Rule 146 and Its Use in State Blue Sky Laws*, 13 REAL PROP. PROB. & TR. J. 841, 851 (1978).

321. *See* Dorroh, *supra* note 288, at 211–13.

322. *See* CAL. CODE REGS. tit. 10, §§ 260.140.110.1–.119.1. Whereas the Commissioner had actively discouraged the use of large limited partnerships, except in private offerings to sophisticated investors, these new rules caused a reversal of this policy. *See* Ronald R. Hrusoff & Carlos A. Cazares, *Formation of the Public Limited Partnership*, 22 HASTINGS L.J. 87, 88 (1970).

323. CAL. CODE REGS. tit. 10, §§ 260.140.110.1–.119.1.

324. The NASD was a self-regulatory organization that had been formed to increase oversight of over-the-counter brokers and dealers. *See infra* note 403.

325. Act of Aug. 27, 1969, ch. 928, § 3, 1969 Cal. Stat. 1855, 1856–65 (codified at CAL. BUS. & PROF. CODE §§ 10250–10340). Harry Miller recommended adoption of the Real Estate Syndicate Act because "the present regulation still does not meet all public needs," and "the Real Estate Commissioner may be able to supervise the regulation more efficiently because of the knowledge and experience of his staff with real estate, the real estate market and its procedures." *See* Miller, *supra* note 283, at 394, 402.

owners that were formed for the sole purpose of, and engaged solely in, investment in real estate.[326] While the investor suitability standards of the Department of Real Estate were generally lower than those applied by the Commissioner, this Act was not considered to have caused any substantial change in the regulation of real estate programs.[327] In any event, the Act was repealed in 1978, at which point regulation over real estate syndications again became the responsibility of the Department.[328]

With its adoption in 1982, the exemption in SEC Rule 506 became available for use by syndicators to comply with the 1933 Securities Act.[329] When NSMIA was enacted in 1996, reliance on SEC Rule 506 became even more prevalent because of the preemption of state registration, and this was later aided by the change in 2013 permitting general solicitation under SEC Rule 506(c).[330]

With the adoption of the Beverly-Killea Limited Liability Company Act that became effective in 1994, limited liability companies began to be used for some real estate investments. The legislature also amended the definition of "security" in section 25019 to exclude interests in limited liability companies in which it can be proved that all of the members are actively engaged in management.[331]

As discussed below in more detail,[332] the JOBS Act in 2012 exempted equity crowdfunding and expanded the exemption for Regulation A offerings, both of which have been used by some real estate developers as an alternative to more traditional means of financing real

326. *See* Hall, *supra* note 286, at 479–80. The Department issued guidelines that addressed the respective jurisdictions of the Department and the Department of Real Estate over the offer and sale of real estate securities. *See* Cal. Dep't of Corps., Jurisdiction of Real Estate Syndication Qualification, Commissioner's Release No. 32-C (June 27, 1973) (superseded by Cal. Dep't of Corps., Guidelines for Determining When Real Estate Brokers Selling Interests in Entities Owning Real Property Are Exempt from the Certification Requirements of the Corporate Securities Law of 1968, Commissioner's Release No. 62-C (July 2, 1980)).

327. *See* Hall, *supra* note 286, at 480.

328. Act of Sept. 23, 1977, ch. 991, § 3, 1977 Cal. Stat. 2977, 2979.

329. *See* Revisions of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, 47 Fed. Reg. 11,251 (Mar. 16, 1982).

330. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9415, 78 Fed. Reg. 44,471 (July 24, 2013).

331. Act of Sept. 30, 1994, ch. 1200, § 29, 1994 Cal. Stat. 7362.

332. *See infra* text accompanying notes 442–59.

estate investments.[333] For the smaller real estate investments, crowdfunding is available without the necessity of qualifying the offering under California law.[334] Crowdfunding platforms have also been used to solicit investments from "accredited investors" through general advertising in reliance on SEC Rule 506(c).[335]

In 2013, the legislature adopted a requirement that a form be filed with the Department by issuers in certain exempt real estate offerings.[336] This form was intended to provide the Department with information regarding those controlling these offerings, the disclosure documents provided to prospective purchasers, the licenses required, and the licensed persons who undertake these activities.[337] No filing is required for an offering that involves the offer or sale of securities to any person who is an "accredited investor" in a transaction not registered with the SEC under the 1933 Securities Act.[338]

C. Public Stock Offerings

The final issuer transactions to be discussed are public stock offerings. For this purpose, a public stock offering is the offer and sale

333. *See* Michele Bresnick Walsh, *Avoiding Securities Law Pitfalls in Real Estate Transactions*, GORDON FEINBLATT LLC (Jan. 3, 2019), https://www.gfrlaw.com/what-we-do/insights/avoiding-securities-law-pitfalls-real-estate-transactions.

334. *See infra* text accompanying notes 452–55. Because of the limitations in the SEC regulations pertaining to crowdfunding, it can only be used by the smaller syndicates. *See generally* Mark Hiraide, *Ready Capital*, 39 L.A. LAW., no. 4, Feb. 2017, at 21 [hereinafter Hiraide, *Ready Capital Part II*] (describing the requirements for utilizing the exemption for crowdfunding). For recent rule amendments liberalizing the limitations, *see infra* text accompanying notes 462–63.

335. *See* Andrew A. Schwartz, *Inclusive Crowdfunding*, 2016 UTAH L. REV. 661, 666–67.

336. S.B. 978 ch. 669, § 5, 2011–2012 Reg. Sess. (Cal. 2012) (codified at CAL. CORP. CODE § 25102.2); *see* Cal. Dep't of Corps., New Filing Requirements for Certain Securities Issuers Exempt from the Corporate Securities Law of 1968, Commissioner's Release No. 121-C (Dec. 5, 2012), https://dfpi.ca.gov/wp-content/uploads/sites/337/2019/03/121-C.pdf. The number of notices filed, many of which are multiple filings by the same companies, has steadily declined from twenty-eight in 2015 to two in 2019. *See Self-Service Portal*, CAL. DEP'T OF FIN. PROT. & INNOVATION, https://docqnet.dfpi.ca.gov/ (last visited Oct. 4, 2020) [hereinafter Self-Service Portal]. The Self-Service Portal was launched in 2014 to facilitate the filing of applications and notices and payment of fees. The data in this note were derived by searching the Self-Service Portal online at https://docqnet.dfpi.ca.gov/search/ (in "Application Type" select "Real Estate Related Information," check filings for each year from 2015 to 2019 and click "Search").

337. Cal. Dep't of Corps., New Filing Requirements for Certain Securities Issuers Exempt from the Corporate Securities Law of 1968, Commissioner's Release No. 121-C (Dec. 5, 2012), https://dfpi.ca.gov/wp-content/uploads/sites/337/2019/03/121-C.pdf.

338. *See* CAL. CORP. CODE § 25102.2 (Deering 2020).

of stock to the public generally, without restriction as to persons or class of persons.[339]

1. Background

In the years before 1890, the dominant securities exchange—the New York Stock Exchange—listed securities of only a few industrial companies.[340] During the first four decades of the twentieth century, a growing population of middle-class investors, influenced by the prospects of gain and increasing dividends, began committing resources to industrial and utility stock investments.[341] This transition was facilitated by large-scale business enterprises controlled by professional management in both the manufacturing and utilities sectors that began to fully flourish during the 1920s after World War I.[342]

One of the problems investors encountered was determining the value of a public enterprise.[343] Skepticism of common stock remained high because of the difficulty of assessing future earnings trends, the lack of adequate financial information, and the suspicion about the honesty of corporate promoters.[344] For a time, dividend returns became the prevailing factor in valuing stock.[345] During the 1920s, the broadening of public ownership was facilitated by the growth of several types of intermediaries, including commercial banks that served as underwriters, and financial advisors and retail brokerage firms that earned commissions from selling shares directly to middle class investors.[346]

After the stock market crash in 1929, various actions were undertaken by the New York Stock Exchange and the public accounting profession to protect investor interests by requiring the public disclosure of more reliable information on financial performance and

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339. *See* CAL. CODE REGS. tit. 10, § 260.001(f) (2020) ("'Open Qualification' means a qualification which authorizes the offer and sale of securities to the public generally, without restrictions as to persons or class of persons.").

340. *See* Gene Smiley, *The Expansion of the New York Securities Market at the Turn of the Century*, 55 BUS. HIST. REV. 75, 84 (1981).

341. *See* BASKIN & MIRANTI, *supra* note 128, at 167.

342. *See id.* at 167–68.

343. *Id.* at 189–90.

344. *Id.* at 189.

345. *Id.* at 190.

346. *See id.* at 196.

management stewardship.[347] There were also significant governmental reforms in the 1930s, including the enactment by Congress of the 1933 Securities Act, the 1934 Exchange Act, and the 1933 Banking Act.[348] The 1933 Banking Act separated commercial banking from underwriting and securities trading, following which public offerings were underwritten by new securities firms that had been organized separately or spun off by commercial banks.[349] That portion of the Act was largely repealed in 1999.[350]

Increased confidence in the continuance of prosperity and a growing informational base about public companies helped to revive the financial markets.[351] In later years, efficiencies were derived from the great scale and scope of the operations of companies, which became diversified and relied on research and development to discover new opportunities for utilizing their pools of technological and management skills.[352] By the 1950s and 1960s, dividend yield was increasingly overshadowed by the prospects of gain from these investments.[353]

By this time, the securities of most of the nation's major companies were listed on the New York Stock Exchange, which in 1967 transacted almost 78 percent of the dollar volume of all exchanges followed by the American Stock Exchange at about 14 percent.[354] There were also some regional exchanges, most notably the Midwest Stock Exchange and the Pacific Coast Stock Exchange.[355] These exchanges, as self-regulatory organizations, provided a vehicle for raising capital for their listed companies and established standards that these companies were required to meet for initial listing and maintaining the listing of their securities.[356]

As described previously with respect to private stock offerings, the emergence of private equity and venture capital firms led to

347. *See id.* at 197–201.
348. *Id.* at 201–04.
349. *Id.* at 204
350. *See supra* note 128.
351. *See* BASKIN & MIRANTI, *supra* note 128, at 232.
352. *See id.* at 235.
353. *See id.* at 233.
354. *See* ROBERT SOBEL, N.Y.S.E.: A HISTORY OF THE NEW YORK STOCK EXCHANGE 1935–1975, at 300 (1975).
355. *Id.*
356. *Id.* at 303.

investments in companies with heightened risk and greater potential reward.[357] Many of these companies eventually offered stock to the public that allowed investors to realize gains from their investments, while the companies were able to raise capital from the public.[358] This was facilitated in 1971 when NASDAQ (an acronym for the NASD's Automated Quotation System) became operational as an over-the-counter trading network and soon emerged as the second largest securities market in the United States.[359] Many emerging technology companies began listing their stock on NASDAQ rather than on the New York Stock Exchange.[360]

"Going public" was of course not without risk. Adding to the normal volatility in the securities markets, there have been four market crashes since 1929.[361] These market crashes occurred in 1987 following a boom led by takeovers, buyouts, and the use of highly-leveraged, questionable financing tools; in 1999–2000 following a boom in the stock of technology and so-called new technology companies; in 2008 fueled by the widespread use of mortgage-backed securities;[362] and in 2020 caused by the COVID-19 pandemic.

In recent years, Congress has adopted legislation aimed at stronger investor protection and securities regulation pertaining primarily to public companies. This includes the Sarbanes-Oxley Act of 2002[363] and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.[364]

2. Practice Under the 1917 Act (1917 to 1968)

Under the 1917 Act, an issuer could apply to the Department for what was called an "open permit" that would allow securities to be sold to the public.[365] In the early years, most corporations applying for

357. *See supra* text accompanying notes 141–43.

358. *See* NICHOLAS, *supra* note 120, at 239.

359. *See* SOBEL, *supra* note 354, at 341–43.

360. MARK INGEBRETSEN, NASDAQ: A HISTORY OF THE MARKET THAT CHANGED THE WORLD 9–10 (2002).

361. Brian O'Connell, *Biggest Stock Market Crashes Throughout History*, THESTREET (Feb. 29, 2020, 8:45 AM), https://www.thestreet.com/markets/history-of-stock-market-crashes-14702941.

362. *See id.*

363. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

364. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

365. *See* MARSH & VOLK, *supra* note 1, § 6.05[3][a].

open permits were newly organized and used by a promoter "as a means by which he may exchange his assets, whether tangible or intangible, for stock and exploit these assets by the capital raised from numerous scattered stockholders."[366] A smaller number of applications for open permits were filed by corporations that had a financial and business history.[367] To protect existing shareholders against dilution, the Department often required that the new shares be offered proportionately to the shareholders first before they could be offered to the general public.[368]

For those issuers with an earnings history and in a solvent position, the price would be considered in light of their net worth and capitalized earnings.[369] The Department's treatment of issuers without earning power was similar to that used in dealing with promotional schemes.[370] When promoters were involved, the valuations of property and awards for services of the promoter had to be satisfactory before a permit would be issued.[371] Depending on the outcome of the examination, the Department could require that the proceeds be impounded or escrowed or that the promoters submit to a waiver of dividends or liquidating distributions until certain financial or other results were achieved.[372] The Department could allow the issuance of stock to a promoter for those assets that could be valued with ordinary certainty, but not for assets of an intangible value.[373] Additional stock could then be issued once the issuer showed an earnings record that justified a higher value.[374]

By 1929, many public offerings were conducted through syndication, whereby securities were sold on a "firm-commitment" basis to a syndicate of underwriters and then resold in a number of states either directly or through selected dealers.[375] If the issuer was a California corporation or its principal place of business was in California, a

366. John E. Dalton, *The California Corporate Securities Act*, 18 CALIF. L. REV. 373, 384 (1930) [hereinafter Dalton III].

367. *Id.*

368. *See* Dalton II, *supra* note 57, at 263.

369. *See id.* at 384.

370. *Id.* at 385.

371. *See id.* at 376–77.

372. *Id.* at 377–79.

373. *Id.* at 376–77.

374. *See id.* at 377.

375. *See id.* at 391.

permit would be required to offer and sell the securities.[376] For other issuers when the closing took place outside California, no permit would be required for the offer and sale of the securities in California because this constituted a nonissuer transaction.[377] Instead, the managing underwriter would file the preliminary prospectus and any advertising material to be used in California with the Department. The review by the Department focused primarily on the truthfulness of the material and, if not satisfactory, the burden was on the Commissioner to forbid sales by brokers and dealers.[378] If the Commissioner determined that the standards were met, the underwriters were advised that the material could be used upon supplying any missing data, including the price.[379] John E. Dalton wrote about this practice in 1930 as follows:

> At the present time, more than one-half of the securities purchased through investment bankers and dealers are qualified for sale by the simplified method of presentation of advertising material. Although this offers adequate protection, it places local corporations and bankers under a greater burden in qualifying securities of the same type which are sold through identical channels. In this regard, the California law is an anomaly.[380]

The enactment by Congress of the 1933 Securities Act brought about dual state and federal regulation of public offerings.[381] The 1933 Securities Act prohibited the offer or sale of securities using the means or instrumentalities of interstate commerce unless a registration statement is filed with the SEC and is in effect or the offer or sale is

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376. MARSH & VOLK, *supra* note 1, § 1.03[8][e].

377. *Id.* This is to be distinguished from an offering in California by a foreign issuer on a "best efforts" or "all-or-none" basis, for which a permit would be required. *See* Howard D. Sterling, *California Corporate Securities Law of 1968: Underwritings and Corporate Reorganizations*, 23 BUS. LAW. 645, 645 (1968).

378. *See* Dalton III, *supra* note 366, at 399.

379. *See* Jennings, *supra* note 19, at 218.

380. Dalton III, *supra* note 366, at 395. An attempt was made by the Commissioner to address this issue in the early 1960s. After reviewing the situation, the Commissioner issued orders to block the sale by brokers licensed in California of shares in certain specified foreign corporations doing business in California. Thereafter, the Department's staff regularly reviewed registration statements filed with the SEC to determine which of these corporations had not applied for a permit, after which the problem seemed to be under control. *See* Sobieski, *supra* note 12, at 16–18.

381. Securities Act of 1933, Pub. L. No. 111-229, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa).

exempt.[382] The federal regulatory scheme is based on the adequacy of disclosure rather than merit review.[383]

At the outset, the process of registering securities with the SEC in Washington, D.C. was fairly simple and could be accomplished easily. As the years went on, the process became more complicated and time consuming, the required disclosures more extensive, and the review by the SEC staff more intense.[384] As explained by Professor Louis Loss, "[w]hile in theory the Commission's staff merely 'suggests' amendments, the practicabilities of financing do not allow any real alternative of complying."[385]

The 1933 Securities Act contained several exemptions from registration that would permit offerings to the public, namely intrastate offerings under section 3(a)(11)[386] and small offerings under section 3(b).[387] In intrastate offerings, offers and sales are limited to persons residing within a single state or territory where the issuer is resident or incorporated and doing business within that state or territory.[388] Regulation A was adopted by the SEC in 1936[389] as an exemption for offerings pursuant to the authority granted in section 3(b). It initially permitted offerings of up to $100,000, which was increased to $300,000 in 1945, $500,000 in 1970, $1.5 million and later $2 million in 1978, and $5 million in 1980.[390] While Regulation A offerings avoided registration, the filing and qualification of an offering circular with the SEC was still required.[391]

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382. *See id.*

383. *Id.*

384. *See generally* Neal H. Brockmeyer, *Looking Back: Reflections of a California Securities Lawyer*, BUS. L. NEWS, no. 3, 2011, at 6, 9–12 (a description of the registration process and changes in the regulation of public offerings in the early years). For years, the large New York City law firms dominated the public offering practice, particularly in the representation of major underwriters and established companies. The New York firms were also better equipped to qualify an offering under the securities laws of multiple states. Relatively few California law firms or lawyers engaged in this practice and those that did were primarily based in San Francisco and Los Angeles. Beginning in the late 1960s, more firms and lawyers throughout California began representing regional companies and underwriters, and eventually the large companies and major underwriters.

385. Jennings, *supra* note 19, at 211 (quoting LOUIS LOSS, SECURITIES REGULATION 175 (1951)).

386. Securities Act of 1933 § 3(a)(11); 15 U.S.C. § 77c(a)(11) (2018).

387. Securities Act of 1933 § 3(b); 15 U.S.C. § 77c(b)(1).

388. Securities Act of 1933 § 3(a)(11); 15 U.S.C. § 77c(a)(11).

389. Securities Act Release No. 627, 1936 WL 30895 (Jan. 21, 1936); *see* 17 C.F.R. §§ 230.251–.263 (2019).

390. *See* Concept Release, *supra* note 260, at 30,486 n.272.

391. *Id.* at 30,460.

Notwithstanding this new level of federal regulation, public offerings in California, whether registered or exempt under the 1933 Securities Act, continued to be subject to the permit requirements of the 1917 Act and the "fair, just, and equitable" standard.[392] T.W. Dahlquist stated that the 1917 Act

> is not a registration act but a specific permit act. It goes far beyond the disclosure theory of the Securities Act of 1933, and it also reaches far beyond the prevention of fraud. It is designed to prevent deception, the exploitation of ignorance, and all unfair dealings in the issue of securities.[393]

If a permit was required, the lawyers would prepare and file an application with the Department.[394] The Department's staff would examine the proposed plan of business, the method of transacting the business, the securities proposed to be issued, and the methods to be used in issuing and disposing of them.[395] The issues addressed typically involved promotional consideration, sales expenses, salaries, offering materials, and the price of the stock.[396] The resolution of these issues was sometimes difficult and often required the lawyers to meet with the Department's examiners and sometimes with a supervisor or a Deputy or Assistant Commissioner.

As the market for IPOs developed, this opportunity for liquidity was utilized by many corporations that had been in existence for a relatively short period of time and had been financed by groups of investors.[397] This presented "cheap stock" issues for the Department in those situations in which the investors received stock proximate to the offering at a significant discount from the proposed offering price.[398] The Department also sought to restrict the price/earnings ratio of the pricing that was set in negotiations by the issuer and underwriters.[399] To overcome this problem, an issuer would be required to show the growth of the business or a significant improvement in its prospects.[400]

392. Dahlquist I, *supra* note 25, at 348.
393. *Id.*
394. *See* Dalton I, *supra* note 23, at 130.
395. *Id.*
396. *Id.* at 125.
397. *See supra* text accompanying notes 152–54.
398. *A.B.A. Report*, *supra* note 2, at 810–11.
399. *See* MARSH & VOLK, *supra* note 1, § 8.07[1].
400. *Id.* § 8.07[2][b].

It became apparent, however, that forcing a reduction in the offering price could not only be to the detriment of the issuer and cause greater dilution for existing shareholders, but it might also allow customers of the brokers who were able to purchase shares in the initial offering to take a quick profit once the price increased, as it usually did, in the aftermarket.[401]

During this period, both the Department and the NASD began questioning underwriting compensation and reviewing the discounts, commissions, and noncash components for reasonableness.[402] The NASD had found that in some cases underwriters had received unfair and unreasonable compensation that it determined to be inconsistent with its requirement that underwriters operate their businesses in observance of "just and equitable principles of trade."[403] In 1962, the NASD began reviewing underwriting compensation for offerings by unseasoned companies.[404] Shortly thereafter, it began issuing interpretations specifying the factors that it would take into account in determining the reasonableness of underwriting compensation, including the size of the offering, the type of underwriting (firm commitment or best efforts), and the type of securities offered.[405]

3. Practice Under the 1968 Law (1969 to the Present)

The 1968 Law made it clear that it is the offer or sale, not the issuance, of securities that requires qualification, and it clarified the jurisdictional reach by adding the defined term "in this state."[406] It overruled the long-standing position that a firm-commitment underwritten offering of a foreign issue was a nonissuer transaction and therefore was not subject to the permit requirements.[407]

401. *See id.* § 8.07[1]. The sale of these securities in the aftermarket at a substantial premium caused other regulatory problems. *See generally* Comment, *Securities Regulation: Legislative and Administrative Treatment of the "Hot Issue" Phenomenon*, 1968 DUKE L.J. 1137 (discussing how federal and state security laws and the rules of the NASD deal with "hot issues" and suggesting revisions).

402. William K. Sjostrom, Jr., *The Untold Story of Underwriting Compensation Regulation*, 44 U.C. DAVIS L. REV. 625, 627 (2010).

403. *Id.* The NASD, which was founded in 1939, adopted Rules of Fair Practice that proscribed various unfair practices by members and required that members observe high standards of commercial honor and just and equitable principles of trade. *Id.* at 633–34.

404. *See id.* at 635.

405. *Id.* at 636.

406. *See supra* text accompanying notes 78–80.

407. *See* Volk, *supra* note 73, at 77–78; Levin, *supra* note 31, at 88.

As previously discussed, the 1968 Law introduced a simplified process for qualification by coordination for offerings in which a registration statement has been filed with the SEC under the 1933 Securities Act.[408] While qualification by coordination becomes effective automatically, subject to certain conditions having been met, the Commissioner can issue a stop order denying, suspending, or revoking effectiveness on a finding that, among other things, the proposed plan of business or issuance is not "fair, just, and equitable."[409] More often, however, an application would be withdrawn or abandoned. During the waiting period, the staff of the Department has an opportunity to review the application and resolve any problems. It is also necessary to qualify the offering in the other states and jurisdictions in which the securities were to be offered and sold. The Department permits the filing to be made on the Uniform Application to Register Securities (Form U-1)[410] in order to facilitate the process in multi-state offerings.[411]

For many years, California had been known as one of the most difficult states in which to qualify a public offering. The 1968 Law specifically addressed the issue of "cheap stock," which had been a particular problem under the 1917 Act. There is an express limitation in the 1968 Law on the power of the Commissioner to pass upon the fairness of the price of securities that are publicly offered for cash in a registered, firm-commitment offering, with an exception for "unreasonable discounts, commissions or other compensation to underwriters, sellers or others, unreasonable promoters' profits or participations or unreasonable amounts or kinds of options."[412]

The rules under the 1968 Law establish guidelines for dealing with compensation to underwriters, sellers or others, and promotional shares.[413] While the potential of questions regarding underwriting compensation being raised by the Department remained, the shifting

408. CAL. CORP. CODE § 25111 (Deering 2020), which provides for qualification by coordination, was amended in 1996 to apply as well to an offering statement filed under Regulation A. Act of May 6, 1996, ch. 41, 1996 Cal. Stat. 154.

409. Jennings, *supra* note 19, at 214.

410. Uniform Form Library, NASAA, https://www.nasaa.org/industry-resources/uniform-forms/ (last visited Oct. 4, 2020).

411. CAL. CODE REGS. tit. 10, § 260.111(a) (2020).

412. *See* CAL. CORP. CODE § 25140(d).

413. *See* CAL. CODE REGS. tit. 10, §§ 260.140.20–.21, .30–.33.

of the burden and listing of the factors to be considered tended to make this less of a problem than it had been previously.

Underwriting compensation and arrangements also continued to be regulated by the NASD (now the Financial Industry Regulation Authority).[414] In 1992, the NASD adopted a Corporate Financing Rule that refined and updated the interpretations that had been developed over the years.[415] There were some differences between the Corporate Financing Rule and the Commissioner's rules. For example, the definition of selling expenses in the Commissioner's rules includes discounts and commissions (including fees of the underwriters' attorneys paid by the issuer) and all other expenses incurred by the issuer directly related to the offering, but excludes fees of the issuer's accountants' and attorneys and options to underwriters.[416] Options to the underwriters are excluded because the Department, unlike the NASD, did not want to be involved in valuing options for this purpose.[417] Because of the difference in approach, the maximum amount of compensation that is considered reasonable by the NASD as a percentage of the gross offering price varies from the amount as determined by the Commissioner to be acceptable.[418]

While the qualification process was simplified by the 1968 Law, it applied to fewer preliminary acts by virtue of several exemptions that were adopted. For example, the 1968 Law exempted from the qualification requirements offers, but not sales, of a security for which a registration statement has been filed under the 1933 Securities Act but has not yet become effective.[419] In addition, any transactions or agreements between an issuer and an underwriter or among

414. In 1983, Congress amended the 1934 Exchange Act to require that virtually all brokers and dealers operating in the United States become members of a self-regulatory organization, such as the NASD or a securities exchange. Act of June 6, 1983, Pub. L. No. 98-38, § 3, 97 Stat. 205, 206–07 (codified as amended at 15 U.S.C. § 78o(b)). In 2007, the NASD was consolidated with the member regulation, enforcement, and arbitration functions of the New York Stock Exchange to create the Financial Industry Regulation Authority (FINRA). Sjostrom, *supra* note 402, at 635.

415. Sjostrom, *supra* note 402, at 636.

416. CAL. CODE REGS. tit. 10, § 260.140.20(a).

417. MARSH & VOLK, *supra* note 1, § 8.04[3].

418. *See* Sjostrom, *supra* note 402, at 640–41.

419. *See* CAL. CORP. CODE § 25102(b) (Deering 2020). This change is consistent with section 5(c) of the 1933 Securities Act, 15 U.S.C. § 77e(c) (2018). Section 25102(b) was amended in 1993 to add an exemption for an offer (but not a sale) for which an offering circular under Regulation A has been filed with the SEC but has not yet been qualified. *See also* CAL. CODE REGS. tit. 10, § 260.105.29.

underwriters are exempt if the sale of the securities is qualified or exempt from qualification at the time of distribution in California.[420]

One of the most significant changes in the 1968 Law was the adoption of a marketplace exemption that reflected a growing reliance on the listing standards imposed by the national securities exchanges, as well as enforcement by the SEC of its disclosure requirements.[421] Exempted from qualification are securities listed or authorized for issuance upon notice of issuance on a national securities exchange certified by the Commissioner as maintaining specified minimum listing and delisting standards.[422] Also exempted were warrants or rights to subscribe to these securities, and only later were securities senior to the listed securities added.[423] An earlier study had shown that the Commissioner had taken no action to disapprove or change any of the terms or conditions of offerings by companies of additional shares of stock listed on the New York Stock Exchange.[424]

The Commissioner initially certified the New York Stock Exchange and the American Stock Exchange,[425] and later, tiers of various regional exchanges.[426] When NASDAQ became operational in 1971, it consisted of the National Market and the Capital Market. In 1989, the Commissioner certified the National Market,[427] which had been permitted by a statutory amendment. In 2006, the SEC approved the application of the Nasdaq Stock Market, LLC to become a national

420. CAL. CORP. CODE § 25102(d).

421. *Id.* § 25100(o). For a summary of the development of the marketplace exemption in California, see Therese H. Maynard, *Commentary: The Future of California's Blue Sky Law*, 30 LOY. L.A. L. REV. 1531, 1539–41 (1997). Professor Maynard has been a member of the faculty at Loyola Law School, Los Angeles, since 1983.

422. CAL. CORP. CODE § 25100(o).

423. In 1983, the Commissioner exempted by rule securities senior to those listed on a certified exchange. CAL. CODE REGS. tit. 10, § 260.105.33.

424. MARSH & VOLK, *supra* note 1, § 1.03[8][c].

425. Cal. Dep't of Corps., Certification of the New York Stock Exchange and the American Stock Exchange Under Section 25100(o) of the Corporations Code, Commissioner's Release No. 27-C (Revised) (Mar. 9, 1992).

426. *See, e.g.*, Cal. Dep't of Corps., Exemption from Qualification Requirements for Securities Listed on Tier I (Select Market Companies) of the Pacific Stock Exchange, Commissioner's Release No. 95-C (Dec. 27, 1994); Cal. Dep't of Corps., Exemption from Qualification Requirements for Securities Listed on Tier I of the Philadelphia Stock Exchange, Commissioner's Release No. 96-C (Sept. 12, 1995).

427. *See* Cal. Dep't of Corps., Exemption from Qualification Requirements for NASDAQ Global Market and NASDAQ Capital Market Securities Under Corporations Code Section 25100(o), Commissioner's Release No. 87-C (Revised) (Aug. 17, 2009), https://dfpi.ca.gov/wp-content/uploads/sites/337/2019/03/87c.pdf.

securities exchange.[428] The National Market was renamed the NASDAQ Global Market and contained two tiers (the NASDAQ Global Market and the NASDAQ Global Select Market), both of which were certified by the Commissioner in 2007.[429] The NASDAQ Capital Market was later certified by the Commissioner.[430]

Since NSMIA became law in 1996, the California marketplace exemption has had only limited importance.[431] NSMIA preempted from state registration and merit review securities listed or authorized for listing on the New York Stock Exchange, the American Stock Exchange, or any national securities exchange determined by the SEC to have substantially similar listing standards to those markets, or any security of the same issuer that is equal in seniority or that is senior to such security.[432] The California Legislature in 1997 added section 25100.1 to the 1968 Law recognizing this federal preemption.[433]

The SEC later designated as exempt securities those quoted or authorized for quotation in the NASDAQ National Market and Capital Market,[434] and ultimately those listed or authorized for listing on the Nasdaq Stock Market, LLC when it became a national securities exchange. Congress in 2018, as part of the Economic Growth, Regulatory Relief, and Consumer Protection Act,[435] expanded this exemption to include as a "covered security" any security qualified for trading in the national market system that is listed or authorized for listing on a national securities exchange (or tier or segment thereof) or any security of the same issuer that is equal in seniority or that is senior to such security.[436]

428. *Id.*

429. *Id.*

430. *Id.*

431. The California exemption, unlike the federal exemption, exempts warrants and other rights to acquire a security, CAL. CORP. CODE § 25100(o) (Deering 2020), and provides an exemption from the California usury law for evidence of indebtedness, *id.* § 25117(a)(2).

432. *See* National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 102, 110 Stat. 3416, 3417–18 (codified as amended in scattered sections of 15 U.S.C. § 17r).

433. Act of Aug. 26, 1997, ch. 391, § 6, 1997 Cal. Stat. 2614, 2631 (codified at CAL. CORP. CODE § 25100.1).

434. Covered Securities Pursuant to Section 18 of the Securities Act of 1933, Securities Act Release No. 8791, 72 Fed. Reg. 20,410 (Apr. 24, 2007).

435. Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, 132 Stat. 1296 (2018).

436. Securities Act of 1933, Pub. L. No. 111-229, §§ 18(b)(1)(A), (b)(1)(B), 48 Stat. 74, 106; 15 U.S.C. § 77r(b)(1)(A)–(B) (2018). A "national securities exchange" is an exchange that has been registered by the SEC under section 6 of the 1934 Exchange Act, 15 U.S.C. § 78f (2018).

As the global nature of the securities markets increased, the SEC had also provided guidance for foreign offerings.[437] To more definitively reflect the SEC's position about the territorial reach of the registration requirements, the SEC in 1990 adopted Regulation S.[438] It provides a safe harbor from the registration requirements under the 1933 Securities Act for certain offers and sales of securities that occur outside the United States.[439] Some U.S. companies have used Regulation S to offer securities on the Alternative Investment Market (AIM), which is a submarket of the London Stock Exchange launched in 1995 to facilitate the raising of capital by smaller companies from any country or industry sector.[440] The SEC also made it clear that foreign offerings can be structured to take advantage of a combination of exemptions.[441]

In 2012, the JOBS Act expanded the exemption from registration under the 1933 Securities Act for Regulation A offerings and added a new exemption for equity crowdfunding, the terms of which were embodied in Regulation Crowdfunding adopted by the SEC.[442] This was intended to increase access to capital for small and medium-sized companies without having to bear the cost of registration under the 1933 Securities Act.[443]

Prior to the JOBS Act, Regulation A had not been widely used. The maximum dollar amount authorized for these offerings in section 3(b) of the 1933 Securities Act had been increased to $5 million in

437. *See* Registration of Foreign Offerings by Domestic Issuers, Securities Act Release No. 4708, 29 Fed. Reg. 9828 (July 22, 1964).

438. *See* Offshore Offers and Sales, Securities Act Release No. 6863, 55 Fed. Reg. 18,306 (May 2, 1990). Regulation S consists of SEC Rules 901 to 905, 17 C.F.R. §§ 230.901–.905 (2019).

439. Offshore Offers and Sales, Securities Act Release No. 6863, 55 Fed. Reg. 18,306 (May 2, 1990). For a discussion of the jurisdictional reach of the California securities law and its application to Regulation S offerings, see Keith Paul Bishop, *California's Blue Sky Law Problems for Foreign Issues and Foreign Issuers*, 23 INSIGHTS, no. 7, July 2009, at 28.

440. *See AIM*, LONDON STOCK EXCH., https://www.londonstockexchange.com/companies-and-advisors/aim/aim/aim.htm (last visited Oct. 4, 2020).

441. *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9415, 78 Fed. Reg. 44,771 (July 24, 2013). The rules adopted by the SEC in November 2020 provide that foreign offerings under Regulation S will not be integrated with other offerings. *See* Private Markets Adopting Release, *supra* note 271, at 3,511.

442. *See* U.S. SEC. & EXCH. COMM'N, REPORT TO THE COMMISSION: REGULATION CROWDFUNDING 6 (2019), https://www.sec.gov/files/regulation-crowdfunding-2019_0.pdf [hereinafter REPORT TO COMMISSION ON REGULATION CROWDFUNDING].

443. *Id.* at 5.

1980.[444] The SEC was directed by Congress in the JOBS Act to add a class of securities to those exempted under section 3(b) for offerings of up to $50 million.[445] The SEC adopted rules in 2015 to provide for two tiers of offerings under Regulation A (now commonly referred to as Regulation A+): Tier 1 for a maximum of $20 million and Tier 2 for a maximum of $50 million.[446] For Tier 1 offerings, there are no investor qualifications and audited financial statements are not required.[447] For Tier 2 offerings, audited financial statements are required, and sales are limited to accredited investors or nonaccredited investors who invest no more than 10 percent of their annual income or net worth.[448]

The JOBS Act also added as a "covered security" a security that is offered or sold to a "qualified purchaser" as defined by the SEC.[449] The rules adopted by the SEC define a "qualified purchaser" as any person to whom securities are offered or sold pursuant to a Tier 2 offering.[450] As a result, Tier 2 offerings are preempted from state registration and merit review. The California legislature in 1997 added section 25102.1(a) recognizing the exemption from qualification for an offer or sale to a "qualified purchaser" as defined by the SEC and provided for the filing of a notice and payment of a fee.[451] This covers

444. *See supra* text accompanying note 390.

445. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 401(b), 126 Stat. 306, 323–24 (2012) (codified as amended at 15 U.S.C. § 77c(b)). Congress in 2018, as part of the Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, 132 Stat. 1296 (2018), directed the SEC to make Regulation A available to companies subject to reporting under sections 13 or 15(d) of the 1934 Exchange Act, 15 U.S.C. §§ 78m, 78o(d) (2018).

446. *See* Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), Securities Act Release No. 9741, 80 Fed. Reg. 21,806 (Apr. 20, 2015).

447. *See* Philip A. Feigin, *SEC's New Regulation A+ and the States' M Word (Merit Review)*, 5 NAT'L L. REV., no. 85, Mar. 26, 2015, at 1–2.

448. *Id.*

449. Securities Act of 1933, Pub. L. No. 111-229, § 18(b)(3), 48 Stat. 74, 107; 15 U.S.C. § 77r(b)(3).

450. 17 C.F.R. § 230.256 (2019).

451. Act of Aug. 26, 1997, ch. 391, § 9, 1997 Cal. Stat. 2614, 2632–33 (codified at CAL. CORP. CODE § 25102.1(a)); *see* Cal. Dep't of Bus. Oversight, Notice Filing Requirements for Regulation A—Tier 2 Offerings, Commissioner's Release No. 122-C (Sept. 15, 2015), https://dfpi.ca.gov/wp-content/uploads/sites/337/2019/03/122-C.pdf. The Commissioner had initially declared this exemption inoperative because the SEC had never defined a "qualified purchaser." That changed in 2015 when the SEC applied this definition to Regulation A. *See* Keith Paul Bishop, *California's Regulation A Notice Filing Requirement*, ALLEN MATKINS (July 11, 2017), https://www.calcorporatelaw.com/2017/07/californias-regulation-a-notice-filing-requirement.

only Tier 2 offerings, while Tier 1 offerings remain subject to qualification in California.

In addition, the JOBS Act added section 4(a)(6) to the 1933 Securities Act to permit equity crowdfunding, whereby issuers can raise initially up to $1 million in a twelve-month period, subject to certain financial limitations and other requirements.[452] Crowdfunding is a means by which a project or business venture can be funded by raising small amounts of money from a large number of investors, typically through the Internet. While online crowdfunding had been around since the early 2000s, anything that might be the offer or sale of a "security" under state or federal law was required to be registered.[453] Under the JOBS Act, states are preempted from requiring the registration or merit review of equity crowdfunding offerings.[454] This preemption from qualification in California is recognized in section 25102.1(c).[455]

The final rules implementing section 4(a)(6) were adopted by the SEC in October 2015 as Regulation Crowdfunding and became effective in May 2016.[456] Regulation Crowdfunding provides a framework for these offerings, as well as the regulation of registered funding portals and brokers that issuers use as intermediaries for the offerings.[457] Issuers are required to file the offering statement and other information with the SEC.[458] While states are permitted to assess a filing fee and require filing of a notice, California has not yet done so.[459]

Some states have enacted crowdfunding exemptions linked to the federal exemptions for interstate offerings in section 3(a)(11) of the

452. Securities Act of 1933 § 4(a)(6); 15 U.S.C. § 77d(a)(6).

453. *See* Christopher H. Pierce-Wright, Comment, *State Equity Crowdfunding and Investor Protection*, 91 WASH. L. REV. 847, 848 n.5 (2016).

454. Securities Act of 1933 § 18(b)(4); 15 U.S.C. 77r(b)(4).

455. CAL. CORP. CODE § 25102.1(c) (Deering 2020).

456. 17 C.F.R. §§ 227.100–.503 (2019); *see* Crowdfunding, Securities Act Release No. 9974, 80 Fed. Reg. 71,388 (Nov. 16, 2015). *See generally* Hiraide, *Ready Capital Part II*, *supra* note 334, at 22. For recent rule amendments, see *infra* text accompanying notes 562–63.

457. Crowdfunding, Securities Act Release No. 9974, 80 Fed. Reg. 71,388, 71,388 (Nov. 16, 2015).

458. *Id.* at 71,398.

459. The Department has issued several advisories for investors and small businesses describing equity crowdfunding and pointing out certain concerns and risks. *See, e.g.*, *Informed Investor Advisory: Crowdfunding*, NASAA, https://www.nasaa.org/12842/informed-investor-advisory-crowdfunding/ (last revised Aug. 2017); *Small Business Advisory*: *Crowdfunding*, NASAA, https://www.nasaa.org/13676/small-business-advisory-crowdfunding/ (last revised Aug. 2017).

1933 Securities Act and the corresponding SEC Rule 147, and for offerings under SEC Rule 504 of Regulation D.[460] To date, efforts to pass legislation to permit local equity crowdfunding in California have been unsuccessful.[461]

As previously discussed, the SEC in November 2020 adopted rule amendments to deal with exemptions and other aspects of exempt offerings that had been raised in the Concept Release.[462] These amendments are intended to make offerings under Regulation A and Regulation Crowdfunding more attractive by, among other things, increasing the limit for offerings under Tier 2 of Regulation A from $50 million to $75 million, for Tier 2 secondary offerings from $15 million to $22.5 million, and for Regulation Crowdfunding offerings from $1.07 million to $5 million and removing or revising certain investment limits.[463] The rules also provide general principles and "safe harbors" for integration with other offerings that permit the solicitation of indications of interest by an issuer in an exempt offering prior to determining which exemption it would rely on, such as Regulation A or Regulation Crowdfunding and provide that offers and sales made in compliance with Rule 701 or with Regulation S will not be integrated with other offerings.[464]

The qualification process was also impacted by the JOBS Act. For a new class of issuer, the emerging growth company, the solicitation of indications of interest (called "testing the waters") from certain institutional investors was permitted before or after the filing of a

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460. *Intrastate Crowdfunding Resources*, NASAA, https://www.nasaa.org/industry-resources/securities-issuers/instrastate-crowdfunding-resources/ (last visited Oct. 4, 2020).

461. *See* JD Alois, *California Expected to Attempt Intrastate Crowdfunding Legislation Once Again*, CROWDFUND INSIDER (Dec. 11, 2018, 3:31 PM), https://www.crowdfundinsider.com/2018/12/142262-california-expected-to-attempt-intrastate-crowdfunding-legislation-once-again/; JD Alois, *Is California the State Where Crowdfunding Goes to Die? Maybe Not, as Intrastate Legislation Resurfaces*, CROWDFUND INSIDER (Jan. 24, 2018, 3:00 PM), https://www.crowdfundinsider.com/2018/01/127522-california-state-crowdfunding-goes-die-maybe-not-intrastate-legislation-resurfaces/.

462. *See supra* text accompanying notes 271–77.

463. *See* Private Markets Adopting Release, *supra* note 271. The SEC had earlier adopted temporary final rules intended to expedite the offering process under Regulation Crowdfunding for smaller, previously established companies affected by COVID-19. *See* Temporary Amendments to Regulation Crowdfunding, Securities Act Release No. 10,781, 85 Fed. Reg. 27,116 (May 7, 2020); Temporary Amendments to Regulation Crowdfunding, Securities Act Release No. 10,829, 85 Fed. Reg. 54,483 (Sept. 2, 2020) (extension to September 1, 2021).

464. *See* Private Markets Adopting Release, *supra* note 271.

registration statement with the SEC.[465] In 2019, the SEC expanded this by rule to all issuers.[466] In 2015, the SEC had also permitted the solicitation of indications of interest in Regulation A offerings before the submission or filing of an offering statement.[467] Solicitation is preempted from state registration and merit review if the securities will be "covered securities" upon completion of the offering.[468] This preemption applies to registered offerings of securities qualified for trading in the national market system and Tier 2 offerings, but not Tier 1 offerings, under Regulation A.[469]

IV. THE CURRENT STATUS OF QUALIFICATION AND MERIT REVIEW

To determine the extent to which the requirement of qualification and the application of merit review currently play a role in regulating the offer and sale of securities in California, it is instructive to examine data showing the number of filings with the Department by issuers that are relying on exemptions from qualification, as well as the number of applications filed with the Department for qualification by coordination, notification, and permit. The data do not reflect offers and sales of securities that do not require qualification due to exclusions in the definitions[470] or exemptions for securities or transactions for which notices are not required to be filed with the Department.[471]

A. Securities and Transactions Exempt from Qualification

As previously discussed, the 1968 Law contains a number of exemptions from qualification, many of which require that notices be

465. *See* Securities Act of 1933, Pub. L. No. 111-229, § 5(d), 48 Stat. 74, 86; 15 U.S.C. 77e(d) (2018).

466. 17 C.F.R. § 230.163B (2019); *see* Solicitations of Interests Prior to a Registered Offering, Securities Act Release No. 10,699, 84 Fed. Reg. 53,011 (Oct. 4, 2019).

467. Keith Paul Bishop, *California Lags Behind the SEC in Permitting Testing of the Waters in Regulation A Offerings*, ALLEN MATKINS (July 6, 2017), https://www.calcorporatelaw.com/2017/07/california-securities-rules-impede-regulation-a-offerings.

468. *See* Securities Act of 1933 § 18(a)(1)(B); 15 U.S.C. § 77r(a)(1)(B).

469. 15 U.S.C. § 77r(b)(3).

470. Examples are exclusions from the definitions of "sale" in CAL. CORP. CODE § 25017(f) (Deering 2020) and "security" in § 25019.

471. Examples are exemptions for changes in rights, preferences, privileges, or restrictions in CAL. CORP. CODE § 25103(e), (g), for nonissuer transactions in § 25104, and for transactions exempted by rule of the Commissioner pursuant to § 25105.

filed with, and fees paid to, the Department.[472] The transactions for which the notices are filed represent offers and sales that, but for these exemptions, might otherwise be subject to qualification and merit review. While the Department's review of these notices is somewhat limited, letters pointing out deficiencies in compliance with the filing requirements are occasionally sent to issuers by the Department.[473]

The following is a breakdown of the type and number of notices filed with the Department in 2019 for offers and sales of securities exempt under the 1968 Law, other than those offers and sales that are not subject to qualification in California by virtue of federal preemption:[474]

Table 1
Notices for Exempt Offers and Sales (Other Than Federal Preemption) Filed in 2019

Code/Rules Section and Description	Number of Notices Filed
Code Section 25102(h) Small Issue	193
Code Section 25102(f) Limited Offer	18,598
Code Section 25102(n) Qualified Purchasers-1st Notice	14
Rules Section 260.103 Changes in and Exchanges of Securities Otherwise Exempt	36
Code Section 25102(o) Compensatory Stock Purchase and Option Plans	3,409
Code Section 25103(h) Exchanges Incident to Reorganizations	80
Total	22,330

472. The fees for notices filed with the Department are set forth in CAL. CORP. CODE § 25608. Some are fixed amounts and others are set within a range depending on the value of the securities proposed to be sold.

473. Ward, *supra* note 211, at 460–61.

474. The data in Table 1 for the number of notices filed are derived from spreadsheets provided by the Department that are on file with the author. The notices filed by reason of CAL. CODE REGS. tit. 10, § 260.103 (2020) are for (1) changes in rights, preferences, privileges, or restrictions and (2) exchanges of securities with existing security holders that otherwise would have been exempt under CAL. CORP. CODE § 25102 or CAL. CODE REGS. tit. 10, § 260.105.14.

Other California exemptions from qualification recognize Congress's preemption of state registration and merit review for certain offers and sales that are exempt from registration under the 1933 Securities Act. These exemptions cover securities offered or sold pursuant to SEC Rule 506,[475] Tier 2 of Regulation A,[476] and section 4(a)(6) of the 1933 Securities Act,[477] as well as securities issued by investment companies that are registered or have filed a registration statement under the Investment Company Act[478] and registered offerings by companies having securities qualified for trading on the national market system.[479] Some of these exemptions require the filing of notices with, and payment of fees to, the Department. The following is a breakdown of the number and type of these notices filed with the Department in 2019:[480]

Table 2
Notices for Offers and Sales Exempt by Federal Preemption Filed in 2019

Code Section and Description	Number of Notices Filed
Section 25102.1(d) SEC Rule 506	1,972
Section 25102.1(a) Regulation A Tier 2	50
Section 25100.1(b) Investment Companies	2,378
Total	4,400

475. *See* CAL. CORP. CODE § 25102.1(d).
476. *See id.* § 25102.1(a).
477. *See id.* § 25100.1(a).
478. *Id.* § 25100.1(b).
479. *Id.* § 25100.1(a).
480. The data in Table 2 for the number of notices filed are derived from spreadsheets provided by the Department that are on file with the author. The data for the SEC Rule 506 filings may not totally reflect the actual number of filings due to a failure of some issuers to file Form Ds with the SEC and the Department. *See* Keith Paul Bishop, *No Form D Filing—Now What?*, ALLEN MATKINS (Aug. 10, 2010), https://www.calcorporatelaw.com/2010/08/no-form-d-filing-now-what. It has been estimated that Form D filings are not made for as many as 10 percent of unregistered offerings made under Regulation D. *See* Study, Scott Bauguess et al., U.S. Sec. & Exch. Comm'n, Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009–2017, at 7 n.18 (Aug. 2018).

To put this in perspective, it is helpful to examine the number of filings for these exemptions with the SEC and the significance of California in both the number of filings and amounts raised.[481]

SEC Rule 506(b) dominates the market for exempt offerings.[482] In 2019 there were 24,636 offerings under Rule 506(b) in which \$1,492 billion was reported raised, and 2,269 offerings under SEC Rule 506(c) in which \$66 billion was reported raised.[483] From 2009 to 2018, the largest number of issuers in the Rule 506 offerings designated their principal place of business to be in California,[484] and California was one of the largest states in terms of the amount raised by issuer location.[485]

From June 19, 2015 to December 31, 2019, there were 277 offerings qualified under Tier 2 of Regulation A in which \$2,216 million was reported raised, and 105 offerings under Tier 1 in which \$230 million was reported raised.[486] California was one of the largest states in terms of the capital sought and proceeds reported by issuer location.[487]

No notice filings or fee payments are required for Regulation Crowdfunding offerings in California. From May 16, 2016 to December 31, 2019, there were 2,003 offerings of securities under Regulation Crowdfunding in which the targeted amount sought was \$126.9 million.[488] It was estimated that in 2019 there were 735 Regulation Crowdfunding offerings in which \$137 million had been raised, compared with \$86 million in 2018.[489] Through 2018, California was one of the largest states in which the issuers of securities offered under Regulation Crowdfunding were located.[490]

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481. *See* U.S. SEC. & EXCH. COMM'N, ANNUAL REPORT FOR FISCAL YEAR 2019, *supra* note 154, at 14–15.

482. *See* Private Markets Adopting Release, *supra* note 271, at 205 tbl.5.

483. *Id.* at 206 tbl.6.

484. Concept Release, *supra* note 260, at 30,505.

485. *See id.* at 30,485 fig.6.

486. Private Markets Adopting Release, *supra* note 271, at 281–82 tbl.14.

487. *See* U.S. SEC. & EXCH. COMM'N, REPORT TO THE COMMISSION: REGULATION A LOOKBACK STUDY AND OFFERING LIMIT REVIEW ANALYSIS 20, figs.5a & 5b (2020), https://www.sec.gov/files/regulationa-2020.pdf [hereinafter REGULATION A STUDY].

488. Private Markets Adopting Release, *supra* note 271, at 207 tbl.8.

489. Brian Belley, *2019 US Equity Crowdfunding Stats—Year in Review*, CROWDWISE: BLOG (Jan. 10, 2020), https://crowdwise.org/funding-portals/2019-equity-crowdfunding-stats-data/.

490. REPORT TO COMMISSION ON REGULATION CROWDFUNDING, *supra* note 442, at 15 tbls.1 & 20 fig.2.

B. Transactions Subject to Qualification

Under the 1968 Law, securities can be qualified by coordination, notification, or permit.[491] The following is a breakdown of the number of applications for qualification filed with the Department in 2019:[492]

Table 3
Applications for Qualification Filed in 2019

Code Section and Description	Number of Applications Filed
Section 25111 Coordination	109
Section 25112 Issuer Notification	0
Section 25131 Nonissuer Notification	7
Section 25113 Issuer Permit	109
Section 25162 Post-Effective Amendment	23
Section 25121 Exchange Permit	5
Section 25142 Fairness Hearings Permit	4
Total	257

Offerings for which applications are filed for qualification by coordination or notification (including securities to be offered or sold in nonissuer transactions pursuant to section 25131) become effective, subject to the issuance of a stop order by the Commissioner based on, among other things, a failure to meet the "fair, just and equitable" standard.[493] The number of applications filed for qualification by coordination has decreased substantially due to the marketplace exemption in the 1968 Law and later the preemption by Congress of certain

491. *See* CAL. CORP. CODE §§ 25110, 25121, 25131 (Deering 2020).

492. The data in Table 3 for the number of applications filed are derived from spreadsheets provided by the Department that are on file with the author. Applications for post-effective amendments under CAL. CORP. CODE § 25162, for qualification by coordination under § 25111 and by permit under § 25113 are included separately. Only two of the applications for issuer permits were filed as small company applications under § 25113(b)(2).

493. CAL. CORP. CODE § 25140. No stop orders were issued by the Commissioner for offerings qualified by coordination or notification in 2018 or 2019 (through October 31st). The source of this information is a communication from the Department dated Oct. 31, 2019 on file with the author.

publicly-traded securities that now extends to any security qualified for trading in the national market system.[494] Only seven applications were filed for qualification by notification, all of which were for nonissuer transactions.

Offerings for which applications are filed for qualification by permit are subject to review by the Department and, for a permit to be issued, there must be an affirmative finding that, among other things, the business and issuance meet the "fair, just, and equitable" standard.[495]

Included in the table are three types of issuer transactions for which qualification by permit is applicable: issuer permit, exchange permit, and fairness hearing permit.

The first permit is for the typical issuer transaction under section 25113. The number of applications filed and permits issued under that section has dropped dramatically since the 1960s. As stated earlier, it was estimated that twenty-two thousand permits had been issued in the fiscal year ending June 3, 1968, just before the 1968 Law became effective.[496] For the twelve months ended January 31, 1999, the Department reported that 551 offerings were not exempt and therefore subject to California regulation.[497] In more recent years, the number of permits issued under section 25113 has declined further. Table 4 shows the number of permits issued by the Department under section 25113 in each of the years 2014 through 2019, showing a slight increase in 2019 from the prior year but an overall decline during that period:[498]

494. Maynard, *supra* note 421, at 1539–40, 1545.

495. CAL. CORP. CODE § 25140(b).

496. *See supra* text accompanying note 179.

497. ROSA MARIA MOLLER, SECURITIES REGULATIONS AND THEIR EFFECTS ON SMALL BUSINESSES 1, 5 (Cal. Rsch. Bureau 2000).

498. CAL. DEP'T OF BUS. OVERSIGHT, COMMISSIONER'S REPORT ON THE OFFER OR SALE OF SECURITIES BY PERMIT UNDER CORPORATIONS CODE SECTION 25113 FOR 2019, at 7 (2020), https://dfpi.ca.gov/wp-content/uploads/sites/337/2020/12/2020-Commissioners-Report-on-the-Offer-or-Sale-of-Securities-by-Permit.pdf [hereinafter COMMISSIONER'S PERMIT REPORT]. Since 2013, the Commissioner has been required by CAL. CORP. CODE § 25113(d) to prepare an annual report summarizing the data collected from issuers to which the Department issues permits, including the general categories of investments, the net worth and experience requirements, the total amount of money sought to be raised by category, and the number and nature of enforcement actions. It is interesting to note that no enforcement action had been taken by the Department against any of the issuers that received a permit in the years reported on through 2018, but for 2019 the Department reported that nineteen enforcement actions were taken against permit holders in violation of CAL. CORP. CODE § 25401.

Table 4
Permits Issued Under Section 25113 From 2014 to 2019

	2014	2015	2016	2017	2018	2019
Number of Permits Issued	139	138	131	126	104	110

From a review of the Self-Service Portal, it appears that eighty-seven applications for permit under section 25113 were filed in 2020, excluding eleven applications for post-effective amendments, but the official number of permits actually issued is generally not reported by the Department until the end of the following year.[499]

A review of applicants' files for permits that were issued in 2019 under section 25113 shows that about forty-seven included one or more written communications between the Department and the issuers, consisting of comment letters and issuers' responses to comments.[500] Some of these permits contained legend conditions restricting transfer and orders withholding the exemption from nonissuer qualification in section 25104(h).[501] This latter section provides an exemption from qualification if the offer or sale of any securities of the same class has been qualified and become effective within a specified period of time, but it can be withheld by the Commissioner in a limited offering qualification.[502]

In addition to the number of permits issued, it is interesting to examine the types of issuers that are seeking qualification by permit under section 25113. During the years 2014 through 2019, offerings of church extension fund securities and church debt accounted for from 29 to 44 percent of the permits issued, and church extension fund securities offerings consistently accounted for the largest amount sought to be raised in these offerings.[503] Table 5 shows the number of

499. Self-Service Portal, *supra* note 336 (under "Application Type" select "Permit", select the date range from 03/01/2018 to 12/31/2019, and then click Search).

500. *Id.*

501. *Id.*

502. CAL. CORP. CODE § 25104.

503. This data are derived from a review of each of the Commissioner's Reports on the Offer or Sale of Securities by Permit under Corporations Code Section 25113 for the years 2014 through 2019. *See Publications—Corporate Securities Law 1968*, CAL. DEP'T OF FIN. PROT. & INNOVATION, https://dfpi.ca.gov/publications-corporate-securities-law/ (last updated Dec. 29, 2020, 12:21 PM).

permits issued under section 25113 and amount sought to be raised by category of issuer in 2019:[504]

Table 5
Permits Issued and Amounts Sought to be Raised by Category of Issuer in 2019

Category of Issuer	Number of Permits Issued	Amounts Sought to be Raised
Church Extension Funds	29	$5,937,000,000
Financing	18	$1,259,500,000
Hard Money Lending	10	$710,000,000
Church Debt	14	$329,850,000
Mobile Home Parks	9	$5,344,316
Country Clubs	3	$124,500,000
Mutual Water Companies	5	$479,378
Cooperatives	7	$14,340,226
Agricultural	1	$700,000
Retail	1	$10,258,000
REITs	2	$1,017,524,000
Sports and Recreation	5	$505,150,000
Food and Drink	2	$1,500,000
Educational Services	1	$450,000
Manufacturing	1	$363,655,336
Pharmaceuticals	1	$260,700,000
Banking	1	$9,639,193

504. COMMISSIONER'S PERMIT REPORT, *supra* note 498, at 3, 7.

This clearly does not represent the same cross section of small businesses that sought permits in earlier years. For example, only one permit was issued in each of the manufacturing and retail categories in 2019 and none in the technology category.

Qualification by permit is also required by other sections of the 1968 Law, but relatively few permits are issued under these sections. Section 25121[505] requires qualification by permit for the offer or sale of securities in connection with changes in the rights, preferences, privileges, and restrictions of or on outstanding securities, exchanges of securities by an issuer with its security holders, exchanges in connection with any merger, consolidation or sale of assets, and entity conversion transactions.[506]

Another section requiring qualification by permit applies to those seeking a "fairness hearing" under section 25142.[507] This section allows companies proposing to issue securities in exchange for outstanding securities to request a hearing at which the Commissioner can approve the terms and conditions and the fairness of the transaction.[508] An application can be filed even if the transaction may be eligible for qualification by coordination or notification or is exempt from qualification.[509] The benefit is that if a permit is issued, the offer and sale of the securities may qualify for the exemption from registration under the 1933 Securities Act pursuant to section 3(a)(10).[510]

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505. CAL. CORP. CODE § 25121 (Deering 2020).

506. CAL. CODE REGS. tit. 10, § 260.121 (2020).

507. CAL. CORP. CODE § 25142.

508. This process is often used for exchanges of securities in mergers and acquisitions. The hearings provide transactional lawyers with an opportunity to examine witnesses and introduce exhibits to support the fairness of the terms and conditions of an offering. *See, e.g.*, Craig D. Miller, *What's Fair Is Fair for Bank Holding Companies: Using Fairness Hearings in Mergers to Avoid SEC Registration*, MANATT, PHELPS & PHILLIPS, LLP (Apr. 10, 2012), https://www.jdsupra.com/legalnews/whats-fair-is-fair-for-bank-holding-com-59173/.

509. CAL. CORP. CODE § 25113(a).

510. Securities Act of 1933, Pub. L. No. 111-229, § 3(a)(10), 48 Stat. 74, 83; 15 U.S.C. § 77c(a)(10) (2018). *See generally Division of Corporation Finance: Revised Staff Legal Bulletin No. 3 (CF)* (Oct. 20, 1999), https://www.sec.gov/interps/legal/cfslb3r.htm (providing guidance regarding reliance on the exemption for fairness hearings); Richard B. Glickman, *The State Administrative Fairness Hearing and Section 3(a)(10) of the Securities Act—Some Questions*, 45 ST. JOHN'S L. REV. 644 (1971) (discussing questions regarding application of the exemption for fairness hearings in California and other states). When NSMIA was enacted, there was a question as to whether it had the effect of preempting the Department from holding a "fairness hearing." This was remedied by the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, § 302, 112 Stat. 3227, 3237 (codified as amended at 15 U.S.C. § 77r(b)(4)(C)); *see* Cal. Dep't of Corps., Fairness Hearings Under the Corporate Securities Law of 1968 After the Enactment of the

As discussed above, the use of negotiating permits was essentially eliminated by the 1968 Law.[511] No applications for a negotiating permit have been filed during the seven years from 2014 through 2020.[512]

In summary, there has been a significant shift in recent years from the qualification of offerings under the California securities law to reliance on new and expanded securities and transactional exemptions. Of the applications being filed, qualification for many of the offerings now becomes effective automatically and requires a negative finding by the Commissioner for a stop order to be issued.

Among the transactions that may still require qualification by permit in California are those exempt from registration with the SEC pursuant to SEC Rule 504, Tier 1 of Regulation A and section 3(a)(11) of the 1933 Securities Act, as well as public offerings of securities that are traded over-the-counter through a broker-dealer network, such as the OTC Bulletin Board electronic platform or the markets operated by the OTC Markets Group LLC. In addition, qualification may be required for offerings that otherwise do not come within an exemption under the 1968 Law, including offerings of stock and options to employees that do not meet the requirements of SEC Rule 701 or the Commissioner's regulations.

This shift away from qualification is also evident anecdotally from the changes that have occurred in the practice of transactional lawyers before the Department.[513] For those lawyers involved with private offerings, the practice has evolved from preparing, filing, and processing applications for negotiating and definitive permits to simply preparing and filing notices evidencing reliance on exemptions.[514] For those involved with public offerings, qualification in California is now seldom required as a result of federal preemption of state registration and merit review for "covered securities" or, if required, a simplified form for qualification is applicable.[515] While this has substantially decreased the time that these lawyers practice before

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National Securities Markets Improvement Act of 1996, Commissioner's Release: No. 102-C (Revised) (Dec. 1, 1998), https://dfpi.ca.gov/commissioners-release-102-c-revised/.

511. *See supra* text accompanying note 91.

512. Self-Service Portal, *supra* note 336 (in "Application Type" select "Negotiating Permit," check filings for Jan. 1, 2014 through Dec. 31, 2020 and click "Search").

513. Petillon, *supra* note 227, at 32.

514. *See id.*

515. *Id.*

the Department, it has been more than made up for by the additional time they are now required to devote to structuring, documenting, and processing private offerings and dealing with the increasing complexity of the compliance and disclosure requirements of federal law that are applicable to public offerings and publicly-held companies.[516]

V. RATIONALE FOR REVISITING THE METHOD OF REGULATING THE OFFER AND SALE OF SECURITIES IN CALIFORNIA

Given the significant role that California businesses and investors play in the United States and international capital markets and the time that has elapsed since the enactment of the 1968 Law, it is appropriate to examine whether the intervening changes in circumstances warrant revisiting the method of regulating the offer and sale of securities in California and, in that connection, determining whether the system of merit review has outgrown any usefulness it may have had originally.

The only significant attempt to revise the 1968 Law was in 1996 with the introduction of A.B. 2465 in the 1995–1996 Regular Session of the California legislature.[517] The principal draftsman of this bill was Keith Paul Bishop, who served as Commissioner from May 1996 to September 1997.[518] In November 1996, committees of both houses of the legislature conducted a two-day joint hearing, the purpose of which was to provide committee members with an opportunity to explore the framework of the statutory and administrative requirements that California law imposes on the capital formation process.[519] The bill was approved by the Assembly, but failed to be voted out of a Senate committee.[520]

Senate Bill (S.B.) 1205,[521] which was introduced the next year, contained substantially the same provisions as A.B. 2465.[522] First, S.B. 1205 substituted the term "registration" in the 1968 Law for "qualification" of the offer and sale of securities.[523] Next, the bill

516. *Id.*
517. Assemb. B. 2465, 1995–1996 Reg. Sess. (Cal. 1996); Maynard, *supra* note 421, at 1531–33.
518. Maynard, *supra* note 421, at 1531.
519. *Id.* at 1531–32.
520. *See id.*
521. S.B. 1205, 1997–1998 Reg. Sess. (Cal. 1997).
522. Maynard, *supra* note 421, at 1556 n.78.
523. S.B. 1205.

provided that, if no delaying amendment or stop order was in effect, an application for registration by permit became effective automatically upon the thirtieth business day after filing of the application or the last amendment.[524] Finally, the provisions granting authority to the Commissioner for the issuance of a stop order were consolidated and made applicable to each type of registration—coordination, notification, and permit.[525] A finding that a plan of business or the issuance or sale was either "fair, just, and equitable" or, in the case of qualification by coordination or notification, was not "fair, just, or equitable," was no longer required.[526] In order to issue a stop order, the Commissioner would have to find that (1) the offer or sale is or is about to be made by means of a communication that includes a material misstatement or omission, (2) the stop order is in the public interest, (3) the issuer does not intend to transact business fairly and honestly or intends to transact business in a fraudulent manner, or (4) the method of offering or selling the securities will tend to work a fraud upon the purchasers.[527]

S.B. 1205 was amended in April 1997 to simply direct the Legislative Analyst to conduct a comprehensive study of the state's system of consumer protection and new securities offerings, and it later died in committee.[528] While this occurred some years ago, it illustrates the difficulty in achieving any meaningful change in the California approach to the regulation of securities offerings and limiting the system of merit regulation.

In an article written around the time these changes were being proposed, Professor Therese H. Maynard came to the conclusion that "merit review has outgrown whatever usefulness it may have had originally."[529] She made a compelling argument for the elimination of merit review in California, supported by changes in the regulatory framework that she believed had rendered merit review obsolete as a practical matter, dramatic changes in the world's financial and capital

524. *Id.*
525. *Id.*
526. *Id.*
527. *Id.*
528. *Id.*
529. Maynard *supra* note 421, at 1533. *See generally* Mark A. Sargent, *A Future for Blue Sky*, 62 U. CIN. L. REV. 471 (1993). Years earlier, Professor Sargent had authored an article examining the viability of state securities regulation in general and merit review in particular. *See* Mark A. Sargent, *Blue Sky Law: The Challenge to Merit Regulation—Part I*, 12 SEC. REG. L.J. 276 (1984).

markets since 1968, and the increasing perception that the costs of compliance with the requirements imposed by merit review disproportionately burdened the capital formation process for small-business interests.[530] Professor Maynard suggested that the failure to eliminate merit review also does a disservice to both California's business interests and investors, stressing the contention of critics that the likely success of an issuer and an investment depend on matters that the merit review standards do not address.[531] She added that those issuers making every effort to comply with the registration and exemption requirements are not the primary source of fraudulent securities offerings[532] and furthermore that investors may be encouraged to rely on a review by the Commissioner for a greater measure of protection that can actually be provided.[533] It was her belief that "California's scarce administrative resources would be better utilized by concentrating them on efforts to enhance the state's current enforcement activities."[534]

Several years later, an extensive study was undertaken at the request of a California Senator to "describe the regulatory process for private and public securities offerings, emphasizing the impact of this process on small businesses."[535] The author of the study, Dr. Rosa Maria Moller, examined two "strong" arguments against merit review, namely that it discriminates against small businesses and that the economic costs of merit review may not outweigh its benefits, the main benefit being fraud prevention.[536]

Not surprisingly, Dr. Moller found that the lawyers and regulators she consulted disagreed as to whether there was a lack of fairness from offerings by small businesses being subject to merit review, with the regulators believing that the problem was not the system but its implementation and therefore merit review should be retained.[537] She also determined that the economic costs to businesses of merit review were hard to assess. Finally, she did not believe there was enough empirical

530. Maynard, *supra* note 421, at 1556.

531. *Id.* at 1548.

532. *Id.* at 1552.

533. *Id.* at 1549.

534. *Id.* at 1534; *see also* Sargent, *A Future for Blue Sky*, *supra* note 529, at 505 (Professor Sargent similarly concluded that "[if] blue sky law has a future, it will be principally in more vigorous prosecution of antifraud enforcement").

535. MOLLER, *supra* note 497, at 1.

536. *Id.* at 5.

537. *Id.* at 6.

data to perform a statistical analysis that could prove or disprove the ability of the merit review system to prevent fraud and protect investors.[538] Her recommendations included ways to improve, but not eliminate, the merit review system, and she suggested various changes that might be made to the Department's regulations.[539] No legislation resulted from this study.

Over twenty years have now passed since the last effort was made to make substantive revisions to the 1968 Law. Rather than repeating Professor Maynard's analysis, it will be more productive to review the additional changes that have occurred since her article was written in three areas, namely (a) the regulatory framework, (b) the financial and capital markets, and (c) the burden that qualification and merit review imposes on the capital formation process for small businesses.

Regulatory Framework. Before her article was published, Congress had enacted NSMIA, which for the first time preempted state registration and merit review as applied to certain federal exemptions.[540] In approving NSMIA, the Congressional Conference Committee stated that "[t]he system of dual Federal and state securities regulation has resulted in a degree of duplicative and unnecessary regulation . . . that, in many instances, is redundant, costly, and ineffective."[541] In reallocating responsibility over the regulation of the nation's securities markets in a more logical fashion, the states under the legislation were to "continue to exercise their police power to prevent fraud and broker-dealer sales abuses," but abstain from regulation of "the securities registration and offering process."[542] NSMIA specifically preserved the authority of state securities regulators to not only investigate and bring enforcement actions, but also to require the filing of documents that have been filed with the SEC pursuant to the 1933 Securities Act and, with certain limitations and exceptions, to continue to collect filing or registration fees with respect to these securities or

538. *Id.* at 5.

539. *Id.* at 6–7.

540. *See* Maynard, *supra* note 421, at 1547 n. 62.

541. Stephen M. Cutler, Remarks, *F. Hodge O'Neal Corporate and Securities Law Symposium*, 81 WASH. U. L.Q. 545, 548 (2003) (alterations in original) (quoting H.R. REP. NO. 104-864, at 39 (1996) (Conf. Rep.)).

542. *Id.* at 548–49 (H.R. REP. NO. 104-864, at 40).

transactions.[543] Also noteworthy was that Congress significantly enhanced the rule-making power of the SEC to exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision of the 1933 Securities Act.[544]

Since then, the regulatory framework has undergone many changes, including additional legislation by Congress that further limits the offerings that are subject to registration and merit review by state regulators, as well as rules adopted by the SEC implementing or expanding the scope of that legislation.

As previously discussed, Congress adopted legislation that preempts registration and merit review for offerings under Tier 2 of Regulation A, Regulation Crowdfunding offerings under section 4(a)(6) of the 1933 Securities Act, private resales of "restricted securities" to "accredited investors" under section 4(a)(7) of the 1933 Securities Act, and offerings of securities qualified for trading in the national market system that are listed or qualified for listing on a national securities exchange under the 1933 Securities Act.

Meanwhile, the SEC continues to expand federal preemption of state registration through its rule making that implements Congressional legislation or increases the categories of exempt securities or transactions. These actions include the adoption or amendment of rules defining as a "qualified person" any person to whom securities are offered or sold pursuant to Tier 2 of Regulation A, setting forth the terms and conditions for Regulation Crowdfunding offerings, permitting general solicitation of "accredited investors" under SEC Rule 506(c), adding certain natural persons and entities to the definition of "accredited investors" in SEC Rule 501(a) and of entities to the definition of "qualified institutional buyer" in SEC Rule 144A, and, most recently, increasing the limit for offerings under Tier 2 of Regulation A from $50 million to $75 million, for Tier 2 secondary offerings from $15 million to $22.5 million, and for Regulation Crowdfunding offerings from $1.07 million to $5 million.

The expansion of those who would qualify as potential investors under the definition of an "accredited investor" has been particularly significant. For example, it has been estimated that the number of U.S.

543. *See* Securities Act of 1933, Pub. L. No. 111-229, § 18(c), 48 Stat. 74, 91; 15 U.S.C. § 77r(c) (2018).

544. *See* Securities Act of 1933 § 28-3; 15 U.S.C. § 77z-3.

households that qualify as "accredited investors" has grown from approximately 2 percent of the population in 1983 to 13 percent in 2019 simply as a result of inflation.[545] By the SEC choosing not to raise the income and net worth thresholds or adjust them for inflation and then adding new categories of natural persons and entities, the number of those who will qualify to participate in the offerings under SEC Rule 506 should continue to increase. It is likely that other groups representing holders of certifications, designations or credentials that may evidence financial literacy will also seek accredited investor status under the new criteria established by the SEC.

Eventually, Congress might preempt registration from state regulation entirely, rather than continuing to do so in steps. This has been advocated for some time by members of the SEC staff, a former SEC Commissioner, and others.[546] More recently, Professor Rutheford B. Campbell Jr. wrote that the efficient regulation of capital formation can be further enhanced by the states reallocating their resources to the enforcement of state antifraud provisions with complete preemption of state authority by the federal government over registration.[547] He believes that "[s]tates, certainly, will not voluntarily surrender their authority over registration, and there is no indication that the [SEC] can overcome its longstanding reluctance to extend preemption by regulation," meaning that "[a]ny improvement in the efficient

545. *See* Accredited Investor Release, *supra* note 267.

546. *See, e.g.*, Cutler, *supra* note 541; Manning Gilbert Warren III, *Reflections on Dual Regulation of Securities: A Case for Reallocation of Regulatory Responsibilities*, 78 WASH. U. L.Q. 497, 504 (2000); Roberta S. Karmel, *Blue-Sky Merit Regulation: Benefit to Investors or Burden on Commerce?*, 53 BROOK. L. REV. 105, 112 (1987); *see also* Marianne M. Jennings et al., *Federalism to an Advantage: The Demise of State Blue Sky Laws Under the Uniform Securities Act*, 19 AKRON L. REV. 395, 416 (1986) ("If state regulators do not become more aware of the need for capital and the changed structure of the securities market, their regulatory grip could strangle capital ventures growth, unless and until federalism removes their authority.").

547. *See* Rutheford B. Campbell, Jr., *The Case for Federal Preemption of State Blue Sky Laws*, CLS BLUE SKY BLOG (May 18, 2017), http://clsbluesky.law.columbia.edu/2017/05/18/the-case-for-federal-preemption-of-state-blue-sky-laws/; *see also* Rutheford B. Campbell Jr., *The Role of Blue Sky Laws After NSMIA and the JOBS Act*, 66 DUKE L.J. 605, 631 (2016) [hereinafter Campbell, *Blue Sky Laws After NSMIA and the JOBS Act*]; Rutheford B. Campbell, Jr., *Federalism Gone Amuck: The Case for Reallocating Governmental Authority over the Capital Formation Activities of Businesses*, 50 WASHBURN L.J. 573, 582 (2011) (pointing out that the original legislation that led to NSMIA would have preempted state authority over the registration of securities, except offerings made under the federal interstate exemption).

regulation of capital formation, especially small-business capital formation, will require congressional action."[548]

While the SEC has recently shown a willingness to extend preemption of state registration and merit review by rulemaking, there is no indication that the states are likely to surrender their regulatory authority. This was particularly evident in NASAA's reaction to the SEC's proposed rules implementing the JOBS Act as it applies to offerings under Regulation A. In the release proposing these rules, the SEC commented that "[c]ompliance with blue sky requirements can impose significant costs, predominantly as a result of having to coordinate independent reviews across multiple regulatory regimes when issuers are offering securities to investors in multiple states."[549] NASAA objected to the SEC's attempt to preempt state authority over any offerings under Regulation A as being beyond the SEC's statutory authority and failing to adequately consider all relevant costs and potential harm to issuers and investors.[550] More recently, NASAA objected to the SEC expanding the availability of private offerings and the definition of "accredited investor" with its focus on the private markets[551] and asked to "pause" major SEC rulemaking, especially on efforts to expand private offerings and private markets, stating that despite profound changes in the economy, "the SEC so-far appears intent on proceeding with a deregulatory agenda, as if little has changed."[552]

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548. *See* Campbell, *Blue Sky Laws After NSMIA and the JOBS Act*, *supra* note 547, at 631.

549. *See* Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act, Securities Act Release No. 9497, 79 Fed. Reg. 3,926, 3,991 (Jan. 23, 2014).

550. *See* Letter from Andrea Seidt, President, NASAA, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 1 (Mar. 24, 2014), https://www.sec.gov/comments/s7-11-13/s71113-75.pdf; Letter from Andrea Seidt, President, NASAA, et al., to Hon. Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n 1 (Feb. 19, 2014), https://www.sec.gov/comments/s7-11-13/s71113-12.pdf; *see also* Feigin, *supra* note 447.

551. *See, e.g.*, Letter from Christopher Gerold, President, NASAA, to Vanessa Countryman, Sec'y, U.S. Sec. & Exch. Comm'n 2 (Mar. 16, 2020), https://www.sec.gov/comments/s7-25-19/s72519-6960323-212740.pdf; Letter from Christopher Gerold, President, NASAA, to Vanessa Countryman, Sec'y, U.S. Sec. & Exch. Comm'n 4–5 (Oct. 11, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6288085-193367.pdf.

552. Christopher Gerold, President, NASAA, Statement on Examining the Impacts of the COVID-19 Pandemic on U.S. Capital Markets before the U.S. House Financial Services Committee, Subcommittee on Investor Protection, Entrepreneurship and Capital Markets (May 26, 2020), https://www.nasaa.org/54987/examining-the-impacts-of-the-covid-19-pandemic-on-u-s-capital-markets/.

The California Attorney General also objected to some of these changes. Writing on behalf of himself and the Attorneys General of certain other jurisdictions, he submitted comments in response to the Concept Release and the SEC's proposal to expand the definition of "accredited investor."[553] The expansion of the definition was said to ignore the serious risk that private placements pose for individual investors. In that regard, a distinction was drawn between institutional investors who participate in private offerings and generally have sufficient resources to spread their risk over numerous private investments and individual investors who are far less likely to have sufficient wealth or income to diversify their risk.[554] It was also proposed that a sophistication requirement be added for investors under Rule 506(b) and that, at a minimum, the financial thresholds for an "accredited investor" be raised and indexed to account for inflation, thereby limiting the investors who would qualify.[555]

Financial and Capital Markets. In addition to these changes in the regulatory framework, we have witnessed significant changes in the world's financial and capital markets. In recent years, there has been a significant movement of capital into the private markets.[556] It has been reported that worldwide pools of private capital, including private equity and private debt, as well as unlisted real-estate and hedge-fund assets, grew by 44 percent in the five years through 2019.[557]

This movement of capital has resulted in a substantial increase in the reliance by issuers on exempt offerings.[558] In fact, the SEC staff

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553. *See* Letter from Xavier Becerra, Cal. Att'y Gen., et al., to Vanessa A. Countryman, Sec'y, U.S. Sec. & Exch. Comm'n 1 (Mar. 16, 2020), https://www.sec.gov/comments/s7-25-19/s72519-6960384-212775.pdf [hereinafter Letter from Xavier Becerra of March 16, 2020]; *see also* Letter from Xavier Becerra, Cal. Att'y Gen., et al., to Vanessa Countryman, Sec'y, U.S. Sec. & Exch. Comm'n 1 (Sept. 24, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6193375-192522.pdf.

554. Letter from Xavier Becerra of March 16, 2020, *supra* note 553, at 6.

555. *Id.* at 9.

556. *See* MICHAEL J. MAUBOUSSIN & DAN CALLAHAN, MORGAN STANLEY, PUBLIC TO PRIVATE IN THE UNITED STATES: A LONG-TERM LOOK 4 (2020), https://www.morganstanley.com/im/publication/insights/articles/articles_publictoprivateequityintheusalongterm-look_us.pdf?1596549853128.

557. *See Privacy and Its Limits—Everyone Now Believes That Private Markets Are Better Than Public Ones*, THE ECONOMIST (Feb. 1, 2020), https://www.economist.com/finance-and-economics/2020/01/30/everyone-now-believes-that-private-markets-are-better-than-public-ones.

558. Private Markets Proposing Release, *supra* note 266, at 17,957.

estimated that in 2019 registered offerings accounted for $1.2 trillion (30.8 percent) of new capital compared with approximately $2.7 trillion (69.2 percent) that was raised through exempt offerings.[559] This resulted in a large increase in cash raised and not yet invested by venture capital and private equity firms in the last several years.[560] Meanwhile, growing companies are staying private substantially longer. The public equity markets are being used more for liquidity by venture capital and private equity firms than for accessing new growth capital.[561] Interestingly, the stock of most of the companies that went public in 2019 was trading toward the end of the year below the last private valuations and pre-IPO expectations of pricing.[562] For those companies choosing to become publicly owned, new techniques are being used with increasing frequency to bring securities to market, including direct listings,[563] auctioning shares to the highest bidders, bought deals (sometimes referred to as "overnight deals"), registered

559. *Id.*

560. *See* Marc Vartabedian, *Banking & Finance: Venture Firms' Cash Pile Hits Record Level*, WALL ST. J., Jan. 10, 2020, at B10.

561. *See* Jay Clayton, Chairman, Sec. & Exch. Comm'n, Testimony on Oversight of the Securities and Exchange Commission before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Dec. 10, 2019), https://www.sec.gov/news/testimony/testimony-clayton-2019-12-10 [hereinafter Clayton Testimony]. Promoters of private investing say that the new IPO is the FPO—the final private offering—and some private rounds are said to be so large that they upend the IPOs. *See* Alistair Barr et al., *The Big Money in Startups Comes from Investing Before the IPO*, BLOOMBERG BUSINESSWEEK (Oct. 22, 2019, 5:00 AM), https://www.bloomberg.com/news/articles/2019-10-22/the-big-money-in-startups-comes-from-investing-before-the-ipo.

562. *See* Maureen Farrell, *IPOs Fell Short of Expectations in 2019—Investors' New Focus on Profits Stung Hotly Anticipated Debuts Like Uber, Lyft and Slack*, WALL ST. J., Dec. 30, 2019, at B1. *See generally* Frank Partnoy, *The Death of the IPO*, THE ATLANTIC (Nov. 2018), https://www.theatlantic.com/magazine/archive/2018/11/private-inequity/570808/ (discussing how the declining number of IPOs is negatively affecting small investors). However, in 2020 a record $167.2 billion was raised in 454 IPOs through December 24th due to a substantial increase in the fourth quarter. *See* Maureen Farrell, *U.S. IPO Market Reaches Record Total*, WALL ST. J., Dec. 31, 2020, at A1.

563. Direct listings involve the listing of shares on an exchange and the registration with the SEC of shares for resale by existing shareholders without conducting a firm commitment underwritten offering. Both the New York Stock Exchange and NASDAQ filed proposed rule changes with the SEC to permit listed companies to conduct concurrent primary offerings of shares as part of a direct listing. *See generally* Laura Anthony, *NYSE Continues to Struggle With Direct Listing Rule Changes*, LAWCAST (Sept. 18, 2020), http://lawcast.com/2020/09/18/nyse-continues-to-struggle-with-direct-listing-rule-changes/ (analyzing direct listings in relation to alternatives and discussion of status of regulatory approvals). On December 22, 2020, the SEC approved the rule changes proposed by the New York Stock Exchange. *See* Alexander Osipovich, *SEC Approves NYSE's Plan for New IPO Alternative*, WALL ST. J. (Dec. 22, 2020, 2:50 PM), https://www.wsj.com/articles/sec-approves-nyses-plan-for-new-ipo-alternative-11608665152.

direct offerings,[564] and sales to special-purpose acquisition companies (SPACs).[565] Some companies with international operations are choosing to conduct their IPOs through listings on foreign securities exchanges.[566] Another change is that the number of public companies has been decreasing in the last twenty years, but the total value of public companies has increased.[567]

These developments have had a profound impact on California. Not only have California businesses created a significant demand for capital, but individual and institutional investors based in California have been one of the largest sources of capital for businesses located in the United States and abroad. Nationally, issuers based in California have been one of the largest filers for exemptions with the SEC, as well as being among the highest in amounts raised.[568]

The securities markets have become truly international in nature, both for exempt and registered offerings. The markets have been affected by continuing advances in technology that impact trading, as well as the advent of instant communication between and among issuers, potential investors, broker-dealers, and other market participants. The issues that regulators are now dealing with include innovative investment products, such as coin, token and other digital currency and cryptocurrency-related offerings;[569] trading of cryptocurrency and

564. Registered direct offerings are public offerings of securities sold on a best-efforts basis through a placement agent.

565. SPACs (sometimes called "blank-check" companies) are formed by their sponsors for the purpose of raising funds from the public to make acquisitions of existing businesses. The volume of these transactions has increased in each of the last five years, reaching an all-time high in 2020 of 143 IPOs with an average size of $385 million and over $55 billion in gross proceeds through October 16th. *See SPAC IPO Transactions—Summary by Year*, SPACINSIDER, https://spacinsider.com/stats/ (last visited Oct. 16, 2020).

566. *See, e.g.*, David Carnevali et al., *How Pandemic Fueled a Banner Year for IPOs*, L.A. TIMES, Dec. 31, 2020, at A6.

567. *See* Partnoy, *supra* note 562. The SEC staff had estimated that there were roughly half the number of publicly-traded companies in 2018 than there were twenty years ago. *See* Clayton Testimony, *supra* note 561.

568. *See* Concept Release, *supra* note 260, at 30,485, figs.5 & 6; REGULATION A STUDY, *supra* note 487, at 19, figs.5a & 5b; REPORT TO COMMISSION ON REGULATION CROWDFUNDING, *supra* note 442, at 15, tbls.1 & 20, fig.2.

569. *See generally* ANDREW P. SCOTT, CONG. RSCH. SERV., R46333, FINTECH: OVERVIEW OF FINANCIAL REGULATORS AND RECENT POLICY APPROACHES 1 (2020) (discussing how regulators are approaching issues involving new technologies in the financial services sector); U.S. DEP'T OF JUST., REPORT OF THE ATTORNEY GENERAL'S CYBER DIGITAL TASK FORCE, CRYPTOCURRENCY: ENFORCEMENT FRAMEWORK vi (2020) (describing emerging threats and enforcement challenges associated with cryptocurrency); Bill Hinman, Dir., Div. of Corp. Fin., & Valerie Szczepanik,

digital assets, with some dealers intending to launch exchange-like electronic trading platforms;[570] and the organization and SEC approval of new national securities exchanges.[571]

Burden on Small Businesses. The third issue is whether the effort and costs of qualification and merit review adversely affect capital formation for small businesses. The data show that qualification by permit in California is largely limited to smaller businesses.[572] Moreover, offering costs of private placements have increased significantly over the years. One estimate put the front-end offering commissions and other expenses for private placements at around 12 percent of the gross offering proceeds.[573] Some of these costs, however, are not based solely on the gross proceeds and therefore have a disproportionate impact on the smaller offerings that can inhibit the ability of these small

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Senior Advisor for Digit. Assets and Innovation, Statement on Framework for "Investment Contract" Analysis of Digital Assets (Apr. 3, 2019), https://www.sec.gov/news/public-statement/statement-framework-investment-contract-analysis-digital-assets (discussing how a technology framework for investment contracts may be a useful "analytical tool to help market participants assess whether the federal securities laws apply to the offer, sale, or resale of a particular digital asset"). On June 26, 2020, the SEC announced that it had obtained court approval of settlements relating to an unregistered offering of digital tokens that included substantial amounts ordered to be returned to investors and payable as a civil penalty. *See* Press Release, U.S. Sec. & Exch. Comm'n, Telegram to Return $1.2 Billion to Investors and Pay $18.5 Million Penalty to Settle SEC Charges (June 26, 2020), https://www.sec.gov/news/press-release/2020-146. On July 11, 2019, the SEC qualified a Regulation A offering circular for the distribution of up to $40 million of crypto tokens. *See* Muneeb Ali, *Blockstack Token Sale Becomes the First SEC-Qualified Offering in U.S. History*, BLOCKSTACK (July 10, 2019), https://blog.blockstack.org/blockstack-token-sale-sec-qualified/.

570. *See* Dennis Chu, Note, *Broker-Dealers for Virtual Currency: Regulating Cryptocurrency Wallets and Exchanges*, 118 COLUM. L. REV. 2323, 2338 (2018); Order Disapproving a Proposed Rule Change, Exchange Act Release No. 88,284, 85 Fed. Reg. 12,595, 12,596 (Mar. 3, 2020) (disapproving of listing and trading shares of U.S. Bitcoin & Treasury Investment Trust on NYSE Arca, Inc.); Carl A. Fornaris et al., *SEC Issues No-Action Letter Facilitating the Secondary Trading of Digital Assets*, NAT'L L. REV. (Oct. 8, 2020), https://www.natlawreview.com/article/sec-issues-no-action-letter-facilitating-secondary-trading-digital-assets.

571. *See generally* In the Matter of the Application of Long Term Stock Exchange, Inc., Exchange Act Release No. 85,828, 84 Fed. Reg. 21,841 (May 15, 2019) (discussing the procedural history, statutory standards, and governance of the Long Term Stock Exchange in relation to its registration under the 1934 Exchange Act). The Long Term Stock Exchange, the registration of which was approved by the SEC on May 10, 2019, was organized by a technology entrepreneur to give high-growth technology companies more options to list their shares than afforded by the traditional exchanges. *See* THE LONG-TERM STOCK EXCHANGE, http://ltse.com (last visited Oct. 4, 2020).

572. *See, e.g.*, COMMISSIONER'S PERMIT REPORT, *supra* note 498, at 6 (minimum, maximum, and average net worth required of issuers or sponsors and amounts sought to be raised by category for permits issued in 2018).

573. Russell Putnam, *Private Placements Explained: Part 4 (Fees and Expenses)*, FACTRIGHT (Jan. 3, 2018), http://blog.factright.com/private-placements-explained-part-4-fees-and-expenses.

businesses to raise capital. For example, a random sampling of attorneys' fees for the preparation of a private placement memorandum showed a range of from $10,000 to $40,000, depending on the amount of work involved and the hourly rate charged. While many of these costs would be incurred in any private placement, being subject to qualification by permit and merit review adds filing fees and additional legal costs that would not be incurred if an exemption were available.

There are other factors that add to the burden on small businesses. Professor James D. Cox noted that "[i]t is ironic, if not paradoxical, that the hotbed of entrepreneurism, and one of the most resilient economies during the [2008] financial crisis, California, is among the most restrictive states in the scope of its exemptions."[574] He pointed out that under section 25102(f) sales are limited to thirty-five persons, general solicitation and advertising are prohibited, and all purchasers must meet certain standards as to personal or business relationships with the issuer or affiliates or as to their business or financial experience or that of their professional advisors.[575] Many smaller enterprises are unable to reach potential investors who meet these standards, as well as the standards of SEC Rule 506.[576] In addition, their reliance on the exemptions in section 25102(h) and (n) is limited, so the only way to raise funds may be through qualification by permit with the attendant cost.

VI. CONCLUSION

For the reasons discussed and on the basis of the data presented, I believe that it is time for a change in the method of regulating the offer and sale of securities in California that would eliminate or limit the system of merit review, with a view to enhancing the antifraud enforcement of the California securities law.

Before considering the changes that might be made, it is important to consider the role that California and the other states play in the enforcement of the securities laws, particularly antifraud enforcement. We appear to be moving closer to a dual regulatory system in

574. James D. Cox, *Who Can't Raise Capital?: The Scylla and Charybdis of Capital Formation*, 102 KY. L.J. 849, 858 (2013/2014).

575. *See id.*

576. *See id.*

which registration and merit review of offerings by the states will be further limited or eliminated in favor of a greater emphasis on enforcement.[577] It has been argued that, while reducing the cost of capital, the combination of federal preemption of the regulatory authority of states and the expansion of exemptions from registration at the federal level may also lead to more pervasive securities fraud.[578] States have always been active in the civil and criminal enforcement of the antifraud provisions, particularly at the local and regional level, and that is likely to increase.[579]

In California, the Department is authorized to issue administrative and civil enforcement orders and actions to enforce the various laws that it administers. Of the 501 administrative and civil enforcement orders and actions by the Department in 2019, only twenty-three involved the offer and sale of securities, primarily cease and desist and consent orders.[580] Another fifty orders and actions involved

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577. *See generally* James J. Park, *Rules, Principles, and the Competition to Enforce the Securities Laws*, 100 CALIF. L. REV. 115, 123 (2012) (comparing centralized, supervised, and decentralized models of securities enforcement). *But see* Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2176 (2010) ("[A] superior approach would be to consolidate the enforcement authority now shared between federal regulators, state regulators, and class action lawyers in a federal agency, such as the SEC, and to grant that agency exclusive authority to prosecute national securities frauds—while simultaneously enacting reforms to align that agency's enforcement incentives more closely with the public interest.").

578. *See* Carlos Berdejó, *Small Investments, Big Losses: The States' Role in Protecting Local Investors from Securities Fraud*, 92 WASH. L. REV. 567, 572 (2017); Jennifer J. Johnson, *Private Placements: A Regulatory Black Hole*, 35 DEL. J. CORP. L. 151, 153–54 (2010).

579. *See* Sargent, *A Future for Blue Sky*, *supra* note 529, at 504. NASAA reported that from 2014 through 2018 its U.S. members initiated 23,416 investigations, conducted 12,403 enforcement actions, and were responsible for the ordering of $2.2 billion in restitution and $1.6 billion in fines and penalties. In addition, they were responsible for the ordering of 5,885 years of incarceration and 2,567 years of probation for securities violations. *See* NASAA, NASAA 2019 ENFORCEMENT REPORT 4, 11 (2019), https://www.nasaa.org/wp-content/uploads/2019/11/2019-Enforcement-Report-Based-on-2018-Data-FINAL.pdf. In comparison, the SEC in fiscal 2020 brought 715 enforcement actions, opened close to 1,200 inquiries and investigations, and obtained judgments and orders totaling more than $4.7 billion in disgorgement and penalties, while returning $602 million to investors. *See* U.S. SEC. & EXCH. COMM'N, 2020 ANNUAL REPORT 7, at 16–18 (2020), https://www.sec.gov/files/enforcement-annual-report-2020.pdf.

580. *See Summary of Actions and Orders—Listed by Month*, CAL. DEP'T OF FIN. PROT. & INNOVATION, https://dfpi.ca.gov/actions-and-orders-listed-by-month/ (last updated Dec. 17, 2020) [hereinafter *Cal. Dep't Summary of Actions and Orders*]. *See generally* Botong Shang, The SEC's Deterrence Effect on Corporate Fraud 1 (Nov. 6, 2020), https:/ssrn.com/abstract=3710224 (unpublished paper) (analyzing evidence supporting the proposition that firms decide to commit fraud strategically in response to the probability of detection by regulators).

investment advisors and a few involved broker-dealers.[581] The rest related to the financing, escrow, and franchise investment laws and mortgage lending for which the Department is responsible.[582] The Department also assists in the criminal investigation and prosecution of violations of these laws and refers criminal violations to United States Attorneys, the California Attorney General, and District Attorneys for prosecution. In that regard, the SEC and the Department have somewhat complementary tools to deal with securities fraud and other violations.[583]

With the passage of the California Consumer Financial Protection Law by the California legislature and the reorganization of the Department, increasing the Department's emphasis on antifraud enforcement under the California securities law may complement the Governor's focus on enforcement of consumer protection with respect to financial products and services.[584]

There are several approaches that could be taken to change the method of regulation of securities offerings in California. One possibility would be to adopt a revised version of the Uniform Securities Act, as had been attempted sixty years ago.[585] Versions of the Uniform Securities Act have been adopted by thirty-nine states and the District of Columbia.[586] However, given the long history and familiarity of California practitioners and regulators with the 1968 Law, that would probably be the preferred starting point rather than dealing with a different statutory scheme. Another approach would be to eliminate the qualification of securities offerings and merit review entirely and substitute a notice requirement. However, this would likely be viewed by the legislature as being too radical at this time.

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581. *See Cal. Dep't Summary of Actions and Orders*, *supra* note 580.

582. *See id.*

583. *Compare* CAL. CORP. CODE §§ 25530–25536 (Deering 2020) (authorizing actions to enjoin or enforce compliance, seek ancillary relief, conduct investigations, and obtain desist and refrain orders), *with* 15 U.S.C. §§ 77h-1, 77t (2018) (authorizing prosecutions of offenses, cease-and-desist proceedings, investigations, and injunctions). The SEC can work in parallel with the states, such as in situations in which it may be better equipped to seek a temporary restraining order, seize assets, or seek appointment of a receiver in cases of ongoing fraud. *See* U.S. SEC. & EXCH. COMM'N, 2019 ANNUAL REPORT 7 (2019), https://www.sec.gov/files/enforcement-annual-report-2019.pdf.

584. *See supra* text accompanying notes 7–9.

585. *See* Edwards, *supra* note 70, at 835.

586. *See Securities Law Research Guide (U.S. and International)*, GEO. L. LIBR., https://guides.ll.georgetown.edu/c.php?g=365494&p=2469255 (last visited Oct. 4, 2020).

The approach that might have the greatest chance of gaining traction would be to start with the changes proposed over twenty years ago in S.B. 1205, which would involve providing for automatic effectiveness of applications for permit after a specified period of time and revising the circumstances under which the Commissioner can issue a stop order.[587] The affirmative and negative "fair, just, and equitable" standards would be eliminated, but other criteria could be added or retained as proposed in S.B. 1205.[588] These changes would leave the Commissioner with less discretion and make it less likely that this discretion will be exercised. A less satisfactory alternative would be to make the same changes, but require the Commissioner to determine that the proposed plan of business or the issuance or sale of the securities is not "fair, just, or equitable" to warrant the issuance of a stop order in all three types of qualifications. This is one of the options for issuance of a stop order that states can select in adopting the Uniform Securities Act.[589]

These changes need not affect the requirements for filing notices and applications for qualification with the Department. It is important that the fee income generated from these filings, as well as from the licensing of securities professionals, including broker-dealers, agents, and investment advisors, continue to be used to support the Department. Of course, some changes in budgetary allocations and the reassignment of personnel would be required. These filings can also continue to be a source of information for enforcement purposes.

587. An advantage of retaining the qualification requirements would be that for those who are required to file an application for the sale of securities and fail to do so, a fairly straight-forward civil or criminal action could be filed under CAL. CORP. CODE § 25503 or § 25540, whereas an action for fraud or misrepresentation under CAL. CORP. CODE § 25501 or § 25540 would be more difficult and costly. For a discussion of the distinction between rule-based enforcement (such as for a failure to register) and principle-based enforcement (such as for fraud), see Park, *supra* note 577, at 130–43.

588. *See supra* text accompanying notes 521–27.

589. The Uniform Securities Act of 2002 provides for registration by coordination or qualification, the latter of which generally becomes effective thirty days after filing, subject to the issuance of a stop order. UNIF. SEC. ACT § 304(c)(1) (UNIF. L. COMM'N 2002) (amended 2005). A stop order may be issued, among other things, if the offering (a) would work a fraud on the purchasers, (b) has unreasonable amounts of underwriters' and sellers' compensation or promoters' profits or participations, or (c) is being made on terms that are unfair, unjust, or inequitable. *See* UNIF. SEC. ACT § 306(a)(7) (UNIF. L. COMM'N 2002) (amended 2005). States and other jurisdictions can select all, some, or none of these provisions when they adopt the Act. *See* UNIF. SEC. ACT at 5, 83–84.

Whatever the approach that is adopted, other changes in the 1968 Law and regulations are also warranted.[590] At the outset, changes should be made to achieve better coordination with federal law. For example, sections have been added to the 1968 Law on a piecemeal basis to recognize the federal exemptions for which state authority has been preempted.[591] For greater clarity, these should be integrated with the other securities and transactional exemptions in Part 2 and appropriate definitions should be added in Part 1. In addition, an effort should be made to harmonize the securities and transactional exemptions by expanding or adding some new exemptions and eliminating others that are seldom used, as well as giving consideration to whether changes in the qualification process are warranted, including the amount of information required for applications. One area of inquiry should be the expansion of the exemption in section 25102(f), including the limit on the number of purchasers, the ban on general solicitation or advertising, and the suitability of purchasers.[592] In addition, this effort should include an examination of case law in which application of the 1968 Law has been considered to determine whether any changes in the statute or rules might be required. Substantial changes will be required in the Commissioner's rules, particularly those dealing with the procedure for qualification and the standards for the exercise of the Commissioner's authority. Finally, the sections dealing with the process of enforcement, including fraudulent and prohibited practices, should be reviewed with a view to providing the Department with the necessary tools for enforcement and facilitating coordination with federal and other state and local enforcement efforts.

To gain support for this project, it is recommended that, as was the case with the effort to replace the 1917 Act, a working group of prominent practitioners, legislators, regulators, and academicians be formed to begin consideration of changes to the 1968 Law. The formation of such a group could be initiated, for example, by the Commissioner, by members of the legislature, or by the leadership of the

590. *See, e.g.*, Keith Paul Bishop, *California's Corporations Code and Securities Rules Are Rife with Errors*, NAT'L L. REV. (Apr. 6, 2017), https://www.natlawreview.com/article/california-s-corporations-code-and-securities-rules-are-rife-errors. The errors pointed out in the Corporations Code have been corrected, but most of the errors in the Commissioner's rules remain.

591. *See, e.g.*, CAL. CORP. CODE §§ 25100.1, 25101.1, 25102.1.

592. *See* Cox, *supra* note 574, at 858.

Business Law Section of the California Lawyers Committee or its Corporations Committee.