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March 30, 2016

Via Email Only to
assemblymember.Dababneh@assembly.ca.gov

Honorable Assembly Member Matthew Dababneh
Chair
Assembly Committee on Banking and Finance
1020 N Street
Suite 360B
Sacramento, California 95814

Re: AB 2178 (Chiu) - OPPOSITION AND CONCERNS

Dear Assembly Member Dababneh:

The Public Investors Arbitration Bar Association (PIABA) is a national association of more than 400 attorneys who represent victims of investment frauds and stockbroker and financial planner misconduct in securities industry arbitration forums and the courts. On a daily basis in our practices, we see devastating losses resulting from violations of investor protection laws and regulations that govern the securities industry and issuers of securities. Disproportionately, those losses fall on elderly and vulnerable savers and investors. We believe that further deregulation of securities offerings would be a predictably devastating mistake.

AB 2178 is the latest in a series of bills that, in the name of making capital formation easier, would endanger seniors and other savers and investors by weakening longstanding investor protections. SB 875, AB 2081, AB 783, AB 2096 and AB 722 all have been stopped sort of passage since 2010.[1] The first three took the form of proposed exemptions. AB 2096 started out that way as well, only to be converted into a bill that would have allowed offerings that had undergone no regulatory review whatsoever to pretend that they had and masquerade as having been "qualified by notification" – a type of qualification that always has been reserved exclusively for Securities Exchange Act publicly-traded companies and for investment companies (generally, mutual funds) regulated under the Investment Companies Act of 1940. Such a result would have been unfair to investors, unfair to competitors whose securities actually deserved to be deemed "qualified," and unfair to the capital markets themselves. It is a good thing that the five predecessor bills did not become law.

[1] Note that the last three of those were defeated ***after*** the enactment of the JOBS Act, which was signed into law on April 5, 2012.

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AB 2178 takes an approach similar to that in AB 722, proposing to allow small offerings to be qualified under a new and easier permit process. It is a process that, as with the predecessor bills, runs the serious risk of exposing a trusting public – trusting because it has the right to expect that a permit from the Department of Business Oversight (DBO) is an indication of having undergone meaningful regulatory scrutiny – to securities that may have received no vetting but look as though they had and ***can be advertised*** as though they had.

The DBO's review under AB 2178 will be more limited and may be nonexistent. For example, under AB 2178, if the DBO has not acted on an application within 60 days, the permit will be issued automatically. It is analogous to enacting a rule that if a person took medical board exams and the examining board did not grade the exams within 60 days, the applicant would become an M.D. automatically, whether or not he or she actually had passed the exams.

There are multiple ways in which such permits-by-default could happen. The most obvious is that if there is a flood of applications, it simply might not be possible for DBO to investigate and process them all within 60 days. The result would be that securities that had received not a glance from a regulator tasked with protecting the investing public could be advertised as though they had, the implication being that they had been examined and determined to be fair, just and equitable to the investors – the standard for issuing a permit.

Even in times of normal levels of applications, the DBO could be busy enough or short enough on personnel to be unable to do all necessary vetting of an application within the allotted time. Studying a proposed securities offering and determining whether it is fair, just and equitable to investors is not a perfunctory task. So even in times of lower application levels, offerings that had received no review could receive a permit by default and be sold as though they had received meaningful vetting.

Either way, if DBO cannot review an issuer's application within 60 days, the offering will be worse than exempt. It will be as un-vetted as if it were exempt but it will be marketed as though it had been qualified by permit.

And for those applications that are reviewed by DBO, what assurance do we have that review of an offering seeking qualification under Corporations Code section 25113.1 will be subjected the same level of scrutiny as an offering qualified under section 25113?

The Human Cost of Reducing Protection of Seniors' Savings

PIABA understands that businesses sometimes need additional capital. Our concerns are the people who are the sources of that capital and the methods by which they are approached. The concerns are greater when the target population, by virtue of age, cannot reasonably expect to recoup losses and when those most likely to say "yes" to an investment "opportunity" lack the investment acumen necessary to evaluate the offerings.

The enterprises that raise capital under the proposed statute will likely fit one of two molds:

(1) small or start-up companies that may be making good faith attempts at building new, growing enterprises but which are too risky for traditional capital sources to be willing to invest in them; and

(2) companies whose key personnel believe that the real money is made by putting investment deals together, not by putting years of hard work into growing a business after the capital is raised. The economics of capital formation – the reality that the quick money is made in the capital formation itself, not in the steady growing of a business – make it likely that large sums of money raised as a result of the legislative changes in AB 2178 will be in this latter category.

Finding capital for the risky but possibly promising businesses that make up the first group might seem a laudable goal. But one should question whether business should be permitted to find capital for ventures that are too risky for traditional funding sources by targeting the life savings of senior citizens and retirees who cannot replace the savings they lose and from other unsophisticated savers and investors who might lose 10% of their net worth multiplied by some unknown number of risky investments. Shouldn't the startups' funding come from investors who understand risk capital investments and want to be involved rather than inexperienced individuals who respond to an enticing advertisement?

The second group will consist largely of repeat purveyors of cookie-cutter investment programs with no societal value. There simply is no justification for exposing California's seniors, retirees or anyone else to their sales efforts.

Yet the bill, as drafted, applies equally to both categories of issuers of securities. The dangers of that are obvious. All but the most sophisticated and experienced savers and investors are vulnerable to promises of higher returns with safety. Promoters know this, so they promise higher returns and safety and make confident predictions about the future. PIABA members see this every day in our practices.

All too often, the victims of those misrepresentations and risky deals are elderly retirees. The reason? They're disproportionately the ones with money. Their homes have had longer to appreciate, their retirement plans have had longer to grow, they may have received life insurance proceeds from the loss of a spouse. They are particularly vulnerable to promises of higher returns because returns on fixed-income investments such as bonds and certificates of deposit are at historic lows. So they risk their principle to get a few extra dollars of promised return, only to find that they have lost savings they never will have any way to replace.

All of this is compounded by the reality that many seniors are more trusting than they should be, and often are particularly vulnerable to sales people who are friendly and attentive and sound knowledgeable. And sadly, many do not have the energy or alertness they once had. Combine all of these factors and you have a recipe for a nearly limitless number of personal financial disasters. Retirees whose savings would have been sufficient to see them through the rest of their lives suddenly cannot afford to stay in their homes because their Social Security checks, now their sole source of income, simply won't cover all the bills. Worse, they may require other forms of public assistance, including MediCal – or may require it far sooner than would have been the case otherwise.

And why is this even being considered? The sponsors promise job creation. The theory is that the small businesses whose prospects are not promising enough to attract risk capital from traditional sources will raise money from people who respond to advertisements and invest in the companies, and that the companies will create jobs. But note that **nothing in the bill requires the companies raising the money (called "issuers") to use the money in a way that creates jobs anywhere, let alone in California.** There is nothing

to prevent the promoters behind the issuers from setting up a series of cookie-cutter entities to raise money for tax shelter programs or other programs that have no social utility and instead simply move assets around and benefit primarily the promoters at the expense of seniors and the rest of the saving and investing public.

The promise of job creation has great appeal in the best of times. When unemployment rates are high, it has all the more. The irony is that the bill that would enable issuers and promoters of securities to sell investments by making false promises to savers and investors is being sold to the legislature by making unsupported statements about job creation. Any tie-in between AB 2178 and the creation of real jobs in California is itself speculation.

Inadequacy of Remedies

The bill's $5,000-per-issuer limit for investors who are not accredited is not much comfort. Exposing people of lesser means to losses of $5,000 times as many different speculative investments as they can be talked into buying is fundamentally unfair. And people of greater means are likely to be tapped multiple times – or, once the contact is made, to be steered by the sales people into programs that are not subject to the same limitations. ***Indeed, a key consequence of this bill may be that the advertising it permits will be used to establish small investment relationships with investors, mostly elderly, who then can be steered into unadvertised private placements that have no limit on the amount invested.***

Further, for the reasons discussed below, violations of the bill's meager limits on sales of speculative securities are likely to occur on a broad scale because the only viable remedial mechanism – private litigation – is not practical on the scale that many of these investments are likely to take.

Aggressive advertising is very effective when directed at non-professional investors, who will be the vast majority of offerees under the proposed section. The initial sales pitch drives the yes-or-no decision regarding an investment. An advertisement that makes promises is likely to be relied upon, even though the inches-thick, already-filled-out official documents in the stack of paper that the investor is required to sign will disclaim the representations made in the ads or by the salespeople.

In the current market especially, with interest rates on savings at all-time lows, large numbers of seniors and retirees are especially vulnerable to promises of higher returns. The money they lose is, in many cases, unrecoverable. They suffer not just financially but emotionally and physically as well when they lose the nest-egg that they have accumulated over a lifetime. To be put at that kind of risk so that their capital can be made available for ventures too risky to merit bank or traditional venture capital financing is inappropriate. To allow their savings to be lost in cookie-cutter deals devoid of social value is worse still.

PIABA believes that money lost by investors in these deals as a result of wrongdoing is likely never to be recovered. First, there is a collectability issue. By the time bilked savers or investors sue, and certainly by the time they obtain a judgment or award, there often is no defendant with funds to pay it. Second, even when the funds might exist, securities litigation is so expensive that it may be impossible or impractical to pursue the matter. Much of this is due to the high cost of expert witnesses in these cases. Thus, for example, a $150,000 loss, which might be devastatingly large to the senior who has suffered it, might well be too small to pursue due to the high cost of securities litigation, especially when combined with the collectability risk. A series of $5,000 losses presents an even more daunting prospect. Third, the promoters are very likely to include

forced arbitration clauses in the subscription documents and thereby make pursuing a remedy both unaffordable and all the more unlikely to yield a recovery for the investor.

Sadly, PIABA's members have seen this scenario play out far too many times. The likely futility of attempts to remedy these losses after they occur makes it imperative that laws designed to prevent the losses be allowed to operate in their current form, unimpaired by this proposed rollback in investor protection. This is an area where prevention is by far the best medicine, where the law must be proactive rather than reactive.

PIABA believes that the broad and pervasive advertising that will be brought about by AB 2178 will invite large-scale losses, with seniors vastly overrepresented among those harmed. Allowing that to happen is wrong. So is telling California savers that securities that may have received no regulatory oversight whatsoever are "qualified."

A Non-Exhaustive Discussion of Other Problems with AB 2178

Nothing Requires Funds Raised to Be Used to Create Jobs in California. Nothing in the statute requires funds raised to be used to create jobs anywhere, let alone in California. A startup desiring to hire programmers in India or China to service European customers could raise money from California investors under this bill – a far cry from the sponsors' promises of job creation. And even within California, nothing in the bill would prevent the bill from being used to fund endless strings of cookie-cutter asset-acquisition investment programs that are great for the sponsors but terrible for investors. In fact, the entity raising the money does not even have to be a California corporation.

No Limit on Number of Investments. The bill limits the investment in any one program but does not limit the number of programs in which an investor may invest. Thus, even with the limit that the bill imposes, an investor who was latched onto by a salesperson with multiple deals to peddle could be wiped out in short order.

No Suitability Standards. Despite any claims that may appear in promotional materials about suitability requirements, what would constitute "suitability" is not defined in the bill.

No Effective Limit on Amounts Raised. The $1,000,000 limit in a 12-month period may be less effective than one might think because it is a limit ***per issuer***. There is nothing in the bill to prevent promoters from getting around that limit by setting up multiple corporations to act as issuers/applicants.

Direct Advertising Rather Than Investment Portals. The JOBS Act provides for investment portals to be the sole provider of marketing of securities offerings under the JOBS Act. That provides a measure of uniformity because a few portals will be controlling the advertising communications. It can be expected to provide some measure of caution as well, because the portals will have assets to lose and will receive five to ten percent of the amount raised rather than the entire amount. This bill, in contrast, allows direct advertising by issuers of securities. Issuers can be expected to be far more aggressive in their advertising, both because they have less to lose and more to gain, and because it is in the nature of entrepreneurs to be enthusiastic about their prospects. Overly aggressive advertising and solicitation can be expected to lead to significant losses for investors. Investments in startups are extremely risky, and conservatism in marketing them is appropriate.

Sales by Securities Law Violators – Proposed Corp. C. Section 25113.1(b)(2)(B). The bill would allow money to be raised by companies that already have raised money in violation of the federal Securities Act of 1933. In other words, a federal securities law violation would not disqualify an issuer from using the bill to raise money from California investors.

Non-Integration Provision – Proposed Corp. C. 25113.1(b)(2)(C). The bill contains a provision that prevents offers under the proposed rule from being integrated with a long list of other kinds of offerings. ***That suggests that offerings under the proposed rule may turn out to be one small part of a larger collection of offerings and, by virtue of that, to facilitate advertisements of small-increment investments as a way of establishing pre-existing investment relationships with investors who then can be tapped for much larger – and potentially financially devastating – sums in private placement offerings that have no investment ceiling.***

And at a minimum, a non-integration provision is dangerous because it can effectively invalidate limitations on amounts raised.

The Real Investment Limit – Proposed Corp. C. 25113.1(b)(2)(D). The bill's limitation on investment amounts to the lesser of $5,000 or ten percent of the investor's net worth has a tag line: "or such amount as the commissioner may provide by rule or order." So the limit could rise substantially in the future. Thus, the investment limits currently in the bill, if they give any comfort at all, should be viewed as temporary.

Inadequate Fees for the Review Required – Corp. C. Section 25608(e). The fee for an offering under the bill would be $200 plus 0.4% of the offering amount. That means that a $500,000 offering would require a $2,200 fee – hardly enough for attorneys and others to perform a thorough vetting of the offering, particularly given the risky nature of the issuers for which the bill is designed.

Allowing Offers to be Made Before Any Review Whatsoever – Corp. C. Sections 25102(b) and 25104(g). The bill contains two so-called "testing the waters" provisions that allow offers ("but not sales") to be made before a permit is received. The first and most obvious problem with this is that once investors have made a decision to buy, subsequent changes to the deal – such as additional disclosures that might be required by the DBO – are unlikely to cause them to change their minds. ***This, in turn, creates an incentive for promoters to make the initial "testing the water" disclosures inadequate.*** The second problem is that "testing the waters" offers generally are associated with issuers that have filed registration statements or Regulation A offering statements and are inappropriate for offerings that might simply get a permit by default if the DBO lacks the staff or resources to vet them within 60 days.

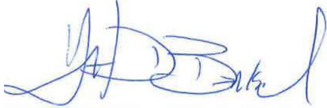
Allowing Sales Designed to Cash Out the Promoters – Corp. C. Section 25104(g). One of the two "testing the waters" provisions takes the form of an exemption in Corporations Code section 25104, the code section that exempts offers and sales of securities in ***non-issuer*** transactions. Those are transactions in which individuals who already own a company's shares are selling them. If the sponsors thought to include a "testing-the-waters" exemption in not just section 25102 (exemptions for issuer transactions) but in section 25104 as well, it must be because they contemplate investors' money being used to cash out existing insiders. Such an "investment" does not go into the company's coffers and, almost by definition, cannot increase employment.

Similarity to Corporations Code Section 25113 (b)(2). The bill is similar in many respects to a qualification provision that already exists. If the bill will not weaken substantially the investor protections inherent in offerings under section 25113(b)(2), we are forced to wonder what difference it will make in the availability of capital to businesses. In other words, we wonder why anyone would use it and whether there is any benefit to offset the cost of writing and adopting regulations for its use. Conversely, if the bill will weaken investor protections substantially, it should not be enacted for that reason. Either way, there seems to be either no reason to enact the bill or a strong reason not to enact it.

We as a people have a long history of learning and relearning the harsh lessons of the past. We have been battered mercilessly in the last eight years for forgetting repeated lessons about the dangers financial industry deregulation, including the lessons of the 1920s and 1930s. We must resist continuing efforts at further deregulation of financial and securities markets. We should remember and move back toward the regulatory environment that, for the approximately six decades that ended in the mid-1990s, imbued U.S. capital markets with a level of honesty and transparency that made them the envy of the world. And closer to home, we should maintain for California's savers and investors, and for seniors and retirees in particular, the level of protection that currently exists.

Thank you for your consideration of our concerns about AB 2178.

Sincerely,



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