FINAL STATEMENT OF REASONS
FOR RULES UNDER THE
CORPORATE SECURITIES LAW OF 1968

As required by Section 11346.9 of the Government Code, the California Corporations Commissioner ("Commissioner") sets forth below the reasons for the adoption of Section 260.004.1 of the Corporate Securities Law of 1968 to Article 1 of Subchapter 2 of Title 10 of the California Code of Regulations (10 C.C.R. Section 260.004.1).

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

In particular, Corporations Code section 25004 excludes from the definition of the term "broker-dealer," "an agent, when an employee of a broker-dealer or issuer." Section 25003(a) defines, in relevant part, an agent as "any individual […] who for compensation represents an issuer in effecting or attempting to effect purchases or sales of securities in this state." Importantly, section 25003(d) states that "[a]n officer or director of [an] issuer, or an individual occupying a similar status or performing similar functions, is an agent only if he otherwise comes within this definition and receives compensation specifically related to purchases and sales of securities."

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

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

In *Cole*, the court examined broker-dealer licensure requirements for directors and officers of issuers. The holding of the case, while addressing serious and unscrupulous behavior by its principals, creates uncertainty in the capital markets for company management seeking to raise capital.

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

During the proceedings, the defendants argued that they were "agents" of an issuer within the meaning of Section 25003(d), and thus not "broker-dealers" under Section 25004(a).[2] Section 25003(d) excludes from the definition of the term "agent" certain officers and directors of issuers that do not receive compensation specifically related to purchases or sales of securities, which includes, but is not limited to, commissions. However, the court held that since the defendants did not receive such compensation for the sale of securities, they were not "agents" of the issuer, and thus were not excluded from the definition of the term "broker-dealer." Consequently, the court found that the defendants should have been licensed as broker-dealers, in violation Corporations Code section 25210.

While the defendants' actions were fraudulent, the implications of *Cole* create confusion regarding when officers and directors are or are not acting as broker-dealers when participating in capital raising activities on behalf of a corporation. Generally, officers and directors of California companies that otherwise comply with securities laws, are able to engage in limited capital raising activities incidental to their core business, without having to obtain a broker-dealer license. *Cole* creates capital raising hurdles for California companies, by creating uncertainty surrounding licensure requirements and compensation limitations.

Practitioners have commented that *Cole* is creating serious difficulties in advising clients on how to properly comply with broker-dealer licensing requirements.[3] Moreover, a narrow reading of *Cole* could result in practitioners providing advice to clients fundamentally at odds with the policy aims of state and federal securities laws.[4] For example, the Department is concerned that directors and officers of issuers could, paradoxically, elect to receive commissions, or other compensation specifically related to purchases or sales of securities, in order to become an agent and thereby avoid broker-dealer licensure requirements.

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

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[1] The defendants were also convicted of multiple counts of selling securities by means of false statements or omissions in violation of Corporations Code section 25401

[2] Unless otherwise noted, all statutory references are to the Corporations Code.

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

[4] See Commissioner's Release No. 119-C (2008) (discussing, inter alia, the narrow basis for the *Cole* decision).

solution to the issues raised by *Cole* must place strict limitations on the receipt of these types of compensation.

This rulemaking action establishes a non-exclusive "safe harbor" from the definition of broker-dealer in Corporations Code section 25004, by excluding from the definition the associated persons of issuers who do not receive compensation specifically related to purchases of sales of securities, who limit their activities as specified in the rule, and who are not subject to federal or state statutory disqualification provisions.[5] The rule applies solely to the associated person's participation in offer and sales of securities of such issuer. The "safe harbor" incorporates by reference Securities and Exchange Commission rule 3a4-1 (17 CFR 240.3a4-1).

The rule excludes associated persons of issuers who:

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

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

- Promotes California capital markets activity by facilitating capital-raising by issuers, in situations where the imposition of broker-dealer licensure requirements would not provide corresponding investor protection.
- Provides added clarity with regard to licensure requirements, in light of a recent California Court of Appeal decision in *People v. Cole*, 156 Cal.App. 4th 452 (2007).
- Protects investors by ensuring that associated persons of issuers that receive commissions for the sale of securities, or have committed acts in violation of the CSL and federal securities laws, are required to be licensed as broker-dealers in California, and thus subject to increased regulatory supervision.

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

- Expands and clarifies the scope of Commissioner's Release No. 119-C (2008).

- Increases consistency with federal Securities and Exchange Commission licensure requirements.

DETERMINATION GOVERNMENT CODE SECTION 11346.9(a)(2)

The Commissioner has determined that the adoption of the regulation does not impose a mandate on local agencies or school districts, which require reimbursement pursuant to Part 7 (commencing with Section 17500) of Division 4 of the Government Code.

ALTERNATIVES CONSIDERED

No alternative considered by the Department would be more effective in carrying out the purpose for which the regulation is proposed, or would be as effective and less burdensome to affected private persons, or would lessen any adverse impact on small businesses.

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

ADDENDUM, REGARDING PUBLIC COMMENTS

No request for hearing was received during the 45-day public comment period, which ended on July 12, 2010. Accordingly, no hearing was scheduled or held. On July 9, 2010, the Corporations Committee of the California State Bar requested an extension of the public comment period. The extension to the public comment period ended on July 20, 2010.

COMMENTS RECEIVED DURING THE 45-DAY COMMENT PERIOD

The Department received five (5) public comment letters during the 45-day public comment period. Those comments are summarized below, together with the Department's response.

1. COMMENTOR: E-mail dated July 12, 2010, from Keith Paul Bishop

COMMENT: Commentor supports the proposed regulatory action to clarify the status of individuals associated with issuers. Commentor suggests the proposed exception for an employee of an issuer is not consistent with existing Rule 3a4-1. Commentor suggests revising the proposed rule to fully conform with Rule 3a4-1.

RESPONSE: The Department has eliminated the exception for employees of issuers, to promote consistency with Rule 3a4-1.

2. COMMENTOR: E-mail dated July 12, 2010, from Nancy H. Wojtas, Esq.

COMMENT: Commentor suggests the proposed exception for an employee of an issuer is not consistent with Rule 3a4-1, because officers are also employees of the issuer.

RESPONSE: See response to comment No. 1.

3. COMMENTOR: E-mail dated July 15, 2010, from Alan M. Parness with Cadwalader, Wickersham & Taft LLP.

COMMENT: Commentor supports the intent of the proposed regulatory action. Commentor suggests the proposed regulatory action be amended to adopt the SEC Rule 3a4-1, without any exceptions, which will provide ample protection of investors California.

RESPONSE: See response to comment No. 1.

4. COMMENTOR: Letter dated July 19, 2010, from John C. Oehmke, on behalf of the Corporations Committee of the Business Law Section of the State Bar of California.

COMMENT 1: Commentor supports the intent of the proposed rulemaking and suggests amending the proposed rule to eliminate the exclusion of employees from the scope of the safe harbor.

RESPONSE: See response to comment No. 1.

COMMENT 2: Commentor recommends adoption of additional rules that directly address the analytical elements and actions that would result in a person being considered to be a broker-dealer.

RESPONSE: The Department is considering the recommendation for future rulemaking.

COMMENTS RECEIVED DURING THE 15-DAY COMMENT PERIOD

The Department received one public comment letter during the 15-day public comment period, which ended on October 21, 2010. The comment is summarized below, together with the Department's response.

1. COMMENTOR: E-mailed letter dated October 8, 2010, from Lee R. Petillon with Petillon Hiraide & Loomis LLP.

COMMENT: Commentor is supportive of the Department's proposed amendments.

RESPONSE: A response is not necessary.

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