with statute, commissioner's rules, or the Department's administration of the rules, as well as the relative effects of these factors.

There are no measurements of the costs to investors from their inability to participate in profitable ventures that have not been able to register. One example in Arizona illustrates how merit review can be harmful to investors. This was the case of Genentech, the pioneer of a new biotechnology industry, which was never approved by the Arizona Commission. The price more than doubled on the day of the issue, but the offering was not available to Arizona investors.[92]

Benefits of the Merit Review System

The benefit of merit review is the prevention of fraud and costs associated with its occurrence. Research on fraud prevention and investor protection faces the same data problems as research focusing on the costs of merit review to businesses. There are no data on the number of troublesome security offerings the state regulations prevent from being sold. Fraud incidence and data on the relationship between the number of filings, regulatory system, and fraud are not readily available. However, as discussed earlier, there are powerful examples that the system could not prevent a series of massive fraud incidents totaling about $2 billion in securities. These include American Continental, Z-Best, and Pioneer Mortgage among others.

3. The Need to Protect Investors

The merit review system protects investors by not only requiring the disclosure of information needed by the investors to make informed decisions, but also eliminating offerings that regulators consider substantively flawed.

One of the main arguments supporting a merit review system is that full disclosure systems are not sufficient to prevent fraud. Unsophisticated investors either do not read prospectuses, or they do not have the knowledge required to evaluate investments. Critics think that this is a paternalistic approach that protects investors from themselves. They also think that regulators do not have the expertise to understand and evaluate offerings and that the merit review system permits regulators to take the investment decision out of the hands of investors.[93] According to many, regulations may not be needed in many instances. This is because sophisticated investors often understand the implications of a deal's structure better than a regulator does.[94] Merit review supporters respond to these critics that, in comparison to the average investor, administrators have more expertise and they are better able to detect deceitful schemes.

[92] Tara Ellman, "The Cost of…" Op. cit.
[93] Mark A. Sargent, "A Future for Blue Sky Law." *University of Cincinnati Law Review*. Volume 62, No 2. Fall 1993.
[94] See testimony of Mr. Stuart Buchalter in: Senate Finance, Investment and International Trade and Assembly Banking and Finance Committees. "Capital Flows and Leaky Buckets: Regulation of Securities in California." Information Hearing Final Report. March 18, 1997, p. 19.

4. Contemporary Relevance of Merit Review

The following developments are creating the need for state regulators to reexamine their securities regulatory processes.

- Changes in federal regulations.
- Financial technological advances and integration of world capital markets.
- Information technology.
- The need for equity investment.

a) Changes in Federal Regulations

In the last decade, in an effort to coordinate and respond to changes in the federal regulations, there have been changes in many blue-sky systems that have substantially reduced the role of merit regulation. For instance, states have been implementing numerous piecemeal changes to coordinate their standards with federal regulations. One example is California law, Section 25102(f), a state-exemption for private offerings promulgated to coordinate with federal exemptions contained in Regulation D.

Furthermore, the passage of NSMIA in 1996 preempting states from imposing merit standards on certain offers has substantially restricted the scope of state regulation, leaving only a relatively narrow class of offerings subject to qualification. Since the number of exemptions is larger than the number of cases subject to merit review, critics of merit review think the significance of this system has declined over time and its existence no longer makes sense.

b) Financial Technological Advances and Integration of World Capital Markets

The increasing integration of regional and national financial markets will also impose changes in blue-sky legislation. With globalization, Californians can buy securities throughout the world. This change makes it more difficult for state regulators to impose state qualification standards on foreign issuers. State regulatory requirements may prevent foreign issuers from selling in California. In a world where the mobility of capital across national boundaries is important for economic development, this would not be beneficial for the economy of the state.

c) Information Technology

States like California have had the same policy of regulating the offering and sale of securities for over 80 years. This policy may no longer meet the needs of the electronic age and instantaneous information transfer. For instance, high-speed computers allow securities to be traded in large volumes very rapidly. With the Internet, investors will be able to buy and sell securities via their laptop or home computers without the help of a traditional broker-dealer. In the new environment where investors can buy their securities electronically, the current qualifications may no longer be relevant or they may be very difficult to enforce. For example, in the past, Americans who wished to trade on foreign markets had to go through an

American broker with overseas connections or an overseas broker who was a member of the foreign trading facility. The SEC regulated the brokers as "gate keepers." Now that Americans can interact directly with foreign computerized trading markets, there are no intermediary brokers for the SEC to regulate.

There are some key issues that sooner or later the SEC and states like California will have to confront as a result of all these changes. One is the regulators' establishment of jurisdiction to trade markets that have no state or national boundaries.

d) The Need for Equity Investment

There is an increasing need for equity capital as bank lending is no longer a source of capital for new ventures and venture capitalists specialize in certain types of high profitable ventures and geographic regions (communications, software, electronics in Silicon Valley, for example).

There are about 23 million small businesses in the United States. The National Federation of Independent Businesses found that almost three million companies were started in 1997. In the 1990s, the average has been one million starts per year compared to half a million in the 1980s.[95] The increase in the number of small business starts calls for a serious look at the regulatory system that affects capital formation in these companies. After the passage of NSMIA, state registration and merit review systems may impede the flow of capital to small businesses since merit review generally applies only to small company offerings.

5. The Fairness of Merit Review

One problem with the merit review system is the subjective nature of the review standards and processes where staff and applicants can expect to find differential treatment for similar situations. Some securities attorneys point out that since the fair, just, and equitable standard is subjective, merit review systems put regulators in an awkward position when evaluating businesses. What is fair for one company is not necessarily fair to another. The judgement is left to the regulator.

Critics point out that the current system is unfair since only a relatively narrow class of offerings, including most offerings from small businesses, remains subject to stringent substantive regulation while many other offerings of a similar character escape it. The vast majority of securities sales in California are done through exemptions that are currently allowed in regulations. In California, during the 12 months ending January 31, 1999, the Department of Corporations received 44,143 filings exempt from qualification. Only 551 offerings were subject to state regulations.[96]

Others do not think that a merit review system that applies only to smaller companies is an unfair system. They argue that the large companies are the ones that are continually exposed to a review by the market. For example, they are subject to tight scrutiny by investment banks. Small companies do not get this type of review so that merit review is appropriate for

[95] "Capital Formation Alternatives for Small Companies." *The SCOR Report*. Vol. 6, No. 1, January 1999. Dallas, Texas.

[96] Letter from Mr. Ronald C. Carruth, Securities Regulation Division, to Rosa Moller. February 9, 1999.

investor protection. On the other hand, the costs may be borne by investors when they are willing to pay a higher price for registered offerings, since the risk of these offerings has been lower through the qualification process.

Another fairness issue with the current regulatory process is that the full cost of the qualification process is borne by the issuer while the benefits of the process are directed to investors. The question is whether there is an alternative way to protect investors without imposing all the costs on the business.

SECTION 4

CALIFORNIA SECURITIES REGISTRATION SYSTEM

This section discusses how issuers must qualify their securities with the Department of Corporations, how the current system works, and the steps for obtaining a permit from the state to offer and sell securities.

A study in the early 1980s found California to be among the most "stringent" states at the time.[97] However, California and other states have modified their laws since then and it is not clear how the California system ranks today among other states. Still, according to interviews with securities attorneys from all over the country, California's regulatory system continues to be one of the most difficult in the U.S.

OFFERINGS QUALIFIED BY THE DEPARTMENT OF CORPORATIONS

The offer or sale of any security in California that is not qualified or exempted is illegal.[98] A transaction occurs in California if any of these three acts occur:[99]

- An offer to sell or buy is made in California.
- An offer to buy or sell is accepted in California.
- Both the seller and the buyer of a security are located in California, or the security is delivered to a California purchaser.

There are three methods by which an applicant may qualify issuer transactions: qualification by coordination, by notification, and by permit.

Qualification by Coordination. This method applies to issuers registered under the Securities Act of 1933. The offering of securities may be qualified as part of the same process of SEC registration. In practice, this merely means that an issuer filing with the SEC can attach the SEC registration form to the California registration form to receive expedited attention from the Department of Corporations. The process is basically the same as the one followed for issuers that qualify by permit.[100]

Qualification by Notification. Some securities such as those issued by investment companies registered under the Investment Company Act of 1940 may be qualified by notification. This

[97] Jay T. Brandi, "Securities Practitioners and Blue Sky Laws: A Survey of Comments and a Ranking of States by Stringency of Regulation" 10 *Journal of Corporation Law*, No 13. Spring 1985.
[98] California Corporations Code, Sections 25110, 25120 and 25130.
[99] California Corporations Code, Section 25008(a).
[100] California Corporations Code, Section 25111.

type of registration is generally reserved for issuers with a sound earnings track record. It requires a mere notice filing with the state.[101]

Qualification by Permit. All other offers and sales by issuers must be qualified by permit.[102] Securities eligible for qualification by coordination or notification may also be qualified by permit.

The permit procedure differs from coordination and notification in that the Commissioner must take affirmative action to issue a permit. No offer or sale of nonexempt securities not qualified by coordination or notification is permitted before the Commissioner has issued a permit, unless the transaction itself is exempt.

An open qualification is one that authorizes the offer and sale of securities to the public in general, without restriction regarding persons or class of persons. A limited offering qualification authorizes the offer and sale of securities only to persons designated therein by name or class.

The majority of offerings do not need any California filing. For example, the following offerings are not required to file in California:

- Offerings to qualified purchasers.
- Offerings under the California private placement exemption (Sections 25102(f) or 25102(n).
- Offerings that use Rule 506 of Regulation D.
- Offerings that will result in national listing or quotation.
- Reorganization and overcapitalizations under the eight exemptions of California Corporations Code, Section 25103.

As noted earlier, many offerings are exempted from any filing and are not recorded by the Department. Other issues are subject to exemptions that require notice to the Department. Only a small number of offerings, typically from smaller firms or intrastate issues, are subject to the Department's review. As stated in the previous section, during the 12 months ending January 31, 1999, the California Department of Corporations recorded 44,143 exemptions from qualification that required filing a simple notice form and a fee, and only 551 applications for permit.[103]

How Does the System Work?

California securities offerings and sales are regulated by:

- The Corporate Securities Law of 1968.[104]
- The Rules of the Commissioners.[105]

[101] California Corporations Code, Section 25112(a).
[102] California Corporations Code, Section 25113(a).
[103] Data provided by Mr. Ronald Carruth, Supervising Counsel of the Department of Corporations, Securities Regulation Division, and San Francisco Office.
[104] As amended, codified in Sections 25000-25706 of the California Corporations Code.

- Releases of the Commissioner.

The Department of Corporations is responsible for administering the Corporate Securities Law of 1968. It is headed by the Commissioner. The department has offices in Los Angeles, Sacramento, San Diego, and San Francisco.

Under the current system, the Commissioner promulgates rules identifying the particular requirements used by the department when reviewing an application. These regulations provide wide administrative discretion, covering a wide range of issues such as:

1. The terms of the securities offered and the business plan of the issuer. For example:

    - The degree to which the business is anticipated to provide profits within a reasonable period of time.
    - The degree to which the business depends on a product to be developed in the future.
    - The distribution of voting rights among various classes of shares. Equal voting rights for public investors vis-à-vis the existing inside investors.
    - The existence of protective provisions for holders of preferred shares and holders of debt securities.
    - The offering price of the securities.
    - The allowable amount and proportion of selling expenses (typically 15 percent) and promotional shares. It limits the amount of stock held by promoters to typically 30 to 35 percent.[106]
    - The use of promotional shares to encourage sales.
    - The requirement that the company have the financial resources to meet debt or preferred stock responsibilities.

2. The accuracy and completeness of disclosure to investors.

3. Effects on subsequent purchasers of the securities.

4. Requirement that the company must have the financial resources to meet debt or preferred stock responsibilities.

The Commissioner's discretion is broad in its interpretation of what are fair, just, and equitable criteria. However, there are two limitations. First, the Commissioner has the burden of proving that the offering is unfair, unjust, or inequitable. Second, the Commissioner cannot refuse to issue a permit based on the price of a security offered publicly under the 1933 Securities Act, when the offering is underwritten by a registered

[105] Which are adopted by the Commissioner under California Corporations Code Section 25610, contained in Sections 250.9 through 260.617 of Title 10 California Code of Regulations. The Commissioner's rules regarding securities begin with the designation 260 and are followed by three numbers that correspond to the last three numbers of the relevant statutory sections. For example, rules relevant to Section 25102 of the California Corporations Code are found in Sections 260.102 through 260.102.14 of the regulations.

[106] Promoter means a person who, acting alone or in conjunction with one or more persons, takes the initiative in founding and organizing the business or enterprise of an issuer.

underwriter or underwriting syndicate.[107] The Commissioner has developed a set of regulations that define the fair, just, and equitable standards to be imposed on issuers.

The Steps of the Application Process

Typically, the application process includes the following stages:[108]

- Issuer files application with the department. Fees range from $25 to $600.
- Department assigns staff attorneys to review the application.
- Staff attorneys determine the merit of the application by comparing the application materials to the standards specified by the Commissioner in Title 10.
- Within 15 days the department must decide whether the application qualifies. The attorney either 1) approves the application and issues an order to this effect, or 2) contacts the applicant to explain application's deficiencies that need to be amended.
- Applicant negotiates with the department on areas of non-compliance.
- Non-compliant applications are either "pending" until approved, withdrawn by the applicant or "abandoned" by the commissioner when the applicant has not responded to the department communications in a reasonable period of time.

Critics of the California Securities Registration Process

Through interviews with corporate securities lawyers who have dealt with the California Department of Corporations and blue-sky administrators from various states, the following views were expressed regarding the California Securities Registration process:

- Most securities attorneys indicated that they discourage their clients from raising capital through public offerings due to the difficulties involved in the registration process. When asked about specific examples of offerings that would illustrate the problems of the registration, most of them could not cite any specific case. The reason for this is that as lawyers, they had not experienced any particular problem since they knew how to work the system. This would not be the case with direct issuers. Furthermore, most of them avoid the system, recommending issuers to raise capital through private placements, or to look for other capital sources. To avoid problems, some of them just did not deal with small issuers. Finally, most of the securities attorneys agreed that the small issuers are the ones that have the most difficulties, particularly those filing for SCOR offerings.

- Most of the securities attorneys indicated that the registration processes in states with merit review systems are all difficult and expensive.[109] According to most of the securities attorneys and some regulators, California has one of the toughest merit review-based registration processes. They reported that the California Department of Corporations has been, at times, very unreasonable and very rigid, although it has changed in a positive way in recent years. However, the statute itself is vague. There are

[107] Marsh and Volk. Practice Under the California Securities Laws, Vol. 2 of three volumes, rel. No. 23, 1995.
[108] From Staff Briefing Paper, in Senate Finance, Investment and International Trade and Assembly Banking and Finance Committees. "Capital Flows and Leaky Buckets: Regulation of Securities in California." Information Hearing Final Report. March 18, 1997, p. 61.
[109] In this sense, the California regulatory system imposes costs on businesses as any merit review system does. For a discussion of the costs imposed by merit review, see Section 3.

areas that are still tougher than in other regulatory systems. Furthermore, after NSMIA, the merit review system is applying to fewer and fewer issuers.

- The system is especially difficult for non-California issuers. Foreign companies have problems in at least two areas: shareholders voting rights and regulations related to corporate governance. For example, some European countries such as Sweden have strict laws on the permissible amount of voting stock outside the country. Other countries such as the United Kingdom have veto power provisions that conflict with California regulations. These are issues that need attention in a world of increased financial globalization.

- Most regulators and some securities attorneys that were interviewed thought that merit review is needed, but that the California process could be simplified. They also thought that the system does protect investors although it cannot prevent fraud.

- Many securities attorneys and regulators indicated that most of the problems with the California regulatory system derive from the application of the laws and regulations rather than the regulations themselves. The main problems with the California system are the subjective nature of merit review and the application of laws by California regulators that go beyond their statutory authority to either administer or enforce. In general, there is no consistency in the regulators' approach. The staff of the Department is perceived as using unwritten policies when reviewing deals. Some members of the Department have dealt with the review process in a very rigid manner.

The imposition of shareholder democracy rights provisions is a clear example of subjective interpretation of the broad "fair, just and equitable" language by staff counsel alone. Shareholder democracy provisions are not specifically found in statutes (California Corporations Code), regulations, or the Department of Corporations' publications. In the past, policies on these matters were often based on references to California's General Corporations Law, a law the Department of Corporations has no statutory authority to either administer or enforce.[110]

Tidewater Marine, a New Orleans-based work boat company took the Labor Commissioner to the State Supreme Court over the regulators' subjective interpretation and imposition of Industrial Welfare Commission (IWC) wage order standards. The Court held that the consistent and rigid imposition of such unwritten policies by a state administrative agency is, in effect, the imposition of an "underground" regulation not subject to any official public comment period requirement, and that is both "illegal and unenforceable under the state Administrative Procedures Act." [111] This case was important because it had implications for all state agencies. For example, the former Assistant Commissioner of Securities of the

[110] "California High Court Outlaws Department of Corporations' Secret Policies." *The SCOR Report*. Vol. 5, No. 13. November 1998. Dallas, Texas. Although this article is confused about the defendant in the Tidewater case, the case still may be relevant to the Department of Corporations practices. The defendant in the Tidewater case was indeed the Labor Commissioner. However, Mr. Blake Campbell, during his former position as Assistant Commissioner of Securities in the Department of Corporations, issued an e-mail directive to his staff to assure that the Department's regulatory review staff was not in violation of the law as set forth in Tidewater.

[111] "California High Court Outlaws Department of Corporations' Secret Policies." *The SCOR Report*. Vol. 5, No. 13. November 1998. Dallas, Texas.

Department of Corporations sent a directive to his staff to prevent the Department's regulatory review staff from being in violation of the law as set forth in Tidewater.[112]

Recently, the California Department of Corporations has adopted the following internal practice when reviewing staff counsel comments. Comments will be restricted to, or emanate from either:

1. A specific California securities law, rule, or regulation officially adopted and published by the Department of Corporations, or
2. A formal Interpretative Opinion or Policy Release promulgated in writing by the Department of Corporations.[113]

[112] E-mail communication with Mr. Stewart-Gordon.
[113] "California High Court…" Op. cit.

SECTION 5

EFFECTS OF THE CALIFORNIA MERIT REVIEW SYSTEM ON CALIFORNIA BUSINESSES

This section describes the business sectors that are likely to be most affected by the California merit review process. Smaller companies are subject to the review process. Larger well-established companies are usually exempted. Studies in other states indicate that a significant proportion of companies fail the registration process. It also appears that many smaller companies are discouraged from applying.[114] Unfortunately, there is no readily available data on how many companies in California are not successful in obtaining approval for their offerings.

Lack of capital affects most small businesses. Particularly vulnerable are businesses developing new products or technologies in areas that are not currently the focus of venture capital. Venture capital disregards these businesses perhaps for their lack of experience in investing in those activities, or because the immediate returns are modest in comparison to those offered by software, communications, and electronic networks. Activities such as mechanical engineering, environmental technologies, trade and services companies need more funding. Businesses located in Sacramento, San Diego, and Los Angeles also need more access to equity capital.

FIRMS THAT ARE MOST LIKELY HURT BY THE MERIT REVIEW SYSTEM

There is agreement in the literature on securities regulations and among the experts in the field that merit review affects small businesses at an early stage of development the most. This is particularly true for those applying for SCOR.

Anecdotal Evidence Gathered From Companies That Filed for SCOR

I requested from the Department of Corporations a list of companies that had been subject to merit review during the last few years. I received a list of 12 companies; all of them had filed under SCOR.[115] In addition, I also obtained some additional names of companies from the various issues of *The SCOR Report*. Most of the companies on these lists were not interviewed because their telephones were either disconnected, or the companies' representatives did not want to share their experiences with us. Only five companies agreed to discuss their varied experiences:

One company reported an excellent experience. This was a direct offering by the issuer. The regulatory process was fairly rapid although the process of raising money was slow. Stock

[114] See Ellman, Tara. "The Cost of …" Op. cit. This Arizona study indicates that two-thirds of small companies fail to get through the process. It also appeared that many smaller companies are discouraged from applying.
[115] See Attachment for the list of companies provided by the California Department of Corporations.

was sold to investors, friends, family, clients, and persons acquainted with the company's history and products. This company was at the edge of bankruptcy and the purpose of the offering was to save the firm.

Two other companies also indicated that they did not have major problems. One of them was a business that had been operating for 18 years and had a history of revenues. The representative of the company emphasized that SCOR was a wonderful tool to raise capital and that the problem is a lack of information on the existence of this resource for small companies. It took them four months to register and cost them $30,000. They sold the stock to customers.

The other company filed in Ohio and in California. The company's lawyer did the filing. The company's lawyer indicated that he did not have major problems with the registration process. Although California and Ohio's registration rules differ, the lawyer thought that these states are comparable in the level of difficulty of the registration process. He also felt that the lack of uniformity between states makes it costly to clients.

Two of the five contacted companies reported a very bad experience. One of them was a manufacturing company. Representatives of the company reported that they had experienced difficulties because the process was bureaucratic and standards were applied unevenly by the regulators. In other words, different regulators asked for different things related to the same aspect of the application. The company had to hire an attorney since they were unable to register by themselves. Their registration process took six months.

The other company that reported a bad experience was a services company. This was a direct issuer. They described the process as lengthy, four to five months of negotiations back and forth. "The regulator, a person with a big ego, demanded one piece of information at a time, instead of laying out at once all that was needed to complete the application." Finally, the offering was approved, but for qualified investors only (suitability standards were imposed). This company also made an offering in New York, where the process was slow but easy (it took two months). After many months, they have not been able to sell any stock in California. They raised $200,000 in New York. The representatives of the company believe their experience is not unique and that other companies that offer similar products have encountered the same problems.

California Businesses That Need Equity Capital and Their Economic Significance

The small business sector has high investment risks. Traditionally, the high probability of failure of small businesses has deterred capital from this sector. Currently it is even more difficult for small ventures to raise capital, since the booming stock market is providing a variety of more lucrative investment alternatives.

The small business sector is important for the state and national economy. Most of California employment is provided by small businesses (less than 100 employees). From 1993 to 1997, small business created over 1.3 million new jobs in California, while large businesses lost almost 280,000 jobs. The greatest number of small businesses is in the service industry, followed by trade, construction, and manufacturing. The services sector is a major contributor of job growth in the economy, particularly business services, computer

programming, engineering, and health and research services. New, fast-growing firms are concentrated in manufacturing and transportation, communications and utilities.[116]

Growth is led by two types of firms: those that create new technology and those that are sufficiently new to apply the new technological innovations. Most venture funds go to the former group. Within this group of firms, the businesses that actually get funded are those in telecommunications, computer, electronic devices, electronic networks, and biotechnology, where the returns on investment are currently very high. More than 75 percent of venture capital investments in California tend to be concentrated in the communications, computer, and software industries located in the Silicon Valley. In the meantime, venture capitalists and other investors that are searching for unusually high returns are ignoring other businesses with lower and moderate rates of growth. Particularly underserved are:

- Businesses located in Los Angeles, San Diego, Sacramento, and the Central Valley.

- Businesses developing new products or technologies in areas that have been traditionally neglected by venture capitalists and other investments due to their lack of expertise to judge these new ventures. These include mechanical engineering, environmental technologies, and new companies in the trade and services sectors.

Based on 1996 estimates by the U.S. Small Business Administration, small businesses yearly need about $90 billion early-stage (high risk investment) equity capital. Using the fact that 13 percent of U.S. firms are located in California, capital needs for early-stage businesses are about $12 billion. This figure has to be taken with caution. On one hand, this can be a conservative estimate, since the highest proportion of U.S. fast growing firms are in California. On the other hand, the amount of venture capital available in California is higher than in the rest of the nation. However, venture capital funds are used by only one percent of U.S. small businesses (under 100 employees).[117]

It is important for economic development that capital is available for innovation and the development of new industries that apply new technologies. Regulatory bottlenecks that increase the cost of doing business and interfere with the flow of economic resources without clearly identifiable benefits are detrimental to economic growth.

Still, it is important to note that even if all capital channels were open to small businesses (including the establishment of a very simple securities regulatory system) a large majority of them may still fail in raising capital. There are many small businesses that satisfy the regulatory process but are unable to raise the total targeted amount of their offerings. This is due to many factors. For example, small businesses have to compete for funds with other investments that offer high returns. Others are misguided by false promises from brokers who, in their eagerness to carry the offerings and make money from it, mislead companies on their capability to actually raise the amount of capital needed from the public.

[116] Gus Koehler and Rosa Maria Moller. "Business Capital Needs in California: Designing a Program." First part (developed by Gus Koehler). California Research Bureau, Issue Paper, 1998. CRB-98-005.
[117] Gus Koehler and Rosa Maria Moller. "Business…" Op. cit.

SECTION 6

POLICY OPTIONS

This section summarizes the policy alternatives suggested by the parties contacted during this study as well as those that can be drawn from the literature written by professionals who have analyzed the securities regulatory systems.

The suggested policy alternatives range from eliminating the merit review system altogether to policy changes that could improve capital access to business and decrease the costs of regulation. Most securities attorneys, some regulators, and some experts contacted for this study did not see the merit review process as an effective tool of investor protection. The fact that there were more than 10 massive fraud cases (American Continental, Z Best, Pioneer Mortgage, among others) involving more than $2 billion in securities approved by the Department of Corporations illustrates this. The evidence collected in this research indicates that there may be high costs to businesses searching for equity capital due to merit review, while the investors' benefits may not be that significant since the system is not an effective fraud prevention tool. The issue is how many troublesome securities does merit review actually prevent from being sold in the state, and how significant would these losses be? Can the same benefit be achieved at a lower cost?

In conclusion, most of the consulted parties felt that the registration process in California could be improved. The following options can be drawn from the analysis of the registration process to raise capital in public and private markets.

ELIMINATE THE MERIT REVIEW SYSTEM

Most practicing securities attorneys consulted in this study recommended getting rid of the merit review system and replacing it with full disclosure. In addition to being an ineffective tool for fraud prevention, merit review is a subjective process that places the evaluation of investment projects in the hands of regulators, who do not always have the expertise to judge or evaluate them. According to some of the consulted parties, investor education and public awareness is the best tool to prevent fraud. Fraud prevention could be achieved by focusing more resources on enforcement and by educating investors. There are many states that focus on investors' education by disseminating information and conducting investor seminars. California could develop an investor outreach and education program as an alternative to merit review.

Other experts in securities regulation have suggested that merit review could be replaced by full disclosure. To protect investors, issuers and brokers could be required to impose suitability standards for certain risky investments. However, a system that would depend on the issuers and brokers regulating themselves may not work since it is in the interest of the issuers to get as broad a pool of investors as possible.

IMPROVE THE IMPLEMENTATION OF MERIT REVIEW

Most regulators consulted in this study[118] disagree with the position of eliminating the merit review system. They think that, although merit review does not prevent fraud, it protects investors from highly risky ventures. For example, the imposition of a rule on the number of directors in an offering company, as it is implemented in the state of Washington, protects investors' interests in a way that full disclosure systems do not. Many regulators pointed out that the problem is not the merit review system but its implementation. The following options could improve the current system:

- Establishing and sticking to objective standards, reducing the possibility of regulators' applying subjective criteria in the review process.

- Streamlining the paperwork and speeding up the registration process.

- Changing the operational structure in the Department of Corporations to one that would improve the efficiency of the review process.

- Establishing a business friendly climate by:

    1. Training regulators to provide their services focusing on customer satisfaction. This has been done in Washington.

    2. Providing clear information, in plain English, on the requirements, procedures to follow, and the process itself.

    3. Opening a small business ombudsman office to educate, counsel, and provide legal assistance to applicants on the registration process. The state of Washington assists small businesses toward understanding the compliance process in order to minimize security review delays. They educate issuers on the qualification process.

    4. Disseminating information throughout the state on the various ways a small business can raise capital through public and private offerings, so that small businesses can be informed.

- Creating an organization that provides issuers and investors with information, education, and technical assistance on securities registration and various ways to raise capital through public and private markets. This organization could be part of the California Trade and Commerce Agency. It may have multiple functions, among them:

    - Provide a forum for discussion of issues, problems, and opportunities related to small business investment.
    - Educate investors through the dissemination of information on various aspects of investment decisions.
    - Educate small businesses on the various ways to raise capital.
    - Educate businesses on the registration process.

[118] Including the Assistant Commissioner for Enforcement for the Department of Corporations.

- Monitor efficient electronic networks bringing together accredited, sophisticated investors and businesses.
- Collect data on the regulatory effect on various issuers.
- Evaluate and propose legislative actions to improve the regulatory process for offering and sales of securities.
- Organize seminars; publish newsletters and other educational materials on small business investment-related issues.

CHANGE REGULATIONS

Capital access may be improved by establishing new and/or modifying existing exceptions to open the number of potential investors for small businesses. For example:

- Modifying the California qualified purchaser definition by:

  1) decreasing the amount of assets that define these investors. For example home equity could be included to calculate the net worth requirements on purchasers,
  2) eliminating merit review for small offerings exempted from federal registration, such as SCOR or Regulation A offerings, and just apply full disclosure to these issues.

- Permitting public offering (instead of a general announcement tombstone add) for issues of $1 million or less, without restrictions. Texas and Pennsylvania have these statutes.

- Facilitating the identification of potential investors by businesses. This could be achieved by expanding the test-the-waters provision to other offerings, or establishing some criteria that would allow companies to evaluate the interest on the offerings.

  A way of facilitating the identification of potential investors by businesses is allowing finders to become more visible. Finders are persons that bring together businesses and wealthy investors. They usually receive a commission on the investment. Finders are very important in raising money for small businesses and private placements. However, it is hard for businesses to get in touch with finders. To help businesses identify finders, California may consider:

  1) Creating a new category of certified broker-dealer-finders. This process would allow finders to become more visible, or
  2) Creating a body of law to protect and recognize the role of finders in order to stimulate their activities.

COOPERATE WITH OTHER STATES AND NASAA'S EFFORTS TOWARDS UNIFORMITY

The Department may consider continuing to work towards uniformity of procedures with other states and the SEC. For example, it may:

- Coordinate the registration process with other involved parties (other states and the SEC).

- Participate more actively in national efforts towards uniformity, such as NASAA guidelines or others that streamline the process for multiple-state offering registration.

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ADDENDUM

LETTER FROM WILLIAM KENEFICK, ACTING COMMISSIONER, DEPARTMENT OF CORPORATIONS, BUSINESS, TRANSPORTATION AND HOUSING AGENCY, SEPTEMBER 21, 1999, WITH 2 ATTACHMENTS.

Attachment No. 1. Copy of Letter to Rosa M. Moller, dated February 9, 1999, from Ronald C. Carruth, Supervising Counsel, Securities Regulation Division, Department of Corporations

Attachment No. 2. Copy of Commissioner's Release No. 1-CACL, dated August 9, 1999, titled "Capitol Access Company Law"

DEPARTMENT OF CORPORATIONS
SACRAMENTO, CALIFORNIA

IN REPLY REFER TO
FILE NO. Alpha

September 21, 1999

Rosa M. Moller, Ph.D.
California Research Bureau
900 N Street, Suite 300
P. O. Box 94237-0001
Sacramento, CA 95814

Re: Securities Regulation and Small Businesses in California

Dear Dr. Moller:

This letter follows-up on our telephone conversations during the week of September 12, 1999, and follows-up on the February 9, 1999 letter to you from the Securities Regulation Division of the Department of Corporations. I have attached a copy of the February 9th letter for your convenience.

After a previous conversation with you, I also forwarded to you a copy of Commissioner's Release No. 1-CACL with respect to the implementation of the newly-enacted Capital Access Company Law. A copy of this release is attached, as well.

Our telephone conversations during the week of September 12, 1999 centered around whether the Department of Corporations was a participant in the Western Regional Review Program. I have been informed by the Securities Regulation Division that, early-on, when the Western Regional Review Program was a "pilot program," the Department of Corporations participated with other western states. As part of the pilot project, approximately five SCOR applications were reviewed by the Department's Securities Regulation Division. I am informed that after the termination of the pilot program there was not much activity under the Western Regional Review

Program, especially with respect to Regulation A offerings. Consequently, the Department of Corporations has not participated in the Western Regional Review Program. Furthermore, recent discussions with the Department of Financial Institutions in the State of Washington revealed that only about 10 applications are filed each year requesting review under the Western Regional Review Program, and that these filings are generally SCOR applications and not Regulation A applications. Finally, the Department of Corporations has been informed that the small businesses seeking review under the Western Regional Review Program seek registration (or qualification) of a common stock offering in only four or five of the participating Western Regional Review Program states. This seems both reasonable and understandable to us, as SCOR limits the amount that a small business can raise through the sale of common stock at $1 million in the aggregate.

During this same period, I am informed by the Securities Regulation Division that California has processed 13 SCOR applications for the 1997 calendar year, 10 SCOR applications during calendar year 1998, and approximately seven applications for the current calendar year. As I mentioned to you over the telephone, the California SCOR filing requirements are more liberal than the SCOR filing requirements of other states. This may explain why the California SCOR filings appear to track the number of SCOR filings under the Western Regional Review Program. In this regard, please see Corporations Code Section 25113(b)(2), specifically paragraphs (B) and (C).

In addition, with respect to a "small business issuer" that proposes to raise more than $1 million (and, therefore, is not eligible for SCOR), the Rules of the Commissioner of Corporations have been significantly liberalized to accommodate the concerns of these small businesses. Specifically, see Commissioner's Rules 260.140.01(e), 260.140.05, 260.140.20(b) and (c), and 260.140.31(b) found in Title 10 of the California Code of Regulations.

Finally, looking at the totality of the provisions of the Corporate Securities of 1968 and the Rules of the Commissioner of Corporations (including the statutory exemptions from the review and approval process for the offer and sale of securities, the liberalized SCOR requirements, and the liberalized qualification standards for a "small business issuer"), as well as the provisions of the new Capital Access Company Law, one may conclude that significant and efficient capital-raising opportunities exist for small businesses in this state, consistent with the appropriate balance between the interests of small businesses and the Legislature's mandate to protect California investors.

If I can be of further assistance to you, please feel free to contact me at the telephone number below.

Very truly yours,

WILLIAM KENEFICK
Acting Commissioner
(916) 322-3553

WK:kw

Attachments

cc: Brian A. Thompson
Acting Chief Deputy Commissioner &
Assistant Commissioner, Securities Regulation Division

STATE OF CALIFORNIA – BUSINESS, TRANSPORTATION AND HOUSING AGENCY
GRAY DAVIS, Governor
DEPARTMENT OF CORPORATIONS
SECURITIES REGULATION DIVISION
SAN FRANCISCO, CALIFORNIA

February 9, 1999

IN REPLY REFER TO:
FILE NO: ALPHA

Rosa M Moller, Ph.D.
California Research Bureau
900 N Street, Suite 300
P. O. Box 942837
Sacramento, CA 94237-0001

Re: Securities Regulation and Small Businesses in CA

Dear Dr. Moller:

Reference is made to your letter of January 29, 1999 and our several telephone conversations.

In addition to the qualification process (filing an application and undergoing merit review before receiving a permit) many small business utilize exemptions from qualification, a process that involves filing a simple notice form and paying a filing fee scaled on the amount of securities being sold.

During the 12 months ending January 31, 1999, the Department of Corporations ("DOC") received the following filings exempt from qualification:

Type of Filing:	No. of Filings:
1. Notice under CSL§25102(f)	38,321
2. Notice under CSL§25102(h)	1,365
3 Notice under CSL§25102(n)	63
4. Notice under CSL§25102(o)	1,881
5. Notice under CSL§25102.1(d) (Rule 506)	2,513
Total number notices filed:	44,143

I am also enclosing a copy of SB2189 (Vasconcellos), the Capital Access Company Law, that will become effective July 1, 1999 and will be administered by the DOC and copies of the DOC's Document OP 17/98-A, B and C which contain the text of the DOC's Statement of Reasons and Proposed Rules under the Capital Access Company Law. Also enclosed is a list of SCOR applications that have been qualified by the DOC. I don't have the names of any Reg A filings; the staff was not able to recall the names of any.

Please contact me if I can be of any further assistance. I trust you'll find this helpful.

Respectfully,

Ronald C. Carruth
Supervising Counsel
(415) 557-8577

Enc.

RCC:eah

SCOR Applications Qualified by the Department of Corporations:

Name	DOC File No	Contact Person
1. QUORUM FINANCIAL GROUP, INC.	#309-0853	Kevin Brundrett (805) 965-7670 Quorum Financial 803 Chapala Street Santa Barbara, CA 93101-3201
2. CROWN AMERICA, INC.	#309-1556	Joseph Giampaolo (626) 280-5838 Crown America 100 No. Citrus St., Suite 508 West Covina, CA 91791
3. STOVEACT, INC.	#309-2015	Joe Escareno (213) 239-0057 STOVEACT, Inc. 731 So. Spring St., Suite 500 Los Angeles, CA 90014
4 AUTOWISE USA, INC.	#309-2138	Charles Self (949) 855-9991 AUTOWISE, Inc. 51 Auto Center Drive Irvine, CA 92618
5 ATHEM	#309-2100	David Hitchcock (330) 963-5494 ATHEM 3147 Killingwoth Lane Twinsburg, OH 44087
6 SIMIS LABS INCORPORATED	#308-9991	Robert Richards (914) 361-4802 SIMIS LABS, Inc. 268 Petticoate Lane Bloomingburg, NY 12721
7 ALE AND LAGER ENTERPRISES dba Skagit River Brewing Company	#309-0360	David Charles (360) 336-2884 Skagit River Brewing Company 404 South Third Street Mount Vernon, WA 98273
8 GLOBAL OSTRICH GROUP NO. 7, LLC	#309-1406	Bill Ruvelson (310) 476-1533 Global Ostrich 2934 ½ Beverly Glen Circle, Ste 332 Los Angeles, CA 90077

SCOR Applications Qualified by the Department of Corporations (con't.):

Name	DOC File No	Contact Person
9. BRAINTAINMENT RESOURCES, INC.	#506-1059	Josh Reynolds (714) 494-7575 Braintainment Resources, Inc. 289 Wave Street, Suite A Laguna Beach, CA 92651
10. CAMP AMERICA JAVA * JUICE, INC.	#506-1284	John Foley (408) 620-0340 Camp America Java * Juice, Inc. 100 Delores Street, Suite 289 Carmel, CA 93921
11. DRIWATER, INC.	#506-1370	Glenn M. Smith (707) 528-WATER 50 Old Courthouse Square, #606 Santa Rosa, CA 95404
12. WIND HARVEST CO., INC.	#506-1409	George Wagner (888) 456-WIND 11101 Highway One Point Reyes Station, CA 94956

STATE OF CALIFORNIA
BUSINESS, TRANSPORTATION AND HOUSING AGENCY
DEPARTMENT OF CORPORATIONS

Gray Davis
Governor

William Kenefick
Acting Commissioner of Corporations

DATE: August 9, 1999

RELEASE No. 1-CACL

THE CAPITAL ACCESS COMPANY LAW

Senate Bill 2189 (Chapter 668, Statutes 1998) enacted the Capital Access Company Law (the "CACL"), which, among other things, provides for the licensure and regulation of capital access companies by the Commissioner of Corporations. This law, which is found at Corporations Code Section 28000 et seq., became operative on July 1, 1999, and is intended to facilitate California small businesses obtaining financing by enabling certain investment companies to rely on a recently-enacted exemption from registration under the federal Investment Company Act of 1940 (the "Investment Company Act").

Under the Investment Company Act, investment companies are subject to registration and oversight by the Securities and Exchange Commission. At the federal level, investment companies must comply with various requirements (e.g., periodic reporting, disclosure of information, examination and audit) that are designed to protect the investing public. The National Securities Markets Improvement Act of 1996 ("NSMIA") amended the Investment Company Act to exempt any investment company not engaged in the business of issuing redeemable securities if its operations are regulated by the state where it is formed pursuant to a statute regulating companies that provide financial or managerial assistance to businesses in the state, and if certain additional conditions are met. Section 6(a)(5) of the Investment Company Act. The CACL provides for the licensure and regulation of capital access companies that are exempt from the Investment Company Act by virtue of Section 6(a)(5). Capital access companies are defined under the CACL as providing financing or managerial assistance to small business firms in California. Corporations Code Sections 28047, 28200 and 28400-28404.

Also, under the existing California securities law, the Department of Corporations and the Commissioner of Corporations regulate the offer and sale of securities in this state, as well as license and regulate broker-dealers and investment advisers, under the Corporate Securities Law of 1968 (the "CSL"). The offer or sale of non-redeemable securities to accredited investors by a capital access company licensed under the CACL is exempt from the qualification requirements of the CSL. Corporations Code Section 25102(p). A capital access company licensed under the CACL is also exempt from the broker-dealer licensure requirements of the CSL. Corporations Code Section 25208.

The CACL provides that a capital access company is limited primarily to providing financial or managerial assistance to small businesses that meet specified requirements, including that the small businesses receiving the financial assistance have a significant connection to California. Corporations Code Section 28047. Although the CACL imposes obligations on the board of directors, executive committee, or other policy body of the capital access company in regard to the approval of the investment contract between the company and the person who will make recommendations with respect to the investment of funds, neither the CACL nor the rules adopted by the Commissioner under the CACL limit in any way what the organizers or fund managers can earn from their investment efforts on behalf of the capital access company. Corporations Code Sections 28152, 28153 and 28212.

Below are additional requirements of the CACL:

- The capital access company's securities can be sold only to accredited investors. Corporations Code Sections 28031 and 28200(d).
- The capital access company may not issue redeemable securities. Corporations Code Section 28200(b).
- Not less than 80% of the capital access company's securities must be held by California residents or investors with a substantial business presence California. Corporations Code Section 28200(c).
- The investment of funds by a capital access company will be limited by and subject to provisions of the Investment Company Act, the CSL, and the CACL. Corporations Code Section 28200(e).
- The CACL also requires that capital access companies have:
    - A tangible net worth of at least $250,000, exclusive of the funds to invest in small businesses. Corporations Code Section 28152(a).
    - At least $5 million in funds to invest before a license is issued. (This requirement will be satisfied by the Commissioner's issuance of the license to the capital access company, subject to an escrow or impound of funds until the company raises the minimum amount during a specified period of the offering.) Corporations Code Section 28152(b).
    - Financial resources to cover expenses for three years. Corporations Code Section 28152(c).
    - The directors, officers, and controlling persons of the company must be of good character and sound financial standing, competent to perform their functions, and be collectively adequate to manage the business of the company. Corporations Code Section 28152(d).

- A person who makes investment recommendations to the management of the capital access company be an investment adviser. Corporations Code Section 28152(e). This person need not be registered or licensed under federal or California law. However to protect investors, the law does require the investment adviser to have a clean disciplinary record in the investment business. Moreover, and importantly, upon a showing by the capital access company that it is not in the public interest, the requirement that management must rely on an investment adviser may be waived. Corporations Code Section 28951(b).

- The capital access company must comply with the provisions of the CACL, Section 6(a)(5) of the Investment Company Act, applicable provisions of the CSL, and any regulation or order adopted or issued under the CACL. Corporations Code Section 28152(f).

The Commissioner is authorized to administer and enforce provisions of the CACL, including the authority to issue licenses, establish examination and compliance procedures, and establish audit requirements and procedures. In order to implement the provisions of the CACL, the Commissioner adopted Subchapter 2.3 to Chapter 3 of Title 10 of the California Code of Regulations (the "CACL Rules"). 10 C.C.R. Sec. 280.100 et seq. The CACL Rules, which also became operative on July 1, 1999, were drafted consistent with the provisions of the exemption under the Investment Company Act and pursuant to the guidelines provided to the Department by staff of the Securities and Exchange Commission.

The application forms and instructions are contained in the CACL Rules, and are available from any of the Department's offices and through the Department's Home Page (www.corp.ca.gov). CACL applications are accepted only in the Department of Corporations' Sacramento Office, however. The Department's Sacramento office is located at 980 Ninth Street, Suite 500, Sacramento, California, 95814.

In addition, organizers of capital access companies are encouraged to contact the Department to schedule a pre-filing conference before organizing and filing an application. A prefiling conference will assist organizers in the application process.

Finally, the CACL is a new law and the Department recognizes the importance of adjusting the application process and the requirements of the CACL and the CACL Rules to accommodate legitimate business concerns consistent with the intent and purposes of the law.

WILLIAM KENEFICK
Acting Commissioner
(916) 322-3553