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June 11, 2014

Via Email Only
assemblymember.muratsuchi@assembly.ca.gov

Honorable Assembly Member Al Muratsuchi
State Capitol
P.O. Box 942849
Sacramento, California 94249-0007

Re: **AB 2096 (Muratsuchi) as Amended April 9 and 24 and June 9, 2014 OPPOSITION AND CONCERNS**

Dear Assembly Member Muratsuchi:

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.

PIABA believes that allowing general solicitation and general advertising of securities offerings that have not undergone meaningful regulatory scrutiny diminishes investor protection and likely will lead to enormous losses for California's most vulnerable savers and investors. Anyone proposing such a radical change in nearly century-old investor protections should be required to prove that it will not cause the harms that appear inevitable in this situation.

In the Beginning – Another Exemption Bill

AB 2096 began its life as a proposed exemption very much like the bills that were defeated in 2000, 2010, 2012 and 2013.[1] It was an exemption that would have allowed offerings that were exempt from federal securities registration under SEC Rule 504 to sell securities by way of "general solicitation and advertising" – the very kind of advertising that is forbidden by Rule 504.

The dangers of that ought to be obvious. All but the most sophisticated and experienced savers and investors are vulnerable to promises of higher returns with safety.

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

Promoters know this and they promise – no surprise here – higher returns and safety. 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 promise of jobs. The sponsors' pitch 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 what will be inadequately supervised advertisements – or who simply pick up the phone and talk to a cold caller – and invest in the companies, and that some of 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 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, so much so that the underlying pitch might not receive the strict scrutiny it deserves. The irony is that the bill that 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 2096 and the creation of real jobs in California is pure speculation.

The Switch – Now It's a "Qualification" Bill

In April, AB 2096 was amended. It now is no longer an exemption bill. Now it's a "qualification" bill. Now, the securities offered under the statute as modified by the bill will be deemed to have been "qualified by notification." Under longstanding California law, the ONLY securities deemed worthy of qualifying by notification were securities of federal Securities Exchange Act of 1934 reporting companies (i.e., large, public

companies) and "investment companies" (generally mutual funds and the like) subject to strict federal regulation under the Investment Companies Act of 1940. If AB 2096 passes, securities of start-ups or cookie-cutter investment programs will be able to be sold as "qualified by notification," just like the large publicly-held companies that for decades have worn that label legitimately. It is not fair to trick California's saving and investing public with such a radical and illogical change.

A bit of legal background is necessary here. When advertised offerings of securities are going to take place at the federal level, they go through intensive scrutiny in a process known as "registration." Many states have a "registration" process as well. These processes are designed to assure that the required written disclosures about the securities and adequate and accurate.

In California and a number of other states, the process is called "qualification" rather than "registration." The purpose of the qualification process is to assure that the offering is fair, just and equitable to the participants, particularly the investors. These are, after all, investor protection laws that were enacted after the public learned the punishing lessons of what happens when capital formation activities are not adequately regulated.

As a practical matter, the difference between registration and qualification is more theoretical than actual. Either way, investors know that a registered or qualified offering has received substantial scrutiny from regulators who are knowledgeable about the pitfalls of investment programs and can require promoters to structure things in a way that makes failures and catastrophic losses less likely. California's qualification rules, for example, place limits on excessive compensation for program promoters. An investment program that puts too much of the investors' money in the promoters' pockets in the myriad of forms that can take – sales compensation, acquisition fees, development fees, management fees and many others – can leave so little capital available for the purported purpose of the investment that the program is doomed from the start. Not surprisingly, most or all of the harm from that failure falls on the investors. The promoters already have been compensated.

The qualification described above is qualification by permit. Qualification also can be done by "notification" in those rare instances where another regulatory body is doing the job so thoroughly and adequately that there is no meaningful need for California to insert itself into the process. As discussed at the beginning of this section, the only two examples of that sufficient outside scrutiny are 1934 Act reporting companies (*i.e.*, large publicly-traded companies) and 1940 Act investment companies like mutual funds. Both kinds of companies are subject to thoroughgoing federal regulation by the Securities and Exchange Commission. Allowing securities that have received zero regulatory oversight to masquerade as a member of that exclusive club is inherently misleading – a sucker punch that will leave many savers, particularly elderly retires, with losses they simply cannot sustain. It would be irresponsible to allow that to happen under any circumstances, and all the more so when there is nothing in the bill to suggest that the promised jobs will even materialize.

The June 9 Amendment Does Not Solve the "Qualification" Problem

The sponsors have agreed to an amendment that would require the following words

to be placed on the front of the disclosure document:

> The Commissioner of Business Oversight has in no way passed upon the merits or qualifications of, or recommended or given approval to, any person, security, or transaction associated with this offering.

The problem is that savers who find out that it's a "qualified" offering will think one of two things: (1) sophisticated investors will believe that the offering has been qualified with the Commissioner of Business Oversight, with all of the comfort that provides regarding the regulatory scrutiny the offering has passed; and (2) everyone else will think that "qualified" means good because it sounds positive and certainly sounds better than "unqualified."

Assuming someone in the very small first group even reads the disclaimer on the front of the offering document, he or she will be likely to disregard it as boilerplate because it's well known that "qualified" means that the offering has received meaningful scrutiny. And feeling that way would be somewhat justified. For years, many if not nearly all prospectuses have had the following legend emblazoned prominently on the cover:

> **THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.**

When that tiny minority of investors who truly are sophisticated about investing sees those words on a prospectus for an offering that is registered with the SEC, they are correct in not being dissuaded from believing that the offering has undergone the scrutiny that is required for an offering to be registered under federal law. When they see the legend that the sponsors of AB 2096 added to the bill on June 9, they will think the same thing: the offering really is qualified because it says it's qualified. And you can rest assured that a large percentage of promoters and salespeople who are trying to sell the securities will do nothing to disabuse those investors of that misunderstanding – if they even understand the issue themselves. They're selling, so from their perspective, the rule is the more positive, the better.

As for the people in the second group – that large majority who don't have any idea about the regulatory significance of the word "qualified" and just get a positive feeling about it – to them, the words will be meaningless. Most could not even explain from actual knowledge what the Department of Business Oversight is or does.

Call it What You Will, It's Still an Exemption Bill

The sponsors may call this a "qualification" bill or a "qualification-by-notification" bill, but in reality it still is an exemption bill. If the bill becomes law, the securities sold to Californians pursuant to the permissions that California will be granting under the statute will not have to undergo the regulatory oversight that always has been required for securities to be called "qualified." In any reasonable use of the English language, that means that they are **exempt** from the compliance that otherwise would be required.

Further Discussion and Background

This section begins with a more detailed discussion of the impact of the April and June changes to AB 2096. We will follow that with a discussion of the obvious and predictable impact of opening up this new route to retirees' and others' savings through cold calling and general solicitation and advertising, regardless of whether the bill calls itself an exemption or purports to be a method of "qualification."

AB 2096 as Amended:
The Impact of "Qualification" Versus Exemption

As discussed above, the April 2014 amendments to AB 2096 change the bill so that instead of creating a new exemption from qualification of securities, it will create a new route to having those same securities – with the same absence of regulatory scrutiny – deemed to have been "qualified" by the California Department of Business Oversight. So, in terms of its practical effect, the amendment has changed nothing. Promoters of those securities still will be able to engage in general solicitation and general advertising of their offerings, which will not have been subjected to any regulatory scrutiny to assure that the disclosures are adequate or that the offering is fair to investors.

Why do we say that the securities will not be subjected to any regulatory scrutiny? Here is how Corporations Code section 25112, the bill's proposed qualification-by-notification provision, will read if AB 2096 passes:

> 25112. (a) (1) Any security issued by a person which is the issuer of any security registered under Section 12 of the Securities Exchange Act of 1934 or issued by an investment company registered under the Investment Company Act of 1940, and which is not eligible for qualification under Section 25111, may be qualified by notification under this section.
>
> (2) Any offer or sale of any security that meets all of the following criteria may be qualified by notification under this section:
>
> . . .
>
> > (C) The offering meets the requirements of the federal exemption for limited offerings and sales of securities not exceeding one million dollars ($1,000,000) in Section 230.504 of Title 17 of the Code of Federal Regulations.
>
> . . .

That's it. There is a lot more detail in the description of the requirements for this proposed new way to "qualify by notification," but items (1) and (2) will be the only two ways to do that. And the difference between (1) and (2) couldn't be more stark. Currently and for a long time, the ***only*** way to qualify by notification has been in connection with an offering that already has been subjected to extensive federal registration – a company subject to the detailed reporting requirements of the Securities Exchange Act of 1934 or to

the extensive regulatory framework of the Investment Companies Act of 1940. "Qualification by notification" always has meant that the securities don't need California oversight because of the extensive federal oversight to which they already have been and are being subjected.

Now, if AB 2096 passes, "qualification by notification" will mean something very different: securities that have not received any federal scrutiny or oversight whatsoever and have not received any of the state scrutiny and oversight that the word "qualification" has meant for at least the 45 years since the California Corporate Securities Law was enacted. (California, a merit review state rather than a full-disclosure state, uses the word "qualification" (meaning that the offering has been determined to be fair, just and equitable to all participants) instead of the term "registration," which is used in the federal securities laws and in states that have adopted the Uniform Securities Act, among others.)

So ironically, the April amendments actually make the proposed legislation more dangerous to savers and investors than it already was. Now, the people selling securities to seniors and others will be able to call this a "qualified" offering rather than an exempt one. The word alone conveys a very favorable misimpression. To believe that people selling securities under the new provision will not take advantage of that misimpression is unrealistic. Their goal is to sell.

Thus, everything that PIABA said in its recent opposition to the pre-amendment version of AB 2096 still applies. And the bill is more dangerous now because of the comforting and retiree-lulling implications of the word "qualification."

**AB 2096 in Either Form:
The Human Cost of Reducing Protection of Seniors' Savings**

Our nation learned harsh lessons from the late 1920s through the 1930s about the dangers of inadequately regulated securities markets and capital formation activities. The lessons were so harsh and lasting that it was not until nearly 70 years later, in the mid- to late 1990s, that the nation began dismantling the federal regulatory framework that for most of a century had preserved the stability and transparency of those markets. The increasingly violent gyrations in the markets and increasingly large and shocking scandals, culminating in the 2008 meltdown and the years of misery that have followed, should not have surprised anyone, certainly not anyone familiar with our history or the history of capital markets generally. But what is a surprise is the speed with which those more recent lessons have been forgotten. Here we are, not six years after the calamity that was 2008, talking about deregulation again.

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 the steady growing of a business – make it likely that the large majority of money raised as a result of the legislative changes in AB 2096 will be in this latter category.

Finding capital for the risky but potentially 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.

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 exemption, as drafted, applies equally to both categories of issuers of securities. Gone would be the experienced oversight necessary to prevent predictable financial disasters and assure basic fairness to investors. It is critical that the types of offerings contemplated by this bill be qualified – truly qualified under the longstanding meaning of that term, not just labeled as though they were – with the Commissioner of Business Oversight to ensure that what is being advertised is in fact what is delivered to investors. Substituting advertising and solicitation for the Commissioner's oversight would be a mistake from which countless seniors will suffer irreparable harm. The State agencies that provide those individuals' safety net inevitably will lose as well.

By deeming offerings under the new de facto exemption to be "qualified," AB 2096 will bring about a dramatic broadening of the kind of advertising permitted. If AB 2096 passes, general solicitation and general advertising suddenly will be possible for securities that have received no regulatory oversight. Similarly, savers and investors – especially seniors – will receive cold calls on their home and cell phones.

The kind of general solicitation and general advertising that will take place if AB 2096 is enacted is the very kind of advertising that is *prohibited* in offerings that are exempt under SEC Regulation D. Proposed § 25112(2)(C) applies if

> The offering meets the requirements of the federal exemption for limited offerings and sales of securities not exceeding one million dollars ($1,000,000) in Section 230.504 of Title 17 of the Code of Federal Regulations.

"Section 230.504" refers to an offering that is exempt from federal securities registration under SEC Rule 504. But a real Rule 504 offering would have to ***refrain from general solicitation or general advertising*** as required by Rule 502(c).[2]

So the proposed statute takes a federal exemption that prohibits general solicitation and advertising and twists it into a "qualification" provision that allows that exact kind of advertising. In other words, the proposed exemption permits the very forms of solicitation and advertising that are forbidden by the SEC rule it cross-references. The permission for general solicitation and general advertising in AB 2096 represents a dramatic rollback in the longstanding protection of California's savers and investors.

The kind of advertising that will be used if AB 2096 passes will put large numbers of Main Street savers and investors at risk, whether they are accredited investors or not. But accredited investors will be at the greatest risk, because the limits on the amount invested will not apply to them.

And being an "accredited investor" is by no means any kind of protection against fraud and wrongdoing. There is no test or experience bar that one must pass to be labeled "accredited." Rather, one's status as an "accredited investor" is based primarily on an outdated computation of net worth. It offers no guarantee or even likelihood of investment sophistication or the ability to evaluate risky but legitimate startup ventures, let alone the

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[2] Rule 504 offerings must comply with SEC Rule 502(c), which states:

> (c) *Limitation on manner of offering*. Except as provided in §230.504(b)(1) or §230.506(c), **neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising,** including, but not limited to, the following:
>
> (1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and
>
> (2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising; *Provided, however,* that publication by an issuer of a notice in accordance with §230.135c or filing with the Commission by an issuer of a notice of sales on Form D (17 CFR 239.500) in which the issuer has made a good faith and reasonable attempt to comply with the requirements of such form, shall not be deemed to constitute general solicitation or general advertising for purposes of this section; *Provided further,* that, if the requirements of §230.135e are satisfied, providing any journalist with access to press conferences held outside of the United States, to meetings with issuer or selling security holder representatives conducted outside of the United States, or to written press-related materials released outside the United States, at or in which a present or proposed offering of securities is discussed, will not be deemed to constitute general solicitation or general advertising for purposes of this section.

[Emphasis Supplied.]

profusion of highly speculative, cookie-cutter capital-raising programs that will spring up to take advantage of the new exemption.

Because it indicates far less about investment acumen than it does about assets, accredited investor status correlates best with age. Elderly retirees make up a disproportionately large percentage of people who meet the definition of accredited investors simply because their property has had longer to appreciate; their savings have had longer to accumulate; they have taken rollovers or lump-sum payouts of pension assets that they have accumulated through decades of hard work; and, sadly, many are widowed and hold the proceeds of their spouses' life insurance policies. The funds they lose cannot be replaced. They have neither the time nor the employment prospects to recoup their losses.

The prior version of this bill limited the amount of an investment to 10% of the saver's or investor's net worth. That was bad enough. For those who depend on their savings as their primary source of income, losing a tenth of everything they have is devastating. ***But the current version of the bill imposes no such limit.*** If it passes, there will be no limit whatsoever on how much of a speculative security can be sold to an "accredited investor." Exposing "accredited investors," many of them seniors and retirees, to unlimited losses in speculative programs is simply unacceptable. And the bill's $5,000-per-issuer limit for investors who are not accredited is not much comfort either. Exposing people of lesser means to losses of $5,000 times as many different speculative investments as they can be talked into buying is unacceptable as well.

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 exemption. 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, 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.

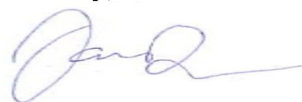
Sadly, PIABA's members have seen this scenario play out far too many times. The likely futility of attempts to remedy these losses after they occur makes it imperative that laws designed to prevent the losses be allowed to operate in their current form, unimpaired by this radical proposed rollback in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

PIABA believes that the broad and pervasive advertising that will be brought about by AB 2096 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 have received no regulatory oversight whatsoever are "qualified."

We as a people have a long history of learning and relearning the harsh lessons of the past. We have been battered mercilessly this time around 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 2096.

Sincerely,



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