DEPARTMENT OF CORPORATIONS
STATE OF CALIFORNIA

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LIMITED OFFERING EXEMPTION
CORPORATIONS CODE SECTION 25102(f)

The purpose of this release is to comment on the 1981 amendment to Section 25102(f) of the Corporate Securities Law of 1968 ("Law") effected by AB 1518 (Statutes 1981, Chapter 1120), as well as the related rules which will become effective on November 1, 1981.

In effect, the amendment to Section 25102(f) repealed the former exemption for nonpublic offerings of interests in partnerships, joint ventures and trusts and enacted a new exemption extending to any security but subject to specific limitations. The language of the new exemption, sometimes referred to here as the "limited offering exemption", presents a number of interpretive questions and it is to these questions that this release is principally addressed.

In the following discussion, it is presumed that the reader has available both new Section 25102(f) and the new and amended rules discussed below. Copies of these items are being distributed with the initial publication of this release. Unless otherwise indicated, sectional references are to provisions of the Corporations Code and rule references are to the Commissioner's rules in Title 10, California Administrative Code.

In considering the provision of the limited offering exemption, the reader should bear in mind the provision of Section 25163 which provides that: "In any proceeding under this law, the burden of proving an exemption or an exception from this definition is upon the person claiming it."

General Comments

The new limited offering exemption is applicable to offerings which are otherwise subject to qualification under Section 25110. It is extended to transactions subject to qualification under Section 25120 by Rule 260.103. Excluded from the exemption are transactions involving an offer or sale to a pension or profit-sharing trust of the issuer.

The exemption is available to any issuer for any security of the issuer, if the transaction is kept within the limitations of the exemption. The major elements of these limitations are (1) that the sale must be limited to 35 purchasers and to certain classes of purchasers who are not counted, including purchasers not in this state, (2) all must either have a pre-existing relationship with the issuer or its principals or investment sophistication adequate to the transactions, (3) all purchasers must purchase for investment and not for resale, (4) no advertising may be published, and (5) a notice must be filed if required by rule of the Commissioner.

The reader will detect, both in the rules and in these comments, a note of concern. The purpose of the securities law is to protect investors against abuse through fraud and unfairness in securities transactions and exemptions from the qualification provisions of the Law are framed around factors which will generally accomplish the Law's objectives. The Department sponsored the new limited offering exemption in the belief that its limitations, especially those concerning the qualifications of investors, defined an area of generally equivalent protections. An added reason for support of the exemption was the frequency of enforcement problems involving offerings in which investors were being victimized by offerings purportedly under the exemption for nonpublic offerings of limited partnership interests and the belief that these abuses would be greatly reduced by an exemption which provided more specific guidelines. To a not inconsiderable degree, some of these problems can be traced to educational programs directed to non-attorneys in which the numerical test under Rule 260.102.2 was emphasized at the expense of the more significant relationship and sophistication tests.

The Department is concerned that a similar tendency will develop under the new exemption. Surveillance and related enforcement activities with respect to the new exemption will be one of the priorities of the Department's Enforcement Division. But enforcement cases, however successful, are after the fact and therefore seldom a source of investor satisfaction. What will be far more effective is a recognition by members of the bar and others who work with this exemption of the factors which will make the exemption work effectively. This will require a careful adherence to the qualifications required of purchasers, both those who must be counted and those who are not counted for the purposes of the 35-purchaser limitation. In addition, it will require a recognition of the necessity of furnishing investors with appropriate information.

"TRANSACTION"

The new exemption extends to "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 the criteria discussed below.

The "transaction" referred to is one or more offers or sales of a security which have such a connection with each other as to be considered one transaction for statutory purposes. Necessarily, it is the issuer which must take the initiative in defining the transaction it proposes to conduct within the limitations of the exemption and in executing that transaction. It is the statutory concept of "transaction" which determines whether or not other offer or sales of securities, past, present or future, will be considered as constituting a part of the transaction under the exemption and integrated with it, and whether such integration will result in a violation of any of the limitations of the exemption. It is therefore essential that persons contemplating the use of the limited offering exemption do so in the light of the other past, present and future securities transactions of the issuer.

The varied circumstances under which securities transactions arise and the flexibility present in their formulation preclude a single definition of transaction or a single test for integration. In Release 33-4552 concerning a nonpublic offering exemption under the Securities Act of 1933, the Securities and Exchange Commission described five factors which it considered relevant to the question of integration: (1) The different offerings are part of a single plan of financing, (2) the offerings involve issuance of the same class of security, (3) the offerings are made at or about the same time, (4) the same type of consideration is to be received, and (5) the offerings are made for the same general purpose. To illustrate the application of these factors, the release gives the example of offerings of fractional undivided interests in separate oil or gas properties where the promoters must constantly find new participants for each new venture and indicates it would appear appropriate to consider the entire series of offerings to determine compliance with the requirements for the nonpublic offering exemption. (See Commissioner's Opinons 74/81C, 74/57C, 78/19C and 80/8C.)

For the average issuer, such illustrations serve merely as warnings that, based on the general interpretive principal that exemptions are to be narrowly construed to effectuate the statutory purpose, the interpretation of the word "transaction" must necessarily be one which permits the issuer to accomplish a "plan of financing" without permitting it to evade the limitations of the exemption by artificially dividing that plan into a series of nominally distinct yet interdependent offerings. It has been suggested, for example, that the use of the term "the security" in Section 25102(f) means that, irrespective of the other factors referred to above in connection with integration, the use of distinct classes of securities, such as preferred and common or various classes of common or equity and debt securities, permits an issuer to have 35 purchasers for each separate class, limited presumably only by the ingenuity if not the practicality of ring distinct classes (or possibly series). While such a suggestion is so contrary to the legislative intent underlying Section

25102(f) as to appear facetious, it nonetheless, illustrates the potential trap for those who seek to rely upon an overly simplistic test.

In considering the factors referred to above, the most important factors will generally be whether the offerings are made for the same general purpose and whether they constitute a part of a single plan of financing. If so, differences in the securities, in the consideration or in the times the offers are made would appear to afford an insufficient basis for concluding that there are distinct transactions for the purposes of Section 25102(f).

In determining whether or not other offerings should be integrated for the purposes of Section 25102(f), it is not relevant that the other offerings were conducted under another exemption, or under a qualification (see Rule 260.102.12(b)), or in violation of the qualification provisions. This appears especially significant in connection with transactions conducted under the so-called "institutional investor" exemption in Section 25102(i). While the limited offering exemption provides that the investors described in Section 25102(i) are not to be counted with respect to the 35-purchaser limitation and both exemptions require compatible representations that the purchase is for investment, Section 25102(i) does not on its face preclude the publication of advertising.

It should be noted here that definition of "transaction" and the related integration factors have a bearing on the content of the notice required under the limited offering exemption (see below in connection with Rule 260.102.14).

Number of Purchasers

The limited offering exemption restricts the number of purchasers to 35, but excludes from the count persons described in Section 25102(i), any officer, director or affiliate of the issuer and any other purchaser who the Commissioner designates by rule.

Rule 260.102.12(c) defines "purchaser" as a person who acquires the beneficial ownership of the security, whether individually or in joint ownership. Thus a person who holds merely as a nominee without beneficial ownership is not counted. In the case of joint beneficial owners, each beneficial owner is counted as one. The exception to this is in connection with a husband and wife (together with any custodian or trustee acting for the account of their minor children), who are counted as one regardless of how they take beneficial interests in securities in the transaction.

In some instances, a person may contract with the issuer to acquire the security and then not actually acquire it, either through withdrawal by mutual agreement or otherwise. It may, of course, be necessary for the issuer to seek others who will take these

securities in order to complete the plan of financing which constitutes the transacation. If the withdrawing person has not paid for the securities by delivering the consideration contracted for (in whole or in part) such person is not a "beneficial owner of the securities" and need not be counted. (See also Rule 260.102.14(b), Items 2 and 3 of the General Instructions.)

Rule 260.102.12(m) is intended to resolve a potential conflict between the provision which excludes "affiliates of the issuer" from the counted purchasers and the provision which provides that a corporation or other organization "not specifically formed for the purpose of purchasing the security offered in reliance upon this exemption, is counted as one person." The purpose of the latter provision is analogous to the purpose of the final paragraph in the small offering exemption (Section 25102(h)), to prevent an evasion of the numerical and other limitations of the exemption through a structure of business entities which, while nominally distinct, are selling their securities in transactions which should be integrated for the purposes of these exemptions. Rule 260.102.12(j) defines "affiliate" and Rule 260.102.12(m) states that when a person is both an affiliate and an organization specifically formed to invest in the securities offered in reliance on the exemption, each beneficial holder of its securities shall be counted or not counted under the provisions of Section 25102(f) as though that person is a direct purchaser of the issuer's securities in the transaction.

Purchasers Who Are Not Counted

Excluded from the count of purchasers under the limited offering exemption are the institutional investors "described in subdivision (i), any officer, director or affiliate of the issuer and any other purchaser who the commissioner designates by rule."

Rule 260.102.12(l) indicates that the reference to institutional investors in Section 25102(i) includes those recognized by rule of the Commissioner under the provisions of that section (Rule 260.102.10).

The definition of "affiliates of the issuer" is contained in Rule 260.102.12(j). It should be noted that Section 25102(f) employs the term "affiliates" of the issuer in two places. In addition to its use as described in the penultimate paragraph above, it is used to identify a person who will be disqualified as a "professional advisor" if compensated by an "affiliate" of the issuer. The term "affiliates" is sometimes given an extremely broad meaning when used in securities laws, including for example officers, directors and employees of an issuer as well as persons holding nominal amounts of its voting securities. That its meaning here is in line with the narrowest definitions of the term is indicated by its use in conjunction with the words "officers" and "directors" and "selling agent". When used in connection with professional advisors, the

problems with a narrow definition are relieved by the use of the words "directly or indirectly". The definition of "affiliate" in Rule 260.102.12(j) does not embrace the concept of control through a minority of the voting power because of the failure or forebearance of others but rather control through an absolute majority of the voting power.

The exclusion of officers and directors of the issuer from the counted purchasers raises the question as to whether these terms were intended to encompass similar positions in organizations which do not employ such titles. Such an interpretation is open to substantial question. However, Rule 260.102.13 in Subsections (a) and (b) provides for the exclusion of comparable persons by rule of the Commissioner. Subsection (c) of that rule also excludes from the count entities that are 100% owned by such persons.

Qualifications of Purchasers

As indicated in the general comments above, the qualifications which are imposed upon all purchasers under the terms of the limited offering exemption are extremely significant to its effective operation. While Section 25102(f)(2) may be read as imposing its terms upon all purchasers, whether counted or not in connection with the 35-purchaser limitation, as a practical matter and unless an unjustifiably broad interpretation is given to the word "affiliate" it would be somewhat difficult to suggest that the not-counted purchasers do not meet this provision.

Subsection (d), (e), (f) and (g) of Rule 260.102.12 interpret terms in Section 25102(f)(2). Except with respect to Subsection (e), these provisions indicate they are intended to define circumstances within the scope of the exemption without suggesting that other circumstances are necessarily outside its scope (see Rule 260.102.12(a)). The language in Subsection (g) as to the investor's ability to bear the economic risk of such person's investment requires specific evaluation of that person's circumstances and of the risks of the particular investment.

Rule 260.102.13 specifies additional purchasers who are not to be counted pursuant to Commissioner's rule. In part, this section closes the gap which arises from the failure of Section 25102(f) to exclude from the count persons who may be regarded as the equivalent of officers and directors of the issuer.

Professional Advisor

The term "professional advisor" is defined in Rule 260.102.12(h). While this provision is derived from the "purchaser representative" provision found in certain exemptions under the Securities Act of 1933 and operates in the same manner,

it is materially different in requiring that the function be performed at a professional level, and in requiring that the professional advisor be unaffiliated with and not compensated by the issuer, its affiliates or its selling agents. The term "unaffiliated" is defined in Rule 260.102.12(i).

Advertising and Disclosures

With language that is somewhat redundant, Section 25102(f)(4) provides that the offer and sale of the security under the limited offering exemption must not be accomplished by the "publication of any advertisement". Sections 25002 of the Law defines the terms "advertisement" as any communication by writing, recorded telephone messages, radio, television "or similar communications media, published in connection with the offer or sale of a security." The word "publish" is defined in Section 25014 to mean "publicly to issue or circulate by newspaper, mail, radio or television, or otherwise to disseminate to the public."

The thrust of Section 25102(f)(4) is to preclude the "dissemination to the public" within the meaning of Section 25014 of anything that would otherwise constitute an "advertisement" within the meaning of Section 25002. Thus the use of written materials such as soliciting letters or disclosure documents is not at all precluded so long as these are not disseminated to the public. Whether the use of mailing lists or seminars are a dissemination to the public depends upon whether appropriate criteria are used in selecting the persons addressed or attending, as they constitute a "similar communication media" for the purposes of Section 25002.

Th redundant language in Section 25102(f)(4) was employed to make it clear that written materials, including disclosure documents as well as other "advertising" may be used in connection with offerings under the limited offering exemption and also to make it clear that the public dissemination of such materials was prohibited under the exemption.

The Notice

The notice required under the exemption by Rule 260.102.14 serves several purposes. It will afford information on the use and impact of the exemption. It will also identify persons using the exemption, as is the case with the notice under the small offering exemption, and eliminate questions that might otherwise have to be answered by investigation. Finally, it may promote compliance with the terms of the exemption, even though the notice is not specifically directed to this end.

While the length of the instructions for the notice is somewhat intimidating, their purpose is to simplify the task of

preparing the notice through the use of a uniform terminology. This will, of course, enable us to better summarize the data obtainned through the notices. A person familiar with the issuer its transaction and the provisions of the exemption should require but a few minutes to complete the notice.

Section 25102(f) provides that the notice must be filed if required by rule of the Commissioner but that the failure to do so does not affect the availability of the exemption. Nonetheless, the failure to file the notice in conformity with the rule is a violation of the Law, as would be the failure to file the notice after a demand by the Commissioner as provided in the exemption.

Rule 260.103

This rule, in part, exempts from the qualification provisions of Section 25120 of the Law a change in the rights, preferences privileges or restrictions of outstanding securities, or an exchange of securities by an issuer with its existing security holders exclusively, if the transaction would be exempt under Section 25102 as the sale of a new security. The extent to which this rule has been used in connection with Section 25102(h) is unknown. This problem is eliminated by providing for a disclosure of this information in notices filed under Subdivisions (f) or (h) of Section 25102.

Hearings on the Emergency Rules

At this time it is contemplated that no notice of hearing will be issued in connection with the emergency rules under AB 1518 until about 60 days after their adoption. Persons using the limited offering exemption during this period are urged to use this 60-day period to make comments and suggestions on the rules. This will enable the Department to propose changes in the rules when they are noticed, should that appear desirable.

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