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California Corporate Securities Law: Small Business Capital Formation and Investor Protection

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California Corporate Securities Law: Small Business Capital Formation and Investor Protection

Small business,[1] through the drive, creativity, and spirit of individual entrepreneurs, is the essence of our free enterprise system.[2] Small business accounts for more than 96 percent of all businesses, more than 50 percent of all scientific and technological development, 55 percent of all private employment, and 48 percent of all national output.[3]

The economic growth of small business has been slowed by a combination of inflation, tight credit, and a decline in the amount of available equity financing.[4] Institutions have been reluctant to invest in small business,[5] and the stock market as a whole has experienced a flight of individual investors.[6] Thus, presently there exists a need to enhance capital formation.[7]

Small business capital formation often is best achieved through the issuance of equity securities since periodic interest payments are not required and the risk of failure is shared with outside investors.[8] Increased access to the securities market through liberalization of securities regulation is thought by many to be an appropriate method for

1. A small business, as defined by the U.S. Small Business Administration, has assets not exceeding $9 million, a net worth of less than $4 million, and an average annual net income of not more than $400,000. *Small Business Financing—The Current Environment and Suggestions for Improvement, reprinted in Hearings on Various Tax Proposals Before the Subcomm. on Taxation and Debt Management Generally of the Senate Comm. on Finance*, 96 Cong. 2d Sess. 1, 277 (1980) (special report published by the National Association of Securities Dealers, Inc.) [hereinafter cited as *Hearings*].

2. *Hearings, supra* note 1, at 277.

3. Further, small business produces as much as 24 times the amount of technological innovations per research and development dollar as do larger businesses. *Hearings, supra* note 1, at 277.

4. *Hearings, supra* note 1, at 271-72.

5. Survey results that included responses from bank trust departments, insurance companies, investment companies, mutual funds, and college endowment funds indicate that the most prominent reason for the disinclination to invest in small business is illiquidity of investment. *Hearings, supra* note 1, at 283-86.

6. *Hearings, supra* note 1, at 273. For most small businesses, loans from banks, insurance companies, and even the Small Business Administration are either inadequate or unavailable. J. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS, 43 (1971) [hereinafter cited as MOFSKY].

7. Capital formation, for purposes of this comment, refers to the financing of business operations via the issuance of equity or long-term debt securities. For a discussioon of the capital formation problems of small business see *Hearings, supra* note 1, at 271-74.

8. *See* MOFSKY, *supra* note 6, at 19-20.

enhancing capital formation.[9] Recent modificiation of the California Corporate Securities Law[10] (hereinafter referred to as CSL) reflects this view.[11]

The current CSL was enacted in 1968, superseding its 1917 predecessor.[12] The CSL established a merit-based system of securities regulation by authorizing the Commissioner of Corporations (hereinafter referred to as Commissioner) to deny qualification of the sale of any security *unless*: the plan of business and terms of the issuance are "fair, just, and equitable," the applicant intends to transact business fairly and honestly, and the sale will not work a fraud on the purchasers.[13] Because every nonexempt securities transaction must be qualified by the Department of Corporations (hereinafter referred to as Department), this fairness standard must be met before the offer or sale of a security within California is legitimate.[14]

To further the goal of "fairness" in securities transactions, qualification requires nine areas of departmental inquiry: (1) practicability of the proposed plan of business,[15] (2) honesty, competency, and experience of management,[16] (3) plan of financing and adequacy of capitalization,[17] (4) fairness of the terms of the offer to both proposed and existing shareholders,[18] (5) fairness of selling expenses,[19] (6) fairness of the amount of shares given for promotional consideration,[20] (7) fairness of the offering price,[21] (8) financial condition of the corporation,[22] and (9) disclosure of material facts surrounding the offering.[23] When any of these inquiries reveals that an aspect of a securities transaction is unfair, the Department communicates its objection to the issuer[24] in a

9. *Hearings, supra* note 1, at 274. *See generally* MOFSKY, *supra* note 6; SECURITIES REGULATORY REFORM PANEL, BUSINESS, TRANSPORTATION AND HOUSING AGENCY, SUMMARY OF PROCEEDINGS 7-13 (Feb. 11, 1981).
10. CAL. CORP. CODE §§25000-31316.
11. California Corporations Code Section 25102(f) as amended grants small issuers greater access to securities markets. See notes 147, 148 and accompanying text *infra*.
12. 1 H. MARSH & R. VOLK, PRACTICE UNDER THE CALIFORNIA SECURITIES LAWS §1.01 (1980) [hereinafter cited as MARSH & VOLK].
13. CAL. CORP. CODE §25140(b).
14. It is unlawful for any person to offer or sell any security unless it is exempted or is qualified by the Department. *Id.* §25110.
15. MARSH & VOLK, *supra* note 12, §8.14[3].
16. MARSH & VOLK, *supra* note 12, §8.14[2].
17. MARSH & VOLK, *supra* note 12, §8.14[3].
18. MARSH & VOLK, *supra* note 12, §§8.02[3]-8.03[5].
19. 10 CAL. ADMIN. CODE §260.140.20.
20. *Id.* §§260.140.30-260.140.33.
21. *Id.* §260.140.50; CAL. CORP. CODE §25140(d).
22. *See* 10 CAL. ADMIN. CODE §§260.001(f) (consideration of profit to determine if corporation is seasoned); 260.140.05 (use of profit-making objectives to determine if the business is speculative); 260.613 (requirement of financial statements).
23. *Id.* §260.113; CAL. CORP. CODE §25401.
24. Issuer means "any person who issues or proposes to issue any security." *Id.* §25010. For purposes of this comment, the terms issuer and offeror are used interchangeably.

deficiency letter.[25] The issuer then may remedy the deficiency and bring the offering up to standard by filing an amendment with the Department.[26] Thus, the CSL not only provides for a review procedure, but also protects investors by withholding the right to issue securities, until any deficiency or question of fairness raised by the Department is cured by the issuer.

The investor protection provided by the departmental inquiries into fairness[27] must be considered for an accurate evaluation of an exemption to qualification.[28] The need to enhance capital formation through reform of state blue sky laws[29] has been widely discussed.[30] Legislation adding a new exemption to the CSL qualification requirements addresses this concern for reform by wholly exempting from qualification issuer transactions to certain types of individual investors.[31]

The purpose of this comment is to evaluate the current CSL and the new exemption and to propose a modification of this exemption to provide for disclosure of information to the investor. The CSL and its exemptive provisions will be analyzed in light of the twin goals of investor protection and small business capital formation. This analysis, although restricted to offerings by corporate entities,[32] will extend to both open and limited offering qualification procedures. An examination of the newly adopted exemption will reveal that investor protection is not adequately safeguarded because this exemption makes no provision for disclosure of information necessary for an informed investment decision. Consequently, this comment will propose that the exemption include a provision for disclosure of information by the issuer to any investor who is not an officer, director, or controlling person of the issuer. The goal of this proposal is to provide a substitute for the Department's inquiries into fairness, yet provide greater flexibility to

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25. MARSH & VOLK, *supra* note 12, §2.02[4].
26. MARSH & VOLK, *supra* note 12, §2.02[4].
27. See notes 15-23 and accompanying text *supra*.
28. A rough analogy to federal law is applicable here. In *Securities and Exchange Commission v. Ralston Purina Co.*, 346 U.S. 119, 127 (1953), the Court held that the federal exemption for nonpublic offerings must provide "the protections afforded by registration." Thus, an exemption from the CSL qualification requirements should provide a substitute for the Department's inquiries into fairness.
29. The term blue sky law is a popular metonymy used to describe state laws, such as the CSL, which are intended to prevent sales of securities that are tantamount to sales of building lots in the blue sky in fee simple. MOFSKY, *supra* note 6, at 10.
30. See note 9 *supra*.
31. The exemption amends Section 25102(f) of the California Corporations Code. Section 25102 only exempts issuer transactions from qualification. CAL. CORP. CODE §25102. Nonissuer transactions must either be exempt under California Corporations Code Section 25102 or be qualified. *Id.* §25130. A nonissuer transaction is defined as "any transaction not directly or indirectly for the benefit of the issuer." *Id.* §25011. By implication, an issuer transaction is for the benefit of the issuer. This comment is limited to a discussion of issuer transactions.
32. The California Corporate Securities Law, however, applies to any security. *See id.* §25110. For the definition of a security see California Corporations Code Section 25019.

small corporate offerings than is allowed under the qualification requirements. Disclosure is also intended to promote accurate and complete financial record-keeping. Before discussing the proposal, however, a thorough appraisal of the qualification and exemption provisions of the CSL and their impact on small corporate issuers and offerees is needed to understand why reform is called for in this area.

CONFORMING A SECURITIES ISSUANCE WITH THE CSL

The small businessperson desiring to sell securities in California must either find an exemption to qualification or qualify the securities.[33] Qualification under the CSL can be for an open offering or a limited offering.[34] A limited offering qualification is one which "authorizes the offer and sale of securities only to persons designated therein by name or class."[35] An open qualification "authorizes the offer and sale of securities to the public generally, without restriction as to persons or class of persons."[36]

The purpose of distinguishing limited from open offerings is to allow review to be made in light of the sophistication and financial condition of the proposed offerees.[37] Thus, certain departmental objections that preclude a finding of fairness for offerings to the public at large may be waived when the offering is restricted to certain offerees.[38]

A. Qualifying an Open Offering

Because an open qualification allows for unrestricted offers and sales of securities, the issuer will not be allowed the variation from the standards of fairness which might be allowed in a limited offering qualification.[39] A small corporate issuer should not seek an open qualification when the promoter[40] or controlling shareholder desires to use one or more control devices to retain a contemplated percentage of voting shares or when the business is considered speculative.

33. *See id.* §25110.
34. 10 CAL. ADMIN. CODE §260.140. This comment will only address permit qualification—a procedure that can be used to qualify any security. CAL. CORP. CODE §25113. The two other procedures, qualification by coordination and qualification by notification, do not apply to small issuers. Coordination applies only to securities for which a registration statement has been filed pursuant to the Securities Act of 1933. *Id.* §25111. Notification applies only to issuers of securities registered either under Section 12 of the Securities Exchange Act of 1934 or under the Investment Company Act of 1940. *Id.* §25112.
35. 10 CAL. ADMIN. CODE §260.001(e).
36. *Id.* §260.001(d).
37. MARSH & VOLK, *supra* note 12, §6.05[3][c].
38. *See* 10 CAL. ADMIN. CODE §260.140.
39. *See id.* The Commissioner's rules governing the fairness of an offering are contained in Title 10 of California Administrative Code Section 260.140-260.140.139.
40. The terms "promoter" and "entrepreneur" are used interchangeably in this comment. They both refer to the organizer of an economic venture.

1. Control Devices

An entrepreneur who lacks sufficient personal resources to finance a venture will attempt to obtain capital from others.[41] Control may be retained by the entrepreneur in a securities offering if one or more control devices are used.[42] These devices are issuance of promotional shares, issuance of nonvoting securities, and imposition of transfer restrictions on the shares issued. The fairness standards adopted by the Commissioner, however, limit the use of these control devices.[43]

Promotional shares are those securities which are issued in consideration for: (1) services rendered in connection with founding or organizing the business, (2) property to the extent its value is unsatisfactorily established, or (3) a price lower than the amount others must pay for the security.[44] The two principal restrictions on promotional shares are amount limitations and transfer restrictions.

The amount of promotional shares that may be issued by an unseasoned corporation[45] is 25 percent of all common shares.[46] A seasoned corporation[47] cannot issue promotional shares except in unusual circumstances.[48] Thus, control cannot be obtained by a promoter through the use of promotional shares alone.[49] Limiting the amount of promotional shares that can be issued, however, protects investors by limiting the dilutive effect these shares have on the investment of others.[50]

Promotional shares also must carry transfer restrictions.[51] These restrictions are not removable until an earnings record, satisfactory to the Department, has been achieved for at least three years.[52] The restrictions on transfer of promotional shares are designed to protect investors by preventing promoters from selling these shares soon after comple-

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41. *See* MOFSKY, *supra* note 6, at 19-20.
42. *See* MOFSKY, *supra* note 6, at 41-54.
43. See notes 44-51 and accompanying text *infra*. Authority to promulgate regulations in furtherance of the fair, just, and equitable standard is given to the Commissioner in Sections 25140 and 25610 of the California Corporations Code.
44. 10 CAL. ADMIN. CODE §260.140.30.
45. A seasoned corporation is one "which has been conducting bona fide business operations, either directly or through a predecessor, for more than two years, and has operated at a profit during at least one of the last three fiscal years." *Id.* §260.001(f). Thus, an unseasoned corporation is one which has not met this criteria.
46. The issuance of 25% or less promotional shares by an unseasoned corporation is presumptively reasonable. *Id.* §260.140.31.
47. See note 45 *supra*.
48. 10 CAL. ADMIN. CODE §260.140.31; MARSH & VOLK, *supra* note 12, §8.05[4].
49. MARSH & VOLK, *supra* note 12, §9.02[3][a].
50. The dilutive effect of promotional shares is noted in MARSH & VOLK, *supra* note 12, §9.02[4][a].
51. 10 CAL. ADMIN. CODE §260.141.1.
52. Satisfactory earnings are described as "a reasonable return for the particular type of business on an amount determined by multiplying the total number of outstanding shares of the issuer by the average price at which the nonpromotional shares were originally issued and sold." *Id.* §260.141.2.

tion of the public offering.[53] The prevention of these promoter "bail-outs" appears to be based on the assumption that another person actually will buy diluted shares having little or no dividend yield.[54] Transfer restrictions preclude sales prior to the achievement of a sufficient earnings record. Notwithstanding, such sales may be justified when made to incoming professional management[55] or to pay the tax due on the bargain purchase of the promotional shares.[56]

In sum, the Department protects investors by preventing excessive dilution caused by the issuance of promotional shares and by preventing sale of promotional shares until the Department is satisfied with the corporation's earnings. Consequently, use of promotional shares alone does not assure the entrepreneur of retaining a controlling interest and does not appeal to entrepreneurs who anticipate a need to liquidate some or all of their investment in their shares.

Another method of issuing securities, without the resulting dilution of control, is the issuance of nonvoting securities.[57] Examples of these nonvoting securities are nonvoting common stock, preferred stock, and debt securities. Because nonvoting common stock is only deemed fair by the Department when issued for estate planning purposes in small, family-owned corporations, its proposed issuance will prevent open qualification.[58] The Department usually finds unfair the issuance of preferred shares or unsecured debt securities by a corporation lacking a significant earnings history.[59] The ability of a corporation lacking a significant earnings history to make dividend or interest payments is speculative; hence, the grant of a dividend preference or the promise to pay interest can be grounded only on the conjecture of the issuer and may be misleading to the investor.[60] Thus, for many entrepreneurs seeking open qualification, the retention of control through the issuance of nonvoting securities is impossible.

Nevertheless, even when initial control is obtained, subsequent sales by investors to outsiders cannot be prevented by issuer-imposed transfer restrictions. A corporate issuer seeking open qualification cannot

53. MOFSKY, *supra* note 6, at 35.

54. MOFSKY, *supra* note 6, at 34, 35.

55. It is generally acknowledged that entrepreneurs tend to be dysfunctional as managers during later stages of corporate growth. *See* Charan, Hofer & Mahon, *From Entrepreneurial to Professional Management: A Set of Guidelines*, 18 J. SMALL BUS. MANAGEMENT 1 (1980).

56. *See* TREAS. REG. §1.61-2(d)(1) (1957).

57. *See* MOFSKY, *supra* note 6, at 52.

58. *See* Applications for Qualification of Securities by Permit, Department of Corporations, Sacramento, California [hereinafter cited as Applications] (copy on file at *Pacific Law Journal*).

59. Interviews with William Bickford, Senior Corporations Counsel, Department of Corporations (August 1981) [hereinafter cited as Interviews] (copy on file at *Pacific Law Journal*).

60. Interviews, *supra* note 59, at 1.

impose transfer restrictions on its shares.[61] This acts to the disadvantage of the entrepreneur since transfer restrictions are often essential to the success of a business.[62] Restrictions, when found reasonable, may prevent unwanted outsiders from gaining an interest in, or even control of, a corporation.[63] Therefore, an entrepreneur seeking control over who invests in the corporation will not apply for open qualification.

Open qualification, because of its protective limitations, is undesirable to promoters who need outside financing without the concommitant loss of control or the threat that unwanted outsiders will acquire an interest in the business. Aside from these control considerations, the business promotion aspect of the corporation may prevent open qualification.

2. *Speculative Business Offerings*

The express statutory provisions mandating the fair, just, and equitable standard do not preclude a new business' securities offerings from open qualification.[64] When the proposed plan of business is deemed speculative, however, an open qualification will be denied.[65] Whether a particular *new* business actually will be considered *non*-speculative is uncertain.[66] Most *small* businesses, however, choose the path of lesser resistance[67] by seeking a limited offering qualification.[68] This trend may stem from a desire to retain control without use of personal funds alone, or from a belief that the business will be found speculative, or simply from a desire to avoid an invariable standard of fairness.

When an issuer foregoes an open qualification in favor of a limited offering qualification, the securities cannot be offered to *anyone* willing to purchase them.[69] Instead, the offering must be limited to those persons the Department believes can understand and withstand the risks associated with a desired variation from a particular fairness

61. 10 CAL. ADMIN. CODE §260.140.8.

62. Tu-Vu Drive-In Corp. v. Ashkins, 61 Cal. 2d 283, 287, 391 P.2d 828, 830, 38 Cal. Rptr. 348, 350 (1964).

63. *Id.* at 287, 391 P.2d at 830, 38 Cal. Rptr. at 350.

64. *See* CAL. CORP. CODE §25140.

65. A business is speculative where:

a) profits are not anticipated within a reasonable time;

b) business depends on a product or system not completed prior to the offering; or

c) preliminary profit-making objectives have not been achieved.

10 CAL. ADMIN. CODE §260.140.05.

66. This uncertainty arises when the issuer attempts to apply the test for speculativeness enumerated in note 65. For example, if a business is new, it would be difficult to predict whether the Department will find that the business can produce profits within a reasonable time.

67. See note 73 and accompanying text *infra*.

68. Out of the 19 corporations reviewed, ten chose the limited offering qualification and one chose the open qualification. Applications, *supra* note 58.

69. See note 71 and accompanying text *infra*.

standard.[70]

B. Qualifying a Limited Offering

A limited offering qualification is one which "authorizes the offer and sale of securities only to persons designated therein by name or class."[71] The purpose of distinguishing limited from open offerings is to allow review to be made in light of the financial condition and sophistication of the proposed offerees.[72] This type of offering must be used when the business is speculative or when the issuer seeks a more liberal standard than the fairness standards applicable to open qualifications.[73]

Unlike open qualifications, securities issued pursuant to a limited offering qualification are required to carry transfer restrictions.[74] This restriction allows the Department to make a fairness determination in consideration of the financial condition and sophistication of the proposed transferee.[75] Unfortunately, transfer restrictions make the limited offering less marketable, hence less valuable than securities of otherwise similar quality.[76]

Limited offerings, like open offerings, must be qualified.[77] While limited offerings are subject to the same statutory standards of fairness and the same nine departmental inquiries,[78] a variation from the standards imposed on open offerings sometimes may be obtained.[79] The Department makes three additional inquiries in deciding if objections, when present, should be waived and a limited offering qualification granted.[80] These inquiries look to the type of offeree, the dollar amount of the offering, and the sufficiency of the information provided both to the Department and to the offeree.[81]

1. Type of Offeree

Objections that would otherwise prevent an offering from qualifying

70. See note 72 and accompanying text *infra*.
71. 10 CAL. ADMIN. CODE §260.001(e).
72. MARSH & VOLK, *supra* note 12, §6.05[3][c].
73. 10 CAL. ADMIN. CODE §260.140.
74. Authority to restrict transfer is given to the Commissioner in California Corporations Code Section 25141. The purchaser of the restricted securities can obtain a consent to transfer from the Department. CAL. CORP. CODE §25151.
75. *See* MARSH & VOLK, *supra* note 12, §6.05[3][c].
76. *See Hearings, supra* note 1, at 573; Brooks, *Small Business Financing Alternatives Under the Securities Act of 1933*, 13 U.C.D. L. REV. 543, 579 (1980).
77. *See* CAL. CORP. CODE §25110.
78. *Id.* §§25110, 25140(b). See notes 15-23 and accompanying text *supra*.
79. 10 CAL. ADMIN. CODE §260.140.
80. *Id.*
81. Interviews, *supra* note 59, at 1, 2.

for issuance may be waived[82] when each of the proposed investors has knowledge of the facts surrounding the proposed issuance[83] and the ability to understand the offering and its peculiar risks or defects.[84] A further requirement for such waiver, when the business plan involves an unusually high degree of risk of losing a substantial sum of money, is a showing that the proposed investors are financially able to afford the loss.[85] The prerequisites to investor suitability, such as sophistication and wealth, reduce the number of potential investors that the issuer seeking a limited offering qualification can attract. Because speculative businesses can qualify only a limited offering, the number of potential investors for these businesses is limited. Capital formation in speculative business is impeded.

2. *Insubstantial Aggregate Offering Price*

A limited offering involving an insubstantial amount of money does not justify the full statutory standard of disclosure.[86] Consequently, these offerings require less detail about plan of business than do offerings which are open or involve a substantial offering price.[87] Unaudited, rather than audited, financial statements also are acceptable.[88]

3. *Sufficiency of Information and its Disclosure*

Applications for qualification must include any information the Commissioner requires.[89] The amount and type of information required by the Department will vary with the situation. For example, when a substantial amount of money is sought, audited financial statements are required.[90] Additionally, when the terms of the offer are par-

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82. 10 CAL. ADMIN. CODE §260.140.

83. Such facts include the proposed plan of business and the qualities of the securities which the investor seeks to purchase. Interviews, *supra* note 59, at 1.

84. These investor qualifications can be made by adequately demonstrating with *specific factual averments* that the person:
a) is an insider and participated in the formation of the plan; or,
b) is knowledgeable and negotiated the terms of the investment; or,
c) has knowledge and understanding by virtue of:
i. a preexisting relationship to the issuer, or
ii. investment or business experience, or
iii. financial background.
Interviews, *supra* note 59, at 1.

85. Interviews, *supra* note 59, at 1. Substantial wealth in relation to the amount of the investment is also required when the investment is found to be illiquid. *See* Applications, *supra* note 58, at 1.

86. Interviews, *supra* note 59, at 1.

87. Interviews, *supra* note 59, at 1. Since it is unclear how little "insubstantial" is, a call to the Department before attempting to limit this disclosure is warranted.

88. Interviews, *supra* note 59, at 1.

89. CAL. CORP. CODE §25113.

90. Interviews, *supra* note 59, at 1.

ticularly precarious, a substantial showing of sophistication is required.[91] What constitutes a showing of sophistication is uncertain and misunderstood by many attorneys.[92] For example, an averment that the offeree was active in a industry trade association to which the issuer belonged and that the offeree had a preexisting business and personal relationship with the offeror was found insufficient to demonstrate sophistication.[93] An amendment specifying the tenure and nature of the offeree's actual business experience along with her familiarity with the business itself, including the terms of the offer, satisfied the Department's inquiry.[94]

Some offerings have appeared to be so unreasonable that they completely contradict the notion that the investors are sophisticated.[95] Thus, when the Department's objections are of a sufficient magnitude, the issuer is required to disclose certain information to the offeree. This disclosure is usually accomplished by providing a copy of the Department's "letter of transmittal" to each offeree *before* consideration is accepted or shares issued.[96] This disclosure specifies the effects that certain aspects of the offering will have on the particular offeree.[97] For example, investors were told that a purchase of a minority interest in a corporation operating at a loss, when the purchase price greatly exceeded book value, would be an illiquid investment.[98] In some instances, shares may be issued absent a showing of sophistication if an "offering circular" is provided to each offeree.[99] The rationale for these two types of mandated disclosure is the Department's experience that the terms of many limited offerings are not actually negotiated by the parties.[100]

To summarize, the limited offering qualification procedure is a beneficial departure from the mechanical application of arbitrary, mathe-

91. Examples of these objectionable terms are: obvious or gross inadequacy of capital, absence of an impounding provision, sale of promotional shares without subordination, or sale of nonvoting common stock. Interviews, *supra* note 59, at 2.
92. *See* Applications, *supra* note 58, at 3, 4, 7.
93. Applications, *supra* note 58, at 7.
94. Applications, *supra* note 58, at 7.
95. Interviews, *supra* note 59, at 2. Two situations arose in the study of applications. In one offering, the offeree was allegedly the company's bookkeeper and as such, was sophisticated; yet, financial statements sent to the Department indicated an unexplained increase in the number of shares issued to the controlling shareholder without any additional paid-in capital shown. In another offering when the offeree was allegedly sophisticated, the offering price was $10 per share, but the book value per share after the proposed sale was only $0.25 per share. In this latter instance, the company did not appear to have the kind of assets that would have a great deal of unrealized appreciation, and the company was consistently losing money. *See* Applications, *supra* note 58, at 4, 7.
96. Applications, *supra* note 58, at 7, 9.
97. Applications, *supra* note 58, at 7.
98. *See* Applications, *supra* note 58, at 7.
99. Interviews, *supra* note 59, at 3, 12.
100. Interviews, *supra* note 59, at 2.

matical rules to a facts-and-circumstances approach to qualification.[101] This process enables independent investigation and assures that disclosure of the *effects* of objectionable terms is made.[102] The limited offering procedure appears to be an attempt to balance the need for investor protection with the need for small business capital formation. Three aspects of the limited offering qualification procedure, however, hamper its usefulness to small, corporate issuers. First, the transfer restrictions imposed by the Department on a limited offering make the securities less valuable in relation to unrestricted securities of otherwise similar quality.[103] Second, limiting speculative business to a closed group of investors restricts the entrepreneur's access to the capital market.[104] Third, the uncertainty of what constitutes a showing of sophistication makes compliance with the requirements of a limited offering difficult.[105]

The entrepreneur who is dissatisfied with both open and limited offering qualification requirements may still attempt to exempt the security from qualification. The following section will briefly analyze some current exemptions applicable to small corporations and will demonstrate the need for reform addressed by the legislature in adopting a new small offering exemption.

C. Registration Exemptions

Because an offer or sale of any security in California must either be qualified or exempted, an exemption applicable to *both* offers and sales of securities enables the offeror to avoid the qualification process.[106] The institutional investor[107] and the ten-or-fewer-shareholders[108] exemptions apply to offers and sales, while the nonpublic offering exemption applies only to offers.[109]

1. Institutional Investor Exemption

Any offer or sale of a security is exempt from issuer qualification if made to certain institutional investors[110] or to any company registered

101. MARSH & VOLK, *supra* note 12, §6.05[3][c].
102. See notes 96-100 and accompanying text *supra*.
103. See note 76 *supra*.
104. See note 85 and accompanying text *supra*.
105. See notes 92-94 and accompanying text *supra*.
106. *See* CAL. CORP. CODE §25110.
107. *Id.* §25102(i).
108. *Id.* §25102(h).
109. *Id.* §25102(a). The burden of proving that any of the three exemptions apply to a particular offer or sale is on the person claiming an exemption. *Id.* §25163.
110. Institutional investors include entities such as banks, savings and loans, investment companies, and certain college endowment funds. 10 CAL. ADMIN. CODE §260.102.10; CAL. CORP. CODE §25102(i).

under the Securities Exchange Act of 1934, and such investor "represents that it is purchasing for its own account . . . for investment and not with a view to or for sale in connection with any distribution of the security."[111] This exemption presupposes that the knowledge and economic bargaining power of these offerees eliminates the need for departmental review.[112]

The institutional investor exemption is beneficial because the offeror can structure the terms of the offer in any manner acceptable to the offeree.[113] This exemption is of little aid to the small corporate issuer, however, because institutional investors are generally unwilling to invest in small business.[114] Thus, the small issuer must look for exemptions that apply to sales to *individuals*.

2. *Ten-or-Fewer-Shareholders Exemption*

Another exemption available to the small corporate issuer is the ten-or-fewer-shareholder exemption. This exemption applies to offers and sales of voting common stock to be beneficially owned by no more than ten persons.[115] The protective features of this exemption are designed to exempt only those securities transactions in which the qualification requirements are considered unnecessary.[116] Consequently, the ten-or-fewer-shareholders exemption is narrow in application. A detailed analysis of this protective, yet restrictive exemption is beyond the scope of this comment. A brief highlighting of some of these restrictive provisions, however, reveals the need for a more useful exemption.

First, the ten-or-fewer-shareholders exemption applies only to securities issuances taking place upon the initial organization[117] of the issuer.[118] The only exceptions to this rule are sales to institutional investors[119] and sales to existing shareholders for cash when unanimously approved by all shareholders.[120] This rule and its exceptions are designed to prevent majority shareholders from issuing stock to themselves at an unfairly low price or from attempting to freeze out minority shareholders by excluding them from a subsequent stock issu-

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111. CAL. CORP. CODE §25102(i).
112. This is the rationale for the comparable accredited investor exemption under Rule 146 of the federal securities law. *See* note to 17 C.F.R. §239.146(e) (1980).
113. *Cf.* CAL. CORP. CODE §25102(h).
114. See note 5 and accompanying text *supra*.
115. CAL. CORP. CODE §25102(h).
116. MARSH & VOLK, *supra* note 12, §4.02[1].
117. "Initial organization" means the first issuance of stock after incorporation of a business. MARSH & VOLK, *supra* note 12, §4.02[10][d].
118. CAL. CORP. CODE §25102(h)(3)(i), (ii).
119. *Id.* §25102(i).
120. *Id.* §25102(h)(3)(iii).

ance in which only the majority participates.[121] Nonetheless, if shares are issued to additional individual investors *after* the initial organization, the exemption is lost and qualification must be obtained, even when the total number of shareholders remains at ten-or-fewer.

Second, if non-cash property is the consideration for the stock, the property must be assets of an existing business enterprise in operation for at least one year and the owners of the enterprise must be issued stock in proportion to their interest in that enterprise.[122] Consequently, the ten-or-fewer-shareholders exemption is unavailable to the promoter who wants to contribute business assets and obtain additional cash by issuing securities to other investors.

Third, control can only be retained through the purchase of a controlling amount of common stock issued in consideration for cash or cancellation of indebtedness.[123] This method for retaining control is the sole method available under the exemption when securities are issued to others.[124] The absence of alternatives arises in part because the only allowable consideration (with the exception of business assets) is cash or cancellation of indebtedness for money borrowed or both.[125] In addition, all stock issued must be voting common stock,[126] and there may be only one class of stock outstanding.[127] Thus, the promoter desiring outside financing through issuance of securities must provide a majority of the money to receive a majority vote.

Finally, the ten-or-fewer-shareholders exemption requires that a legend[128] restricting transfer be placed on all shares issued pursuant to the exemption.[129] Because liquidity is a major concern of many securities investors, this restriction makes the stock less marketable and less valuable.[130]

The ten-or-fewer-shareholders exemption fails to provide any assurance that the proposed plan of business is practicable, that the manage-

121. MARSH & VOLK, *supra* note 12, §4.02[10][c].
122. *See* CAL. CORP. CODE §25102(h)(4).
123. *Id.* §25102(h)(3)(i).
124. *Id.*
125. *Id.* §25102(h)(3)(ii). The use of promotional consideration is expressly disallowed under the exemption. *Id.* §25102(h)(4).
126. *Id.* §25102(h).
127. *Id.* A second class of stock is created if, at the time the shares are issued, there exists or is presently intended to be executed a shareholders agreement pursuant to which any of the rights, preferences, or privileges of any shares are modified. 10 CAL. ADMIN. CODE §260.102.4(b); Berger, *Statutory Close or Closely Held Corporation?* 11 PAC. L.J. 699, 708-09.
128. A legend is a standard paragraph placed on shares that have transfer restriction imposed under the CSL. *See* 10 CAL. ADMIN. CODE §260.141.1. While California Corporations Code Section 25102(h) specifically refers to a legend requirement, the Commissioner is empowered under §26141 to require legends or even the deposit of the securities in escrow to prevent transfer.
129. CAL. CORP. CODE §25102(h)(1).
130. See note 76 *supra*.

ment is honest, competent, or experienced, that the plan of financing will result in adequate capitalization, or that the material facts surrounding the offering will be disclosed to the offerees.[131] Unlike the qualification requirements, the ten-or-fewer-shareholders exemption imposes no duty to disclose financial information to the Department.[132] These gaps in investor protection arise because this exemption fails to require disclosure by the issuer and to limit the exemption to offerees who are able to make an informed evaluation.[133] Empirical evidence suggests that many issuers using this exemption fail to maintain accurate and complete financial information.[134] Deficiency in financial reporting not only makes later attempts at qualification more difficult,[135] but prevents investors from making an informed investment decision.[136] Without sufficient financial information,[137] investors cannot substitute their own inquiries regarding the offering for those made by the Department during the qualification process.[138]

Thus, the restrictive provisions of the ten-or-fewer-shareholders exemption make this exemption unacceptable for many small corporate issuers. The exemption also fails to provide protective features, such as disclosure, as a substitute for certain departmental inquiries.

3. Nonpublic Offers and Agreements

The nonpublic offers and agreements exemption exempts only the *offer*, not the sale, of securities.[139] The actual sale must either fall within another exemption or be qualified with the Department.[140] The small corporate issuer, therefore, is still left with a choice between qualification, the institutional investor exemption, or the ten-or-fewer-shareholders exemption.

While the small corporate issuer is given a choice between several methods of conforming an issuance to the requirements of the CSL, for many of these issuers, the only real alternative is the limited offering qualification.[141] This Hobson's Choice[142] partially arises because open

131. Compare notes 15-17, 23 and accompanying text *supra*.
132. *See* CAL. CORP. CODE §25102(h).
133. *See id.*
134. Survey results indicated that of the seven issuers whose initial issuance was made pursuant to Section 25102(h) and who later sought to qualify an issuance, five issuers had their qualification applications objected to because of inaccurate or incomplete financial information.
135. See note 134 *supra*.
136. Inaccurate or incomplete financial data is clearly misleading for persons who rely on this data for investment decisions. See note 172 *infra*.
137. Applications for permit qualification require the issuer to provide reports of financial condition. 10 CAL. ADMIN. CODE §260.113, Item 22.
138. See notes 15-23 and accompanying text *supra*.
139. CAL. CORP. CODE §25102(a).
140. *See id.* §§25102(a), 25110.
141. Survey results show that out of the 14 small businesses studied, five initially applied for a

qualification requirements dissuade those promoters who desire to retain control of their business without use of personal funds alone, to issue securities for a speculative business venture, or to be permitted a variable standard of fairness.[143] The institutional investor exemption is also useless for many small issuers because these investors rarely invest in small business.[144] Finally, the ten-or-fewer-shareholders exemption, because of its protective, yet restrictive provisions, does not exempt many types of securities issuances sought by small corporate issuers.[145] Thus, small corporations are left with the limited offering qualification. This exemption, although frequently used by small issuers, inhibits capital formation because of the requirement of transfer restrictions, limitations on the type of offeree, and the uncertainty of what constitutes a showing of sophistication.[146]

The California Legislature, through the adoption of a new exemption,[147] provides the small corporate issuer with another possible exemption. Although this exemption favors capital formation of small business, its ability to safeguard adequately the interests of investors is questionable.

LEGISLATIVE RESPONSE TO CALL FOR CAPITAL FORMATION ENHANCEMENT: AMENDED SECTION 25102(f)

The California Legislature amended Section 25102(f) of the California Corporations Code to provide an exemption applicable to any security.[148] Offers and sales of *any* security are exempt if offered in a

limited offering qualification, and five more applied for a limited offering qualification after initially claiming a Section 25102(h) exemption. *See* Applications, supra note 58, at —.

142. This predicament is named after Thomas Hobson, an English liveryman, for his practice of requiring every customer to take the horse which stood nearest the door and indicates an apparent freedom of choice where there is no real alternative.

143. See notes 39-70 and accompanying text *supra*.

144. See note 5 and accompanying text *supra*.

145. See notes 115-131 and accompanying text *supra*.

146. See notes 71-85, 91-94 and accompanying text *supra*.

147. California Corporations Code Section 25102(f) was amended by the legislature in 1981. This section previously exempted only nonpublic partnership or joint venture interests. CAL. STATS. 1974, c. 1103, §4, at 2357. This amendment leaves unaffected all qualification procedures and exemptions previously discussed. If an issuer does not fall within this new exemption, any of these qualification procedures and exemptions may apply to the offering.

148. Amended Section 25102(f), in pertinent part, reads:

> Any offer or sale of any security in a transaction (other than an offer or sale to a pension or profit-sharing trust of the issuer) which meets each of the following criteria:
>
> (1) Sales of the security are not made to more than 35 persons, including persons not in this state.
>
> (2) All purchasers either have a preexisting personal or business relationship with the offeror or any of its partners, officers, directors or controlling persons, or by reason of their business or financial experience or the business or financial experience of their professional advisors who are affiliated with and who are not compensated by the issuer or any affiliate or selling agent of the issuer, directly or indirectly, could be reasonably

transaction to no more than 35 offerees.[149] These offerees must:

> either have a preexisting personal or business relationship with the offeror or any of its partners, officers, directors, or controlling persons, or by reason of their business or financial experience . . . could be reasonably assumed to have the capacity to protect their own interests in connection with the transaction.[150]

This latter sophistication test is also satisfied when offerees rely on:

> the business or financial experience of their professional advisors who are unaffiliated with and not compensated by the issuer or any affiliate or selling agent of the issuer, directly or indirectly[151]. . . .

Amended section 25102(f) enhances capital formation by making available a new and useful exemption to the small, corporate issuer.[152] This exemption, like the institutional investor exemption, would allow the offeror freedom to structure the terms of the offer in any manner acceptable to qualified offerees.[153]

Such freedom, however, leaves the risk of investment in securities unregulated. Any type of security offered at any price to finance any business venture could be issued to qualified purchasers.[154] Selling expenses could be incurred in any amount, and promotional shares could be issued in any amount.[155] Further, the plan of financing is not required to result in adequate capitalization.[156] Consequently, the bur-

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assumed to have the capacity to protect their own interests in connection with the transaction.

(3) Each purchaser represents that the purchaser is purchasing for the purchaser's own account (or a trust account if the purchaser is a trustee) and not with a view to or for sale in connection with any distribution of the security.

(4) The offer and sale of the security is not accomplished by the publication of any advertisement. The number of purchasers referred to above is exclusive of any described in subdivision (i), any officer, director or affiliate of the issuer and any other purchaser who the commissioner designates by rule. For purposes of this section, a husband and wife (together with any custodian or trustee acting for the account of their minor children) are counted as one person and a partnership, corporation or other organization which was not specifically formed for the purpose of purchasing the security offered in reliance upon this exemption, is counted as one person. The commissioner may by rule require the issuer to file a notice of transactions under this subdivision; provided, however, that the failure to file the notice or the failure to file the notice within the time specified by the rule of the commissioner shall not affect the availability of this exemption. An issuer who fails to file the notice as provided by rule of the commissioner shall, within 15 business days after demand by the commissioner, file the notice and pay to the commissioner a fee equal to the fee payable had the transaction been qualified under Section 25110.

149. CAL. CORP. CODE §25102(f)(1).

150. *Id.* §25102(f)(2).

151. *Id.*

152. Out of 14 businesses reviewed, 13 had offerings that appeared to qualify for the present exemption.

153. Besides limiting the type of investor and proscribing the use of advertising and purchases with a view to sale, the terms of an offering issued under this exemption can be virtually unlimited. *See* CAL. CORP. CODE §25102(f).

154. *See id.*

155. *See id.; cf. id.* §25102(h).

156. *See id.* §25102(f).

den of investigation into the merits of the investment falls squarely on the investors or their advisors. For investors to be adequately protected, they must have the ability to make the same inquiries into the merits of a securities investment that are made by the Department.[157] These inquiries require access to information concerning the investment.[158] An analysis of relevant portions of the exemption will show that merely limiting its coverage to designated classes of purchasers is an insufficient substitute for Departmental inquiry.

A. Capacity to Protect One's Own Interests

Amended section 25102(f) exempts offers and sales of any security to those who "by reason of their business or financial experience . . . could be reasonably assumed to have the capacity to protect their own interests in connection with the transaction."[159] This standard requires the issuer to make a subjective determination about the sophistication of each offeree.[160] If sophistication is later found not to exist, the exemption is lost, and any purchaser dissatisfied with the investment may bring suit for recission or damages.[161]

Offeree sophistication, however, is not always required. Under the statute, the acumen of an independent professional advisor may be substituted for the sophistication of the investor.[162] This provision for offeree representation is apparently a response to the requests of offerors and their legal counsel that professional advice be determinative of sophistication.[163] Nevertheless, the represented offeree needs access to material facts.

Sophistication itself does not establish a relationship that enables access to information concerning the issuer.[164] While the new exemption does not require disclosure to the Department or to investors and their

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157. See note 28 and accompanying text *supra*.

158. The forms required from the issuer by the Department are contained in Title 10 of the California Administrative Code Sections 260.110-260.113.

159. CAL. CORP. CODE §25102(f)(2).

160. *See* 46 Fed. Reg. 2633, 894 FED. SEC. L. REP. (CCH) 1, 12-14 (Jan. 12, 1981) (discussion of comparable provisions contained in Rule 146).

161. CAL. CORP. CODE §25503. These actions must be brought within two years of the violation or one year after discovery, whichever occurs first. *Id.* §25507.

162. Section 25102(f) exempts from qualification offers and sales of any security to purchasers who:

> by reason of. . . the business and financial experience of their professional advisors who are unaffiliated with and who are not compensated by the issuer or any affiliate . . . could be reasonably assumed to have the capacity to protect their own interests in connection with the transaction.

Id. §25102(f)(2).

163. *See* Rhodes & Garwin, *People v. Park: The Federalization of California's Unrepresented Offerees*, 6 ORANGE COUNTY BAR J. 178, 181 (1979).

164. Compare note 181 and accompanying text *infra*.

representatives,[165] some disclosure may be prerequisite to a finding of sophistication or capacity to protect one's own interest.

The 1978 California Court of Appeal case of *People v. Park* demonstrates that capacity to protect one's own interest depends on the availability of sufficient, accurate information.[166] In *Park*, two women invested $20,000 each[167] in a condominium project that was never built.[168] The money was misappropriated by the offeror.[169] Although these women had occasional meetings with the offeror prior to the transaction, the record was devoid of any showing of sophistication or that the issuer made available to these investors the information necessary to an intelligent investment decision.[170]

Sophistication under federal law requires access to material information.[171] Information is material "if there is a substantial likelihood that a reasonable person would consider it important in deciding whether to invest."[172] This judicially-recognized need for information available to the investor is left unaddressed by the exemption. Until material information is made available by the offeror, the business or financial experience of the purchaser or the purchaser's professional advisor does not guarantee the ability to protect the purchaser's interests.[173] Before an investor can adequately assess the consequences of a securities investment, all material information about the issuer and the terms of the issuance is needed by the investor.[174]

B. Preexisting Personal or Business Relationship

The exemption applies to purchasers with a "preexisting personal or business relationship with the offeror or any of its partners, officers, directors, or controlling persons[175] . . ." The few cases that have construed the meaning of preexisting personal or business relationship simply rearticulate this condition by holding it inapplicable when the offerees and the issuer are "relative strangers."[176] This condition, how-

165. *See* CAL. CORP. CODE §25102(f).
166. 87 Cal. App. 3d 550, 565, 151 Cal. Rptr. 146, 151 (1978).
167. *Id.* at 557, 151 Cal. Rptr. at 153.
168. *Id.* at 560, 151 Cal. Rptr. at 148-49.
169. *Id.*
170. *Id.* at 565, 151 Cal. Rptr. at 153.
171. Securities and Exch. Comm. v. Murphy, 626 F.2d 633, 643 (9th Cir. 1980).
172. *Id.*
173. "Just as a scientist cannot be without his specimens, so the shrewdest investor's acuity will be blunted without specifications about the issuer." Doran v. Petroleum Management Corp., 545 F.2d 893, 903 (5th Cir. 1977).
174. *Id.*
175. CAL. CORP. CODE §25102(f)(2).
176. People v. Skelton, 109 Cal. App. 3d 691, 725, 167 Cal. Rptr. 636, 654 (1980); People v. Humphreys, 4 Cal. App. 3d 693, 698, 84 Cal. Rptr. 496, 499 (1970) (mobile home park owners purchased securities from mobile home park owner through his agents).

ever, appears to embrace relatives, employees, personal friends, or persons having a continuous business relationship with the offeror.[177]

The purpose of exempting offers and sales between persons having a preexisting personal or business relationship is to differentiate public offerings from privately, negotiated securities transactions.[178] While it is plausible that a friend, relative, or business associate can make an informed judgment on the offeror's honesty, it is questionable if that friend, relative, or business associate will actually negotiate the terms of the offer.[179]

Persons having a preexisting personal or business relationship are not assured disclosure of, or access to, material information under the express terms of the statute.[180] Implicit in this kind of statutory exemption is the belief that "employment or family [or other personal or business] relationship . . . enables the offeree to obtain information from this issuer in order to evaluate the merits and risks of the prospective investment."[181] Possession of material information is a prerequisite to the effective negotiation of the terms of the offer.[182] That offerees having a preexisting relationship to the offeror actually obtain this information is conjecture.[183] Small business entrepreneurs are reluctant to share information concerning their business with others.[184] Thus, absent a legal obligation mandating disclosure, it is unlikely that many investors will receive all material information about the issuance or the issuer's business.

C. *Hiatus in Statutory Disclosure Obligations*

When an offering is exempt under the new exemption to the CSL, disclosure of information concerning the offering and the issuer is not required to be made to the Department or to the offerees.[185] If an offering is exempt from registration under Section 5 of the Federal Securities Act of 1933 (hereinafter referred to as 1933 Act), disclosure is often

177. MARSH & VOLK, *supra* note 12, §4.05[2].
178. MARSH & VOLK, *supra* note 12, §4.05[2].
179. See note 100 and accompanying text *supra*.
180. *See* CAL. CORP. CODE §25102(f).
181. Note to 17 C.F.R. §230.146(e) (1980).
182. See notes 173, 174 and accompanying text *supra*.
183. For example, an employee who is offered the "opportunity" to invest in his employer's business is not likely to demand a current set of financial statements before investing.
184. Small business entrepreneurs . . . wish to maintain the confidentiality of their financial positions and operating results. They do not wish to have others tell them how to operate their businesses, even though occasionally they may need outside counsel. They often view outside shareholders as a threat to their freedom of action.

Hearings, supra note 1, at 795 (statement of William C. Penick on behalf of the National Small Business Association).
185. *See* CAL. CORP. CODE §25102(f).

not required under federal law.[186] If an offering falls within both a federal exemption not requiring disclosure *and* the new exemption to the CSL, then there is no regulatory disclosure obligation for the benefit of the offerees.

Qualification of securities under the CSL requires the issuer to make substantial disclosures to the Department concerning the issuer, the issuer's business, and the terms of the offering.[187] Similarly, Section 5 of the 1933 Act requires the issuer to make an extensive disclosure of information in a registration statement.[188] Just as the CSL has exemptions to qualification, the 1933 Act has exemptions to registration.

The exemptions to the registration provision of the 1933 Act, for purposes of this discussion, are of two types: exemptions that require disclosure of information[189] and those that do not require such disclosure.[190] Most prominent among the exemptions not requiring disclosure is the Rule 147 intrastate offering exemption which was adopted pursuant to Section 3(a)(11) of the 1933 Act.[191] Essentially, Rule 147 exempts the offer and sale of securities to persons residing within a single state or territory offered by an issuer doing business within the state or territory.[192] Securities sold under this exemption may be resold to persons residing within the state, and after nine months from original issuance, to persons residing out of state.[193] No disclosure is required under the 1933 Act when securities fall within the Rule 147 exemption.[194]

When an offering falls within the Section 25102(f) exemption, disclosure is not required under the qualification procedures of the CSL.[195] If the offering also falls within a federal exemption from registration, such as Rule 147, no disclosure is required under the 1933 Act registration provisions.[196] The only statutory disclosure obligations that the offering is subject to are the state and federal anti-fraud laws.[197] These anti-fraud provisions make it unlawful for the issuer to make any misrepresentations or material omissions of fact to the offerees in connection with the offering.[198] These provisions are remedial,[199] however,

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186. *See* 17 C.F.R. §230.147 (1981).
187. *See* 10 CAL. ADMIN. CODE §260.113.
188. 15 U.S.C. §77e (1976).
189. *See, e.g.,* 17 C.F.R. §§230.251-230.264 (Regulation A); 230.242 (Rule 242); §230.146 (Rule 146); 239.29 (Form S-18) (1981).
190. *See, e.g., id.* §§230.147 (Rule 147); 230.240 (Rule 240).
191. *Id.* §230.147.
192. *Id.*
193. *Id.*
194. *Id.*
195. *See* CAL. CORP. CODE §25102(f).
196. *See* 17 C.F.R. §230.147 (1981).
197. *See* 15 U.S.C. §§77j, 77q (1976); CAL. CORP. CODE §25401.
198. *See* 15 U.S.C. §§77j, 77q (1976); CAL. CORP. CODE §25401.

and recovery by the offeree in the event of investment loss is not assured.[200] The uncertainty of this after-the-fact recovery indicates the need to fill the gap in disclosure which the federal and the new state exemptions, collectively, create.

Although the new state exemption is limited to purchasers having sophistication or a preexisting personal or business relationship with the offeror or any of its partners, officers, directors, or controlling persons, even these purchasers must be given the opportunity to make *informed* investment decisions.[201] Persons having a preexisting personal or business relationship may be able to judge the offeror's character and may be in a position that permits access to information.[202] Whether these offerees will actually take advantage of their relationship with the offeror to obtain the necessary information and negotiate the terms of the offering, however, is uncertain.[203] Persons having business or financial experience should understand the consequences of investing in a particular offering. Until these investors are given information necessary to an investment decision, however, they cannot accurately assess the consequences of investing in the security.[204] Mandatory information disclosure by the offeror to the offerees gives the investor this opportunity. Absent a disclosure requirement, amended section 25102(f) inadequately safeguards investors' need for information.

PROPOSAL

The addition of a disclosure requirement to section 25102(f) would provide investors with pre-investment information and coerce adequate issuer financial record-keeping by requiring financial statements as part of this information disclosure. A disclosure requirement is needed under section 25102(f) to help prevent the inadequate maintenance of financial data that is prevalent among issuers falling under the ten-or-fewer-shareholders exemption. This provision should include the filing of a disclosure document along with delivery of an offering circular to the offeree prior to receipt of consideration or issuance of shares.

Investor protection is furthered when information is not only accessible, but is *delivered* to the securities offeree via an offering circular filed with a regulatory agency. This disclosure scheme, which should apply

199. *See* 15 U.S.C. §§77j, 77q (1976); CAL. CORP. CODE §25401.
200. Even if the plaintiff-offeree obtains a verdict against the issuer, satisfaction of the judgment may be impossible since proceeds of the issuance will most likely have been expended.
201. See notes 173-174 and accompanying text *supra*.
202. See notes 179-183 and accompanying text *supra*.
203. See notes 179-183 and accompanying text *supra*.
204. See notes 173-174 and accompanying text *supra*.

to the new exemption from qualification, should make specific provisions for the contents of the disclosure documents, filing and diclosure procedures, and exemptions from the required information disclosure.

The major contents of this information disclosure should be the information required under Form 1-A of the 1933 Act.[205] This form was adopted pursuant to Regulation A of the 1933 Act,[206] and was designed to abate the regulatory burdens that federal securities laws place on small issuers.[207] Form 1-A should be filed with the Department regardless if the form has been, or will be, filed with the Securities and Exchange Commission. If the information contained in Form 1-A already has been reviewed by the Securities and Exchange Commission, then the form could be filed with the Department without review.[208] Otherwise, the Department would review the form for accuracy and completeness. Rather than simply enumerating the present requirements contained in Form 1-A, the proposed disclosure provision refers only to Form 1-A by name.[209] This would allow California disclosure requirements to vary with any changes in Form 1-A. Consequently, a basis for coordination with federal law is established, and issuers who are exempt under California law, but who are simultaneously offering securities under a federal exemption requiring Form 1-A, will not have to duplicate effort.[210] If the issuer is not required to file audited financial statements under federal law, the financial statements may be unaudited under this proposal.[211] In addition to the Form 1-A information, the use of promotional shares and selling expenses should be noted by the issuer.

205. *See* [Securities Act—Forms] FED. SEC. L. REP. (CCH) ¶¶7325-7327b (1981).

206. 17 C.F.R. §230.255(a) (1981).

207. 6 R. SHAPIRO, A. SACHS & C. OLANDER, SECURITIES REGULATION FORMS COMPLIANCE—PRACTICE §2.01 (1980).

208. In this manner, the Department could rely on the review made by the Securities and Exchange Commission.

209. A statutory disclosure provision should make only a general reference to disclosure. An administrative code section should be employed to make the reference to Form 1-A. Thus, if Form 1-A undergoes a change of name or is repealed altogether, the California provisions could be modified by the Commissioner without the need for legislative action.

210. Under a proposed revision to the Regulation A filing requirements, the Form 1-A would provide a "pool" of disclosure items. The applicability of any particular item would vary with the type of business a given issuer is conducting. Securities Act Release No. 6275, 46 Fed. Reg. 2639, 894 FED. SEC. L. REP. (CCH) 35, 42-43 (Jan. 12, 1981).

211. The American Institute of Certified Public Accountants provides for two reporting standards applicable to unaudited financial statements. These standards are called compilation and review. Compilation of financial statements involves presenting information that is the representations of management without the independent accountant's expressing any assurance on the statements. Review, on the other hand, involves the accountant's inquiry and analysis which provides a reasonable basis for expressing limited assurance that the statements conform with generally accepted accounting principles or, if applicable, with another comprehensive basis of accounting. *See* STANDARD & POOR'S CORPORATION, 12 THE REVIEW OF SECURITIES REGULATION 967-68 (Mar. 14, 1979). Unaudited financial statements should include an independent certified public accountant's review.

The amount of promotional consideration, as defined by Commissioner's Rule 260.140.30,[212] and the names of the recipients should be furnished. This amount includes the following: promotional consideration given to date, promotional consideration associated with the proposed offering, and a total of those amounts. Estimated selling expenses[213] to be incurred in the proposed offering also should be listed. Finally, a total of estimated selling expenses and the amount of promotional consideration associated with the proposed offering should be set forth. This total should be expressed both in terms of amount and as a percent of the aggregate offering price. Listing selling expenses and promotional consideration in this manner allows the investor to make a quick assessment of the dilutive effect these terms have on the investment. The procedure for disclosing material information should include requirements that the information be filed with the Department for possible review and later delivered to the offerees for review.

After filing and review of the required information, the offeror should then provide each offeree with an offering circular. This circular should contain a standardized letter of explanation by the Department[214] with an attached copy of the issuer's disclosure filing. As a further precaution, each investor should be allowed time for analysis after delivery of the offering circular. This time for "second thoughts" could be provided by a refusal to give legal effect to any purchase agreement entered into before a specified number of days after each offeree receives a circular.

While this proposed disclosure scheme provides useful information to the investor, it does encumber the issuer. Because it does so, the requirement of providing information pursuant to the disclosure scheme should exclude those situations in which the investor's participation in the venture guarantees access to material information. For this reason, when the sole offerees are officers, directors, or controlling persons of the issuer, the disclosure process may be waived.[215] Such

212. 10 CAL. ADMIN. CODE §240.140.30.

213. Selling expenses are defined in Title 10 of California Administrative Code Section 260.140.20. They include total underwriting and brokerage discounts and commissions as well as all other expenses actually incurred in connection with the offering. They do not include accountants' or the issuer's attorney's fees, or options to underwriters. This letter of explanation should include a statement that no fair, just, and equitable determination has been made with respect to the securities offering, an admonishment that the investor should seek professional advice, and an address and phone number at the Department where the investor can call for information.

214. This letter of explanation should include a statement that no fair, just, and equitable determination has been made with respect to the securities, an admonishment that the investor seek professional advice, and an address and phone number at the Department where the investor can call for information.

215. Compare 17 C.F.R. Section 230.257 (1981) which exempts offerings that have an aggregate offering price not in excess of $100,000 from the requirement of using an offering circular in

offeree waiver should be unanimous and in writing.

The new section 25102(f) exemption, therefore, should be modified to include a mandatory disclosure obligation. This disclosure should contain the information required in Form 1-A of the 1933 Act as well as information on promotional securities and selling expenses. After filing this information with the Department, the issuer should provide this information to the offerees via an offering circular. When the *only* offerees are officers, directors, and controlling persons of the issuer, disclosure is unnecessary and may be waived. The goal of this disclosure requirement is to provide information needed by the offerees to make their own inquiries in lieu of the Department's fairness determinations.

CONCLUSION

A need exists to enhance capital formation of small corporations, through reform of the CSL, without unduly sacrificing investor protection. Under current law, small corporate issuers are afforded several options for conforming a securities issuance to the requirements of the CSL. Open qualification of securities is either unacceptable or unavailable to many small corporate issuers. These issuers can find some relief in the limited offering qualification, but the number of potential offerees in a limited offering is restricted, and the risks of the offering are still regulated. Further, the exemptions from qualification available to small corporate issuers are so limited that many of these issuers must turn to qualification.

The California Legislature has adopted an exemption that will be useful to many small issuers. Securities offerings that would not fall under current exemptions or easily qualify under the CSL may be exempt under the exemption adopted by the legislature. These exempt offerings will not carry the restrictions present under the current exemptions or the qualification requirements. Removal of departmental restrictions on the terms of an offering gives the offeror and offerees more freedom to negotiate. This exemption, however, lacks sufficient safeguards for investor protection. There is no assurance that offerees will be furnished the information needed to conduct the type of inquiries that the Department makes in determining whether a securities offering is fair, just, and equitable. Sophistication alone does not guarantee the offeree access to information. While preexisting personal or business relationships may allow investors to gain insight into the

connection with Regulation A filings. Provision for waiver of the disclosure requirement based on dollar amount is rejected under this proposal. The dollar amount of the offering alone bears no rational relation to the need for material information concerning a securities investment.

offeror's character, a relative, friend, or business associate will not likely demand or be given access to material facts surrounding the offering.

This comment has proposed that the exemption adopted by the legislature contain an information disclosure obligation. By exempting a security from qualification and substituting disclosure for departmental inquiry, the offerees are provided a basis for negotiation. Receipt of material information by the offerees affords them the opportunity to make intelligent investment decisions through substitution of their inquiries into the issuance for those of the Department.

The new exemption should be modified to include a mandatory disclosure obligation. This disclosure should contain the information required in Form 1-A of the 1933 Act as well as information on promotional securities and selling expenses. After filing this information with the Department, the issuer should provide this information to the offerees via an offering circular. When the *only* offerees are officers, directors, and controlling persons of the issuer, disclosure is unnecessary and may be waived. Removal of regulation of the risks associated with a securities investment enhances capital formation by allowing entrepreneurs the freedom to structure the terms of outside financing. Disclosure to investors is needed, however, for an informed assessment of the risks those investors are willing to accept.

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