DEPARTMENT OF CORPORATIONS

California's Investment and Financing Authority

California Corporations Commissioner
Sacramento, California

IN THE REPLY REFER TO
FILE NO. PRO 31/06

INVITATION FOR COMMENTS ON ADMINISTRATIVE REGULATION UNDER THE CORPORATE SECURITIES LAW

NOTICE

Pursuant to Government Code Section 11346(b), the Department of Corporations (the "Department") is inviting comments from interested persons to address whether the Department should adopt an exemption and/or limited registration system for finders and private placement broker-dealers.[1]

Comments from interested persons will assist the Department in determining whether amendments to regulations under the Corporate Securities Law of 1968 (the "CSL") are necessary and appropriate.

BACKGROUND

The Department licenses and regulates broker-dealers pursuant to the Corporate Securities Law of 1968, as amended. Corporations Code Section 25004 defines a broker-dealer as any person engaged in the business of effecting transactions in securities in this state for the account of others or for his own account, but does not include certain persons excluded by statute. Corporations Code Section 25204 authorizes the Commissioner of Corporations (the "Commissioner") to exempt from licensing any class of persons, unconditionally or for upon specified terms and conditions or for specified periods, as deemed necessary or appropriate in the public interest or for the protection of investors.

Under Corporations Code 25210, it is unlawful for a broker-dealer to conduct business without first applying for and securing a certificate unless exempt. Persons engaged in unlicensed broker-dealer conduct can be subject to administrative, civil, and criminal sanctions. Furthermore, Corporations Code Section 25501.5 imposes liability for rescission and money damages for the purchase or sale of a security by any unlicensed broker-dealer who is not otherwise exempt from licensure.

[1] For purposes of this notice and consistent with previous guidance issued by the Department, unless otherwise noted, a finder shall refer to a person whose activities do not fall within the definition of a broker-dealer. A private placement broker-dealer shall refer to a person whose activities do fall within the definition of a broker-dealer, but whose activities are generally limited to receiving transaction-based compensation in unregistered offerings to accredited investors.

Under current law, finders do not fall within the definition of a broker-dealer, provided that they engage in only limited activities. One key issue is whether a finder is "engaged in the business of effecting transactions in securities."

Persons who engage in activities that go beyond the limited scope permitted for finders are required to be licensed by the Department as a broker-dealer unless otherwise exempt.[2] Under the current regulation scheme in California, the Department makes no distinction in licensing and examination between a traditional, full service broker-dealer and those persons who might engage in comparatively more limited activities of a private placement broker-dealer.

Recent Developments

In May 2005, a task force created by the American Bar Association Section of Business Law published its report on private placement broker-dealers (the "ABA Report").[3] The ABA Report observed that private placement broker-dealers were critical to the success of smaller and emerging companies obtaining early stage financing, particularly for raising capital in an amount less than $5 million.[4] The ABA Report asserted that a number of legal, regulatory, and economic factors had contributed to creating a very constricted market for obtaining equity financing by smaller issuers.[5]

The ABA Report also raised concerns with persons involved in the negotiation and consummation of mergers and acquisition transactions and whether such activities are subject to broker-dealer licensure.[6] The ABA Report recommended that securities regulators establish a simplified registration system for private placement broker-dealers (including mergers and acquisition specialists).[7]

Similarly, in April 2006, the Advisory Committee on Smaller Public Companies issued its final report to the U.S. Securities and Exchange Commission ("SEC"). One of the primary recommendations in the report was for the SEC to spearhead a streamlined registration process for private-placement broker-dealers.[8] The report noted that "virtually all of the services" provided by private placement broker-dealers in support of capital formation activities amount to unregistered broker-dealer activity.[9]

Existing California Law

Previously judicial decisions and interpretive opinions issued by the Commissioner have addressed the issue of finders and have narrowly construed the scope of permissible activities. In general, a person who simply introduces other parties, without negotiating on behalf of either

[2] Corporations Code Section 25210.
[3] Task Force on Private Placement Broker-Dealers, ABA Section of Business Law, "Report and Recommendations of the Task Force on Private Placement Broker-Dealers," 60 Business Lawyer 959 (May 2005) (hereinafter, "ABA Report").
[4] Id. at 960.
[5] Id. at 968-70.
[6] ABA Report at 989-97.
[7] Id. at 961.
[8] Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission, Final Report, 81 (Apr. 2006).
[9] Id.

party and without providing any information on which either party may rely upon in negotiations, is not a broker-dealer under Corporations Code Section 25004.[10]

A person will not be a finder if such person's conduct goes considerably beyond the mere introduction of prospective parties, such as by assisting in negotiations and providing other services which, as a practical matter, are essential to consummating such transactions.[11] Information that may assist in the negotiations between parties includes information on bids, initial purchase price, quantity of securities, and other information concerning the securities.[12]

A finder may not suggest or recommend any manner or means of consummating a transaction.[13] To the extent a finder represents a potential investor, the finder may not receive any guidance from such investor as to the types of offering that such investor is interested and the finder may not screen out certain offerings as unsuitable for such investor.[14]

Notwithstanding the foregoing, the Commissioner has previously found an exception for nonprofit entities. In Commissioner's Opinion No. 80/11C (Dec. 19, 1980), the Commissioner found that a nonprofit unincorporated association was not "engaged in business" as a broker-dealer even though it might engage in activities which go beyond the "normal" activities of a finder. The Commissioner found it significant that the entity was nonprofit and organized for the purpose of reviewing investment proposals and that all members of the entity were multi-employer pension trusts organized under the Labor Management Relations Act and qualified under the Internal Revenue Code.[15]

Section 260.204.2 of Title 10, California Code of Regulations, exempts from licensing as a broker-dealer any mergers and acquisition specialist so long as such person does not receive, transmit, or hold any funds or securities in connection with such transaction.

Effect of Federal Securities Law

Section 15(a)(1) of the federal Securities Exchange Act of 1934 prohibits any broker or dealer (other than those persons whose business is exclusively intrastate and who do not make use of any facility of a national securities exchange) from effecting, inducing or attempting to induce the purchase or sale of any security unless such person is registered with the SEC.[16] Therefore, unless the business of a private placement broker-dealer is exclusively within California and not through a national securities exchange, there will be concurrent federal jurisdiction over such activities.[17] Nonetheless, given the significant amount of in-state

[10] See Lyons v. Stevenson (1977) 65 Cal. App. 3d 595, 600-606; Evans v. Riverside International Raceway (1965) 237 Cal. App. 2d 666, 675-76; Commissioner's Opinion No. 81/1C (Jan. 19, 1981).
[11] Commissioner's Opinion No. 78/22C (Dec. 13, 1978); see also Interpretive Opinion No. PL/180C (Aug. 19, 1971) (describing activities that fall within the definition of "broker-dealer").
[12] Commissioner's Opinion No. 01/1C (Dec. 6, 2001) (citing Commissioner's Opinion Nos. 77/21C (Oct. 6, 1977), 78/8C (Jun. 9, 1978), and 78/9C (Jun. 9, 1978)).
[13] Commissioner's Opinion No. 73/67C (May 21, 1973).
[14] Id.
[15] Commissioner's Opinion No. 80/11C (Dec. 19, 1980).
[16] 15 U.S.C. Section 78*o*(a)(1).
[17] The SEC staff has taken a very narrow view of finder activity exempt from registration as a broker-dealer. See Paul Anka, SEC No-Action Letter, 1991 SEC No-Act. LEXIS 925 (Jul. 24, 1991). However, the ABA Report questioned whether the position in Paul Anka is still valid due to more recent comments by the SEC staff and whether any transaction-based compensation is permissible for a finder. See ABA Report at 977-78; see also John W. Loofbourrow Associates, Inc., SEC No-Action Letter, 2006 SEC No-

economic activity that exceeds the level of most countries, the Commissioner believes that it is possible to have a viable private placement broker-dealer business on an intrastate basis in California.

Actions by Other States

The states of Michigan, Minnesota, and Texas have each adopted regulatory provisions, which provide for a limited registration system for finders and/or private placement broker dealers.[18] Michigan requires a "finder" (as defined under Michigan law) to register as an investment adviser and finder activities are limited to "locating, introducing, or referring potential purchasers or sellers."[19] However, the ABA Report suggests that the "introduce, then step away" approach is problematic.[20]

The Texas State Securities Board recently adopted regulations to provide for a restricted registration system for finders (as defined by regulation).[21] A finder would be limited to introducing only accredited investors and would not be permitted to negotiate the terms of any investment or give any advice about entering the investment.[22] Securities examination requirements would be waived for finders.[23]

In adopting the Uniform Securities Act of 2002, Minnesota included a non-standard provision, which exempted private placement broker-dealers representing issuers in connection with any exempt transaction from registering as agents.[24] Minnesota conditioned the availability on the absence of any disciplinary history, prohibited the handling or possession of funds and securities, and required a notice filing and consent to service of process.[25] Minnesota's provision permits a private placement broker-dealer to register only once with the state securities regulator but allows the private placement broker-dealer to represent multiple issuers.[26]

Request for Comments

The Commissioner believes that it is in the public interest to obtain the views of interested parties as to whether the existing regulatory structure in California adequately addresses the issue of finders and private placement broker-dealers. The Commissioner has concerns that the current approach with respect to finders and private placement broker-dealers may unduly impede capital formation and jobs creation in California. The Commissioner notes that

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Act. LEXIS 523 (Jun. 29, 2006) (declining to issue no-action relief even though finder would not be (i) involved in structuring or placing securities, (ii) involved in negotiations or discussion of details about the transaction, (iii) making any investment recommendation, (iv) not offer or sell or solicit any offers to buy, and (v) not handle any funds or securities).

[18] See Mich. Comp. Laws Sec. 451.502 (2006); 31 Tex. Reg. 6,709-15 (to be codified at 7 Tex. Admin. Code Secs. 115.1, 115.3, and 115.11) (Aug. 25, 2006); 2006 Minn. Laws Ch. 196 (to be codified at Minn. Stat. Sec. 80A)).

[19] See Mich. Comp. Laws Sec. 451.801(i) (2006).

[20] ABA Report at 966.

[21] Effective as of Sept. 1, 2006. See 31 Tex. Reg. at 6,709.

[22] 31 Tex. Reg. at 6,711. 6,714.

[23] Id. at 6,712.

[24] 2006 Minn. Laws Ch. 196. Sec. 18(a)(11) (to be codified at Minn. Stat. Sec. 80A.57(a)(11) and effective as of Aug. 1, 2007).

[25] Id.

[26] Id.; cf. Mass. Reg. tit. 950, Sec. 12.202(3) (2005) (which permits agent registration for a single issuer).

difficulties in attracting capital may adversely impact small and emerging companies, which have historically been the catalysts for California's leading position in technology, biological science, entertainment and other industries.[27] The Commissioner also desires to improve market transparency and to restrict the ability of those persons with disciplinary records to operate as private placement broker-dealers.

QUESTIONS UNDER CONSIDERATION

1. Should California adopt an exemption or a limited registration system for finders and private placement broker-dealers? Should there be a two-tier approach with very limited activities being permitted to utilize an exemption and more involved activities requiring registration?

2. If a limited registration system was adopted, should there be an examination requirement similar to the NASD-administered exams for private placement broker-dealers?

3. What form and type of disclosure should private placement broker-dealers be required to provide?

4. What limitations, if any, should be placed on the types of investors to which finders and private placement broker-dealers be permitted to solicit?

5. What limitations, if any, should be placed on the types of activities conducted by finders and private placement broker-dealers?

6. Given the concurrent jurisdiction of the SEC with respect to finders and private placement broker-dealers involved in interstate commerce, is it worthwhile to proceed with a California-only system?

TIME FOR COMMENTS

The Department requests that comments be received by December 28, 2006. The Department may schedule a public hearings or a series of public hearings, as necessary, to provide additional opportunities to submit views on the questions under consideration.

WHERE TO SUBMIT COMMENTS

Please reference PRO 31/06 in correspondence to the Department. Please submit comments as follows:

Karen Fong
Office of Law and Legislation
1515 K Street, Suite 200
Sacramento, CA 95814-4052

Written comments may also be sent to Karen Fong (1) via electronic mail at regulations@corp.ca.gov or (2) via fax at (916) 322-5875.

[27] See, e.g., Duane Roth, "Emerging Tech, Life Science Sectors Alive and Well in San Diego," San Diego Bus. J. A27 (Jul. 10, 2006) (describing the "valley of death" for emerging technology companies as the difficulty in obtaining financing during the period after the proof-of-concept stage, but before the company has demonstrated customer interest or the ability to generate revenues).

CONTACT PERSONS

Non-substantive inquiries concerning this INVITATION FOR COMMENTS, such as requests for copies of documents or questions regarding timelines, may be directed to Karen Fong at (916) 322-3553. Inquiries regarding the substance of this invitation for comments may be directed to Mark Uyeda, Chief Advisor to the Commissioner at (916) 324-9011, or Colleen Monahan, Senior Corporations Counsel, at (916) 324-5217.

Dated: September 13, 2006
Sacramento, California

Preston DuFauchard
California Corporations Commissioner

/s/ Preston DuFauchard