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California Owes an Explanation on Securities Rules

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By Keith Paul Bishop

The Golden State has run out of money to pay its bills. So like other debtors, the state has promised to pay its creditors when it has the money. California's promise, or IOU, takes the form of a registered warrant. Unfortunately, in the current economic crisis, many creditors of the state have their own liquidity problems and they can't wait for the state to make good on its promises. These creditors who either can't or don't want to wait are going to sell their warrants and turn California's IOU into cold, hard cash. An important, but as yet unanswered, question is whether trading in these warrants is subject to federal and state securities laws.

Registered warrants are issued by the state controller and are paid by the state treasurer. They differ from "regular" warrants because they are marked "REGISTERED" and have a special endorsement stamp on the back. A regular warrant is redeemable by the treasurer after it is issued, but a registered warrant cannot be redeemed until it matures. In the case of the registered warrants now being issued, the maturity date is on or after Oct. 2, 2009 (assuming the state will then have the money to redeem them). If the state has enough money before that date, the registered warrants may be redeemed earlier. Although the warrants are denominated "registered warrants," this does not mean that they have been registered under federal or state securities laws.

According to Government Code 17205, registered warrants are deemed to be negotiable instruments. Treasurer Bill Lockyer, however, has stated that people to whom the warrants are transferred cannot redeem registered warrants without a notarized bill of sale signed by the payee whose name appears on the registered warrant. The treasurer does not apply this requirement to banks, credit unions, investment banks, other financial institutions, brokerage firms or broker-dealers.

According to the California State Treasurer's Office, it is requiring of a notarized bill of sale as a fiduciary of the state's funds to protect the state and holders from forgery and fraud. While it cannot be doubted that the treasurer is correct in his efforts to protect the state and warrant recipients, it is doubtful that he has the legal basis to impose this requirement. State agencies are not permitted to adopt rules outside the formal rulemaking process under California's Administrative Procedure Act. In fact, the act flatly prohibits state agencies from enforcing any rule or standard of general application that is not adopted as a regulation under its rulemaking procedures. The treasurer's requirement also appears to be inconsistent with Section 17205 of the Government Code that provides that all registered warrants are negotiable instruments. Therefore, the rights of people to whom the warrants are transferred would seem to be governed by Division 3 of the California Commercial Code, which is inconsistent with the treasurer's requirements.

Trading in registered warrants raises the question of whether the warrants will be considered securities under the federal and state securities laws. The consequences of the answer to that question are considerable. If the warrants are securities, people who engage in trading them may be subject to broker-dealer licensing requirements and purchasers and sellers may be subject to anti-fraud statutes. If they are not securities, traders, buyers and sellers will be outside of the protection of the securities laws.

The federal securities laws consist primarily, but not entirely, of two acts. The Securities Act of 1933 regulates the initial offer and sale of securities while the Securities Exchange Act of 1934 regulates securities professionals and regulates markets in securities after their initial issuance and sale. Thus, the

question of federal regulation of trading of the warrants concerns the application of the Securities Exchange Act.

Recently, the Securities and Exchange Commission announced that it believes that California's registered warrants are securities. This announcement is not binding on the courts or even the SEC itself. Further, the announcement does not explain the staff's reasoning for its belief. The failure to explain the legal basis for the decision hides the fact that there are some significant problems with the classifying California's registered warrants as securities under the Securities Exchange Act.

Section 3(a)(10) of that act defines the term "security" by listing a wide variety of instruments, including notes. Interestingly, the statute does not list "evidences of indebtedness," even though that term is included in a similar definition of "security" found in Section 2(a)(1) of the Securities Act. Thus, an initial question will be whether California's registered warrants will constitute notes or one of the other included in the laundry list of securities in Section 3(a)(10) of the Securities Exchange Act.

Even if California's registered warrants are considered to be notes, that does not necessarily mean that they are securities. In *Reves v. Ernst & Young*, 494 U.S. 56 (1990), the U.S. Supreme Court held that even though Section 3(a)(10) plainly states that "any note" is a security, all notes are not necessarily securities. Rather, the court established a rebuttable presumption that a note is a security. The presumption may be rebutted by a showing that a note bears a strong resemblance to one of the following types of notes: a note delivered in a consumer financing; a note secured by a mortgage on a home; a note secured by a lien on a small business or some of its assets; a note relating to a character loan to a bank customer; a note that formalizes an open account indebtedness incurred in the ordinary course of business; short-term notes secured by an assignment of accounts receivable; or notes given in connection with loans by a commercial bank. The determination of resemblance is to be made by assessing four factors: the motivation of the parties, the plan of distribution, the reasonable expectations of the investing public, and whether another regulatory scheme significantly reduces the risk of the instrument.

Assuming that the application of the Supreme Court's "family resemblance" test does not exclude registered warrants from classification as a security, it is possible that they will come within Section 3(a)(10)'s so-called "commercial paper" exception. That exception excludes from the definition of a security "any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months." Although this exclusion is very clear and appears to admit no limitations, the Securities and Exchange Commission has in the past cited legislative history to Section 3(a)(10)'s analogue in the Securities Act of 1933 for the proposition that the exclusion does not extend to all notes with a maturity of less than nine months. There is an obvious problem, however, with using the legislative history from the Securities Act to interpret different (albeit similar) language in the Securities Exchange Act. Justice William Rehnquist noted this very problem in his dissent in *Reves*.

Under California's Corporate Securities Law of 1968, the analysis is considerably less complicated. The law also defines "security" by listing a wide variety of financial instruments. California's statute, however, unlike Section 3(a)(10), specifically includes "evidence of indebtedness" in the list. Further, California does not exclude from the definition notes with maturities of nine months or less. Thus, the only question is whether California's registered warrants are "evidences of indebtedness."

If registered warrants are determined to be securities under either the Exchange Act or the Corporate Securities Law, people who engage in the business of buying or selling the warrants either as agent or for their own account are subject to licensing as broker-dealers, unless exempt. For example, banks and trust companies (but not credit unions) are exempt from broker-dealer licensing under the Corporate Securities Law pursuant to Corporations Code Section 25004(a)(3). Those who are not properly licensed face civil and criminal sanctions. Moreover, Corporations Code Section 25501.5 provides a right of rescission to anyone who purchases a security from or sells a security to an unlicensed broker-dealer. This right of rescission is a potentially powerful remedy because it will allow people to unwind transactions without proving fraud.

Another consequence of a determination that registered warrants are securities is that people trading in those securities will be subject to the anti-fraud provisions of the securities laws. For example, material misstatements or omissions in connection with either an offer to sell or an offer buy a registered warrant would be unlawful under Corporations Code Section 25401. It is even possible that a state official could be

guilty of illegal insider trading under Corporations Code Section 25402 if she trades warrants at a time in which she knows material nonpublic information.

Many recipients of the state's registered warrants are undoubtedly under significant liquidity pressures. These recipients simply cannot afford to wait to get paid. Others will see an opportunity to take advantage of the situation to purchase the warrants at a discount. Need and greed are creating a market for California's registered warrants. The SEC staff is obviously concerned that holders of warrants may be cheated and acted on this concern by declaring the warrants to be securities. Although the legal basis for the staff's declaration is dubious at best, its concern is well placed. The case for treating warrants as securities is much stronger under the Corporate Securities Law and the Department of Corporations should not leave the public guessing as to their status under California law.

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