California Department of Corporations

INFORMED INVESTING

A Reference Guide for California Investors

DEPARTMENT OF
CORPORATIONS

California's Investment and Financing Authority

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Introduction

Investing your money is a major decision, similar to the purchase of a house or car. A large number of today's investors approach banks and brokerage offices without the knowledge required to adequately evaluate their investment options and assess the risks involved. Investors who are not properly informed generally face the greatest risk of making unwise investment decisions.

The California Department of Corporations has developed this guide as a starting point for beginning investors, as well as a valuable source of information for all investors.

NOTE

THIS INFORMED INVESTING GUIDE IS **NOT** PROVIDED FOR THE PURPOSES OF GIVING LEGAL, ACCOUNTING, FINANCIAL, OR INVESTMENT ADVICE. AS AN INVESTOR, IT IS YOUR RESPONSIBILITY TO THOROUGHLY INVESTIGATE AND RESEARCH INVESTMENT OPPORTUNITIES.

READING THIS INFORMED INVESTING GUIDE IS A GOOD BEGINNING. WE ENCOURAGE INVESTORS TO SEEK PROFESSIONAL ADVICE THROUGHOUT THE EVALUATION AND ASSESSMENT OF AN INVESTMENT OPPORTUNITY.

KEEP IN MIND THAT EVEN WITH LEGITIMATE INVESTMENTS THERE IS ALWAYS A RISK OF LOSING YOUR MONEY. YOU SHOULD DISCUSS THE POTENTIAL RISKS, REWARDS AND CONSEQUENCES WITH YOUR INVESTMENT PROFESSIONAL.

V. **Regulation of securities and securities professionals**

D. Basic terms

Before proceeding any further, you should know the definitions of some important terms involved in the regulation of securities and securities professionals. These definitions are provided to help you, the potential investor, better understand investing and investment concepts in general.

4. Definition of a security

While there are some differences among federal securities laws and state blue-sky laws (i.e., state laws regulating securities), the basic definition of a security remains the same. Conventional corporate securities such as stocks and bonds are readily identifiable. Some less conventional ones, however – such as equipment trust certificates, various oil and gas interests, and promissory notes in various contexts – are not as readily identifiable as securities.

Another type of security, called an investment contract, serves as a catchall to embrace all arrangements under which a person invests money in a common enterprise with the expectation of deriving a return primarily through the efforts of others. The investment contract definition is very broad. Under some circumstances, courts have found investments in an orange grove, a condominium, real estate, gold and silver bullion, diamonds, beavers, chinchillas and minks to constitute an investment contract, and thus a security.

5. Definition of a broker-dealer

A broker-dealer is an individual or entity in the business of buying and selling securities for itself and others. When acting as a broker, a broker-dealer executes orders on behalf of his/her client. When acting as a dealer, a broker-dealer executes trades for his/her firm's own account. Securities bought for the firm's own account may be sold to clients or other firms, or become a part of the firm's holdings.

6. Definition of an investment adviser

An investment adviser is any person in the business of providing investment advice about securities. Investment advisers may also be employed to manage investment assets. Financial planners are usually investment advisers and are required to be registered with the Securities and Exchange Commission or licensed by the California Department of Corporations.

E. California regulation of securities and securities professionals

6. The Corporate Securities Law of 1968 (CSL)

The CSL provides a comprehensive system of securities regulation in the State of California. The primary purpose of the CSL is to protect investors from fraud. It does this by requiring the qualification of certain securities, providing the Department of Corporations with enforcement powers, and providing for the licensing and/or regulation of broker-dealers, investment advisers, and sales representatives of securities.

7. Securities qualification

Under the provisions of the CSL, certain securities must be qualified (i.e., reviewed and approved) or exempted from qualification by the Department of Corporations before they can be offered or sold in California. In general, to qualify a security, the Department of

Corporations reviews an application in its entirety and considers the business and financial aspects of the investment, as well as the background of the persons making the offering.

Note: The Department of Corporations does not recommend or endorse the purchase of any securities, qualified or not, nor does the Department of Corporations assure the accuracy of any offering circular, prospectus or advertising material relating to the offer of any securities.

8. Exemption from qualification

The CSL provides exemptions from the qualification requirements for certain types of transactions and securities. Exemption means that the particular transaction or security is not subject to the CSL's qualification requirements. However, the transaction and/or security is still subject to the anti-fraud provisions of the CSL. The various exemptions are of limited scope and require special circumstances to be available for a particular offering.

9. Enforcement of the CSL

The Department of Corporations enforces the CSL through its Enforcement and Legal Services Division (ELS). The enforcement program includes investigation of possible violations by a statewide network of attorneys, investigators and accountants. These investigations may lead to court actions to require compliance with the law. Some lead to criminal prosecution.

Civil remedies also are provided by the law for persons who have been sold unqualified securities (unless exempt from qualification) or who have been defrauded by promoters, sellers or representatives of the company issuing the security. While ELS may offer some assistance in this regard, the Department of Corporations is not authorized to enforce or adjudicate private civil actions between citizens and issuers or sellers of securities.

10. Regulation of broker-dealers and investment advisers and their agents and associated persons

Broker-dealers doing business in California must be registered, unless otherwise exempted. The CSL requires any person that is in the business of offering and/or selling securities to be licensed and/or registered by the Department of Corporations, unless otherwise exempted. (Agents of broker-dealers and associated persons of investment advisers are also monitored to ensure compliance with the CSL.)

Investment advisers who manage $30 million or more in client assets generally must register with the Securities and Exchange Commission (SEC). If they manage less than $25 million, they generally must register with the Department of Corporations to engage in business in California. Between $25 and $30 million, investment advisors may choose whether to register with the SEC or the Department of Corporations.

The licensing process involves written examinations and the submission of information about the applicant and the applicant's business reputation, professional qualifications and financial standing. The activities of licensed individuals are also routinely examined by the Commissioner of Corporations to ensure the continued protection of the public.

Federal regulation of securities and securities professionals

1. In 1996, legislation was enacted that allowed the federal government to preempt individual state regulation of certain types of securities. The Securities and Exchange Commission (SEC) now has exclusive jurisdiction to regulate what are termed "covered securities." Among other categories of securities, the term "covered security" includes securities traded on the major markets, like the American Stock Exchange, Tier I (or National Market Securities) of the NASDAQ, and the New York Stock Exchange. Securities of this character fall under the exclusive authority of the SEC for matters of registration and qualification, but the 1996 law retained the right of states to pursue securities violators in cases involving fraud or deceit.

2. For more information regarding the regulation of securities and securities professionals by the federal government, please visit the SEC's Website located at www.sec.gov.

VI. **Information for investors**

D. Inform yourself

1. Know your investment goals. Decide why you are investing and what you hope to achieve. Also, decide how much risk you are willing to assume. Whether you are investing for long-term growth, investment income or other reasons, an investment should match your investment goals. Once you have determined your investment goals, you will find it easier to choose an investment that will meet your needs.

2. Do your homework. Being an informed investor means taking the time to examine and understand each investment before committing your hard-earned money. Carefully reading all of the relevant written information, like a prospectus or offering circular, is one of the most important steps in making an investment decision. Without solid

information about the company, the salesperson, and the investment, you should think twice before risking your money.

3. Beware of unsolicited telephone calls, e-mails, or letters from strangers offering get-rich-quick schemes. They promise quick profits and usually do not deliver. If an investment sounds too good to be true, it probably is. Ask yourself why someone would offer such a great deal is being offered to complete strangers.

4. Shy away from high-pressure tactics designed to separate you from your money before you have a chance to think about and investigate the investment.

5. A critical step in wise investing for any individual investor is taking the time to check the backgrounds of potential brokers and advisers prior to entering into financial relationships with them. Information may be obtained by calling the Department of Corporations at 1-866-ASK-CORP (1-866-275-2677). You can also access the Department of Corporations' Web site at www.corp.ca.gov, where you can access information regarding the registration/licensing status, as well as any disciplinary history of a brokerage firm.

6. Have a professional (licensed broker-dealer, licensed investment adviser, accountant, or lawyer) review the investment for you. Remember, this is not a guarantee of success, but their experience and expertise may help you navigate the complex financial marketplace.

7. Avoid investments where the seller has little or no written information about the company or its past performance. Before investing, ask for a company prospectus – but remember, even a prospectus is not evidence of legitimacy. Read all materials carefully, ask questions and check with experts.

8. Be wary of investments sold on the basis of rumors or tips. Investments based on "inside information" are illegal and are designed to trick you into thinking you have the inside track.

9. If you are planning to invest in a non-public company, contact consumer organizations such as the Better Business Bureau, National Fraud Information Center and AARP to determine if the companies or promoters have any negative history.

10. Use caution with any investment that is offered over the Internet, through newspaper advertisements, on the radio or on television. Check with the appropriate regulatory agency to determine if the company is licensed.

11. When in doubt about a potential investment, wait. Remember, even with legitimate investments there is always the risk of losing money. If you do not understand the investment, stay away from it. A lack of understanding on your part may be caused by the fact that the investment really doesn't make any sense.

12. Many investment scams are targeted at senior citizens. Older Californians often extend hospitality to phone callers and visitors to their homes, and con artists will not hesitate to exploit the good manners of a potential victim. Do not trust someone just because they are well-dressed or have good manners. Be wary of someone who tells you that you must invest immediately because of the nature and limited availability of the investment. The most important thing to remember, for all investors, is to take the time to investigate the investment opportunity thoroughly.

E. <u>Frequently asked questions</u>

1. <u>What factors should I consider before investing in securities?</u>

   Potential investors should first make certain that they are sufficiently protected against a financial crisis. Adequate life insurance and emergency funds are among the most important of these protections. Other financial resources such as Social Security payments, pensions or savings accounts may be used to support you. An emergency fund should consist of easily accessible sources of money. Most emergency funds are placed in savings bonds or savings accounts. Only after you have provided for the unexpected should you think about investing in securities.

2. <u>What is a good investment?</u>

   The type of investment best suited for you depends in large part on your financial situation and investment objectives. Take into account the risk you are willing to assume, the length of time you can afford to leave your money invested, and your fixed obligations. If you plan to use investment income to put your children through college, then you probably want an investment that will grow steadily and safely and will be liquid when the tuition bills are due. If you want to buy a new car or travel next summer, you may be willing to take some risk for the chance to see your money grow over a shorter period of time.

3. <u>How do I open an account at a brokerage firm?</u>

   The first steps to becoming a securities investor are selecting a broker and opening an account. An "account" is nothing more than the firm's record of information about you, your investing desires and your specific objectives. While there are more than half a dozen different classifications of accounts -- some of them quite specialized -- most investors choose what is called a "cash account." With a cash account, you must be able to make payment for securities purchased within five business days of the purchase. Many couples like to open a joint account, similar to a joint checking account, so that either spouse may trade.

4. What is a prospectus?

A prospectus is a document given to potential investors in connection with a public offering of securities. It is intended to provide potential investors with a written statement of all relevant information about the company -- its history, operations, financial condition and key personnel. A prospectus is required by law; it provides information but not an endorsement.

5. How do I pick a stock or a bond?

First, decide what you want your investments to do. You should be prepared to spend time at the library with financial newspapers and magazines, charts and annual reports. In the case of a conservatively growing stock, as an example, look for: size; a long history as a publicly owned company with market popularity; consistent and rising profits; a unique or indispensable service and a good position in the industry; and earnings that steadily and adequately cover dividends, with money left to invest back into the company.

6. What is the NASDAQ?

The National Association of Securities Dealers Automated Quotation System (NASDAQ) is the computer system that ties together the over-the-counter (OTC) market for the securities of certain eligible companies by providing instantaneous access to bid and ask quotations for those securities. When you place an order (buy or sell) for a NASDAQ-listed security, your broker will "punch up" the market quotations in that security on the office or desk computer terminal to find the best price. Your order will be taken to the firm's trading desk and executed, either by telephone or teletype, with the "market maker" who has the best quote for the security, or from your firm's own inventory (subject to strict requirements).

The Nasdaq Stock Market consists of two distinct, separate markets. The Nasdaq National Market companies include some of the largest, best known companies in the world, and each must meet stringent financial and corporate governance standards to be listed. The Nasdaq SmallCap Market is the second tier of Nasdaq for smaller, developing companies. As such, the financial criteria for listing are not as stringent as for the Nasdaq National Market. The corporate governance standards, however, are the same. As SmallCap companies grow, they often move up to the Nasdaq National Market.

In order for a company to have its securities listed on the NASDAQ, it must have at least $1 million in assets, a minimum of 100,000 publicly-held shares, and 500 initial shareholders. After inclusion, a company must maintain no fewer than 300 shareholders.

7. What is the difference between the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX)?

   Both are auction markets for stocks and bonds. But on average, the AMEX caters to smaller companies, and a far greater percentage of its trading is done by non-institutional traders. The average price per share for AMEX-listed stock is notably lower. To an extent, the American Stock Exchange serves as a proving ground for companies that later qualify for listing on the NYSE -- even though some eminent companies remain on the AMEX by choice.

8. Who are institutional investors?

   Institutional investors are entities with large amounts to invest, such as investment companies, mutual funds, brokerages, insurance companies, pension funds, investment banks and endowment funds. They account for the majority of overall trading volume.

9. What is common stock?

   Common stock is an equity interest in a corporation (equity means that you actually own a bit of the company). Generally, each share of common stock represents pro rata ownership of the corporation and is entitled to equal dividends with all other shares of the same class. Each share carries with it the right to cast one vote per share for the election of directors or for the approval of major corporate decisions, and participates equally with other common shares in the event of liquidation of the business.

10. What is preferred stock?

    Preferred stock is given certain "preferred" treatment over the company's common stock. This preferential treatment usually includes the right of the owners to receive a fixed dividend before the common stockholders receive any dividend and the rights of the owners to a prior claim on assets of the company after all debts have been paid, should the company ever be dissolved.

Because of these advantages, preferred stockholders are usually limited in their participation in company affairs. They generally have no voting privileges (except when a specified number of preferred dividends are defaulted) and they can usually expect to receive no more than their specified dividend, regardless of how well the company may be doing.

11. Is it better to invest in stocks that will pay high dividends?

    Not always. It depends on what you're looking for in your investment. If you want regular income from stocks, you should look for a company that has an established policy of paying large cash dividends on a regular basis. But if you are more interested in long-term capital gains (achieved by a higher selling price than purchase price), you should look for a growth stock. Generally, firms with strong growth records pay smaller dividends because they retain their profits to keep the company and its capital stock growing.

12. How does the bond market work?

    The bond market revolves around one key relationship: when interest rates go up, bond prices go down, and vice versa. Although there are always new issues of bonds, the action is in the secondary market, where you buy bonds secondhand from someone else. The face value, or par value, of a bond is the amount the issuer will pay the owner at maturity. The price people actually pay for the bond, however, depends on how the bond's interest rate compares to the prevailing interest rate.

13. What are certificates of deposit?

    Certificates of deposit (or CDs, as they are commonly called) are fixed maturity debt securities with a set rate of interest. They are sold primarily by commercial banks and savings associations as an alternative to other forms of savings instruments and accounts. Maturities range from 30 days to several years. A certificate of deposit is not automatically renewable, although you may generally buy a new one upon maturity. Most CDs are subject to a substantial interest penalty if cashed prior to maturity.

    Some CDs are sold by securities brokers. These CDs have special risks to an investor.

14. What is an annuity?

    An annuity is an agreement under which an insurance company will receive a certain amount of money from a person in return for guaranteeing that person a retirement income after a certain age, usually for the remainder of their life. An annuity is the opposite of life insurance. You buy life insurance to provide for those left behind when you die; you buy an annuity to provide for yourself for as long as you live after retirement. (Annuities are regulated by the Department of Insurance.)

15. What is a commodity?

A commodity is a physical substance, such as grain or metal, that is interchangeable with another product of the same type. Investors buy or sell commodities, usually through futures contracts, which offer the speculator the possibility of a profit on market price fluctuations. Commodity futures contracts are standardized contracts to purchase a particular quantity of some commodity on a particular date at a particular price. These contracts are traded by hedgers and speculators at prices reflecting the supply of, and demand for, the underlying commodity. Commodity futures are generally considered highly speculative. They provide no regular income and no guarantee of their future value. (Currency traded on commodity exchanges is also considered a commodity.)

Commodities are regulated by the Commodities Futures Trading Commission (CTFC). The California Department of Corporations has state enforcement power over off-exchange commodities sales involving fraud or deceit.

16. What is a mutual fund?

A mutual fund (technically known as an investment company) is a corporation or other business entity that uses the money contributed by its shareholders to invest in securities of many different companies. Each fund has its own investment strategies and objectives, dividend policies and shareholder services. An investment company provides three things usually not available to the small investor: broader diversification of portfolio, professional management, and constant supervision of investments. Many investment companies also provide investors considerable liquidity.

A mutual fund is managed by a professional investment adviser, (an individual or entity). In return for these services, the adviser is paid a "management fee," which is most often calculated as a percentage of the fund's average daily assets. Thus, the adviser will profit more when the investor's shares increase in value. Mutual funds are generally recommended for investors who would prefer not to worry about trading securities. If you are thinking about a mutual fund investment, however, be sure to read the fund's prospectus to see what it intends to do with your money. Mutual funds are regulated exclusively by the SEC.

17. What is the difference between money market funds and other types of mutual funds?

Money market funds differ from other types of funds because they invest primarily in short term, high-interest-bearing certificates issued by governments, businesses or banks, rather than in stocks and bonds. The average maturity of a money market portfolio is relatively short and fluctuations in asset values are limited. Many investors channel cash which is temporarily idle into money market funds. Such investors may hold money market funds for a short period of time, and may "invest" and "redeem" several times in the course of a year, a pattern very different from the great bulk of investors in other mutual funds. Money market funds provide an opportunity previously unavailable to investors with limited cash to take advantage of periods of high interest rates and to obtain good yields in the open money market.

Financial advisers warn that sharp changes in interest rates may have unpleasant consequences for money market investors. If rates increase abruptly, the yields of money market funds will follow. If interest rates drop sharply, chances are that stock and bond markets will be quite active, costing slow-moving investors lost opportunities.

18. What are stock options?

Stock options are a rather complicated form of investment which have attained a degree of popularity among more sophisticated investors. Let's look first at the idea of options in general. You probably know that when you lease a house with an option to buy, this means that any time within a stated period, you have a right to purchase that house at the agreed price. If you wish, however, you may ignore the opportunity altogether and let the option lapse. You alone make the decision. It could be that during the option period the house increases handsomely in value so it would be advantageous for you to exercise the option to buy it at the lower price previously agreed upon. If, however, the house decreases in value during the option period, you may let the option expire. What you spent for the option is likely less than the loss you might have suffered had you purchased the house in the first place.

Stock options work this way, too. You may buy an option from someone who is willing to sell his or her shares at a specified price within a stated time. If the market price of the shares underlying the option rises above the agreed price (called the "strike" price) plus the price of the option, it is economically advantageous for you to exercise your option and buy these shares. Presumably, you could then sell them in the market and make a profit. On the other hand, if the market price of the underlying shares does not increase sufficiently to give you a profit on the transaction, you may let your option lapse and your only cost is the price you paid to obtain the option (sometimes called the "premium").

19. What is an Individual Retirement Account (IRA)?

The Tax Reform Act of 1981 allows anyone with earned income to set up an IRA. Regardless of where you work -- in private industry, for the government, or for a tax-exempt organization -- as long as you have earned income, you are eligible to establish an IRA to invest for your own retirement. The Tax Reform Act allows you to set aside $2,000 of earned income for retirement per year. And it allows you to expand your IRA coverage to include a spouse not working outside of the home. The Tax Reform Act permits a contribution of up to $2,250 in a spousal IRA per year.

When you calculate your income taxes, you can take the entire contributed amount as a first deduction -- even before you include any other itemized or standard deductions. If you set up an IRA, you do not have to pay taxes on your contribution or any dividends, interest, or capital gains generated by the investment of these funds until you begin withdrawing from the account. Many people do not withdraw funds until they retire and take advantage of additional tax breaks available to them at that time. New federal laws affect traditional IRAs.

20. What is a Keogh Plan?

The Keogh Act of 1962 provides for tax-shelter retirement plans allowing self-employed individuals to defer current taxes on part of their earnings. If you are self-employed, the Keogh Act presently allows you to contribute 15% (up to $15,000) of your income per year to a personal retirement fund. This percentage can be taken after you have deducted your business expenses, but before you have added up deductions for other expenses such as mortgage interest and dependents. New federal laws affect traditional Keogh Plans.

21. What is a price-to-earnings ratio?

A price-to-earnings ratio (P-E) is a figure that helps an investor judge whether a stock is priced too high or too low. Corporations arrive at this figure by first dividing the corporation's earnings for the year by the number of shares of stock outstanding (that have been sold throughout the corporation's history and are still out in the hands of investors). That gives an "earnings per share" figure. To calculate the price-earnings ratio, the earnings per share number is divided into the current price of the stock. For example, if a particular stock is selling for $10.00 a share and the company is earning 50 cents per share, you divide 50 cents into $10.00 and get 20. The P-E ratio is 20 to 1.

F. Regulatory agencies and organizations

1. The California Department of Corporations

- Call the Consumer Call Center

  The Department of Corporations regulates the offer and sale of securities in California and investigates consumer complaints involving violations of the Corporate Securities Law. To file a complaint or to receive general information, please call the Department's toll-free telephone number, 1-866-ASK CORP (1-886-275-2677). You will be connected to a Department of Corporations service representative Monday through Friday from 8:00 a.m. to 5:00 p.m.

- Visit us on the Web

  For information concerning securities offerings in California, securities laws and rules, and industry organizations, please visit the Department of Corporations' Web site at www.corp.ca.gov and follow the Securities Regulation Division links. This Web site provides other useful information including consumer complaint forms.

- Stop by one of our offices

  The Department of Corporations' offices are located throughout the state:

  Sacramento
  (916) 445-7205
  1515 K Street, Suite 200
  Sacramento, CA 95814-4052

  San Francisco
  (415) 557-3787
  1390 Market Street, Suite 810
  San Francisco, CA 94102-5303

  Los Angeles
  (213) 576-7500
  320 West 4th Street, Suite 750
  Los Angeles, CA 90013-2344

San Diego
(619) 525-4233
1350 Front Street, Room 2034
San Diego, CA 92101-3697

2. The Securities and Exchange Commission (SEC)

The SEC is the primary federal agency responsible for regulating the securities industry. The SEC is responsible for protecting investors against fraudulent and manipulative practices in the securities markets. You can find the SEC on the Web at www.sec.gov.

3. The National Association of Securities Dealers (NASD)

The NASD is a self-regulatory securities industry organization responsible for the operation and regulation of the NASDAQ stock market and the over-the-counter market. The NASD investigates complaints against member firms and endeavors to ensure that all of its members adhere to both its own standards and those laid out by the SEC. You can find the NASD on the Web at www.nasd.org.

4. The Better Business Bureau

Look in your local phone book or on the Internet for your local Better Business Bureau for further information on securities law violators.

VII. Conclusion

Investing is a very important decision that requires serious thought and deliberation. It is the hope of the Department of Corporations that this guide provides you with a valuable starting point by offering some basic information about investing. Now it is up to you to continue your research, taking the time to educate yourself. There are many factors to consider about investing in general, your chosen investment, and perhaps most importantly, yourself. Ultimately, you must take the time to learn as much as you can about a particular investment and investing in general. And remember, no deal is so good that you must act on it immediately or before questions are answered to your satisfaction.