

12-1-2

Sacramento 14 Principal Office
1020 N Street

Edmund G. Brown
Governor of California

John C. Sobieski
Commissioner

San Francisco 2
213 State Building

Los Angeles 12
800 Mirror Bldg.



State of California
Division of Corporations

San Francisco 2, California
April 2, 1959

CHAIRMAN'S OFFICE
RECEIVED

APR 9 1959

TIME _____
SEC. & EXCH. COMM.

Mr. Edward N. Gadsby
Chairman, Securities and Exchange Commission
Washington 25, D.C.

Dear Mr. Gadsby:

Enclosed herewith is a notice of an additional rule proposed to be adopted by me under the Corporate Securities Law, which rule I think may be of interest to that part of your division of corporate finance which has to do with registration statements under the Securities Act.

I regret that the printing on this proposed rule is so faint, but under Governor Brown's economy program, we are having to save money wherever possible and apparently the printer economized on the ink.

This proposed rule under the Securities Law is somewhat similar in purpose to the proposed rule under the Industrial Loan Law which I have forwarded to you and which is described in a separate communication of this date. The enclosed proposed rule will make two substantial changes, which are as follows:

1. It will require the application for a permit to issue securities to specifically set forth the plan of internal controls adopted, or proposed to be adopted, by the applicant, which controls should be adequate to keep the officers and directors currently informed of the condition of the company so that each may properly perform his function. The rules do not require that these controls be in any particular form. They do require that the company adopt internal controls, suitable to its needs, which will enable the officers and directors to properly perform their functions.

In companies in the promotional stage, we often have directors who are without previous corporate experience and do not appreciate their responsibilities and duties. It is hoped that this proposed rule will, at the outset, direct the attention of companies, and their counsel, to the need for establishing a proper system of internal controls, thereby making the directors aware of their responsibilities as directors and also of the fact that it is wrong for people to run a company without full internal disclosure of its affairs to the directors. In many established

Mr. Edward N. Gadsby

-2-

April 2, 1959

companies, a domineering executive may have channelled the important information to himself and not kept the rest of the management informed - indeed, may have excluded them from important information. It is believed that this rule will help some established companies of this category by focusing attention on this point when they file application to issue additional securities. This will also give some protection to stockholders. If a corporation has represented to my office that it maintains a specific set of internal controls, then if a director fails to receive the reports there specified, he may be guilty of negligence and if, after having received the necessary information, he fails to take action, he again may be guilty of negligence. In short, it is hoped that this rule will improve the standard of conduct of directors, thereby improving corporate practices, and thereby improving the quality of the securities offered to residents of California.

Your staff may wish to require companies, particularly those in the promotional stage, to make adequate disclosure in the prospectus of the form of internal controls which they adopt because, unfortunately, some companies apparently don't have adequate internal controls. If such lack is present, the investing public should, of course, know of it. Under our California statute, I do not propose to issue a permit to a company which does not have adequate internal controls, and your staff may consider this a subject which warrants consideration for possible inclusion in the requirements for disclosure.

2. The second proposed rule (in the lower part of the fine print) will require the escrow of shares of companies which do not furnish annual reports as required by the California Corporations Law. That law makes provision for adequate annual reports. It also provides, however, that the corporate by-laws may waive the furnishing of such reports. It is my understanding that the provision for waiver was intended to apply to small closely held companies where the stockholders were intimately connected with the company's affairs, anyway. In any event, the proposed rule will take the position that a company which does not furnish proper annual reports may not make a public offering of securities but, instead, I will require its shares to be escrowed.

I have long felt that the reporting requirements of the Securities and Exchange Law ought to be extended to the large unlisted companies. I think you must share this view because I understand that the Commission on several occasions has recommended to Congress that legislation be enacted to that effect. It occurs to me that your Registration Division may, by administrative action, accomplish almost the same results. Suppose that the form for registration should require a company to disclose, among other

Mr. Edward N. Gadsby

-3-

April 2, 1959

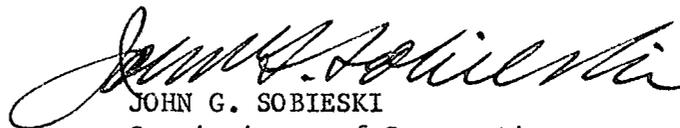
things, the reports which it expected to furnish stockholders and require a statement as to whether or not the company intended to furnish to its stockholders annual and current reports similar in substance to those required under the Securities ~~and~~ Exchange Law. The prospectus properly requires a statement of the current condition of the company. I think stockholders are entitled to know whether the company intends (after it has got our money) to furnish such reports as are necessary to keep that information up to date, or whether the company intends to furnish them less than adequate information. Such a disclosure requirement could very possibly act as a spur to cause the companies to "voluntarily" furnish their stockholders the type of information which listed companies are required to furnish and which your office has very properly declared should be furnished by all publicly-held companies.

The two rules mentioned above are designed to encourage more responsible action on the part of corporate directors and management and to encourage more effective reporting by corporations to stockholders.

As you can see, each of these, together with the cumulative voting proposal, is part of a broader program to make corporate managements more responsible and effective, to make stockholders better informed, and to make stockholder influence on management more direct, thereby encouraging responsible democracy in corporations, as well as elsewhere, which I trust is one of the objectives to be achieved by a disclosure statute, as well as by a permit statute.

I am forwarding this information to you for your consideration because I believe that the more our respective offices can coordinate their activities, the better the public will be served.

Cordially yours,



JOHN G. SOBIESKI
Commissioner of Corporations

JGS:rcs

LEGAL NOTICE

**BEFORE THE
DEPARTMENT OF INVESTMENT
DIVISION OF CORPORATIONS
OF THE
STATE OF CALIFORNIA
NOTICE OF HEARINGS TO CON-
SIDER PROPOSED CHANGES IN
RULES AND REGULATIONS PER-
TAINING TO THE CORPORATE
SECURITIES LAW.**

TO WHOM IT MAY CONCERN:

Notice is hereby given that John G. Sobieski, Commissioner of Corporations, will hold public hearings for the purpose of considering the adoption of certain new rules and regulations, and the amendment of certain rules and regulations relating to the Corporate Securities Law.

Said rules and regulations are to be adopted or amended under the authority conferred by Section 25308 of the Corporations Code.

Said public hearings will be held at the following times and places:

Sacramento: Wednesday, April 29, 1959, at 10 A. M., Room 401, 1020 N Street.

San Francisco: Wednesday, April 29, 1959, at 2 P. M., Room 243, State Building.

Los Angeles: Friday, May 1, 1959, at 10 A. M., Room 800, Mirror Building.

The following changes in the rules and regulations of the Commissioner of Corporations relating to the Corporate Securities Law as set forth in Title 10, Chapter 3, Subchapter 2, of the California Administrative Code are proposed:

1. Amend Section 320 to add thereto a new subparagraph designated (l). The first paragraph of said section and said new subparagraph to read as follows:

"320 Application for Permit. All applications to sell or issue securities shall be verified as provided in the Code of Civil Procedure for the verification of pleadings, and shall set forth in separate paragraphs, or as exhibits attached thereto, the matter required by Section 25502 of the Corporations Code. In addition to such matter the application shall contain the following:

"(l) A specific statement of the internal controls established or to be established by applicant. (Ordinarily such internal controls shall include, at least, monthly written reports of the status of the company to the responsible officers and directors containing such information as would be necessary for each officer and director to be kept adequately and currently informed of the affairs of the company so that he can properly perform his office.)"

2. Amend Section 407 to add thereto a new subparagraph designated (k). The first paragraph of said section and said new subparagraph to read as follows:

"407 Escrow of Securities. Securities may be required to be held in escrow if it appears to the commissioner:

"(k) That the shareholders are not to receive an annual report after the close of each fiscal or calendar year containing the information required by Sections 3007, 3008, 3009 and 3010 of the Corporations Code."

The foregoing proposed rules implement, interpret or make specific Sections 25507, 25508 and 25502 of the Corporations Code.

On the dates and at the times and places specified above any interested person or his duly authorized representative, or both, will be afforded the opportunity of presenting statements, arguments or contentions, orally or in writing, relative to the proposed rules.

The Commissioner will consider all relevant matters presented before adopting, amending or repealing any regulations.

JOHN G. SOBIESKI
Commissioner of Corporations
Dated: Los Angeles, California
March 26, 1959.

(1 to March 28 1959)