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Preston DuFauchard
Commissioner of Corporations
Department of Corporations
1515 K. Street, Suite 200
Sacramento, CA 95814-4052

Re: Broker Dealer Issue Created By Recent Case:
People v. Cole, 156 Cal App. 4th 452 (4th Dist. 2007); Review denied
2008 Cal. LEXIS 936 (January 23, 2008)

Dear Commissioner DuFauchard:

This letter is in keeping with the spirit of the "Speedbumps" program in which you participated last Summer at the ABA meeting. You will recall that one of the concerns I expressed had to do with the complicated broker-dealer registration, and possible exemption from registration, confusion in California. Recently a case came to my attention that I think creates an incredible risk for all early stage California businesses, as well as businesses in other States which try to raise money in California under a well-understood and widely accepted exemption to the broker-dealer registration requirements in the California Corporate Securities Law.

According to the opinion in the *Cole* case referenced above, an officer, founder, director or employee of an entity who participates in the sale of the entity's securities, and does not receive commissions or special compensation based upon sales of the securities, is a broker-dealer as defined in Section 25004, and is in criminal violation of the law if he or she is not registered as such under Section 25210. <u>Thus, any person who, as a regular part of his or her employment or other duties to an entity, assists in the sale of its securities without the assistance of a licensed broker-dealer, is a criminal and could face time in prison along with major fines.</u>

The *Cole* case concerned some very bad actors who clearly deserve to spend a considerable amount of time behind bars. However, in the Fourth District opinion the problem was created by a literal reading of the law, and it is my personal belief that it is a correct literal reading of the law but totally unintended by the legislature and, I believe, not what the Department of Corporations believes the law to be, or at least what it has always been interpreted to be. The relevant pages are 479 to 481 of the 156 Cal. App. 4th reported opinion. For your convenience I have enclosed those pages with this letter.

The defendants claimed they were not selling securities in violation of licensing requirements because they were engaged in the selling activities on behalf of entities of which

they were founders, officers and directors. Moreover, they were not receiving commissions or other transaction-based compensation in connection with the sales of the securities involved. Thus, they claimed they fit within the exception to the definition of "Agent" in Section 25003(d). Relevant portions of 25003 are:

"(a) "Agent" means any individual, other than a broker-dealer or a partner of a licensed broker-dealer, who represents a broker-dealer or who for compensation represents an issuer in effecting or attempting to effect purchases or sales of securities in this state."

and

"(d) An officer or director of a broker-dealer or issuer, or an individual occupying a similar status of performing similar functions, is an agent only if he otherwise comes within this definition and receives compensation specifically related to purchase or sales of securities."

In order to ensure that our clients who are officer or directors of corporations involved in the sale of securities of the corporation are not violating the broker-dealer licensing laws, we insist that there be no transaction-based compensation. As emphatically pointed out by the *Cole* court, the lack of commissions or other transaction-based consideration means that such persons are <u>not</u> "Agents".

However, the Court did not stop there. It then went on to examine the definition of "Broker-Dealer" in Section 25004. Here the only relevant portions of the Section are:

"(a) "Broker-dealer" means any person engaged in the business of effecting transactions in securities in this state for the account of others or for his own account....."Broker-dealer" does not include any of the following:

....

(2) An agent, when an employee of a broker-dealer or issuer."

Section 25004 does not contain a paragraph similar to Section 25003(d) which would exclude from the definition of broker-dealer an officer or director of an issuer selling the issuer's securities but without receiving commissions or transaction-based compensation in connection with such activity.

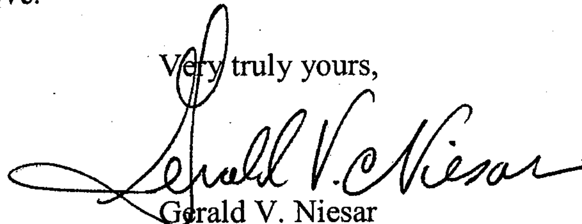
It is well known that virtually every early stage company must raise its capital without the assistance of a licensed broker-dealer. *Therefore, it follows that every officer, director, or other employee of such company who assists in that process is in violation of the licensing requirements of Section 25210. Such violation can subject the person to criminal sanctions as exemplified in the Cole case.* It should further be noted that, with the legislation that went into effect January 1, 2005, specifically Section 25501.5, these persons are unwittingly made "guarantors" of the success of the investment, no matter how complete and accurate the offering materials, and that an argument may be made that the purchaser also has a rescission right against the issuer.

It is submitted that this literal interpretation of the law was not the intent of the legislature when the Corporate Securities Law of 1968 was enacted. Moreover, it is completely at odds with what every business attorney in the State has believed the law to be, and I believe it is not what the attorneys in the Department of Corporations have understood to be the law these many years. Indeed, if this were to be an accurate statement of the law in California, it is a foregone conclusion that formation of new companies in this State, so fundamentally important to our economy, would come to a screeching halt.

Under the circumstances, I would hope that the Department would consider issuing an emergency rule adopting an exemption from the broker-dealer licensing requirements for any person who would fit the definition of broker-dealer but whose activities are limited to those of effecting sales of securities for an issuer of which he or she is an officer, director or person occupying a similar status or performing similar functions, but receives no compensation specifically related to purchases or sales of securities. Further, I would hope that you would spearhead an effort to ensure corrective legislation is adopted as quickly as possible so that innocent persons are not swept up in a net that was not intended to be used for that purpose.

I would be happy to assist in any way in furthering this matter to a resolution consistent with the expectations of businesses and the legal community in California. With his permission I have copied Lee Petillon on this letter. Lee, as you will recall, is also very interested in broker-dealer issues in California and nationally, and he has authorized me to confirm his agreement with the views expressed above.

Very truly yours,



Gerald V. Niesar

Cc: Lee Petillon, Esq.

properly instructed on the definition of a security, and determined the investments were securities. All that is required under section 25210 is that Cole and Robles intentionally committed the proscribed act—selling securities without a broker-dealer's license. Assuming arguendo that at the time Cole and Robles sold investments in Carlmont Capital and/or Alpha Telcom they had no license and did not know the investment they were selling was a security, all the elements of the crime would have been satisfied nonetheless.

To the extent the appellants are arguing that at the time they sold Carlmont Capital and/or Alpha Telcom there had been no legal determination the notes were securities, the argument fails. The licensure requirement of section 25210 is designed to protect the unsophisticated investing public from unscrupulous and incompetent broker-dealers; among other things, to become a licensed broker-dealer, one must qualify by examination and meet financial responsibility requirements. It would be antithetical to the protective purpose of section 25210 if the statute came into play only when there has been a legal determination that an investment is a security. If that were the case, there would be no protection for investors whose investments predated the legal determination by effectively giving nonlicensed broker-dealers immunity for their illegal conduct (selling securities without a license).[26]

2) *Violations of section 25210 involving Pathway entities, Investment Revolution Services and Faith Holdings*

With respect to the investments they solicited in Pathway Strategies, Investment Revolution Services and/or Faith Holdings, Cole and Robles contend the prosecution failed to prove that they were broker-dealers and therefore needed to be licensed under section 25210.[27]

The basis of Cole and Robles's argument is that they were not acting as broker-dealers when they sold promissory notes issued by their own corporate entities because in those transactions they did not fall within, or were excluded from, the statutory definitions of broker-dealer. If one is not a broker-dealer, their argument continues, he or she does not violate section 25210 by not having a broker-dealer's license. We agree section 25210 is not violated if the defendant is not a broker-dealer as defined by section 25004, or fits within one of the enumerated exclusions. But their argument fails as they have misinterpreted the relevant statutes.

[26] Appellants' reliance on language in section 25540 that requires knowledge for violations of a DOC rule or order is misplaced. Cole and Robles were prosecuted for selling securities without a broker-dealer's license in violation of section 25210—not for violating a DOC rule or order.

[27] Neither Cole nor Robles dispute that these investments were security transactions.

Both Cole and Robles met the statutory definition of broker-dealer and did not fall within any exclusions to the definition of broker-dealer. " 'Broker-dealer' means any person engaged in the business of effecting transactions in securities in this state for the account of others or for his own account." (§ 25004, subd. (a).) It excludes the issuer of the security and an agent of the issuer or the broker-dealer.[28]

Cole and Robles admit they met the definition of a broker-dealer and acknowledge they were not the issuers of the Pathway Strategies, Investment Revolution Strategies and Faith Holdings promissory notes they sold; rather, the corporate entities were the issuers. Instead, Cole and Robles argue they were not broker-dealers because they fall within the following exclusionary language of the statute: " 'Broker-dealer' does not include . . . . [¶] . . . [¶] (2) An agent, when an employee of a broker-dealer or issuer." (§ 25004, subd. (a).) The argument fails.

(6) An agent is defined in section 25003 as any person who represents either a broker-dealer or an issuer in effecting or attempting to effect purchases or sales of securities. (§ 25003, subd. (a).) Section 25003 further provides that an officer or director comes within the definition of an agent if he or she receives a commission for the purchase or sale of the securities. (§ 25003, subd. (d).) Cole and Robles were far more than employees of these three corporations; they were corporate officers and/or directors. As such, they could only be agents if they received a commission for the sale of these securities. (§ 25003, subd. (d).) There was no evidence that either Cole or Robles received a commission in connection with the promissory notes they sold in Pathway Strategies, Investment Revolution Strategies or Faith Holdings. As corporate officers/directors who did not receive a sales commission, Cole and Robles were not agents within the meaning of section 25003 and therefore do not fall within the exclusion for agents in the definition of broker-dealer in section 25004. As broker-dealers, Cole and Robles were required to obtain a license to sell securities, and their failure to do so was in violation of section 25210.

(7) Our interpretation of the statutory language is in keeping with the broad scope of the Corporate Securities Law in protecting the public from unscrupulous practices in the sale of securities. " 'The approach of the 1968 California Corporate Securities Law is to sweep all transactions in securities

[28] Section 25004, subdivision (a) provides in pertinent part: " 'Broker-dealer' means any person engaged in the business of effecting transactions in securities in this state for the account of others or for his own account. 'Broker-dealer' also includes a person engaged in the regular business of issuing or guaranteeing options with regard to securities not of his own issue. 'Broker-dealer' does not include any of the following: [¶] (1) Any other issuer. [¶] (2) An agent, when an employee of a broker-dealer or issuer."

within the regulatory net . . . . The 1968 Law then specifically exempts those transactions and securities where regulation is considered unnecessary or too burdensome.' " (*Nationwide Investment Corp. v. California Funeral Service, Inc.* (1974) 40 Cal.App.3d 494, 502 [114 Cal.Rptr. 77], quoting *Nonissuer Transactions Under the California Corporate Securities Law of 1968* (1968) 21 Stan. L.Rev. 152, 157.) The Court of Appeal continued: "We also believe the 1968 act was designed to prevent individuals or others from operating in certain fringe areas of security transactions without a license." (*Nationwide Investment Corp., supra*, at p. 502.)

We reject Cole's convoluted interpretation that officers and/or directors who do not receive sales commissions should be excluded as well. Cole claims there is no logical reason to differentiate between officers and/or directors who receive sales commissions and those who do not. He argues: "The only logical way to read the statutes is to identify section 25004, subdivision (a)(1)'s exemption [exclusion] of 'any other issuer' as extending to officers of corporate issuers when those officers are not receiving commissions." According to Cole, "[t]his makes sense because . . . the officer is not receiving special compensation for selling his corporation's securities, the seller of the securities is in effect the corporation, the issuer, and the issuer does not need a broker-dealer license."

(8) As an appellate court, we must presume the Legislature meant what it said in section 25003, subdivision (d)—namely, corporate officers or directors are agents only when they receive a sales commission. In the absence of positive evidence to the contrary regarding the intent of the Legislature, we must interpret clear and unambiguous statutes in a clear and unambiguous manner. (*Nationwide Investment Corp. v. California Funeral Service, Inc., supra*, 40 Cal.App.3d at p. 502.) Cole and Robles's argument is one that is appropriately made to the Legislature, not to this court. Had the Legislature intended to exclude all corporate officers and/or directors from the definition of broker-dealer—and therefore from culpability under section 25210—it could have done so. Instead, the Legislature wrote and enacted section 25003, subdivision (d).

Further, in our view, Cole and Robles's interpretation is inconsistent with policy reasons behind the Corporate Securities Law. Under their argument, the law would allow individuals to set up a corporation and sell securities without any oversight or licensing, which would be in conflict with the purpose of the Corporate Securities Law. By requiring a licensee to meet "minimum standards of training, experience, miscellaneous qualifications, and appropriate examinations," the licensing statute protects the public. (*Nationwide Investment Corp. v. California Funeral Service, Inc., supra*, 40 Cal.App.3d at p. 503.)