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Securities Regulations and Their Effects on Small Businesses

By Rosa Maria Moller, Ph.D.

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EXECUTIVE SUMMARY

This report was prepared at the request of California State Senator John Vasconcellos who asked the California Research Bureau to describe the regulatory process for private and public securities offerings, emphasizing the impact of this process on small businesses.

Small businesses often have trouble raising capital. They have the following options to raise equity capital:

1) They can run on the owner's capital, including borrowing on home equity and credit cards.
2) They can borrow from a bank, often at relatively high interest and with dangerous cash drain impacts.
3) A few can obtain venture capital.
4) They can sell equity securities, which is in many respects the preferable way to fund most early stage businesses.

California's economy could benefit from facilitating the sale of securities by small businesses because small businesses create most of the state's new jobs and introduce many of the state's new products and technologies. Indeed, in an earlier CRB report, Dr. Gus Koehler estimated that California small businesses could effectively use an additional $12 billion per year in equity capital.

Currently, California captures a substantial and growing portion of the nation's venture capital. Venture capital helps, but it has three limitations:

1) A geographical concentration in the San Jose/San Francisco Bay Area. Data for the third quarter of 1999 indicates that the Silicon Valley attracted more than 81 percent of the national venture capital. Capital flows to the Valley have increased by 167 percent from 1998 (quarter-to-quarter comparison). While this region has increased its dominant share of total California's venture capital, Southern California lost share and the Sacramento/Northern California area has remained basically unchanged.

2) A strong focus on specific high-technology industries. The increased flow is mostly benefiting computers, information technology, software, communications, biotechnology, and semiconductors businesses. Other types of economically viable businesses are not that successful in attracting this type of financing.

3) A higher interest for mezzanine financing (capital provided for a company's expansion) rather than emerging or early stage funding.

Therefore, unless they are able to sell securities, small new companies in other promising fields and in other parts of California are substantially on their own.

SMALL BUSINESSES HAVE PROBLEMS SELLING SECURITIES

The process of selling securities is very complicated. A maze of federal and state regulations of mind-glazing complexity must be negotiated. Section 2 of this paper shows in detail the federal and state options open to small business to raise capital in the private and public markets.

The Regulatory Maze

If a small business sells securities, it must register them with the Securities Exchange Commission (SEC) at the federal level and with each of the states involved in the sale unless the issue is exempted. After the passage of the National Securities Markets Improvement Act of 1996 (NSMIA) relatively few offerings are subject to state review. NSMIA preempted states from reviewing securities listed on the major stock exchanges (New York Stock Exchange; the American Stock Exchange; the National Association of Securities Dealers Automated Quotation National Market System (NASDAQ/NMS); and others having similar listing standards). However, the effect of this act on small business capital formation has been marginal since most NSMIA exemptions benefit larger issuers. Most small issuers have to continue to deal with the various layers of securities regulations imposed by the states.

Registering with various states raises various problems. It can be very costly and complicated as each state has its own securities laws and regulations. There are costs without benefits in registering the same offering repeatedly. States' provisions may conflict with some federal exemptions tailored to facilitate capital access to small businesses.

State securities regulatory structures are based on two approaches: "merit review" or "full disclosure." California is a merit review state. To be able to sell securities in California, issues must be "qualified" by the California Department of Corporations. This process of approval is described in Section 4.

In merit review states such as California, the regulatory agencies determine whether the securities issues are reasonable investments, based on a comparison of regulatory standards and the characteristics of the issue. Thus, getting approval in states with merit review systems can be quite complicated, as the state must find them suitable for investors. Under full disclosure, regulatory agencies simply make sure that investors have all the information to determine the merit and risks of an offering, letting them decide on the quality of the investments. The federal securities regulatory agency (the Securities and Exchange Commission) is based on full disclosure.

There are varying degrees of merit regulation, with some states applying stricter standards than others. Approximately 40 states have, to some degree, regulatory structures based on merit review. California and Texas have the most stringent merit review-based regulatory systems. Colorado, Delaware, New Jersey, Idaho, and Utah

primarily review for full disclosure, but apply merit standards only in specific areas. Iowa, North Carolina, Pennsylvania, and Virginia describe their merit review system as limited merit review rather than full merit review.

Other states (Connecticut, Georgia, Illinois, Maryland, Nevada, New Hampshire, Rhode Island, Wisconsin, and Wyoming) have a system based on full disclosure, similar to SEC's review. New York goes even further, limiting its regulatory scheme to a prohibition on fraud, and emphasizing fraud prosecution.

Businesses, brokers, securities attorneys, and some regulators indicate that the merit states' securities law and regulations are overly restrictive and costly to businesses, increase the cost of raising capital, and prevent the development of some innovative projects. Costs are high due to fees, legal expenses business must pay to understand and comply with the regulations, and lost income due to delays in access to capital. There are also other costs to society such as the foregone benefits from profitable projects that are discouraged because of the difficulties of the merit review process.

Due to lack of data, there is no way to evaluate the exact economic costs from merit review and the severity of these costs to applicants. The Department of Corporations does not process all the information from the application forms. Therefore, detailed data on a company's costs of compliance and the economic characteristics of the applicants (type and size of business) are not readily available. But costs seem to be high enough to discourage broker-dealers and lawyers from filing for state reviews. In surveys administered by the SEC, broker-dealers indicated that they sought to avoid state review and they limited underwriting activities to offerings of securities that qualify for federal preemption.

Small Businesses' Options for Selling Securities and Related Problems

Small businesses have three main ways of selling securities: 1) selling securities to "sophisticated and accredited" investors, 2) selling securities exempted from federal regulations, but subject to complicated state regulations, and 3) selling federally registered securities on a public stock exchange. However, there are problems with all three of these ways of selling securities:

1) ***Privately Selling Securities to Sophisticated or Accredited Investors***. Businesses often choose this method. Such sales can be under federal rules that override state rules, or under specific state exemptions. A fundamental problem for small businesses to raise capital in this way is that securities cannot legally be advertised. Thus, most companies have a problem in finding such "sophisticated or accredited" investors. Sophisticated and accredited investors are generally defined as those with substantial assets or who are experienced investors.

2) ***Selling Securities Exempted from Federal Regulations but Subject to Complicated State Regulations***. There are various federal exemptions to facilitate the process of

raising equity capital for small businesses. However, since businesses have to meet the regulations of each state involved in the offerings and sales of securities, a very complicated process, these issuers have just two real alternatives:

a) Offer and sell securities just in one state so that only that state reviews the issue.

b) Issue offerings under $1 million or less per year and meet a state's registration requirements. In this case, small businesses can file a simplified form with the SEC. Unfortunately, California's "merit review" process may prove a hindrance to such sales. Section 5 of this report provides anecdotal information from companies that have followed this path to raise capital. Furthermore, many sales take place in several states; in this situation, businesses must meet each state's requirements. Since businesses use this avenue more often than federal registration, there is a need for cooperative arrangements between states.

3) ***Selling Federally Registered Securities on a Public Stock Exchange***. Only the largest of small businesses can choose this alternative, for this process is both expensive and complicated. Complex and detailed audited financial information must be supplied, a prospectus and other disclosure documents must be crafted by legal specialists, and a financial underwriter generally participates. The federal law preempts state review for securities issued by larger companies. However, state review is required for securities issued by smaller, less mature companies, such as those traded on the regional exchanges, the NASDAQ/Small Cap market, or the NASD/OTC Bulletin Board System.

   Although federal and state registration forms for smaller issuers are simplified, and various states participate in a coordinated review program, the review process for these companies is still cumbersome and expensive. The minimum practical public sale for these smaller offerings is around $5 million, while around $20 million is a working minimum for most underwriters. Most small businesses are not big enough to use this option.

POLICY OPTIONS TO FACILITATE THE OFFERING AND SALE OF SECURITIES BY SMALL BUSINESSES

Consulted parties in this study, particularly regulators, recognize the importance of providing capital access to businesses. The Department of Corporations feels that they have reached a balance in achieving this goal while providing investors protection. However, the conclusions drawn from this study suggest that there are a variety of regulatory aspects that can be improved significantly to facilitate the process of offering and selling stock by small businesses. Section 6 of this paper discusses some possible lines of action to improve the review system that could help small businesses to raise capital. California has at least five options for making it easier for small businesses to sell securities:

1. Eliminate the California Merit Review Process and Instead Adopt the "Full Disclosure" System

Merit review was enacted to protect investors and eliminate fraud. However, there is debate about whether merit review has outlived its usefulness, and about whether it is performed efficiently and fairly, which this paper reviews in detail (see Section 3). Merit review's advocates think the system efficiently meets its goals. Merit review critics argue that this type of regulatory system fails to prevent fraud, imposes unnecessary costs to businesses, and discriminates against small issuers (only smaller issuers are subject to review). Criticism of merit review also focuses on the paternalistic nature of the approach, the arbitrariness of these reviews, and the system's lack of relevance in the modern world of financial innovation and electronic networks.

There are two strong arguments against merit review. One is that it discriminates against small businesses since only a small number of initial offerings are subject to review, most of them from small businesses. Compared to 44,143 filings exempted and an unknown number of exemptions that do not file with the Department, only 551 offerings were subject to state regulations during the 12 months ending January 31, 1999. This poses the question of whether it is justifiable to support a system to oversee such a small proportion of issues.

The second argument is that the economic costs of merit review may not outweigh its benefits. The main benefit of the system is fraud prevention. Some critics point out that perpetrators of fraud do not register under *any* standard (merit review or full disclosure), and therefore regulators are unable to detect their frauds.

Unfortunately, there is not enough empirical data to perform a statistical analysis that could prove or disprove the ability of the merit review systems to prevent fraud and protect investors. There is no data to support the number of potential frauds that could occur in the absence of merit review. However, the system has failed to detect some large fraudulent offerings that have been registered. One example is the American Continental Corporation case (Charles Keating). This corporation sold $250 million worth of junk bonds through Lincoln Savings and Loan Association; sales persons allegedly misled the public, indicating that these bonds were safe, secured, and guaranteed by the Federal Savings and Loan Insurance Corporation. American Continental subsequently defaulted on the bonds, leaving investors, including many senior citizens who had invested their life savings in the bonds, holding worthless paper.

Costs to businesses due to merit review are also hard to assess due to: 1) lack of data on costs of compliance, 2) delays that prevent businesses from raising the capital on time, and 3) the economic loss from discouraging some businesses from issuing securities due to the difficulties of the qualification process. If the economic costs are high and benefits are low, there is a case for eliminating merit review with significant positive effects on small businesses and the economy. If the merit review system is eliminated, the Department could shift its activities towards fraud enforcement and other regulatory aspects to better protect investors.

The potential negative consequence of replacing merit review by one of full disclosure is an increase in fraud occurrence. This does not seem to have been the case in states that have changed their regulatory process from merit review towards one of full disclosure. Colorado, Wisconsin, and Illinois have changed their systems from merit review towards full-disclosure. Wisconsin and Illinois have had a smooth transition without an increase in fraud incidence since merit review was eliminated. The regulatory agency in Illinois has focused on increasing enforcement and public awareness and regulators seem to be satisfied with the change. The Colorado experience has been quite different. For many years Colorado was a merit review state. During the early 1980s, Colorado became a deregulated state that did not even have a full disclosure requirement. After a series of fraud occurrences, including some in the penny-stock market, Colorado changed to a full disclosure system in 1990. Currently, Colorado regulators view their system as working well. They believe there is still fraud, but it operates outside of any possible state regulations. Instead of coming back to merit review, they increased enforcement and broker-dealer regulation to solve fraud problems.

States with less stringent merit review systems than California (such as Washington) are not experiencing high rates of fraud. For example, Missouri has not reported an increase in fraud activity after the restructuring of their merit review system to a less stringent system.

However, comparisons of fraud occurrence under alternative securities regulatory systems must be taken with caution. There are many other factors that explain differences in fraud in addition to the states' regulatory systems, including the types of regulations, and the way that the regulatory agencies operate. State regulatory agencies differ in size, financial resources, and quality of the staff. States also differ in the size of their population and their socio-economic characteristics.

2. Improve California's Merit Review Process for Allowing Businesses to Issue California Securities That Are Exempt From Federal Regulations

Most regulators consulted in this study disagree with the position of eliminating the merit review system. They think that, although merit review does not prevent fraud, it protects investors from very highly risky ventures. Many regulators pointed out that the problem is not the merit review system but its implementation. Some options to improve the current system are:

- Establish and stick to objective standards, reducing the possibility of regulators applying subjective criteria in the review process.

- Streamline the paperwork and speed up the registration process.

- Evaluate the operational structure of the Department of Corporations to determine if the efficiency of the review process could be improved through some restructuring of the agency.

- Establish a business-friendly climate by training regulators to focus on customer satisfaction, and provide clear information on the requirements and the process itself. A small business ombudsman office could be opened for this purpose.

These changes would decrease the cost of raising capital for small businesses by increasing the efficiency of the regulatory process.

3. Change Some Regulations

The most feasible securities issuance paths for a really small business are those that involve exemption from detailed federal review but require state review. The small issuer's problem is finding state exemptions that would allow them to use the options provided by the federal level. Capital access may be improved by establishing new and/or modifying existing exceptions to open the number of potential investors for small businesses. Other important policy actions could be:

- Change the California qualified purchaser definition by decreasing the amount of assets that define these investors. For example, home equity could be included to calculate the net worth requirements on purchasers. This would increase the number of potential investors without increasing the risk for these investors.

- Eliminate merit review for small offerings exempted from federal registration, such as SCOR or Regulation A offerings, and just apply full disclosure to these issues.

- Allow advertisement of various offerings. For example, a central problem that small business has is reaching a sufficient number of qualified investors without having a general solicitation. Section 25102(n) of the California Corporate Securities Law permits general solicitation of a "general announcement," but not of the offering itself. A change in the law allowing general solicitation of the offering (without restrictions) would allow issuers to reach accredited investors more easily.

4. Facilitate Multi-State Securities Sales (Which Are Also Exempt From Federal Regulations) by Being More Cooperative With Other States and Their Regulatory Agencies

Firms that follow paths involving state review often want to sell their securities in several states. Many states have worked out cooperative arrangements to make multi-state sales easier, such as by designating one state as a lead agency and other states agreeing to accept that state's regulation decisions. California has only partly cooperated with these efforts (insisting on tighter standards in each case). The paper suggests possible improvements that California could make in this area (Section 3).

5. Encourage or Create Development Programs to Put Suitable Investors Together With Businesses

The most useful exemptions that allow small businesses to sell securities require that they be sold to sophisticated, well-heeled investors otherwise known as angels. But, with limited exceptions, the small business owners are not allowed to advertise their investment opportunities. How then can they find sufficient angels (unless they are socially fortunate)? There are several local economic development programs that arrange to put suitable investors together with businesses, to the advantage of both. Perhaps more angel-dating services could be established.

SECTION 1

LEGAL STRUCTURE FOR THE OVERSIGHT OF OFFERINGS AND SALE OF SECURITIES

This section defines the terms "securities" and "offerings and sales of securities." This section also presents a brief description of the various layers of government that regulate and oversee the offering and sales of securities.

DEFINITION OF OFFERINGS AND SALES OF SECURITIES

A "security" may be either an arrangement in which a person supplies "risk capital" for a business, or any sort of "investment contract."[1] The term "security" includes stocks, bonds, debentures, notes, and investment contracts such as limited partnerships where the management rights exist only for the general partner.[2]

The law defines the terms "offer" and "sale" very broadly. Section 2(3) of the Securities Act of 1933 defines "offer" to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." The term "sale" is defined as "every contract of sale or disposition of a security or interest in a security, for value."[3] An "issuer" includes any person who issues or proposes to issue any security.

REGULATORY STRUCTURE FOR THE OFFER AND SALE OF SECURITIES

In the United States, the federal and state governments regulate securities. Private regulatory bodies such as the National Association of Securities Dealers (NASD), also play an important role in securities oversight.

Federal Securities Regulations

Two sets of federal securities statutes regulate the offer and sale of securities at the national level: the Securities Act of 1933 (Securities Act), and the Securities Exchange Act of 1934 (Exchange Act). The Securities and Exchange Commission (SEC) administers these federal laws. All public and private transactions that involve more than one state are under the SEC's jurisdiction. The Securities Act requires all securities offered or sold in interstate

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[1] The definition of a security is virtually the same in the two sets of federal securities regulations (the Securities Act of 1933 (Section 2(1)) and the Securities Exchange Act of 1934 (Section 3a) (0)). The definitions presented here are consistent with these acts. Definition source: 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.

[2] Kathleen S Tillotson, "Small Business Securities Exemptions." *The Practical Lawyer*. Vol. 36, No. 6. 1990.

[3] Kathleen S Tillotson, Op. cit.

commerce to be registered by the SEC, unless these securities, or securities transactions, are specifically exempted from registration by the act. Any person violating the Securities Act is liable to the purchaser to refund the full purchase price of the security.

The SEC regulatory scheme is one of full disclosure. The Securities Act generally requires companies to disclose fully all material facts that investors would find important in making their investment decisions. Full disclosure simply makes sure that the investor has all the information to determine the merit and risks of an offering. It does not matter if the offering is very risky, as long as the issuer informs the investor.

The Exchange Act requires publicly held companies to disclose information continually about their business operations, financial conditions, and management. Registered companies must file periodic reports and other disclosure documents with the SEC.

Self-Regulatory Organizations

There are also private entities such as major stock exchanges and the National Association of Securities Dealers (NASD) that help define the national behavior standards for members and minimum standards for listed securities. These private entities are known as self-regulatory organizations (SROs) and are regulated by the SEC.

State Securities Regulations

All states have their own statutory schemes to regulate securities transactions within their borders. When offerings cover multiple states, not only is the SEC involved, but also those states where the securities are being offered and sold.

The regulatory structure of the states varies from state to state. Approximately 40 states apply, to some degree, “merit review” to the registration of securities offerings.[4] In merit review states, the regulatory administrators pass judgment on the quality of securities issues, based on a comparison of regulatory standards and the characteristics of the issue. Sellers can be prohibited from offering or selling their securities if the issue does not meet the state’s merit standards. This is markedly different from the federal standards of full disclosure.

There are varying degrees of merit regulation, with some states applying stricter standards than others. California and Texas have more stringent merit review-based regulatory systems. Colorado, Delaware, New Jersey, Idaho, and Utah primarily review for full disclosure but apply merit standards only in specific areas.[5] Iowa, North Carolina, Pennsylvania, and Virginia describe their merit review system as limited merit review rather than full merit review.

Other states have a system based on full disclosure, similar to SEC’s review (Connecticut, Georgia, Illinois, Maryland, Nevada, New Hampshire, Rhode Island, Wisconsin, and

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[4] Rutherford B.Campbell, “Blue Sky Laws and the Recent Congressional Preemption Failure.” *The Journal of Corporate Law* 175, Winter 1997, fn. 61, supra n2.

[5] Areas include escrow of offering proceeds, unreasonable underwriter’s compensation, insolvent issuers, and blind pools.

Wyoming).[6] These states focus on whether the material aspects of the proposed offerings are sufficiently disclosed in the offering prospectus. They require issuers and sellers to give investors accurate and timely information about the nature of an offer. New York limits its regulatory scheme to a prohibition on fraud and emphasizes fraud prosecution.

Although there is a tendency to distinguish sharply between the federal "disclosure" approach and the state "merit" approach, merit review states often impose disclosure requirements beyond SEC requirements.

The number of offerings subject to state review has significantly narrowed after the passage of the National Securities Markets Improvement Act of 1996 (NSMIA). This act profoundly changed the dual system of federal-state regulation that has existed since the Securities Act was adopted, by preempting state registration and review of specified securities and offerings called "covered securities."[7] Only offerings of securities that are not included under the law as covered securities continue to be subject to a dual system of federal-state regulation.

California law requires the Corporations Commissioner to approve all securities offered or sold in California. The Legislature has exempted some classes of securities (or securities transactions) from review.[8] Some examples of California exemptions include domestic government securities, credit union securities, investment certificates, securities of nonprofit organizations, and certain publicly traded securities such as those from corporations listed in a national securities exchange. The law also requires the Department of Corporations to license broker-dealers and investment advisors, and provides for administrative, civil, and criminal remedies for violations of the law.

Under the California merit review system, issuers are not only compelled to disclose material information, but the proposed offerings are subject to standards that are outlined in the Commissioner's Rules. California administrators rarely raise disclosure issues. When disclosure issues are raised, it is usually during the evaluation of offerings that are not subject to the jurisdiction of the SEC.[9]

A study conducted during the early 1980s ranked states according to merit review stringency.[10] California's merit review system ranked as the third most stringent in the country. Since then, there have been many changes easing the qualification process in California and other states that may have changed this ranking. However, according to several securities attorneys, regulators, and experts in securities regulation contacted in this

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[6] "According to SEC's "Uniformity Study." Op. cit.

[7] Covered securities include those listed on the New York Stock Exchange; the American Stock Exchange; the National Association of Securities Dealers Automated Quotation National Market System (NASDAQ/NMS); and other stock exchanges specified by the SEC as having similar listing standards. Offerings qualifying for exemption provided under SEC Rule 506 are also exempted.

[8] Securities exempted by California law are listed in California State Law, Sections 25100-25101.

[9] Memorandum sent to Meg Svoboda, Joint Legislative Budget Committee. By Brian Thompson, Chief Deputy Commissioner of the Department of Corporations, published 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. 289.

[10] Jay T. Brandi, "Securities Practitioners and Blue Sky Laws: A Survey of Comments and the Ranking of States by Stringency of Regulation." *The Journal of Corporation Law*. Spring 1985.

study, California securities regulatory system is still one of the most difficult to deal with in the U.S.[11]

Local Law Enforcement

In addition to federal and state regulation, local law enforcement agencies play important roles. The offices of County district attorneys prosecute white-collar crime, including securities fraud.

[11] Interviews were held between January and April of 1999.

SECTION 2

THE PROCESS BY WHICH SMALL BUSINESSES RAISE CAPITAL THROUGH PRIVATE OR PUBLIC OFFERING MARKETS

This section describes the process that small businesses planning to raise capital in the private and public markets must follow. The federal government provides a variety of options to facilitate this process. However, businesses have to contend with state regulations. This is important in the case of multi-state offerings when standards and procedures vary from state to state. State regulations may neutralize the effect of legal options provided at the federal level to facilitate small business capital formation. Specifically, this section describes:

1. Federal regulations and the various options that the SEC provides to small businesses looking to raise capital. These options include the use of federal exemptions that allow issuers to offer and sell securities without registering with the SEC, and in some cases with the states.

2. The complications imposed by state regulations to issuers of multi-state offerings and what the federal government and state regulators have done to solve these problems. The discussion focuses on:

   - How state laws may neutralize federal exemptions.
   - The most recent federal effort to ease the registration process for business offerings through the National Market Securities Improvement Act of 1996 (NSMIA).
   - Existing efforts by state regulators and the North American Securities Administrators Association (NASAA) to facilitate the process of obtaining approval for the offering and sales of securities in multiple states.

3. The most important California exemptions provided by California regulations that benefit small business capital formation, and how these exemptions interplay with the federal exemptions.

The following tables provide a brief summary map of Section 2. Table 1 shows the regulatory procedures that business must follow to offer and sell securities publicly and privately, including the various options open to small business to simplify those processes. Tables 2 and 3 summarize and compare the federal and state options to raise capital in private and public markets for small businesses.

TABLE 1. REGULATORY PROCESS

PRIVATE OFFERINGS			PUBLIC OFFERINGS		
SEC	**CALIFORNIA**	**OTHER STATES**	**SEC**	**CALIFORNIA**	**OTHER STATES**
Regulatory system based on full disclosure. Unless exempted, all issues must be registered.	***Must comply with California Securities Laws.***	***All offerings must comply with the regulations of each state involved in the offering. Federal exemptions must be coordinated with State's exemption.***	***System based on full disclosure. Unless exempted, all issues must be registered.***	***Unless exempted, must be qualified by the Department of Corporations. Regulatory system based on merit review.***	***All offerings must comply with the regulations of each state involved in the offering. Regulatory systems can be based on merit review or full disclosure. Merit review systems vary in their degree of stringency.***
***Exemptions*:** 1. Private Offering Exemption 4 (2) Rule 506, Regulation D. 2. Accredited Investor Exemption 4 (6) Small Issue Exemption ($5 million or less). 3. Section 3 (b) Rule 504 and 505, Regulation D. 4. Limited Offering Exemption under California Section 25102(n) (SEC Rule 1001)..	***Exemptions*:** Private Placement Exemption (Section 25102(f)) and (h) can coordinate with federal exemptions under Regulation D. Only notice filing is required for federal Rule 506. Qualified Purchaser Exemption Section 25102(n).	***Exemptions:*** Each State has its own private offering exemptions and procedures. Private offerings that comply with Rule 506 are preempted from state regulations by NSMIA (Federal Act). Most states follow NASAA's model of accredited investors exemption (MAIE) exempted by federal Rule 504 of Regulation D.	Unless exempted, all public offerings (including initial public offerings and subsequent public offerings) must register under the Securities Act of 1933. S-1 is the registration form that is used by larger companies. ***Small Business Issuers Registration:*** Simplified procedures under Forms SB-1 (for issues of $10 million or less) and SB-2 (unlimited amount). ***Small Issue Exemptions*** ($5 million or less). Regulation A. SCOR, Small company offering registration (Rule 504, Regulation D)($1 million every 12 months).	Companies listed on the NYSE, NASDAQ/NMS, AMEX, and others specified by the SEC are exempted from state registration under NSMIA. All other issues are subject to review. California participates in the Coordinated Equity Review Program created by NASAA. Issues under the federal exemptions Regulation A or SCOR are subject to merit review. California does not participate in the Regional Review Project implemented by NASAA.	Companies listed on the NYSE, NASDAQ/NMS, AMEX, and others specified by the SEC are exempted from all state registration under NSMIA. All other issues are subject to review. To facilitate small business registration in multiple states, NASAA created the Coordinated Equity Review Program. Federal exemptions must be coordinated with each state exemptions. Issuers subject to the federal exemptions Regulation A or SCOR must clear with states. To facilitate the state registration process for these issuers, NASAA implemented the Regional Review Project.

TABLE 2. SEC AND CALIFORNIA PRIVATE OFFERING EXEMPTIONS

	SEC RULE 504 (b) (1) Adopted 4/7/99	***SEC RULE 504 (b) (1) (iii)***	***SEC RULE 505***	***SEC RULE 506***	***CALIFORNIA SECTION 25102(f)***	***CALIFORNIA SECTION 25102(n)***
Maximum amount of the offering	$1 million annually.	$1 million annually.	$5 million annually.	None.	None.	Varies with type of federal exemption that is combined with.
Type of issuer	Any type of entity but not a reporting issuer, investment company or “blank check company.”	Any type of entity but not a reporting issuer, investment company or “blank check company.”	Any type of business entity.	Any type of business entity.	Any type of business entity (corporation, partnership or limited liability company).	California corporation or “quasi-California corporation.”
Maximum number of investors	Unlimited.	Unlimited as long as they are accredited investors.	Unlimited accredited investors and up to 35 non-accredited investors.	Unlimited accredited investors and up to 35 non-accredited investors who have enough knowledge and experience in financial and business matters to evaluate the prospective investment	Up to 35 non-accredited (or excluded) investors as defined in California Rule 260.102.13.	Unlimited as long as they are “qualified purchasers.”
Nature of Investor	No limitations.	No limitations.	No limitations.	Investor, either alone or with his/her representative, must be able to evaluate the investment.	Investor has either a pre-existing personal or business relationship with the offeror or/and is sophisticated enough to evaluate the investment.	All purchasers must be “qualified purchasers.”
Requirement of purchasing the security for investment and not for distribution	Yes.	Yes.	No, if there is a state exemption that permits general solicitation and advertising so long as sales are made to accredited investors.	Yes.	Yes.	Yes.

	SEC RULE 504 (b) (1) Adopted 4/7/99	*SEC RULE 504 (b) (1) (iii)*	*SEC RULE 505*	*SEC RULE 506*	*CALIFORNIA SECTION 25102(f)*	*CALIFORNIA SECTION 25102(n)*
Disclosure Requirements	None.	None.	For reporting companies: last annual report to shareholders or a registration statement on Form S-1, SB-1, SB-2 or S-11 or 10SB. For non-reporting companies: Same information required when filing under Regulation A or any other registration under the Securities Act.	Same as for Rule 505.	None.	A disclosure statement meeting the requirements of Reg. D, or if reliant on Rule 504, the information specified in Rule 502 (b) (2). Regulation A offering statement or the appropriate registration form.
Financial Statement information requirement	None.	None.	Reporting companies: Requirements by the applicable registration form or Exchange Act report requirements. Non-reporting companies: If non-accredited investors are involved, audited financials are required. Requirements vary according to the size of the offering. For offerings up to $2 million, audited balance sheet and 2 years statement of income and changes in stockholders equity are required.	Same as for Rule 505.	None.	The disclosure requirements under Rules 505 and 506.
Restrictive Legend required on stock certificate?	Yes.	No, if there is a state exemption that permits general solicitations and general advertising so long as sales are made to accredited investors.	Yes.	Yes.	No.	No.
Manner of Solicitation	No general solicitation or general advertising permitted.	Yes, only if general solicitation or advertising is permitted by state exemption.	No general solicitation is permitted.	No general solicitation is permitted.	No general solicitation is permitted.	A general announcement of the offering may be published or disseminated in a general solicitation.

TABLE 3. COMPARISON OF PUBLIC OFFERINGS FOR SMALL BUSINESSES

	RULE 504 (b) (1) (I)(SCOR OFFERINGS)	*REGULATION A*	*REGISTERED OFFERING ON FORM SB-1*	*REGISTERED OFFERING ON FORM SB-2*	*REGISTERED OFFERING ON FORM S-1*
Amount of Offering	Up to $1 million.	$5 million annually.	$10 million in any continuous 12 months.	No limit.	No limit.
Type of issuer	Non-reporting issuers except investment companies or "blank check companies."	Non-reporting U.S. or Canadian issuers except investment companies or "blank check companies."	Non-reporting "small business issuer" as defined by the SEC.	Must be a "small business issuer."	Any issuer.
Type of Offering	Issuer offering only.	Issuer offering and shelf (block of stocks offered in specified stages to avoid drastic changes in the stock price) and secondary offerings up to $1.5 million.	No limitations.	No limitations.	No limitations.
Disclosure Required	No federal requirements. NASAA U-7 adopted by most states. California has its own SCOR Form.	Offering statement with three models: Forms U-7, 1-A or SB-2.	Form U-7 and Form 1-A accepted.	SB-2 form.	S-1 basic registration form for most offerings.
Financial Statements Required	No federal requirements. NASAA U-7 requires GAAP last FY balance sheet and 2 years profit and loss unaudited. Requirements vary from state to state.	Federal. GAAP last FY balance sheet and 2 years profit and loss, plus interims unaudited. Requirements vary from state to state.	Federal. GAAP last FY balance sheet and 2 years audited profit and loss, plus unaudited interims. Requirements vary from state to state.	Federal. GAAP last FY balance sheet and 2 years audited profit and loss, plus unaudited interims. Requirements vary from state to state.	Federal. Last 2 FY balance sheets and last 3 years audited profit and loss, plus unaudited interims.
Test the Waters?	No.	Yes. Can solicit indications of interest before filing offering statement. Must file solicitations documents with SEC. May violate state law.	No.	No.	No.
Exchange Act Reporting Requirements	None, unless required under Section 2 (g) ($5 million total assets and 500 shareholders).	None, unless required under Section 2 (g) ($10 million total assets and 500 shareholders).	Yes. Subject to simplified reporting under Reg. S-B.	Yes. Subject to simplified reporting under Reg. S-B.	Yes. All reports required under Section 13.

1. Federal Regulations and Options for Small Businesses

Several filing options are available at the federal level for a small business attempting to raise capital in the public and private markets. The best type of offering for a given business depends on the amount of capital the business wants to raise, the company size, and factors such as the marketability of the stock. The company must also consider how the regulatory options provided by the various states involved in the offering and sales of its securities can be combined with the federal options. Given these factors, it is up to the business to choose the type of filing that is most effective to meet its capital needs.

Public Offerings Registered With the SEC

One option for a business to raise capital is going public (selling stock in the public market). However, the process of going public is difficult and expensive. It demands many requirements from businesses. Many businesses, including a large proportion of those at early stages of development, cannot comply with these requirements. Hence, for them, private offerings and the use of SEC exemptions are the easiest and least expensive way to raise capital.

To go public, the offering should be attractive enough to interest a regional or national underwriter so that the registered stock offerings can be successful enough to be listed on the NASDAQ stock market.[12] Public offerings are more appropriate for businesses that want to raise more than $5 million. A public offering is generally more expensive than a private offering, although the costs of a public offering vary greatly. Investment bankers generally will not underwrite offerings below $5 million because it is not very profitable for them due to high diligence costs. They prefer doing larger deals. For larger brokers and/or investment bankers the minimum is generally $15 or $20 million. Furthermore, brokers avoid stock priced below $5 per share as such stock may be interpreted as cheap stock, commonly referred to as penny-stock by regulators that submit the offering to closer scrutiny. Due to some fraud occurrence related to penny-stocks in the past, regulators scrutinize them more carefully.

Despite tougher disclosure rules, a public offering does offer several advantages to businesses:

- Going public substantially increases the business' access to capital.
- The company may become more widely known and its image may improve.
- Future financing can be available through subsequent issues.
- Stockholders may sell their securities more easily, making the investment in the business more attractive.
- A company can attract personnel if it can offer stock options in a public company or other incentives with a known market value.

[12] Registered stock from small issuers can be listed on the NASDAQ stock market if these companies meet the minimum asset and float and market maker requirements.

On the other hand, a public offering is a lengthy and costly process that can have several disadvantages. For example:

- The company will be faced with an increase in reporting and legal obligation costs.
- The company may be liable if it does not fulfill the new legal obligations.
- The company's management will have less flexibility in managing the company's affairs.

The Registration Process for a Public Offering

To go public, a business has to file a registration statement with the SEC before the company can offer its securities for sale. A company may become public by issuing securities in an offering registered under the Securities Act,[13] or by registering the company's outstanding securities under Exchange Act requirements. Both types of registration require ongoing reporting obligations.[14]

The registration statements have two parts:

Part I is the prospectus, the legal offering or selling document describing important facts about business operations, financial condition, and management. Everyone who buys the new issue or is offered the securities must have access to the prospectus. The company must clearly describe in the prospectus any risks associated with the offering, such as lack of business operating history, adverse economic conditions for the industry, or dependence upon key personnel. The business also has to provide financial statements.

Part II contains additional information that the company does not have to deliver to investors but must make available at the investors' request.[15]

Larger and listed companies usually use S-1 registration.[16] Small businesses have the option to register using simpler forms (SB-1 or SB-2, depending on the amount of capital they are seeking to obtain). Under S-1 filings, the registration statement document is detailed and cumbersome. The company registration statement should be similar to a brochure. The SEC will not accept other forms of registration statements. The company must describe:

- The business.
- The business' properties.
- The identity of officers and directors and their compensation.
- Material legal proceedings involving the company or its officers and directors.
- The plan for distributing the securities.
- The intended use of the proceeds of the offering.

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[13] All public multistate offerings (including initial and subsequent public offerings) are registered under the Securities Act. Before a company may have its securities listed and registered for public trading on an exchange, it must file a registration application with the exchange and the SEC.

[14] SEC. "Questions and Answers: Small Business and the SEC." (http://www.sec.gov/smbus/qasbsec.htm).

[15] Investors can access this information from one of the SEC's public reference rooms or on the SEC Web site.

[16] For example, companies listed on the New York Stock Exchange; the American Stock Exchange; the National Association of Securities Dealers Automated Quotation National Market System (NASDAQ/NMS); and other stock exchanges specified by the SEC as having similar listing standards.

In addition to the information required by this form, the company must also provide any other information that is necessary to make the disclosure complete and not misleading. Once the SEC staff determines that the registration statement complies with all disclosure requirements and declares the registration statement effective, the company may start to sell its securities. The term "registration" is used because once the registration statement is effective, the SEC assigns a registration number to the filing. This number is available in the EDGAR file (The SEC's Electronic Data Gathering, Analysis, and Retrieval System), available to the public on the Internet.[17]

Small Business Issuers Registration

In recent years, the SEC has streamlined the offering and disclosure process for some offerings so that small businesses can access the public market at a smaller cost than under the traditional offering. To qualify as a small business issuer, both the company's sales and market value of the company's float must be under $25 million. The Commission is proposing to raise the ceiling for consideration as a small company from less than $25 million in annual revenues and less than $25 million in public float to a revenue level of $50 million and require no public float limitations.[18] This would allow more companies to use less demanding registration and reporting standards.[19]

Forms SB-1 and SB-2 are alternative registration forms for small business issuers. Form SB-1 is used to raise $10 million or less in any 12-month period, while Form SB-2 can be used by a small business issuer to raise any amount of capital.

These forms are less complicated and also have simpler requirements for financial statements than Form S-1 (required for the registration of large companies).[20] They require less extensive narrative disclosure than Form S-1, particularly in the description of the company and executive compensation. Form SB-1 allows a company to provide information in a question-and-answer format that is simple to prepare and read. Form SB-2 has the advantage that its disclosure requirements are easier to understand and the guidelines are written in simpler language than in Form S-1. It also permits the company to provide audited financial statements for two fiscal years, in contrast to Form S-1 requirements of three fiscal years.

Legal Ways to Offer and Sell Securities Without Registering With the SEC

In most cases, a small business can comply with the securities laws by using regulatory exemptions established by the SEC.[21] These exemptions reduce the business costs, documentation, and reporting requirements involved in the SEC's registration process. A business may choose to use any of the following regulatory exemptions.

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[17] EDGAR is available at the SEC Web site (http://www.sec.gov).
[18] Float is the value of the outstanding stock.
[19] "Commission Divided on Recent Proposals." SCOR Report. Vol. 5, No. 12, October 1998. Dallas, Texas.
[20] This form is similar to that used in Regulation A offerings, a type of exemption offering discussed later in this section.
[21] An exemption establishes the need not to be registered when meeting the conditions of the exemption.

Intrastate Exemption

The Securities Act exempts from federal registration issues offered and sold solely within a state, by issuers that are also resident and doing business within the state. If the issuer is a corporation, it must, in addition to doing business in the state, be incorporated under the laws of such state.[22] Since the section that originally allowed this exemption did not define precisely some key concepts, the SEC adopted Rule 147 to provide objective standards for the use of the intrastate exemption. However, according to many securities attorneys, this rule is not very effective because it establishes that the company has to assure that investors were state residents at the time of the offering. Under this rule, even one offer to, or securities transfer to, a non-resident within nine months from the sale may make the entire intrastate offering illegal. For this reason, the intrastate exemption and Rule 147 are seldom used.

Private Offering Exemption

There are two statutory private offering exemptions: Section 4(2) and Section 4(6) of the Securities Act.

Section 4(2):

This section exempts issuer's transactions that do not involve any public offering. A practical problem with the use of the Section 4(2) exemption is that the term "public offering" is not specifically defined by statute or rule. The Section 4(2) exemption has been interpreted in many SEC opinions and court decisions over the years. Despite several court determinations, securities lawyers continue to be unsure about the exact use of this exemption. Companies prefer to take advantage of safe harbor exemptions as specified under Rules 504, 505, or 506 of Regulation D of the Securities Act, rather than rely on the broader terms of Section 4(2).[23]

Accredited Investor Exemption - Section 4(6):

Section 4(6) of the 1933 Act provides that the registration requirements shall not apply to private offerings to "accredited investors," when the total offering price is less than $5 million. The definition of accredited investors is the same as defined in Regulation D, Rule 501. According to this definition, accredited investors are those who for the reason of their financial position, do not need the protection of the disclosure requirements under Regulation D. These investors include:

- Individuals who have a net worth exceeding $1 million, or income exceeding $200,000 (or $300,000 if married and filing a joint return) in each of the two most recent years and expect the same income level in the current year.
- Certain institutional investors such as banks, investment companies, and broker/dealers, trusts, and employee benefit plans.

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[22] Section 3(a) (11) of the 1933 Act.

[23] Kathleen Tillotson, "Small Business Securities Regulation Exemptions." *The Practical Lawyer* (Vol. 36, No. 6). Regulation D is discussed on the next page. It was adopted by the SEC to facilitate the use of the private offering exemption.

- Charitable organizations, corporations or partnerships with assets exceeding $5 million.
- Businesses in which all the equity owners are accredited investors.
- Organizations with total assets exceeding $5 million.
- Directors and executive officers of the issuer.

The accredited investor exemption does not permit any form of advertising or public solicitation. Section 4(6) has not been used widely since private offerings to accredited investors are also exempted under Regulation D, a widely used exemption.

Regulation D

To facilitate the use of the private offering exemption, the SEC adopted Regulation D in 1982. Regulation D is comprised of eight Rules, 501 through 508. Regulation D establishes three separate exemptions from Securities Act registration. (Rules 504, 505, and 506). Rule 506 establishes an exemption for private offerings under Section 4(2) of the Securities Act. Rules 504 and 505 are under Section 3(b) of the Securities Act that exempts small issue transactions. The other rules contain terms and conditions applicable to the exemptions.

Rule 506

Rule 506 establishes an exemption for private offerings. This is a commonly used exemption for small businesses, particularly when only accredited investors are involved. It permits a private offering of an unlimited dollar amount to an unlimited number of accredited investors plus up to 35 non-accredited investors.

Offerings involving non-accredited investors are much more complicated than offerings strictly to accredited investors.[24] For example, it is up to the issuer to decide on what information to give accredited investors, as long as it does not violate the antifraud prohibitions. However, the issuer must give non-accredited investors disclosure documents that generally are the same as those used in registered offerings.[25] In addition, the issuer must reasonably believe that those non-accredited investors have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment.

Privately placed securities issued under Rule 506 are "restricted." In other words, after the offering, they may not be freely traded in the secondary market until the issue is registered, or unless the purchaser relies on a separate exemption. After three years, sales of restricted securities owned by investors generally may be resold if the following conditions are met:

- The investor is not in a control relationship with the issuer (the security-holder is not a director, officer, or major owner of the company).
- The investor has held the shares for at least two years.

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[24] As it is also true for Rule 505, discussed below.

[25] Because of the antifraud provisions of the federal and state securities laws, securities attorneys strongly recommend that a disclosure document be furnished to all investors, whether or not they are accredited.

- The investor does not engage in a distribution of securities.[26]

To make use of Rule 506, the company must satisfy the following standards:

- File a Form D with the SEC. This is a simpler form than the ones used in S-1, SB-1, and SB-2 type of offerings. This form consists of a few pages asking basic identification company data and information about the offering. It requires information on the type of security and aggregate offering price offered in each state, the type of investors involved in the offering, the states involved in the offering, and the amounts purchased in each state.
- Make no general solicitation or advertising to market the securities.[27] A central problem that small businesses encounter with private offerings is how to reach a sufficient number of qualified investors without having a general solicitation.
- Exercise reasonable care to assure that investors are acquiring the securities for their own account.
- Make sure that the investors are accredited. Only 35 non-accredited investors are allowed.
- Provide required information to non-accredited investors (if any).

NSMIA preempted securities sold under Rule 506 from state regulation. These offerings are subject only to the states' right to impose notice-filing requirements and to charge the filing fees that were in effect one day before the enactment of the law.[28] Most states have adopted notice and filing fee requirements for offerings under Rule 506. California requires notice of filing, but fees have been suspended until June 30 of the year 2000. During the 12 months ending January 31, 1999, the California Department of Corporations received 2,513 notices of Rule 506 filings.[29]

Small Issue Exemption

The Securities Act of 1933 authorizes the Commission to exempt transactions involving up to $5 million in aggregate offering price of securities (small issue exemption).[30] In response, the SEC developed the following small issue exemptions:

- Rules 504 and 505 of Regulation D
- Regulation A
- Rule 1001

[26] The purchaser should not acquire the security from the security-holder in a way that makes the security-holder an underwriter with respect to the resale. Kathleen Tillotson, "Small Business Securities Regulation Exemptions." *The Practical Lawyer* (Vol. 36, No. 6).
[27] In other words, no money is being solicited or accepted on the basis of the general announcement of the issue from the public at large. A general solicitation is an offering of securities to the public without regard to the suitability of the investment (whether the investor has the sophistication or financial position to accept the risk).
[28] Lee, Petillon, "Designed to Scale: The Ability of Small Companies to Raise Capital has Been Dramatically Eased by New Federal and State Securities Rules." *Los Angeles Lawyer*, February 1997.
[29] Letter from Mr. Ronald C. Carruth, Securities Regulation Division, to Rosa Moller. February 9, 1999.
[30] Section 3 (b) of the 1933 Act.

Rule 504 of Regulation D: SCOR

Rule 504 exempts private and public offerings of securities of no more than $1 million of a qualified[31] company during any 12-month period. This federal exemption is the basis for SCOR (Small Company Offering Registration). Rule 504 was intended to help small businesses willing to raise start-up capital in the range of $250,000 to $1 million. Some securities attorneys[32] feel that the use of this rule is the least costly, most flexible way for a small company to carry out a small public stock offering. They see SCOR as a successful way to raise capital for small companies, despite the hurdles imposed by the regulatory systems in some states. However, others do not agree with this position since they see the states' regulatory review process for this type of offering as quite demanding and time consuming, particularly for start-ups and companies at early stages of development.[33] Although the use of this rule is an important source of seed capital for some small businesses, the number of companies that use this exemption is small and it has been decreasing over time.

Rule 504 requires that these securities sales be registered under a state's securities law. In this way, the SEC has left the regulation of offers of $1 million or less up to the states. Rule 504 is not usually used for a private offering because the issuer frequently prefers to use Rule 506, or the less used intrastate exemption.

To make use of Rule 504, a filing of the federal Form D with the SEC is required at the federal level. A copy of the Form D must be sent to the states involved in the offerings and sales of securities. SCOR offerings have become easier to do in recent years, since the adoption of the North American Securities Administrators Association (NASAA) uniform procedures by a variety of states.[34] NASAA designed these procedures to broaden the market for these types of offerings in multiple states by decreasing the cost or time to prepare the required documentation demanded by the various states' regulatory agencies.

The disclosure document on Form U-7, developed by NASAA, constitutes the offering circular or prospectus. Once the states approve the offering, the company may use copies of this form to meet disclosure requirements to potential investors. Form U-7 includes a set of questions related to the company, risk factors, offering price factors, use of proceeds, capitalization, plan of distribution of securities, and financial statements. In addition to its use for SCOR offerings, this form is the general document for corporations registering under state laws securities that are exempt from SEC registration under Regulation A (an exemption discussed later in this section) or Rule 147 of the Securities Act. This form was reviewed in September 1999. The new form has more than 118 questions, but is a better disclosure form.

NASAA has also developed a regional review system to facilitate the process of clearing (obtaining approval for the offering and sales of securities) with multiple states. Under this

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[31] The definition of qualified company includes only issuers that are neither an investment or development company, nor subject to the reporting requirements of the Exchange Act.

[32] See Equity, 504: Whom is it For? *Inc*. February 1996, p. 104.

[33] For example, in some states the information required in the filing application involves all sorts of issues that are new and difficult for the issuers from businesses at early stage of development to answer.

[34] NASAA is a nonprofit body representing 65 state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, Canada, and Mexico.

system, some states allow the sales within their borders once a SCOR state has approved the deal.

Although California SCOR filing uses the standardized Form U-7, it does not participate in the regional review system. Compared to other states, California SCOR filing imposes some additional requirements. For example, financial statements and exhibits required by the NASAA standardized Form U-7 shall comply with California regulations that are stricter than the standards set by other states. Still, in general, according to the Department of Corporations, "California SCOR filing requirements are more liberal than the SCOR filing requirements of other states."[35]

California participated for a while in the Western Regional Review Program when this program was established as a pilot program. However, due to the low number of applications filed in the region, the state withdrew from this program. The number of SCOR applications has been decreasing over time. In 1997, the California Department of Corporations processed 13 SCOR applications. In 1998, there were 10 applications and approximately 7 during the 1999 calendar year.[36]

Until recently, at the federal level, issuers were permitted to generally solicit and advertise their Rule 504 offerings. The stock was not restricted (investors could resell the stock freely) although states could impose restrictions on these offerings. In California, the Department of Corporations generally imposes suitability requirements for investors that purchase securities issued under SCOR, and the stock is not freely tradable through brokers (unless on unsolicited basis). When Rule 504 is coordinated with the private placement exemption under Corporations Code, Section 25102(f), the stock is technically not restricted though the investor must vouch that the stock is not being purchased with a view to further distribution.

The SEC recently amended Rule 504 after several micro-fraud experiences took place in some states.[37] Under the revised rule, issuers may generally solicit, advertise, and issue freely tradable securities only in transactions that are either:

- registered under state laws requiring public filing, or
- exempted under state laws permitting general solicitation and general advertising as long as sales are made only to "accredited investors."

With the new changes, most of the flexibility that the Rule 504 provided for small businesses has been lost. On one hand, the revised rule changed the situation for 504 offerings in states where there was no review for this type of offerings (New York, for example). Now SCOR issues in New York (a state without SCOR statutes) must be registered in another state to be able to use the federal exemption. The MAIE, implemented by NASAA in 1977, provides an exemption at the state level for small companies that offer and sell their securities exclusively

[35] Letter from Mr. William Kenefick, Acting Commissioner of the California Department of Corporations, to Rosa Moller, dated September 21, 1999. See Attachment.
[36] Data from Letter from Mr. William Kenefick, op. cit.
[37] Changed in March 1999. Micro-fraud is fraud originated through small offerings.

to accredited investors, allowing general solicitation of the general announcement, and restricting the resale of such securities.[38]

Rule 505

Rule 505 permits private offerings of up to $5 million in any 12-month period, to an unlimited number of accredited investors,[39] and up to 35 non-accredited investors. To comply with Rule 505, the company must file a Form D; make no general solicitation; and exercise reasonable care to assure that the investors are acquiring the securities for their own accounts and not for resale. The company can decide on what information is given to accredited investors, but the company must give non-accredited investors disclosure documents that generally are the same as those used in registered offerings. Securities are restricted (investors cannot freely resell the securities).

This rule is seldom used as the requirements for non-accredited investors are stiff and companies prefer to use Rule 506 for private placements, since Rule 506 does not set limits on the amount of capital raised through the offering and the state's review is preempted.

Regulation A. Public Offerings Exemption

Regulation A authorizes an exemption for public offerings not exceeding $5 million in any 12-month period. The Regulation A exemption requires the company's filing of a simplified offering statement with the SEC.

Regulation A is used less by issuers because it shares many of the burdens of registration. For instance, the preparation of the offering statement and offering circular with the confirmation of sale to investors are expensive processes. However the disclosure document used for Regulation A is less detailed and cumbersome than a full registration statement. From the investors' viewpoint, this exemption has the advantage that securities can be sold freely.[40]

The main advantages of Regulation A offerings over a full registration are:

- Simpler filing process than under other public offerings.

- Companies may use simpler financial statements that do not need to be audited. However, California imposes high suitability requirements to companies that do not provide audited financials.

- Businesses can also use three alternative disclosure forms: 1) use one offering statement to raise a given amount of capital (for instance $5 million) or 2) combine different offering statements to make two or three stock offerings over the course of several years. These additional offerings can be done with a minimal updating of the business and financial data that was disclosed in the first offering statement. For instance, a business

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[38] This model is discussed in more detail later in this Section (2. The Complications Imposed by State Regulations and the Need for Uniformity).
[39] As defined in Rule 501 of Regulation D.
[40] See Petillon, Lee. "Taking Stock of Your Options." Small Business Reports. January 1994.

can use Form U-7 for SCOR, and later simply update this form for a Regulation A offering.[41]

- No Exchange Act reporting obligations for companies with total assets under $10 million or 500 shareholders or less.

- Less costly than registered public offerings.

- Companies may “test the waters.” The test-the-waters provision in Regulation A allows a business to gauge investor interest before spending time and money in the preparation and filing of an offering statement. Such testing could be done through various media, including television, radio commercials and newspaper ads, provided the company carefully labels the disclosure statement as a solicitation and does not accept any funds from potential investors. However, this test-the-waters provision can only be used when state legislation permitting its use has been enacted.

  Although at the federal level the issuer can test the waters, in California this is not allowed. However, California permits testing the waters in its qualified purchaser exemption, an exemption that can be used with Regulation A.[42] As of 1997, only 17 states reported that they have adopted test-the-waters provisions[43] and nine states were planning to adopt the exemption.[44] Many have adopted the model Accredited Investor Exemption developed by NASAA to achieve uniformity among the states regarding the definition of accredited investors and the application of the test-the-waters provisions.

- Securities can be offered publicly and are not restricted and can be immediately resold.[45]

- There is no strict liability for negligent errors made in the offering.

The offering has to be approved by each state where the offering and sales of securities takes place. Many states accept the SEC review, and approve the issue automatically. California normally does its own review. California had been a member of the Western Review Region for Regulation A type of offerings, a project organized by NASAA. However, the state no

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[41] See Petillon, Lee. “Taking Stock…” Op. cit.

[42] Section 25102(n). Under this exemption issuers can publish a general notice in the media. Among other requirements, the announcement must indicate that: 1) sales will be made to accredited investors only; 2) no money will be accepted on the strength of the general announcement alone; and 3) the securities are being offered under an exemption from registration.

[43] See Securities and Exchange Commission. “Report on the Uniformity of State Regulatory Requirements for Offerings of Securities That Are Not ‘Covered Securities.’” (Referred to as Uniformity Study). The NSMIA, in Section 102 (b) required the SEC to conduct a study on the extent to which uniformity of state regulatory requirements has been achieved for securities that are not covered securities. This study (the “Uniformity Study”) had to be reported to the Congress on October 11, 1997. The 17 states that have adopted test-the-waters provisions are: Colorado, Illinois, Indiana, Iowa, Massachusetts, Nevada, New York, North Dakota, Oregon, Pennsylvania, South Carolina, Utah, Vermont, Virginia, Washington, Wisconsin and Wyoming. Wisconsin’s exemption permits “test-the-waters” in exempt offerings.

[44] Arizona, Maine, Michigan, New Jersey, Delaware, Florida, Kentucky, Maryland, and Rhode Island.

[45] Restricted means that securities may not be resold except pursuant to registration.

longer participates in this program due to the small number of the Regulation A filings submitted to this program.[46]

California Limited Offering Exemption-SEC Rule 1001.

SEC Rule 1001 was adopted in 1996. It provides an exemption from the registration requirements of the Securities Act for offers and sales of securities up to $5 million that satisfies the conditions of Section 25102(n) of the California Corporations Code. This California law exempts from state registration offerings made by California businesses to "qualified purchasers" whose characteristics are similar, but not the same, as accredited investors as defined under Regulation D. Some general solicitation (test-the-waters provision) based on a general announcement prior to the sale of securities is allowed under this exemption. The exemption provided by Section 25102(n) of the California Corporations Code is discussed later in the section, under the small business options provided by the California law.

The Concept of Integration

In determining whether the requirements for an exemption have been met, the concept of "integration" is crucial. Separate offerings can be integrated (considered part of a single offering) depending on whether the offerings were made for the same general purpose, involve the same class of securities, and are part of a single plan of financing. Integration is an important consideration since two exempt offerings, each to 35 investors, might be integrated resulting in one non-exempt offering to 70 persons, in which case, the offering would violate the requirements of Regulation D of the Securities Act.

2. THE COMPLICATIONS IMPOSED BY STATE REGULATIONS AND THE NEED FOR UNIFORMITY

Most offerings are multiple state offerings. In this case, the issuers must get approval from the SEC and from each of those states where the securities are being offered and sold.

There are significant differences among the states' securities laws. When planning a multi-state offering, issuers not only have to evaluate the options provided by the federal government, but also those available in each state. Like the federal system, state laws and regulations also offer exemptions for certain types of securities and transactions. However, state exemptions generally do not match federal exemptions and a small issuer has to coordinate them.

In some cases, restrictive state regulations have neutralized some of the options provided by the SEC to ease small issuers' offerings. For example, because Kentucky's small offering exemption was more stringent than the federal law, many small issuers have been unable to use SCOR since this SEC exemption was trumped by the state securities law.[47]

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[46] Letter from Mr. William Kenefick, Acting Commissioner of the California Department of Corporations, to Rosa Moller, dated September 21, 1999. See Attachment.

[47] Rutherford B. Campbell, Jr., "The Impact of NSMIA on Small Issuers; The National Securities Market Improvements Act: One Year Later." *Business Lawyer*. February 1998.

Although California regulations are considered tough, they generally do not neutralize the exemptions offered by the federal level. However, California businesses issuing multi-state offerings are affected by other states' securities policies that may neutralize the federal options available to them.

The Effects of the National Securities Market Improvement Act of 1996 (NSMIA)

With the passage of NSMIA, Congress attempted to help capital formation by facilitating the regulatory process for private placement and public offerings. NSMIA preempts states from imposing state regulation on certain offers. In this way, NSMIA has substantially narrowed the scope of state regulation. However, the effect of this act on small business capital formation has been marginal since most NSMIA exemptions benefit larger issuers.

For example, NSMIA exempts from state regulations, the offer and sale of "covered securities." Covered securities include those listed on the New York Stock Exchange; the American Stock Exchange; the National Association of Securities Dealers Automated Quotation National Market System (NASDAQ/NMS),[48] and other stock exchanges specified by the SEC as having similar listing standards. Offerings qualifying for the private offering exemption under Rule 506 are also preempted from state regulation. The covered securities exemption from state registration has significantly reduced the number of offerings by larger issuers that are subject to state review, leaving only a relatively narrow class of offerings ("not-covered securities") subject to qualification.

NSMIA has not substantially changed the situation of many small issuers who have to continue to deal with the various layers of securities regulations imposed by the states. With the exemption of offerings under Rule 506, most small business offerings do not fall in the definition of covered securities. Not-covered securities include:

- Those securities that are traded on the regional exchanges, the NASDAQ/Small Cap market, or the NASD/OTC Bulletin Board System. The issuers of these securities are typically smaller, less mature companies with limited revenues, assets and capitalization. These businesses are generally development stage or start-up companies.

- Securities issued in private placements under Section 4(2) of the Securities Act that do not meet the requirements of Rule 506 under Regulation D.

- Securities issued in Rule 504 and 505 offerings under Regulation D (small offerings exemptions).

- Securities issued under Regulation A.

- Various debt securities of non-listed issuers, including asset-backed and mortgage-backed securities.[49]

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[48] The automated quotations system (NASDAQ) is a computerized system that provides up-to-the-minute price quotations on about 5,000 of the more actively traded over-the-counter stocks.
[49] Non-listed issuers are issuers that are not authorized for listing on a national securities exchange (or tier or segment thereof) that has listing standards that the Commission determines by rule.

The Difficulties of Clearing With Multiple States

If the securities are subject to state regulations, issuers that want to offer their securities in various states must comply with each states' substantially different registration provisions. Differences affect both offerings of covered and not covered securities. Differences in dealing with covered securities relate to notice filings, additional information required, and fees paid in connection with the offering. For example, for offerings under Rule 506:

- Alabama requests a manually executed Form D, Form U-2, offering documents, and a fee of $250.
- Arizona only requires Form D and a fee of $250.
- California requires Form D, Form U-2, and a cover letter referencing both Regulation D and the California statute used in the offering. In California, filing fees for 506 issues have been suspended until June 30, 2000.[50]

There are also differences in dealing with the state exemptions. Some exemptions require notice filings. Those states that require notice filings generally review the notice to determine if it complies with the applicable exemption (for example Alaska, Colorado, Maine). Among the states that do not review notice filings are Idaho and Iowa. A majority of the states note that most of their exemptions are self-executing (for example New Jersey, Texas, Massachusetts). Other states require notice filings but they do not review or comment on exempt transactions unless it appears that a violation has occurred (California and Oregon, for example).

Main differences among the states in dealing with securities that are subject to state registration are found in:[51]

- Standards of merit review.
- Disclosure requirements.
- Notice and filing requirements (for example the amount of money required, the paperwork involved, and time of approval).
- Comments issued by various states on the same offering (comments can be totally unrelated).
- Length of review time and comment periods.
- Suitability standards (definitions of accredited investors, for example).
- Notice requirements for exempt offerings.
- Required legends on offering materials (legends imposed on stocks subject to trade restrictions).
- Required forms in addition to the standard Form D in exempt offerings.
- Treatment of offerings of asset-backed securities.

Firms can have difficulty meeting all the various requirements. There are reports of firms that have had to withdraw their applications in some states, while their applications had been approved in others.[52]

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[50] SCOR Report. Vol. 6, No. 1, January 1999, p. 7. Dallas, Texas.
[51] SEC's "Uniformity Study," Op,cit.
[52] SEC's "Uniformity Study." Op. cit.

Efforts to Achieve Uniformity of State Regulations

Broker dealers, NASAA, and individual states recognize that the lack of uniformity among the states is relatively more burdensome and costly for small issuers and that there is need for greater uniformity among state registration requirements.[53] NASAA and the states have been working together to develop uniform guidelines and procedures in permitting offerings.

The Coordinated Equity Review Program (CER) Developed by NASAA

One significant step that the states have taken to achieve uniformity of state regulations is the Coordinated Equity Review program (CER) developed by NASAA. CER is a new program to facilitate the review of multi-state public offerings of corporate equity securities of small cap companies. The program targets equity offerings between $5 million and $20 million that typically are federally registered on Forms S-1, SB-1, or SB-2. These securities usually trade on the NASDAQ/Small Cap market, regional exchanges, or the NASD/OTC Bulletin Board.

The State of Pennsylvania has volunteered to serve as program administrator. The program administrator designates two lead states - one merit review state and one full disclosure review state to gather comments from all of the states in which the issuer is making the offering. States have ten days to comment on the application. The lead states resolve the outstanding comments with the issuer. Once the lead state clears the application, all participating states also clear it. Of 43 states that require the review of non-exempt equity offerings, 38 states have joined the CER program. California participates in this program.

The Uniform Limited Offering Exemption (ULOE)

In 1983, NASAA adopted a model exemption, the Uniform Limited Offering Exemption (ULOE), designed originally to provide an exemption at the state level for offerings that were exempted at the federal level under Rules 505 and 506 of Regulation D. Subsequently, the passage of NSMIA removed securities offerings under Rule 506 from state regulation. The ULOE now only applies to securities offerings under Rule 505, which are types of private offerings. Twenty-nine states have adopted ULOE. Many states have modified the ULOE model provisions. California has existing exemptions for individual accredited investors that are similar to ULOE.

The ULOE provides for uniformity since there are substantial differences among the various states' procedures in connection with 505 type of offerings. For example, some states:

- Have pre-sale or pre-offer notice requirements.
- Require sales reports.
- Require suitability standards.
- Require specific legends.
- Impose holding periods on the securities acquired.
- Restrict record-keeping requirements.

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[53] SEC's "Uniformity Study." Op. cit.

- Restrict commissions and offering expenses.

However, because Rule 505 offerings are limited to offerings of only $5 million or less, NASAA does not believe that non-uniform state provisions have a significant impact on issuers. The reason is that it is not practical to conduct this type of offering in a large number of states due to the limited dollar amount that can be raised. Multistate offerings are much more likely to rely upon Rule 506, which has no dollar ceiling.[54]

NASAA SCOR Form and Regional Review SCOR Project

For some businesses in some states, public offerings under Rule 504, SCOR has represented a significant source of seed capital. These are public offerings of $1 million or less. These offerings are generally registered with the states in which the offerings are to be conducted. NASAA recently has developed a form for SCOR registration and instituted a regional review SCOR project. Most states use the SCOR Form U-7 adopted by NASAA as the required disclosure document for registration for SCOR and Regulation A offerings with the states. According to respondents of a SEC's survey, the SCOR form and the SCOR regional review program among the states holds great hope for facilitating the use of these exemptions through uniform state review.[55]

Under the regional review project, states in a geographical region agree that a leading state coordinates the review of the SCOR form and communicates comments to the issuer. An issuer simply files its registration statement in each jurisdiction in which the offering will be made and requests regional review. Usually, the issuer's home state will be the lead-state. There are three regional review programs consisting of Western, New England, and Midwestern states. In this way, the review process is greatly consolidated and simplified for the issuer. Thirty-six states have adopted the NASAA SCOR model. California and 10 other states have informally adopted it. For example, California has a variation of the standard Form U-7.

California participated in the pilot Western Regional Review Program. Under the pilot project, the Department's Securities Regulation Division reviewed approximately five SCOR applications. 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 no longer participates in this program.[56] According to the Department of Financial Institutions in the State of Washington, the lead-state of the Western Regional Review Program, only about 10 applications are filed each year for regional review. Most of these filings are SCOR applications rather than Regulation A applications.

The Model Accredited Investor Exemption Developed by NASAA

In 1997, NASAA adopted the Model Accredited Investor Exemption (MAIE). It provides an exemption at the state level for small companies that offer and sell their securities exclusively

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[54] NASAA Uniformity Study.
[55] SEC's "Uniformity Study."
[56] Letter from Mr. William Kenefick, Acting Commissioner of the California Department of Corporations, to Rosa Moller, dated September 21, 1999.

to accredited investors. This model is a refinement of testing the waters of California's exemption under Section 25102(n) that provides an exemption at the state level for small companies that offer and sell their securities exclusively to accredited investors. The accredited investor exemption model helps to create more uniformity for small businesses trying to sell securities to angel investors (wealthy individuals) and venture capitalists. Several states have adopted this model. Others have their own version.

Private placement regulations require companies to know wealthy individuals before offering their unregistered investment opportunities. With the accredited investor exemption, companies can contact wealthy individuals (business angels) and then show them the deal. Under the MAIE, issuers can publish a general announcement in the media. The general announcement should include the issuer's identification and a brief description of the business and the securities to be issued. This announcement also must indicate that:

- Sales will be made to accredited investors only.
- No money will be accepted on the strength of the general announcement alone.
- The securities are being offered under an exemption from registration (the securities have not been registered by any state securities agencies or the SEC).

The Office of Advocacy of the Small Business Administration has established the Angel Capital Electronic Network (ACE-Net) to connect accredited investors and small companies. ACE-Net is an Internet-based "bulletin board" for smaller offerings made exclusively to accredited investors. It has been specifically designed to work with the MAIE by giving small companies the opportunity to list their securities offerings and reach wealthy investors at a reduced cost. It is similar to a broker-run operation. However, the private placement exemptions do not allow a broker-run operation to advertise the deals to potential investors. ACE-Net solves this problem by registering the customers and scrutinizing the deals that are offered in the system. For example, in this Internet site, small companies may list their Regulation A, SEC Rule 1001, and Regulation D (504-SCOR) stock offerings. However, the system is not available for filings under Rules 505 or 506, since general solicitation is not permitted for these filings.

Some observers and participants indicate that there are several problems with ACE-Net.[57] For example:

- The quality of the deals varies greatly.
- There is a lack of active investors due to lack of advertising by the network operators and the SBA.
- There are problems related to the design of the web site (slow site, difficult to use).
- Most angel investor groups are formed and function by personal association, rather than through a computer network.

In California, some Internet markets are being established to bring together companies and accredited investors (business angels). One example is Direct Stock Market (www.dsm.com). The purpose of this network is to bring together financial professionals, venture capitalists, business angels, the investing public, and emerging growth companies.

[57] SCOR Report, Vol. 6, No. 7, June 1999, p. 8. Dallas, Texas.

NASAA Statements of Policy

NASAA has also issued statements of policy relating to various aspects of equity offerings, so that state regulators have uniform guidelines in reviewing offerings. These statements address issues such as options and warrants, preferred stock, promoter's equity investment, underwriting and selling expenses, etc. Three states have adopted NASAA Statements of Policy, some have informally applied or have applied or adopted some selected NASAA Statements of Policy. Ten states, among them California, have not officially adopted any NASAA Statements of Policy, although they sometimes follow informally some of these guidelines.

Since the California Department of Corporations has the responsibility of applying California law, the Department thinks that it needs to evaluate each of NASAA statements and see whether these statements meet their merit review requirements before adopting them.[58] The reason is that in general, NASAA guidelines and California regulations do not mesh in many ways and the Department believes it does not have the statutory capability to apply both California standards together with NASAA guidelines.[59]

NASAA Model Exemption for Internet Offerings

With the increased use of the Internet, issuers of securities have been posting securities offering materials on the Internet. Under certain circumstances, some Internet communications could be considered an offer of a security in any state in which a person might access the communication, and therefore, subject to state regulations. In January 1996, NASAA adopted a resolution encouraging the states to exempt Internet offers from the registration provisions for some conditions. Generally, the resolution exempts offerings if:

- The Internet communication indicates that the securities are not being offered to the residents of a state.
- No offer is otherwise specifically directed to any person in a state.
- No sales are made in a state until the offering is registered and declared effective, or the sales are exempt from registration.

As of 1997, thirty-three states had adopted NASAA's model exemption for Internet offers, and three states planned to adopt the exemption. Eight states, among them California, have their own exemptions for Internet offers, or Internet communications that are excluded from their definition of offer.

3. OPTIONS OF SMALL BUSINESSES UNDER CALIFORNIA LAW

This part of Section 2 discusses exemptions that small businesses can use under California State law.

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[58] Conversation with Mr. Bryan Thompson, Acting Chief Deputy Commissioner, Los Angeles. (September 14, 1999).
[59] Conversation with Mr. William Kenefick, Acting Commissioner of the California Department of Corporations. (September 9, 1999).

As already indicated, generally offerings must register with the SEC and the states involved in the offering, unless exempted.

California's regulatory system is based on merit review. The SEC provides for some exemptions of registration discussed earlier (for example Regulation A, Rule 505, 506, etc.). However, with the exclusion of Rule 506, the federal exemptions do not preclude state qualification. In that case, California issuers must go through the merit review process called "qualification" unless they can coordinate the federal exemptions with the exemptions provided by California law. The same is true when the offering involves other states. The issuer has to figure out which states' exemptions can be coordinated with the ones provided at the federal level.

The most important of these exemptions are the California private placement and the qualified purchaser limited offering exemptions. The SCOR exemption is also discussed here, although in California this type of public offering must go through the Department's review.

California Private Placement Exemption (Corporations Code, Section 25102(F))

This exemption is very important for small businesses and is `widely used.[60] It does not require registration of private offerings as long as the issuer satisfies certain conditions:

- Sales of the security are limited to no more than 35 persons, including persons from outside the state.
- All purchasers (other than excluded purchasers)[61] must have a pre-existing personal or business relationship with the issuer (offeror) or its officers, or the issuer must be able to reasonably assume that the investors are financially sophisticated enough to protect their own interests.
- Each purchaser must represent that he or she is purchasing for his or her own account and not in connection with any distribution.
- The offer and sale of the security may not be accomplished by the publication of any advertisement.

This state exemption was intended to coordinate with the federal exemptions provided by Regulation D. To protect investors, the state imposed on this private placement exemption a suitability standard (sophisticated investors).

Except as provided in California,[62] no general solicitation (advertising) is allowed in private placements and the securities are not freely tradable until approved by the Department (qualified) or found to be exempt from qualification. However, California's law, Section

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[60] One of the most important exemptions under the Corporate Securities Law of 1968. Source: Continuing Education of the Bar (CEB). California. "Introduction to Corporate Securities Practice in California. Program Handbook." Edited by University of California, Berkeley. November 1995.

[61] Excluded purchasers include institutional purchasers, officers, directors, and affiliates of the issuer, persons who occupy a position with the issuer, relatives, and others.

[62] For example, under California law the issuer can disseminate private placement memoranda, offering circulars and similar disclosure documents to persons probably believed to be interested or those that meet the qualifications of required purchasers.

25102(n) discussed below has recently allowed the use of "tombstone" ads for private placements with qualified purchasers.[63] Tombstone ads are general announcements on the investment with no specific offering or solicitation of the stock.

The documentation required under Section 25102(f) is the filing of a notice of transaction with the Department. There is no required disclosure document other than the use of a Private Placement Memorandum to avoid fraud charges. During the 12 months ending January 31, 1999, the Department of Corporations received 38,321 filing notices under Section 25102(f).[64]

Qualified Purchaser Limited Offering Exemption. Corporations Code, Section 25102(n)

This exemption, adopted in 1994, is especially important because it allows general solicitation. It also exempts from state registration certain private offerings. It applies to California or quasi-California corporations or any other business entity organized under California law.[65] An offer or sale of a security in a limited public offering by specified issuers to certain qualified purchasers is exempt from qualification. The law places no limits on the number of offerees or purchasers to whom an issuer can approach or sell securities, and allows the issuer to use a general solicitation to disseminate a general announcement of the offering. This announcement is comparable to the test-the-waters solicitations permitted in the federal Regulation A exemption. The announcement can be disseminated through the media, as long as it follows the specifications required by the law. Basically, the announcement must:

- Provide general information on the business and the offering.
- Indicate that sales will be made to accredited investors only.
- Indicate that the securities have not been qualified by the state.
- Indicate that no money will be accepted until approved by the Department of Corporations.

Section 25102(n) defines a qualified purchaser in more flexible terms than the SEC definition of an accredited investor under Regulation D. Qualified purchasers include specified institutions and individuals that have:

- A minimum net worth of $250,000, and gross income of $100,000 during the immediately preceding tax year and who expect such income in the current tax year, or
- A minimum net worth of $500,000.
- The same sophistication requirements established in Section 25102(f).

The calculation of net worth excludes home, home furnishings, and automobiles. A qualified purchaser cannot invest more than 10 percent of his or her net worth.

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[63] California Corporations Code Section 25102(n) became effective on September 26, 1994 and was designed to facilitate the growth of small business capital.
[64] Letter from Mr. Ronald C. Carruth, Securities Regulation Division, to Rosa Moller. February 9, 1999.
[65] Quasi-California corporations are foreign (out-of-state) corporations subject to Corporations Code 2115 because more than 50 percent of their outstanding voting securities are held by California residents and more than 50 percent of the average of their property, payroll, and sales are derived from California.

This state exemption can be coordinated with federal exemptions under SEC Rule 1001, SCOR, or the intrastate federal exemption. In these cases, the federal law will determine the maximum amount raised by the offering. For example, if an issuer relies on the federal exemption provided by Rule 1001, the maximum amount raised will be $5 million, since that is the limit established for the Rule 1001 federal exemption.

During the 12 months ending January 31, 1999, the Department of Corporations received 63 notices of filing under 25102(n).[66]

Small Corporate Offering Registration (SCOR)

As already explained in the description of the federal exemption under Rule 504, California requires that SCOR offerings ($1 million or less) must be qualified by the Commissioner of Corporations. Applicants that satisfy SCOR conditions can use the Form U-7 disclosure document from the North American Securities Administrators Association (NASAA). However, SCOR applicants must provide the financial information required by the Department of Corporations rather than those required by Form U-7.[67] In addition, an opinion of California legal counsel that the securities to be sold have been duly authorized must be filed with the SCOR application.

In California, suitability standards are usually imposed in SCOR offerings for individual stock sales above $2,500. However, the average purchase in a SCOR offering is around $1,600.[68]

Thirty-Five or Fewer Shareholders

California Corporations Code Section 25102(h) exempts from qualification the offer or sale of common stock by a corporation *incorporated in any state* if all of the following requirements are met:

- The stock to be issued is voting common stock, and it is the only class of stock that will be outstanding.
- The number of beneficial owners of the stock does not exceed 35.
- There is no publication of any advertisement.
- No selling expenses in connection with the offer and sale of the stock are paid.
- In exchange for the stock, the issuer must receive one of the four categories of assets specified in the statute (categories include the cancellation of indebtedness for money borrowed, cash only, assets of an existing enterprise transferred to the issuer upon its initial organization).
- No promotional consideration is given, paid, or incurred in connection with the issuance of the stock.

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[66] Letter from Mr. Ronald C. Carruth, Securities Regulation Division, to Rosa Moller. February 9, 1999.
[67] Section 260.113.1.
[68] The California Small Business Rules define suitability standards for investors purchasing securities from small businesses' offerings of up to $5 million. The following are the suitability standards for these investors: $50,000 income and $75,000 net worth (excluding home, auto, and furnishing), or $150,000 net worth.

This exemption is narrower than the private placement exemption. As a result, businesses use the exemption under Corporations Code Section 25102(f) more often than the exemption provided by Corporations Code Section 25102(h).[69] During the 12 months ending January 31, 1999, the Department of Corporations received 1,365 filings under 25102(h).[70]

Recent Amendments to California Securities Regulations That Benefit Small Businesses

California's most recent efforts to facilitate capital access for small businesses are expressed in new departmental rules in the California Administrative Code. For example:

- Section 260.140.01 of the Code of regulations provides for a waiver of the merit review standards in a private or public offering of $5 million or less by a small business issuer.[71] To qualify for this waiver the offering has to be limited to 1) investors who have $50,000 gross income and net worth of $75,000, or net worth of $150,000, or 2) investors that have purchased $2,500 or less of the issuer's securities in the previous 12 months. Investment may not exceed 10 percent of the investor's net worth.

- Section 260.140.05 allows any issuer that is not currently profitable to obtain a permit for a public offering of securities, as long as the issuer can demonstrate expected profits no later than 24 months after the date of the approval of the application. This period can be extended in justified circumstances.

- Section 260.140.20 was modified to establish higher than 15 percent maximum selling expenses in public offerings by small business issuers. These rules are designed to make small offerings more attractive to small broker/dealers who often avoid underwriting small offerings because these issues are not profitable enough.

- Section 260.140.31 raises the proportion of promotional shares from 25 to 50 percent of the total common shares issued and proposed to be issued in SCOR offerings. Promotional shares are securities issued for services rendered in connection with the founding or organizing of a business, or issued to a promoter in consideration for patents, copyrights, or goodwill.

- Section 260.613 reduces from three to two the number of fiscal years for which a small business issuer of a private offering must provide statements of income and cash flows.

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[69] Examples of the advantages of using Section 25102(f) over Section 25102(h) are: 1) Section 25102(h) requires that there be no more than 35 beneficial owners of the stock, while Section 25102 (f) allows a larger number of purchases since accredited investors are not counted in the calculation of the 35 purchaser limitation. 2) Both exemptions (25102(h) and (f) prohibit the publication of any advertisement. 25102 (b) prohibits promotional consideration whereas 25102(n) does not. 3) Under both exemptions, notice must be provided to the Commissioner. However, unlike Section 25102(h), Section 25012 (f) does not need a declaration, verification or an opinion of counsel, and failure to file the notice does not result in loss of the exemption.

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

[71] A small business issuer is defined as an entity having annual revenues of less than $12.5 million. The law also requires that the business be a California corporation or a quasi-California corporation (a corporation that has an average factor of property, payroll, and sales of 25% in California, with at least 50% of the payroll and 25% of shareholders in California).

- Section 260.613(f) establishes easier standards for financial statements for small business seeking a public offering permit for no more than $500,000. Under this section, businesses may provide financial statements that have been reviewed, rather than audited.

All these rules make it easier for small companies to qualify their securities or to obtain appropriate exemptions under the California securities laws.

Summary of Private and Public Market Options Open to California Small Businesses

The various avenues for raising capital for California small businesses are summarized in Tables 2 and 3 at the beginning of Section 2. The most inexpensive ways for a small company to raise initial funding are a Rule 506 private placement, or an interstate offering, or a California Section 25102(f) for an intrastate offering. The central problem for a small issuer is how to reach a sufficient number of qualified investors without resorting to a "general solicitation."

The choice of options available to a given company depends on its financial condition and development stage of the businesses. For example, an attractive method for raising capital for early stage California companies and start-ups is:

1) To raise privately an initial amount of capital (say $75,000 to $250,000).

2) Use a portion of the proceeds to finance a SCOR or a Regulation A offering (both public offerings) using Internet resources to get leads (for example, Ace-Net list of accredited investors to contact potential investors).

3) After achieving a certain degree of development, apply for a full registration using an SB-2 offering, and clearing in other states taking advantage of the Coordinated Equity Review implemented by NASAA. Once registered under an SB-2 offering, the company will achieve the status of a "Reporting Company."[72] Advertising is permitted in a public offering. However, it must be submitted to the regulators and should not go beyond the information contained in the disclosure documents and must comply with various content and prospectus delivery requirements.

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[72] Once a company registers a public offering, it becomes a reporting company. Reporting companies are required to file various reporting requirements with the SEC. Even if a company does not register its offerings, it must become a reporting company if it has at least 500 shareholders and $10 million in assets.

SECTION 3

EVALUATION OF STATE MERIT REVIEW REGULATORY SYSTEMS

All issuers of securities must comply with the regulations of each state involved in the offerings and sales of those securities. In California, the Department of Corporations must qualify all offerings and sales of securities unless these offerings are exempted. State securities regulations are usually referred to as blue-sky laws. States have two types of state regulatory systems, those based on merit review and those that emulate the federal system of full disclosure. Merit review systems also vary in stringency of implementation. The California qualification process is based on merit review.

In a merit review system, state securities administrators seek to determine whether an offering's terms and manner of sale are "fair, just, and equitable" to investors. Thus, such merit review regulatory systems have been justified as ways to protect investors from fraud. However, merit review critics argue that this type of regulatory system fails to prevent fraud, imposes unnecessary costs to businesses, and discriminates against small issuers. Criticism of merit review focuses on the paternalistic nature of the approach, the arbitrariness of these reviews, and the system's lack of relevance in the modern world of financial innovation and electronic networks.

This section discusses the origin of the concept of blue-sky laws and the historical justification for these regulations. It also discusses the pros and cons of merit review systems. Although available data do not allow an accurate evaluation of the costs and benefits of various regulatory systems based on merit review, there has been some research on this issue. Conclusions from this research and other evidence on the effectiveness of merit review in protecting investors is also presented in this part of the paper. This evidence includes:

- Information gathered through interviews with various security regulators, security attorneys, and several companies that have gone through the registration process in California.

- The experience of some states that have switched from merit review towards full disclosure-based systems as described by regulators and experts that have witnessed these processes.

BLUE-SKY LAWS

State securities regulations are usually referred to as "blue-sky laws." Before 1933, state blue-sky laws regulated the sale of securities in the United States almost exclusively. The term blue-sky law is derived from the observation that unscrupulous securities salesmen in

Kansas operated so blatantly that they would "sell building lots in the blue sky in fee simple." The passage of the federal Securities Act of 1933 preserved state securities regulation.[73]

State regulation of securities is justified as a means of preventing fraud and protecting consumers from investments whose terms are not deemed fair, just, and equitable. However, a historical review indicates that blue-sky legislation was supported by special interests whose concerns were not protecting investors. For instance, supporters of blue-sky legislation included banks and savings institutions that saw blue-sky legislation as a means for restricting competition for depositors' funds. Supporters also included small farmers and small business owners who viewed the restriction of securities sales as a means for facilitating their access to bank loans and credit.[74]

Among the opponents of blue-sky regulation were large investment bankers and large issuers of securities who wanted to preserve their ready access to low-cost financing in the public securities markets. These interest groups argued that these regulations inhibited the securities market and denied business access to capital.

MERIT REVIEW VERSUS FULL DISCLOSURE SYSTEMS

The full disclosure system focuses on the information an investor receives. The goal of a full disclosure system is to prevent a promoter or issuer from deceiving the investor. In practice, full disclosure statutes require that the issuer provide prospective investors with all factual information on its proposed offering of securities.

The rationale for merit review is that there is a substantial risk of unfair treatment of investors because they are unable to affect the structure or the terms of the offering. The merit review standards have been implemented to minimize the risks associated with the terms of the investment agreement. It is an attempt to restrict speculative ventures.

In a merit review system, there are standards of review applied by state securities administrators to determine whether an offering's terms and manner of sale are "fair, just, and equitable" to prospective investors. Although there is a tendency to distinguish sharply between the federal disclosure approach and the state merit approach, merit review states often impose disclosure requirements, some of which are beyond SEC requirements.

A fundamental issue with the merit review system is that the terms fair, just, and equitable are difficult to define. These are concepts that mean different things to different individuals. Furthermore, merit review statutes vest state securities administrators with considerable discretionary authority to make qualitative decisions on the merits of an offering. This authority may result in substantial changes in the terms of the offering (price, number of units offered, and ways of distribution).

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[73] Patrick W. Daniels, "The Capital Formation and Securities Fraud Enforcement Act of 1996: Historic and Economic Perspectives for a Balanced and Reasoned Analysis." 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.

[74] Patrick W. Daniels, "The Capital Formation and Securities…" Op. cit.

FIVE WAYS TO EVALUATE MERIT REVIEW SYSTEMS

Many scholars, securities attorneys, and legislators debate the effectiveness and necessity of the merit review system. The debate focuses on:

- Merit review's effectiveness in protecting investors and eliminating fraud.
- The costs and benefits of merit review. Do the benefits of implementing a merit review system justify the economic costs of its implementation, including the constraints it imposes on business investment?
- The need to protect investors. Do investors actually need help in evaluating the profitability and soundness of their investments?
- The contemporary relevance of merit review.
- The fairness of merit review.

1. Merit Review's Effectiveness in Protecting Investors and Eliminating Fraud

Merit review systems are based on the implicit assumption that disclosure alone is insufficient to prevent fraud because certain investors may be unable to evaluate the risks of an equity investment.[75]

Defenders of the merit review system believe that such a system is more effective for investor protection than a system based on fraud prosecution. First, merit review has a prophylactic effect. Criminals know they have to get a permit from the department before selling stocks and in this way, the system discourages unsubstantiated projects. Second, the system is effective because it protects investors before the investor's money is already gone rather than after the fraud is committed, as would be the case where there is emphasis on fraud prosecution. Third, merit review protects investors in ways that pure disclosure cannot. For example, it allows investors to have a fair chance to reap the potential profit they think they are going to get by:

- Limiting excessive costs for promotion that may translate in low, if any return, to investors.
- Requiring issuers to demonstrate that the plan of the business is feasible or not unreasonably speculative.
- Allowing the commissioner to object to an offering that is not firmly underwritten.
- Requiring that estimates of an offering's capital requirements be sound.
- Imposing suitability requirements on investors (for example, conditioning the sales to sophisticated or qualified purchasers).

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[75] For example, unsophisticated and uninformed investors, the widows and orphans so frequently referred to in the literature.

On the other hand, critics offer the following reasons why merit review systems fail to reduce fraud:

- Most perpetrators of fraud essentially operate outside the law.
- Merit review is not designed to detect fraud.
- Merit review regulators do not check the truth of the statements in the offering documents.
- Merit review cannot protect investors from unprofitable projects.

Some of these critics point out that perpetrators of fraud do not register under *any* standard (merit review or full disclosure), and therefore regulators are unable to detect their frauds. They cite numerous fraudulent offerings that have passed merit review, such as the American Continental Corporation case. American Continental sold $250 million worth of junk bonds through Lincoln Savings and Loan Association; sales persons allegedly misled the public, indicating that these bonds were safe, secured, and guaranteed by the Federal Savings and Loan Insurance Corporation. American Continental subsequently defaulted on the bonds, leaving investors, including many senior citizens who had invested their life savings in the bonds, holding worthless paper.

Critics also indicate that merit review regulators cannot detect fraud in advance because an accurate review depends upon applicants providing truthful information. Regulators do not check the veracity of the information in the offering document. These critics also emphasize that the likely success of an issuer depends on matters that merit review does not address, such as the quality of the project, the market demand for the business' products, and management's efficiency. Regulators do not have the necessary background to single out those businesses that will actually be successful, or the ability to actually judge the quality of an investment to the benefit of the market.

What does the data say? There has been little research into the relative effectiveness of the merit review regulatory system versus systems that emphasize disclosure of offering materials and enforcement as methods of discouraging fraud. There are two main reasons for the lack of research:

- There is not enough empirical data to perform a statistical analysis that could prove or disprove the ability of the merit review system to prevent fraud.

- The comparison of fraud occurrence under alternative securities regulatory systems is a difficult subject since there are so many other factors that explain these differences in addition to the states' regulatory systems. For example, states with merit systems have different types of regulations and the agencies that enforce them also operate differently. State regulatory agencies differ in size, financial resources, and quality of the staff. States also differ in the size of their population and their socio-economic characteristics.[76]

[76] There is neither national nor state data on the number of fraud cases and the value of losses due to fraud that specifically relates to public and private offerings, nor the total number of cases of public and private offering with the value of these issues.

a) Research Findings

Some existing studies measure the effectiveness of merit review as a tool of investor protection by comparing average returns on two groups of securities, those that passed merit review versus those that did not. Researchers relate higher average returns from approved securities to the ability of the merit review system to protect investors. Surprisingly, the conclusion of most of these studies is that the average returns on rejected securities are higher than on approved securities, at least during the first two or three years.

For example, some studies divided initial public offerings into two groups 1) those that passed merit review in at least one of the states that has especially stringent merit review, and 2) others. The study found that the first group of initial public offerings was less risky, having a lower probability of a substantial loss. However, the issues in this group also had a lower probability of a substantial gain. Other studies have shown that these differences occur only in the short run, and that after a period of two to three years, returns follow the general market.[77]

b) Examples of Fraud

The occurrence of massive fraud during the last decades suggests that merit review is not an effective tool for fraud prevention. During a public hearing held in 1996, the California Department of Corporations illustrated this point by showing 10 examples of massive fraud, with a cost of about $2 billion to investors, in offerings that have been approved by the Department. Among these examples were American Continental, Z-Best, and Pioneer Mortgage.[78]

c) Anecdotal Evidence

Securities attorneys who have dealt with the California Department of Corporations (including several lawyers from other states), blue-sky administrators throughout the US, NASAA representatives, representatives from the California Department of Corporations, and other experts in the field were contacted during this study to collect evidence based on their experiences.[79] Most securities attorneys and some regulators agree to the following:[80]

- Since merit review applies to a small proportion of securities, it does not prevent fraud.

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[77] For example, see Brophy, David J. and Joseph A. Verga. "The Influence of Merit Regulation on the Return Performance of Initial Public Offerings," School of Business Administration, University of Michigan, Ann Arbor, American Bar Association Monograph, 1994. See also: 1) Goodkind, Conrad. "Blue Sky Law: Is There Merit in the Merit Requirements? *Wisconsin Law Review*, 1976; and 2) Marianne Jennings, "The Efficacy of Merit Review of Common Stock Offerings: Do Regulators Know More Than the Market?," B.Y.U. *Journal of Public Law*, Vol. 7, 1992.

[78] California Department of Corporations Hearing. "Capital Formation and Securities Fraud Enforcement Act of 1996 (Assembly Bill 2465). July 24, 1996. Testimony of Mr. Bill McDonald. Assistant Commissioner, Enforcement Division, California Department of Corporations.

[79] Between January and April of 1999, I contacted 350 experts. Some securities attorneys were reached through the Blue-Sky List Serv established by the Villanova University School of Law.

[80] This is corroborated by the Assistant Commissioner for Enforcement of the Department of Corporations, Bill McDonald, who has been in the Department for 18 years. According to Mr. McDonald, there is little correlation between the registration standards applied by a state securities regulatory system and the effectiveness of the enforcement program.

- Fraud is generally unrelated to securities registration, since criminals simply do not register.

- While it is important to regulate securities offerings, merit review systems are no more effective than full-disclosure systems.

- There should be more emphasis on enforcement than on registration.

However, securities attorneys and regulators disagree on the need to regulate securities offerings. Regulators feel strongly that a registration process is necessary for investor protection.

d) The Experience of States That Have Changed to Full-Disclosure

Another way to assess the effectiveness of merit review is to look at the experience of states with less stringent merit review systems, or states that have changed their regulatory process from merit review towards one of full disclosure. If merit review is an effective tool to prevent fraud, we would expect more fraud occurrence in the states where the review system is closer to full disclosure than to merit review.

Regulators from states with less stringent merit review systems than California, such as Washington, indicate that their states are not experiencing high rates of fraud. Missouri. for example, has a merit review system less restrictive than California. The Missouri system has been simplified during the last few years. They have not experienced an increase in fraud activity after the restructuring of their merit review system.

Colorado, Wisconsin, and Illinois have changed their systems from merit review towards full disclosure. The effects of this change have been different in these states. Wisconsin and Illinois have had a smooth transition without an increase in fraud incidence since merit review was eliminated. Contacts in Illinois seem to be satisfied with the change and regulators have focused on increasing enforcement and public awareness.

The Colorado experience has been quite different. For many years Colorado was a merit review state. During the early 1980s the law was changed, shifting Colorado to a deregulated state that did not even have a full disclosure requirement. After a series of fraud occurrences, including some in the penny-stock market, Colorado changed to a full disclosure state in 1990. Currently, Colorado regulators view their system as working well. They believe there is still much fraud, but it operates outside of any possible state regulations.

According to some experts, the success of regulations and fraud prevention has to do with a particular environment. Several factors explain the Colorado experience. Some experts attribute Colorado's high rates of fraud to:

- The idiosyncrasies of the Colorado investment market.
- The cultural characteristics of the population of the state.

- The high proportion of investments in oil and gas exploration and drilling, mining, and other ventures involving conflict of interest between the investors and the issuers, and even self-dealing.
- The lack of resources allocated to securities regulations and enforcement.

Other experts indicated that Colorado had problems with fraud because some essentials of its regulatory system, such as broker and dealers regulations, fell apart when the merit review system was changed. Markets were killed at the end. However, instead of coming back to merit review, they increased enforcement and broker-dealer regulation. That state preferred to follow the SEC's approach of full disclosure rather than return to merit review. Restrictions were imposed as they were needed, and a balance was found between investor protections and promotion of capital formation.

e) Recent Experiences of Micro-Fraud in States With Full Disclosure

In general, fraud data do not seem to indicate that in non-merit review states like New York and New Jersey, fraud is dramatically different from other states with merit review systems such as Texas. However, recently there has been a series of micro-fraud events in states such as New York and Utah, which do not have a merit review system.[81]

Most of these fraud cases have taken place when someone has sold the stock of a small or non-existent company to an unwary person. This type of fraud is usually committed by crooked brokers, either licensed or unlicensed.

The most frequent micro-fraud schemes involve either stock being sold in a non-existent company or collusion between a broker and a company's management. In the latter case, the broker sometimes buys the stock of a defunct company and sells it to the unsuspecting public. Other times, the broker and the management of a company whose stock is listed on the pink sheets or the over-the-counter electronic bulletin board collude in the "pump and dump" fraud.[82] In this fraud, the broker and the company management (or broker confederates) trade the stock among themselves to increase trade volume and price, then the broker and the management sell the stock to others.[83]

The vast majority of these frauds are related to sales of unregistered stocks. Generally, investors do not try or are unable to obtain information about the company. Stock sales are not reported anywhere. Most fraud of this type is not prosecuted because:

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[81] Micro-frauds are schemes to deceive the public by using small stock offerings of failing or non-existent companies. These schemes can also misuse federal exemptions such as SCOR. See "Does the SEC have the Solution to Micro-Cap Fraud or is it More of a Problem? In *The SCOR Report*, Vol. 5, No. 5, April 1998. Dallas, Texas, and also see "Fraud per Capita" in *Forbes* February 8, 1999.

[82] Bulletin Board stock or Pink Sheet stock: The Bulletin Board lists small-capitalization NASDAQ issues, and the pink sheets will list over-the-counter issues that are non-NASDAQ or non-Bulletin Board issues. In the minds of many people, all Bulletin Board and pink sheet stocks are "penny-stocks." Penny-stocks are defined as any stock which sells for $1 per share or less. However, some brokers only consider penny-stocks those stocks sold for $2 per share or less. The over-the-counter market is a communications network through which trades of bonds, non-listed stocks, and other securities take place. Trading activity is overseen by the National Association of Securities Dealers (NASD).

[83] Analysis provided by Mr. Tom Stewart-Gordon. Editor of *The SCOR Report*. Dallas, Texas.

a) Micro-fraud is not a high priority for law enforcement and prosecutors since they have to allocate their scarce resources to prosecute more significant crimes.
b) Victims do not press charges because it is embarrassing for people to admit they have been fooled.
c) Perpetrators tend to be mobile and difficult to locate.

The fraud schemes discussed above illustrate the fact that most criminals do not register. Still, at least one issuing company recently seems to have committed micro-fraud that registration would have prevented.[84] Supporters of the merit review system indicated that, in general, New York has a high incidence of fraud and that recent micro-fraud experiences demonstrate the value of a merit-review-based regulatory process.

As a result of the increased number of micro-fraud cases, SEC regulators revised the SCOR exemption in March 1999. The new rule restricts the trade of these securities and limits the use of general solicitation when these offerings are not subject to state laws.[85]

2. Costs and Benefits of Merit Review

A fundamental question is whether the benefits of protecting investors supersede the economic costs imposed by the merit review system. The main costs of the merit review system are those imposed on businesses that are subject to the regulatory process and the implementation costs of running the program. There are also costs to investors when regulators weed good investments out together with potential losers. The benefits are derived from fraud prevention and the avoidance of fraud-related losses.

Costs of Merit Review

Merit review critics complain that the state's securities law and regulations impose unnecessary costs to businesses with a detrimental effect on capital formation. Merit review not only increases the cost of raising capital but also prevents the development of some innovative projects.

Businesses, brokers, securities attorneys, and some regulators indicate that the states' securities law and regulations are overly restrictive to businesses, particularly those filing for initial offerings and small issues. For small issuers, offering expenses are a high percentage of the offering amount.

For businesses, the economic costs of a merit review system include:

- Registration fees and legal expenses businesses must pay in order to understand and comply with merit review regulations. These costs are especially burdensome when offerings are denied approval or when applications are withdrawn.

- Unnecessary costs due to overlapping state and SEC requirements. Such costs are particularly significant when businesses have to file in multiple states involved in an offering. Clearly, there is cost without benefit in registering the same offering repeatedly.

[84] Interview with Mr. Tom Stewart-Gordon.
[85] The small company offering exemption under Rule 504 has been discussed in Section 2.

- The lost income due to the time delay in getting capital during the merit review. Many businesses, especially companies with limited liquidity, claim that such losses caused by delays in access to capital can be quite significant.[86]

In California, overlapping of state and federal regulations does not seem to be a significant problem, although some securities attorneys believe that overlapping occurs. According to the Department, California uses an "application by coordination" with SEC for disclosure requirements.[87] The Department feels that California's merit review system itself does not affect the disclosure procedures of an offering, except in cases where the review requires additional disclosure documents to address a merit review related issue. However, in the case of multi-state filings, the various state requirements overlap. In this regard, NASAA efforts towards uniformity can be an important step to decrease business costs.

In addition to the cost to businesses, there are other costs to society derived from:

- Economic costs of the foregone potential economic benefits derived from profitable projects that may have been prevented due to lack of capital and resources to pursue registration.

- Costs to investors derived from their inability to invest in profitable ventures because the system did not allow these investments to be publicly registered at an early stage.

- Costs derived from the imposition of suitability standards. The merit review system (particularly in California) has also been criticized as limiting many lucrative investments to wealthy individuals by the imposition of stricter suitability standards than the ones established at the federal level.[88] Thus, another economic cost of merit review is the foregone profits to the average investor from missing offerings available only to wealthy individuals.

There are also costs derived from the merit review itself, such as:

- *Costs Related to Restrictions on the Offering Price*. The assessment of the initial market value of a security that has not been traded in the public market is a very difficult task. Merit review states set offering price restrictions. When regulators impose restrictions that set the initial price of stock to a level below their fair market price, issuers are deprived of needed capital with the consequent economic costs to society.

- *Costs Related to Restrictions of Cheap Stock, Escrow of Promoter Stock, and Voting Rights.* Regulators set the amount of permissible cheap stock sold to insiders at prices below the public price. They also have escrow provisions that require an escrow of a portion of promoter stock. Regulators also restructure voting rights to assure that the public has some control of the company. In all these cases, regulators affect the share of entrepreneurs' profits and control, lowering their incentives to take risks and perform

[86] State Corporations Commission. Division of Securities and Retail Franchising Staff. "Report of the State Corporations Commission on the Effectiveness of the Commonwealth's Securities Laws." Virginia, 1998.
[87] The offering may be qualified as part of the same process of SEC registration.
[88] Suitability standards are related to the state definition of qualified purchasers.

well. In this way, regulators are introducing unnecessary costs to the business. Furthermore, critics believe that these provisions tend to discriminate against new and/or developing firms that naturally exhibit high risk while they do not significantly protect investors.[89]

Empirical Evidence on the Costs of Merit Review

Due to lack of data, there is no way to evaluate the exact value of the economic costs originated by the existence of merit review and the severity of the costs to applicants. There are no accurate data on the total number and value of the offerings that occur in the state. The Department does not process all the information from the forms. Thus, data on company's costs of compliance and the economic characteristics of the applications (such as type and size of business) is not readily available.

An inherent difficulty in obtaining this information is that the most offerings are 1) exempted from qualification (do not need a permit from the Commissioner) and 2) do not require the filing of a notice with the agencies. Therefore, the California Department of Corporations does not record these offers and sales of securities.

Even more difficult to assess is: 1) the number and value of good projects that cannot be completed due to administrators' misjudgments; 2) the number of good projects that are withdrawn due to regulators' delays and consequent cost burden imposed by the regulatory system; and 3) the number of applicants discouraged due to the difficulties and costs of the qualification process.

In surveys administered by the SEC, broker-dealers indicated that they sought to avoid state review by using either "super suitability standards" or limiting underwriting activities to offerings of securities that qualify for the NYSE, the AMEX, or NASDAQ/NMS.[90]

Some researchers have related the number of small business filings to state regulatory systems. For example, a study of Arizona's merit review system compared the number of small business filings in Arizona to those in Nevada, a state with a simpler registration process. Data indicated that Nevada processed more corporate applications than Arizona, despite Arizona having nearly three times the population of Nevada, a more diverse economy, and a location that is similarly remote from Eastern financial centers. According to the authors, this could suggest that the existence of a more complicated process discourages some potential issuers.[91]

However, research linking the number of filings to regulations is not conclusive due to the number of other factors that could explain a low number of filings. For example the lack of more filings by small businesses can be a consequence of lack of information on the procedures open to businesses, rather than the nature of the regulatory process. Furthermore, it is hard to determine whether the economic costs associated with compliance are associated

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[89] Jay T. Brandi, "Securities Practitioners and Blue Sky Laws: A Survey of Comments and a Ranking of States by Stringency of Regulation." *The Journal of Corporation Law*. Volume 10, No. 3, Spring 1985.
[90] SEC's "Uniformity Study."
[91] Tara Ellman, "The Cost of Regulation. Arizona Corporations Commission's Process of Merit Review. (Review Without Merit)." Goldwater Institute. *Arizona Issue Analysis #132*. August 31, 1994.