REPORT OF THE
STATE CORPORATION COMMISSION ON

THE EFFECTIVENESS OF THE COMMONWEALTH'S SECURITIES LAWS

TO THE GOVERNOR AND
THE GENERAL ASSEMBLY OF VIRGINIA

HOUSE DOCUMENT NO. 16

COMMONWEALTH OF VIRGINIA
RICHMOND
1999

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STATE CORPORATION COMMISSION

December 7, 1998

TO: The Honorable James Gilmore
Governor of Virginia
and
The General Assembly of Virginia

We are pleased to transmit this Report of the State Corporation Commission on the Effectiveness of the Commonwealth's Securities Laws.

The study was initiated and the report prepared pursuant to House Joint Resolution No. 665 of the 1997 Session of the General Assembly of Virginia.

We wish to express our appreciation to members of the Technical Advisory Committee who provided valuable assistance throughout the course of this study.

Respectfully submitted,

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EXECUTIVE SUMMARY

This study was undertaken in accordance with HJR 665 which directed the State Corporation Commission (Commission) to study the effectiveness of the Commonwealth's securities laws. The Commission was requested to:

- conduct a "best practices study" to evaluate the appropriateness of the Commonwealth's securities laws in view of the trends of federal and other states' securities regulations to simplify and reduce the costs of compliance for small issues of securities, and

- determine whether the Commonwealth should adopt legislation that would create a securities regulatory framework to encourage capital formation for small and early development companies while maintaining appropriate protection for the investing public.

Pursuant to the instructions of the General Assembly, the Commission prepared this report including (1) an overview of the current federal and state securities regulatory environment, (2) a presentation of the current obstacles facing small company securities offerings in Virginia as discovered through public forums held by the Commission, an extensive state survey conducted by the Commission, and reports issued by outside organizations, (3) an analysis of securities laws in place in other states and at the federal level, (4) a review of the current securities regulatory system in place in Virginia, and (5) findings and recommended amendments to the Virginia Securities Act and the corresponding regulations.

* * *

Securities are regulated at both the federal and state level. A securities offering must be registered with the United States Securities and Exchange Commission (SEC) or fall within the provisions of a federal exemption from registration. Registration generally requires a pre-offering filing of financial statements and a prospectus for review by the SEC. Registration is the primary means by which a government protects investors from fraudulent or misleading securities offerings.

Most securities offered in federally registered offerings (and some federally exempt offerings) are considered "federal covered securities," which the states are preempted from regulating. Many small securities offerings, however, are exempt from federal regulation, and fall under the jurisdiction of the states in which the securities are offered or sold.

State agencies regulate sales of securities through statutes and regulations known collectively as Blue Sky Laws. This report focuses on those federally exempt securities that are subject to regulation under Virginia's Blue Sky Laws.

* * *

This study reveals several problems facing small securities issuers in Virginia as well as in other states, including:

1. the lack of uniformity among Blue Sky Laws,
2. the expense required to comply with the current law,
3. a gap in financing available for small companies,
4. the lack of liquidity in secondary markets for small company securities.

Lack of uniformity among Blue Sky Laws

Most states based their Blue Sky Laws on the Uniform Securities Act of 1956, however, many states have significantly changed their laws since that time. Issuers must contend with a different set of laws in each state in which they wish to sell their securities. Progress toward a more uniform standard will ease the regulatory burden and related expense imposed on issuers.

While Virginia's Act stands within the mainstream of Blue Sky Laws, several notable exceptions exist which are peculiar to the Commonwealth. Virginia may reduce the regulatory burden on issuers without sacrificing investor protection by adopting more uniform models that have worked effectively in other states.

The expense required to comply with the current law

The complexity of the current securities regulatory framework increases the costs associated with compliance. A typical small business owner lacks the time and expertise to navigate the Commonwealth's registration requirements and exemptions. After hiring a lawyer to interpret the relevant statutes and rules, the business may then need to hire accountants to audit the company's financials and bring them in line with Generally Accepted Accounting Principles (GAAP). If the company wishes to sell its securities directly to investors (rather than through a broker-dealer) at least one employee must register as a professional securities sales agent and pass an examination. If the company is selling under an exemption, it must make certain that the number of investors does not exceed the limit imposed by the exemption and that each purchaser meets the class restrictions of the exemption. Publishing and distributing a guide to small stock offerings in Virginia should help pare the expenses associated with issuing securities by explaining Virginia's Blue Sky Laws in layman's terms.

The gap in financing available to small companies

Because small offerings generally are not profitable enough to attract the services of professional broker-dealers or underwriters, it is difficult to raise capital in the range of $250,000 to $3,000,000. (Below this level, companies often raise money from family members and associates; offerings above this level become cost-effective for professional underwriters). Small companies are filling this gap by selling their securities directly to the public rather than hiring professionals to underwrite and sell these issues. This study shows that states can modify their securities laws to encourage direct public offerings.

Lack of liquidity in secondary markets for small company securities

The lack of a secondary market for small company stocks often deters prospective investors. One factor affecting liquidity in this market is the level of uniformity among Blue Sky Laws. Uniformity among the states' laws decreases the legal costs incurred to comply with the multiple sets of laws. This decreased cost facilitates multi-state offerings, which allows a

company to widen its pool of investors by selling the securities in more states. A larger investor pool increases both initial and secondary interest in the issue.

A second factor affecting liquidity of small companies' securities is the shortage of established markets for these securities. While developing secondary markets is beyond the authority of the Commission and the scope of this research, modifying current regulations to allow these markets to form might improve the flow of capital to small companies.

* * *

A survey of the state securities laws in place across the country reveals a variety of methods of regulating small securities offerings. Based on the study findings and the input of the Technical Advisory Committee, eight aspects of Blue Sky Laws were isolated for study. These areas were scrutinized to determine the best practices among the states and to determine whether Virginia's laws could be amended to facilitate small securities offerings without sacrificing investor protection. The eight areas are:

1. financial statement audit requirements,
2. accredited investor exemptions,
3. the Uniform Limited Offering Exemption (ULOE),
4. other Limited Offering Exemptions (LOE's),
5. counting provisions for limited offering exemptions,
6. issuer-agent registration,
7. employee benefit plan exemptions,
8. the Small Company Offering Registration (SCOR).

1. Financial statement audit requirements

Nearly every state requires an issuer to provide audited financial statements as a condition of registering a securities offering. Many states have provisions to waive audit requirements for small issuers. Virginia requires at least an audited balance sheet for every registration, and there is no provision to waive this requirement.

2. Accredited Investor Exemptions

Over half of all states allow an exemption from registration for issuers who offer and sell securities only to accredited investors. Federal regulations define an accredited investor as a person with a net worth of at least $1,000,000 or an income of at least $200,000 in each of the past two years and reasonably expecting to earn as much in the current year. The premise underlying this exemption is that these investors do not need the benefits of state registration. Most states' accredited investor exemptions are based substantially on the North American Securities Administrators Association (NASAA[1]) model, however some states have modified the model. For example, some states' exemptions require the investor to possess a certain level of financial sophistication in addition to wealth. Virginia does not have an accredited investor exemption.

[1] See Appendix E for a brief description of NASAA and its functions.

3. Uniform Limited Offering Exemption (ULOE)

The NASAA model Uniform Limited Offering Exemption (ULOE) was designed to correspond on the state level with offerings exempt under SEC Rule 505 of Regulation D. (Rule 505 offerings are limited to $5,000,000 dollars. Securities offered under Rule 505 may be sold to an unlimited number of accredited investors, but they may be sold to no more than thirty-five non-accredited investors.) The purpose of the exemption is to standardize the state regulation of these federally exempt offerings. Virginia currently has an exemption comparable to the NASAA model in place, and the exemption appears to operate effectively.

4. Other Limited Offering Exemptions (LOE's)

In addition to the ULOE, some states offer other exemptions for issuers. Generally, these exemptions limit sales to very few investors and prohibit public solicitation and advertising. Examples include exemptions for sales to fewer than ten, twenty-five, or thirty-five investors in any twelve-month period, or exemptions for small offerings by in-state issuers. Currently Virginia has two exemptions of this type. The first exemption limits the total number of security-holders after the offering to thirty-five; the second exemption allows a Virginia company to sell up to $1,000,000 in securities to not more than thirty-five investors during any twelve-month period. This study determined that some states offer exemptions that are more liberal than those allowed in Virginia.

5. Counting Provisions for Limited Offering Exemptions

Limited offering exemptions restrict the number of purchasers who may invest in an offering. Many states allow an issuer to exclude certain investors (usually wealthy or financially sophisticated investors) from the number of purchasers counted under a limited offering exemption. These exclusions allow the issuer to sell its securities to a broader base of investors without disqualifying the offering from the exemption. For example, twenty-three states exclude institutional investors from the count, and eight states exclude accredited investors from the count. Other states have provisions to exclude investors such as officers of the issuing company or investors who purchase large percentages of the issue. Virginia counts every purchaser (including institutional and accredited investors) when totaling the number of purchasers of an offering.

6. Issuer-agent Registration

Many small companies choose to sell their securities themselves rather than through a professional broker-dealer. Companies choose this method either to control costs or because the offering is too small to attract the services of a professional broker-dealer. Absent an exemption, the employees of an issuer who actually sell the securities must register as agents; this registration often requires passing an examination. This adds time and expense to the offering process. Currently twenty-three states exempt issuer-agents from examination or from registration entirely. These exemptions usually require the issuer-agent to forego any sales commission and are typically not available to anyone previously convicted of securities violations. In registered offerings, Virginia requires issuer-agents to register as sales agents and requires the agents to pass an examination.

7. Employee Benefit Plan Exemptions

A popular form of compensating directors is to pay them in shares of stock of the company. This method of payment eases the pressure on the company's cash flow. Under federal and many states' laws, securities transferred under employee benefit plans are exempt from registration, and this exemption is read to include transfers to non-employee directors of the issuer. Currently, the Commission takes the position that non-employee directors are not covered by the Virginia's employee benefit plan exemption. Thus, in Virginia, a company must register securities transferred to non-employee directors.

8. Small Company Offering Registration (SCOR)

SCOR is a registration process created by NASAA in an attempt to standardize and simplify offerings of $1,000,000 or less. SCOR was designed for small companies offering securities under several federal exemptions. A primary benefit of a SCOR offering is that it does not require audited financial statements. SCOR has been formally adopted by thirty-six states, and eleven states have adopted the program informally. Virginia accepts the SCOR format for small offering registrations, but the issuer must provide an audited balance sheet in addition to the SCOR documentation.

Another benefit of a SCOR offering is the Regional Review process. Regional Review allows a company registering in several participating states to answer questions to one or two lead states instead of responding to each state's questions individually. Virginia does not currently participate in any Regional Review program.

* * *

After evaluating the research and considering the policy implications, the Commission, with the input of the Advisory Committee, recommends several changes to the Virginia Securities Act and the corresponding regulations. The proposed statutory amendments and regulatory changes are presented in Appendix B. The proposals are summarized below.

1. In order to alleviate some expense for small issuers, the Commission recommends eliminating the audit requirement for SCOR offerings and adopting the NASAA model. Under the proposed regulation, an offering under $1,000,000 would require only a reviewed (unaudited) balance sheet.

This change will bring Virginia closer to uniformity with her sister states. Further, the Commission believes that the $1,000,000 limit adequately balances relief for the small issuer and investor protection while promoting interstate uniformity. The text of these changes appears in Appendix B, pages B-9 - B-10.

2. The Commission recommends excluding accredited and institutional investors from the thirty-five investor limit imposed by §13.1-514 B 7 b, thus broadening the exemption. This change should increase the market for small issuers, thereby enabling them to sell their securities more easily while spreading the risk among more investors. This change will not place investors at unreasonable risk levels because institutional and accredited investors are financially sophisticated enough to evaluate the risk on their own or through their hired representative, and

they are financially able to bear losses. The text of these changes appears in Appendix B at pages B-1 - B-2 and pages B-3 - B-4.

3. To reduce the gap in financing available to small and development-stage companies, the Commission proposes to raise the offering amount allowed under the §13.1-514 B 7 b exemption from $1,000,000 to $2,000,000. This change would increase companies' ability to raise early-stage capital. The text of these changes appears in Appendix B at page B-12.

4. To reduce the time and expense involved with direct public offerings, the Commission recommends providing discretion to waive the issuer-agent examination requirement under certain circumstances. To ensure that this change does not subject Virginia investors to undue risk, issuer-agents will not be allowed to receive commissions on sales of securities. Nor will this waiver be allowed for persons who have been subject to disciplinary action for previous securities transgressions. These conditions will reduce the incentive for aggressive sales, and will prevent known violators from selling securities. Additionally, an issuer-agent will be required to distribute a copy of NASAA's "Guide to Small Business Investment" to each offeree prior to the sale. This guide describes the risk associated with investing in developing companies, encourages the reader to request information about the company, and warns the prospective purchaser not to invest what he cannot afford to lose. The text of these changes appears in Appendix B at page B-11.

5. The Commission recommends adopting statutory and regulatory changes which will reverse Virginia's current stance of not including non-employee directors in the employee benefit plan exemption currently allowed by the Act at §13.1-514 10. Allowing a company to compensate directors with shares of the company will increase the company's ability to attract talented directors while reducing the strain on the company's cash flow. Allowing the company to transfer these shares without registration will decrease the time and expense to the company without increasing risk to the investing population. The text of these changes appears in Appendix B at page B-17.

6. In order to increase small companies' access to capital markets, the Commission recommends adopting the NASAA Model Accredited Investor Exemption. The exemption will allow companies to sell securities to wealthy individuals and institutions without the expense and delays associated with registration. In order to assure that the company sells only to investors capable of bearing the associated risks, the Commission proposes modifying the definition of accredited investor to state that the investor or his representative possesses the financial sophistication and ability to analyze the business risk and absorb losses. The text of these changes appears in Appendix B, pages B-4 - B-8.

7. The Commission, through its Securities Division, has undertaken three proposals that do not require regulatory or statutory change. Each proposal, listed below, is being handled according to its individual requirements and the study findings.

A. In order to facilitate the registration of multi-state offerings, Virginia is currently working towards the development of a new Regional Review group. No Regional Review group is in existence for the mid-Atlantic or Southeastern sections of the country. A representative

from the Division is participating in an organizational group of securities administrators from the mid-Atlantic and Southeastern region of the United States. This group is coordinating a Regional Review process for these regions. The states are currently in the process of discussing the management of the procedural and substantive differences between the applicable state laws. Each state appears willing to participate in the program, and an agreement is expected in the near future. Contingent on settling these matters, the mid-Atlantic/Southeastern Regional Review group, including Virginia, should be operable before the end of 1999.

B. The Division has contacted representatives from Virginia's Center for Innovative Technology and the Virginia Partnership for Economic Development to establish a working group between the three agencies. The purpose of these contacts will be to ensure that the needs of business in the Commonwealth are being properly served and regulated by the State, to coordinate efforts aimed at developing the state's economy, and to avoid contradictory actions by the various agencies. It is being proposed that representatives from each group meet regularly to discuss issues common to the three agencies including capital formation and small business development.

C. The Committee and the Division agreed that the burden on small securities issuers might be alleviated if the Division published a Guide to Small Securities Offerings in Virginia. The Guide will outline the issues involved in securities offerings, outline the framework of Federal and State regulation of these issues, and describe the exemptions available for small issuers. This Guide should allow a company to better understand both the business and regulatory issues, thus decreasing confusion and reducing the company's reliance on professional help.

The Division is reviewing similar guides published by other states to serve as models for Virginia's own guidebook. An outline to the Guide to Small Securities Offerings in Virginia has been developed. Completion of the publication will be finalized after the General Assembly has acted upon the changes recommended in this Report. Upon publication, the Guide will be publicized on the Division's website and distributed upon request at no charge. The Division will investigate other methods of distribution in order to ensure that the publication reaches the applicable audience.

REPORT ORGANIZATION

This report is organized as follows:

I. Introduction

II. Federal and State Securities Registration Requirements: gives a brief look at the history of securities regulation in the United States and pays special attention to the interplay between federal and state securities regulation

III. The Small Company Securities Offering Experience: presents information from forums held around the state; examines and summarizes reports done by outside agencies and organizations

IV. Different Approaches to Securities Regulation: analyzes the regulatory frameworks of other states, the federal government, and model regulations proposed by multi-state organizations, identifies and summarizes the best practices among the various approaches to state regulation of securities offerings

V. Securities Regulatory Environment in Virginia: examines the current statutes and regulations in place in the Commonwealth

VI. Findings and Recommendations: presents proposed amendments to the Virginia Securities Act and the Virginia Administrative Code

I. INTRODUCTION

In HJR 665, the General Assembly requested the State Corporation Commission to conduct a best practices study to determine whether new legislation was appropriate to "simplify and reduce the costs of compliance for small issues of securities"[2] while maintaining an adequate level of investor protection. Recognizing that small businesses have been a major source of economic growth and job creation for Virginia, that the Commonwealth's current regulatory framework may hinder the development of this resource, and that the trend in federal and state regulatory systems has been toward encouraging small company development, the General Assembly directed the Commission to determine whether the Commonwealth should adopt legislation that would simplify the capital formation process for small and early development companies while maintaining appropriate protection for the investing public.

SCOPE AND PURPOSES

This report investigates the following issues in response to H.J.R. 665:

1. Whether Virginia's regulatory environment includes unnecessary consumer protection standards which stifle small securities offerings by imposing excessive delays and prohibitive costs on the issuers,

2. Whether the lack of uniformity between Virginia's regulations and those of other states places Virginia companies at a disadvantage to securities issuers in other states,

3. Whether the complexity of Virginia's regulatory system deters small business from funding growth through securities offerings,

4. Whether a less restrictive regulatory framework will subject Virginia's investors to excessive risk from fraud,

5. Which model, state, or federal regulatory systems constitute the best practices for balancing the goals of promoting capital formation and safeguarding investors.

The following objectives define the scope of this study:

1. Assemble a Technical Advisory Committee (the Committee) to develop issues, propose solutions, and evaluate the report.

2. Identify specific burdens suffered by small and development-stage companies seeking to raise capital in Virginia's securities markets.

3. Scrutinize Virginia's current securities regulatory system to identify potential areas where changes could be made to reduce the burdens on small and development-stage companies seeking to raise capital in Virginia.

[2] H.J.R. No. 665 (1997), page 1. The full text of H.J.R. 665 is reprinted in appendix A.

4. Examine the securities regulatory schemes of the federal government, other states, and uniform models set forth by multi-state organizations, and propose appropriate approaches in search of the best practices from which to suggest improvements to Virginia's securities regulatory system.

5. Determine the best practices among the various securities regulatory systems.

6. Evaluate potential changes to Virginia's securities regulations and administrative policies with specific attention to the potential benefits to Virginia's small and development-stage companies and potential risk to Virginia's investors.

7. If appropriate, propose statutory, regulatory, and policy amendments to encourage capital formation for small and development-stage companies while maintaining adequate protection for the investing public.

APPROACH AND METHODOLOGY

The first stage of this study consisted of developing a study work plan, making staff assignments, defining the study scope and purposes, assembling the Technical Advisory Committee, and gathering general background information.

The Commission, acting through its Division of Securities and Retail Franchising, (the Division) assembled the Committee of fourteen members. The Committee was composed of corporate and securities attorneys, Division staff, consumer protection advocates, commercial and investment bankers, and members of the business development community. The Committee was selected from nominees suggested by members of the Virginia Bar, the investment banking community, consumer advocacy groups, and business development agencies. The members were selected from this pool of nominees based on their expertise and experience in the securities and business development areas.

The second stage of this study included developing the issues and the means to address those issues. The first Committee meeting was held on November 13, 1997. It was decided that the Commission should survey the other states' securities administrators and compare their securities laws and regulations with those in place in Virginia. In addition to the Commission's research, public forums were scheduled to elicit public opinion and feedback on Virginia's securities laws and their relation to small business capital formation.

The Division submitted detailed questionnaires to the securities administrators in each state. The questionnaires asked for information about all aspects of the statutory and regulatory systems applicable to small business equity capital formation. The Division received responses from the states and compiled a database containing the information gathered.

The Division studied the data gathered from these states in conjunction with their Blue Sky Laws to determine how other states regulated small company securities offerings and to identify the best practices. The Division compared the information from each state to other states and to model acts to determine the spectrum of the different regulatory systems. The information

was then compared to Virginia to determine where the Commonwealth stands along this spectrum. Additionally, the Division looked for evidence of trends in federal and state approaches to securities regulation.

The Division, in conjunction with the Committee, conducted four public forums in separate regions of Virginia (Northern Virginia, Roanoke, Tidewater, and Richmond) to receive testimony from small business owners, securities practitioners, and other interested members of the community. The forums were advertised through the regional newspapers with the broadest distribution, and they were publicized by the Committee members through various industry groups. The public forums, held in March and April of 1998, were moderately attended and provided meaningful grass-roots input.

The Division studied numerous reports from other governmental agencies, multi-state securities associations and private consulting firms. The reports covered topics such as promoting economic growth in Virginia, uniformity of state securities regulations, fraudulent securities practices, and other issue-specific topics. This information was also distributed to the Committee members.

The third stage of this study involved analyzing the information gathered from the various sources, determining what changes might achieve the study objectives, and drafting the necessary amendments and regulatory changes.

The second Committee meeting took place on June 9, 1998. The Committee and Division focused the issues based on members' experience and evaluations of the extensive Commission survey and information available at that time. The Division considered the Committee proposals and input to draft amendments to the Virginia Securities Act (the Act) and the Virginia Administrative Code (the Code). The study supported three proposals that did not involve regulatory or statutory amendments, but could be managed administratively by the Division.

The proposed amendments were founded on regulations from other states and uniform models set forth by the North American Securities Administrators Association. The Division re-established contact with securities administrators in states with provisions similar to the NASAA models to determine the effectiveness of these laws and to illuminate potential problems in the application of these laws.

The Committee convened for its final meeting on August 3, 1998, to finalize the Committee's recommendations. Many of the Committee's proposals were incorporated into the report, and the report was completed. The findings and recommendations set forth in this report are supported by a majority of the Committee and the Division.

II. FEDERAL AND STATE SECURITIES REGISTRATION REQUIREMENTS

Background

States began developing systems to regulate securities as early as 1852. In 1911 Kansas adopted the first modern securities laws. The term "Blue Sky" was coined in reference to fraudulent securities which were often discovered to be worth as much as "lots in the blue sky." By 1933, forty-seven states and Hawaii had adopted their own Blue Sky Laws. One commentator on the subject wrote, "Although the public is probably more aware of the existence and operation of several federal statutes administered by the Securities and Exchange Commission (SEC), most state legislation in this area is broader in scope."[3]

Following the economic turmoil of the Great Depression, Congress passed the Securities Act of 1933 (The Securities Act, or the '33 Act) to govern the issuance of securities by companies raising money in the U.S. capital markets. The following year Congress passed the Securities Exchange Act of 1934 (The Exchange Act, or the '34 Act) to regulate the markets in which securities are traded. The Exchange Act also created the Securities and Exchange Commission, the agency responsible for administering the federal securities laws.

Since their enactment, the '33 and '34 Acts have been amended, and regulations have been issued to encourage small business capital formation. Examples of these rules include Regulation D and Regulation A, created to facilitate small business offerings. Congress continues to modify the federal securities law in an attempt to establish a more perfect balance between the needs for capital formation and investor protection.

State Blue Sky Laws have also developed over time to adapt to the changing needs of the economy. The most sweeping change occurred in 1956 when the National Conference of Commissioners on Uniform State Laws approved the Uniform Securities Act (the '56 Act) which attempted to standardize the Blue Sky Laws among the states. Many states adopted the '56 Act, however, many states modified portions of the '56 Act to accommodate their own policies. This non-uniformity has been exacerbated over the decades as states continued to amend their versions of the '56 Act. Nevertheless, the framework of the '56 Act still forms the backbone of most state Blue Sky Laws.

Federal Registration

An entity seeking to raise capital in the securities markets must comply with federal laws and regulations. To comply with securities regulations, an issuer must either register the securities with the SEC or meet the provisions of one of the exemptions from registration. Registration generally entails filing a registration statement and a prospectus. This documentation includes information about the proposed offering such as the amount of money sought, the proposed use of the proceeds, the financial history of the issuer, risks faced by the company, and any other material information relevant to the issuer and the offering. The issuing

[3] LOUIS LOSS AND EDWARD M. CAWETT, BLUE SKY LAW, p. 3, (1958).

company must deliver its prospectus to each potential investor in order to allow the investor to properly evaluate the investment decision.

The SEC may choose to review an issuer's filings to verify that the information presented is sufficient to allow a purchaser to make an informed investment decision. The SEC does not assess the soundness of the investment, nor does it judge the financial situation of the company. The SEC review is simply a "full disclosure" review designed to ensure that investors have access to complete information regarding the investment. If the SEC believes that full disclosure has not been made, it may request further information from the issuer. When the SEC is satisfied that all the material facts are disclosed, it will declare the registration statement effective. After the SEC declares the statement effective and the issuer registers or otherwise complies with the state Blue Sky Laws, the issuer may begin selling its securities.

Generally, individuals selling registered securities must register themselves, too. The SEC (through the National Association of Securities Dealers) and/or the state authorities usually require broker-dealers and agents to register and pass standardized examinations.

Federal Preemption of State Authority

Prior to the passage of the National Securities Markets Improvement Act of 1996 (NSMIA), state and federal authorities exercised concurrent jurisdiction over securities offerings. Under NSMIA, however, certain offerings registered with the SEC (or sold pursuant to a federal exemption) are no longer subject to state regulation. Although states retain the right to require notice filings, collect filing fees, and enforce antifraud provisions in their states, NSMIA precludes states from further regulating certain federally registered and exempt offerings.

NSMIA also removed sales to "qualified purchasers" from state regulation. The SEC was directed to define "qualified purchaser," but has yet do so. Once defined, it is likely that this exemption will provide another deregulated avenue for small business capital formation.

Federal Exemptions

Many issuers raise capital by filing their offerings under one of several exemptions from federal registration requirements. An exemption may be based on the type of security offered or the nature of the transaction involved. These exemptions exist in the text of the Securities Act or by rule of the SEC. An offering may be exempt from review, but the SEC may still require notice filings in order to track the securities being issued and sold in the market.

Statutory Exemptions:

Securities exemptions are listed in Section 3 of the Securities Act (15 USC §77c):

- Issuances by local, state, and federal governmental issuers; Canadian government issuers
- Issuances by banks and savings & loan associations
- Issuances by certain employee benefit plans
- Issuances by certain charitable, religious, and educational organizations
- Exchanges by an issuer with its current security holders
- Intrastate issuances

Transactional exemptions are listed in Section 4 of the Securities Act (15 USC §77d):

- Private offerings
- Sales by brokers and dealers
- Non-issuer, or secondary market, transactions

Regulatory Exemptions:

The Securities Act grants authority to the SEC to create exemptions by rule. These rules are usually based on section 3(b), which allows the SEC to create exemptions for issuances up to $5,000,000, or section 4(2), which grants the authority to exempt transactions that do not involve any public offering.

Exemptions based on section 3(b), often called "limited offering" exemptions, include:

- Regulation D, Rule 504, for certain offerings up to $1,000,000
- Regulation D, Rule 505, for offerings up to $5,000,000 to specified purchasers
- Regulation A, for certain offerings up to $5,000,000.

Each of these exemptions has certain requirements such as restrictions on the type of company that may use the exemption, restrictions on resale of the securities, restrictions on the type of purchaser who may invest in the issuance, and limitations on the types of advertising that the issuer may use to market the offering. The different exemptions may also require specific filings by the issuing company. Other exemptions have been created under section 3(b), but they are not relevant to this report.

It is important to note that the SEC has recently requested comments on its proposal to restrict the securities sold under Rule 504. Investors would be required to hold such securities for at least twelve months before selling them. In doing this, the SEC hopes to curb fraud perpetrated by boiler-room securities brokers who unlawfully manipulate markets and investors in small company offerings.

Exemptions based on section 4(2), the non-public offerings, include Rule 506 of Regulation D. This exemption prohibits any advertising or general solicitation. Sales under

Rule 506 are limited primarily to accredited investors[4], those investors who satisfy certain net worth, income, or financial sophistication requirements. (Securities issued under Rule 506 may be offered and sold to up to thirty-five nonaccredited investors provided that those investors possess a certain level of financial sophistication.) Other than allowing for notice filing, NSMIA precludes any form of state regulation of Rule 506 offerings.

Other Exemptions:

In addition to the exemptions listed above, NSMIA further grants the SEC authority to define the term "qualified purchaser." Securities offered or sold to "qualified purchasers" will be federal covered securities, thus not subject to state regulation. NSMIA authorizes the SEC to create exemptions for unlimited dollar amounts of offerings as it deems necessary[5]. As of the writing of this report, the SEC had not created any new exemptions under this authority. It is impossible to determine whether the SEC will create new exemptions which would affect small business capital formation in Virginia, or whether any new exemptions would preempt regulation by the states.

State Registration

While NSMIA prevents states from regulating certain federally registered and exempted offerings, securities offered under most federal exemptions are still within the province of state securities administrators. Issuers offering securities under non-preempting federal exemptions must satisfy the registration requirements or comply with exemptions of the states in which the investments will be sold. Most states allow an issuer to register its offerings by notification, coordination, or qualification. Like the federal system, the state laws and regulations offer exemptions for certain types of securities and certain transactions.

State securities administrators play an active role in protecting citizens from fraudulent offerings. Generally, the state registration process of disclosure review is similar to the federal registration process. Unlike the SEC, however, the majority of state regulators review the merits of an offering before declaring a registration effective.[6] A merit review goes beyond a mere disclosure review. In addition to presenting general information about the offering, financial history of the issuer, and material information relevant to the investment, an issuer selling securities in a merit review state must satisfy the state securities administrator as to the fairness of the offering and viability of the issuer.

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[4] The term Accredited Investor is defined by the SEC at 17 CFR § 230.501(a).

[5] Securities Act of 1933, § 28, 15 U.S.C. 77z-3 (granting the SEC authority to exempt "any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation issued under this title [so long as the exemption is] necessary or appropriate in the public interest and consistent with investor protection").

[6] REPORT ON THE UNIFORMITY OF STATE REGULATORY REQUIREMENTS FOR OFFERINGS OF SECURITIES THAT ARE NOT "COVERED SECURITIES," SECURITIES AND EXCHANGE COMMISSION 5 (1997) [hereinafter UNIFORMITY REPORT] (stating, "[a]pproximately 40 states apply a 'merit review' approach to the registration of securities offerings") (quoting Campbell, *Blue Sky Laws and the Recent Congressional Preemption Failure*, 22 Iowa J. Corp. L. 175 n.61 (Winter 1997)).

State Exemptions

Forty-one states have based their securities laws on the '56 Act.[7] As noted above, many states added various modifications when adopting the Act. Due to these initial modifications, as well as the amendments and regulatory changes enacted since adoption, significant differences exist among the states' Blue Sky Laws. Exemptions vary from state to state, and an issuer must comply with the regulations in each state in which securities will be sold.

Registration in Virginia

Companies offering or selling securities in Virginia must register the securities with the Commission unless the security or transaction is exempt from registration. In Virginia, securities may be registered by notification, coordination, or qualification.

Registration by notification is considered a 'blue-chip' registration process, and is available to Virginia companies with sufficient financial histories and which meet asset and net worth requirements. Notification registration is the simplest of the registration options. The issuer must file a registration statement and pay a filing fee, and the Commission may require that a prospectus be delivered with any sale.[8]

Registration by coordination streamlines the registration process. A company that registers with the SEC may submit the federal filings to the Commission. In most circumstances, when the registration is declared effective by the SEC, it will be automatically declared effective in Virginia.[9]

Registration by qualification is a comprehensive registration process, and it is available to any security offering. Virginia requires a detailed registration statement which is discussed at length in Section V of this report. Additionally, the Commission may require that insiders' shares be held in escrow or that offering proceeds be impounded before declaring a registration effective. These restrictions are required until a preset amount of the securities have been sold, and/or a preset amount of money has been raised.[10] The purpose of these restrictions is to deter misappropriation of invested funds and prevent fraudulent insider trading activities.

In Virginia, almost all small capital formation offerings that are registered are registered by qualification.

Like the federal system, Virginia offers issuers a number of exemptions from registration.

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[7] UNIFORMITY REPORT, *supra* at 6.
[8] VA. CODE ANN. § 13.1-508.
[9] VA. CODE ANN. § 13.1-509. It is important to note, however, that, under certain circumstances, a registration by coordination may be denied by the SCC even if it is made effective by the SEC. For example, the SCC may deny effectiveness when an issuer's state filings are improper or incomplete, where there is a stop order in effect, or where the issuance of a stop order is pending.
[10] VA. CODE ANN. § 13.1-510.

Virginia's exemptions allow certain issuers to avoid registering certain securities, broker-dealers, and agents.

III. THE SMALL COMPANY SECURITIES OFFERING EXPERIENCE

Numerous organizations have studied the subject of small business and capital access in both the Commonwealth and the United States. This section presents a digest of the most relevant findings from the Commission's research.

This section will evaluate several issues raised about the current regulatory scheme:

- **the lack of uniformity among state Blue Sky Laws**
- **the gap in available financing for small companies**
- **the complexity of the current securities law**
- **the lack of liquidity in the market for small company issuances**
- **the excessive monetary costs and delays associated with small stock offerings**
- **microcap securities fraud**

Information in this section came from a detailed survey of the securities regulations in Virginia and in the other states, testimony from members of Virginia's business community, reports from various public and private agencies, and the experience and knowledge of the Committee and Staff.

THE LACK OF UNIFORMITY AMONG STATE BLUE SKY LAWS

When Congress enacted NSMIA, they directed the SEC to report on "the extent to which uniformity of state regulatory requirements for securities or securities transactions has been achieved for securities that are not covered securities."[11] The SEC complied by surveying securities administrators, broker-dealers, law firms, companies, stock exchanges, and investors on the current state regulatory environment. The SEC published its report in October, 1997.

The SEC survey responses indicated that there was a lack of uniformity in the manner in which various states regulated some securities offerings. Areas of non-uniformity included:

- length of review time for registrations
- availability of "test the waters" exemptions
- treatment of Rule 504 offerings
- treatment of Rule 505 offerings
- availability of accredited investor exemptions
- use of Small Company Offering Registration (SCOR) and Regional Review[12]

Because of the variations in the laws of different states, a company seeking to conduct a multi-state offering contends with several sets of regulations. The multi-state issuer must prepare several different registration documents, tailor the offering to meet the strictest applicable state

[11] National Securities Markets Improvements Act of 1996, § 102(B) [hereinafter NSMIA].
[12] *See generally,* UNIFORMITY REPORT, *supra* at 15-39 .

requirements, or simply avoid states whose regulations impose extensive costs, and focus instead on "easier" states. The survey summarized the effects of this non-uniformity as "(1) higher offering expenses as a percentage of the offering amount; (2) substantial delays and significant legal fees for companies with limited liquidity; and (3) loss of registration fees by the issuer if the offering is denied approval."[13]

NASAA assembled a task force to "examine the current regulatory structure of the capital markets in the United States and the effectiveness of the interrelationship of state and federal securities regulation."[14] The report, presented in October 1997, intended to set forth "ways in which more efficient and effective regulation can be provided without sacrificing investor protection or eroding investor confidence."[15]

One area in which small securities issuers face barriers from non-uniformity is in private placements. Federal Rule 505, issued under SEC Regulation D, provides a federal exemption for small private placements. The NASAA uniformity report points out that this exemption was intended to be "a basic element in a uniform system of federal-state limited offering exemptions."[16] Yet many states have specialized rules for these offerings. The task force recommended that "disparate requirements that do not further significant investor protection should be eliminated. The states should strive to create uniformity in the requirements for private placements by adopting a uniform private placement exemption and implementing it in a uniform manner."[17]

The NASAA task force report issued several other recommendations, all of which are supported by the belief that the states should make it easier for small issuers to do offerings, but not to the extent where investors are put at undue risk. The task force suggested that the SEC use its authority under newly-added Section 28 of the Securities Act to exempt offerings of up to $10,000,000. The task force also suggested that Regulation D, Rule 504 offerings should be required to be registered at the state level and that states adopt uniform exemptions to coordinate with Regulation D, Rule 505 private placement offerings. Finally, the report suggested that the SEC promulgate a definition for the term "qualified purchaser" and that this class of investor fall somewhere along the spectrum between "accredited investor" and "qualified institutional buyer."

Virginia has conformed to the intention of the federal government by adopting the ULOE for Regulation D, Rule 505 offerings. The Commission has created an exemption which corresponds directly to the ULOE.[18] Companies conforming to the Rule 505 provisions are exempt from Virginia's registration requirements. Virginia's exemption was recently changed to exempt issuer-agents from the agent registration requirements if they offer or sell the issuer's

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[13] UNIFORMITY REPORT, *supra at* 17.

[14] REPORT OF THE TASK FORCE ON THE FUTURE OF SHARED STATE AND FEDERAL SECURITIES REGULATION, North American Securities Administrators Association, page v (1997) [hereinafter TASK FORCE REPORT].

[15] *Id.* at v.

[16] *Id.* at 56, (quoting 17 C.F.R. §§ 230.501 to 508, preliminary note 2).

[17] *Id.* at 58.

[18] *See*, VA. CODE ANN. § 13.1-514 B 13 (authorizing the Commission to create an exemption to "further the objectives of compatibility with similar exemptions from federal securities regulation and uniformity among the several states), and 21 VAC 5-40-30 (promulgating an exemption from registration for offerings in conformity with federal Rule 505 of Regulation D).

securities without receiving any commissions. Virginia's adoption of the ULOE is a functioning example of the Commonwealth's willingness to promote small business offerings by easing regulatory requirements and promoting uniformity among state Blue Sky laws.

Most Rule 504 offerings registered in Virginia have been registered by qualification. The SEC is currently considering tightening the provisions for 504 offerings by restricting the resale of securities for some time period after the original sale.[19] The SEC feels that these offerings are being used by boiler-room operations to perpetrate fraud on investors, and that restricting the sale of the securities will curb this fraud.

The U.S. Small Business Administration's Office of Advocacy has also addressed the issue of opening capital markets for small securities issuers. The Office of Advocacy reported in June 1996 on ways to increase access to capital markets for emerging ventures. Among methods the SBA discussed was to "reduce the cost . . . through the use of standard interstate disclosure documents and policies."[20]

Brad Smith, President of WBS&A, Ltd., Strategic Consulting, reported on the small-business stock offering environment. Smith endeavored to encourage improvements in the state regulatory framework to facilitate small-business owners' ability to package and market their securities offerings and develop secondary markets for these offerings.[21] Smith maintains that uniformity among state Blue Sky laws will ease access to capital markets by decreasing costs as well as deterring securities fraud. The high costs associated with complying with multiple sets of laws could be addressed by simplifying and standardizing the regulatory environment. One means of effecting such standardization is through the increased use of the SCOR form and Regional Review.

The SCOR form is a question-and-answer document created by NASAA to guide a small business owner through the process of writing a proper disclosure document. The SCOR form is designed to elicit all of the information relevant to a small securities offering. The company completes the form with the help of a manual, and the result is a detailed document suitable for use as an offering circular or prospectus. Regional Review allows state administrators from each state in which securities will be offered to channel their correspondences with the offeror through a lead state. The issuing company responds to all of the states' questions in a single document through the lead state instead of answering the same questions several times from several states. These simplifications would reduce the amount of time and paperwork involved in issuing stock as well as reducing the issuer's reliance on expensive accountants and attorneys.

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[19] *See* Revision of Rule 504, Reg. D, Securities Act Release No. 7541, Fed. Sec. L. Rep. (CCH) ¶ 86,019 (May 21, 1998).

[20] CREATING NEW CAPITAL MARKETS FOR EMERGING VENTURES, U.S. SMALL BUSINESS ADMINISTRATION, OFFICE OF ADVOCACY, p. 1 (1996) [hereinafter CAPITAL MARKETS REPORT].

[21] RECOMMENDATIONS TO REFINE SMALL CORPORATE OFFERING REGISTRATION FORM U7; SCOR AND REGULATION A PROGRAMS; SECURITIES POLICIES; REGULATIONS AND PRACTICES TO IMPROVE THE DEVELOPMENT-STAGE MICROCAP COMPANY ISSUER AND SECONDARY MARKET SYSTEM, BRAD SMITH, n. 1 (1998) [hereinafter SMITH REPORT] (describing the focus and intention of the report).

On the issue of micro-cap fraud, Smith notes that simplified, standardized regulations will encourage compliance, while complex expensive regulations do the opposite. For example, Smith suggests that a company facing prohibitive costs to register an offering might opt not to register at all. Instead, the company might sell its securities under the table without any notice to the state authorities. Smith argues that simplified laws will encourage compliance and increase the state's ability to monitor and control securities transactions.

At the Commission's public forum held in Northern Virginia, Thomas Hicks, counsel for the Northern Virginia Technology Council, offered suggestions he had developed during his work with start-up ventures, development stage companies, and fast-growing businesses in the high-tech field. Among other suggestions, Hicks argued for "at least an even playing field, the same opportunity [in Virginia] to attract capital and to help our companies in this state grow as other states have who have traditionally been more competitive."[22] Drawing attention to current government trends, Hicks suggested that "where initiatives on the federal level that are trying to simplify and to expedite and to enable the formation of capital are going, we should make every effort . . . to see that Virginia goes in that direction."[23]

THE GAP IN AVAILABLE FINANCING FOR SMALL COMPANIES

Several sources reported that the investment infrastructure in place in Virginia does not serve the full range of the market for capital. The findings suggest that this is a problem not just in the Commonwealth, but in the United States as a whole.

A report issued by the National Council for Urban Economic Development (CUED) studied the economic growth environment in Virginia. Among its findings, CUED reported that companies in Virginia face a gap in available financing between $250,000 during the start-up phase (where money is typically raised from family and friends) and $3,000,000 (at which point venture capital companies may become interested in investing).[24] The report stated, "Bogged down in the debate as to whether a capital gap exists or not, Virginia is starting to fall behind other states in its efforts to provide increased financing resources to support its firms."[25]

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[22] Transcript of Public Forum on Small Business Capital Formation, Northern Virginia, Apr. 2, 1998, p. 98 [hereinafter, No. Va. Transcript].

[23] *Id.*, at 100.

[24] The U.S. Small Business Administration's Office of Advocacy reported that "[i]t's the gap between $100,000 and $1,000,000 that's still unfilled," CAPITAL MARKETS REPORT, *supra* p. 3, (quoting Richard Meyer, National Census of Early-Stage Capital Financing).

[25] PROMOTING GROWTH IN VIRGINIA, NATIONAL COUNCIL FOR URBAN ECONOMIC DEVELOPMENT, p. 21 (1997) [hereinafter CUED REPORT]. While the study did not specifically address the effects Virginia's securities laws had on this situation, the report noted several times that Virginia's approach to the problem was generally conservative. The report mentioned the inability of the General Assembly to agree on a suitable Capital Formation Act to provide tax incentives to angels and venture capitalists to invest in Virginia's firms. *Id.* at 20. The report also noted that "Many of Virginia's direct competitors (e.g. North Carolina, Georgia, and Maryland) have been more proactive in their support of developing new policy instruments to support new and emerging businesses. They are focusing on policies geared towards home-grown businesses, offering support to start-ups and expanding businesses." *Id.* at 11. The U.S. Small Business Administration's Office of Advocacy reports that this is a national problem. The S.B.A. reported that "[d]espite the record $4.2 billion raised by venture capitalists in 1994, 'few venture funds specialize in seed investments." Capital Markets Report, *supra* at 3 (quoting John Mumbord, Crosspoint Venture Partners).

The CUED report also stated that another means of filling the gap is by "monitoring . . . regulations so they do not negatively influence an investor's decision to invest in the area, and actively encouraging equity investors to investigate the region."[26] Sources indicated that one means of encouraging the markets for small-companies' securities is by modifying regulation to allow growth of accredited investor, or "angel," networks. Adopting an accredited investor exemption might facilitate the development of these networks.

The U.S. Small Business Administration's Office of Advocacy contracted for a report from the Center for Venture Research at the University of New Hampshire's School of Business and Economics. The report was presented in June, 1996, and studies the goals of increasing early-stage ventures' access to seed and start-up capital in the range of $250,000 to $1,000,000. This report discussed several methods of increasing access to early-stage capital. For example, the report suggested attempting to "reduce the cost of raising private equity capital through legislative and regulatory provisions that limit the liability of professional service providers."[27] The report also maintained the underlying goal of "maintaining an appropriate balance between venture promotion and investor protection."[28]

Testimony given at the public forums corroborated the reports' conclusions. Mark Moore, senior vice president of George Mason Bank, addressed the issue of the gap in available capital for development-stage companies. "The larger [companies] that catch the attention of the [venture capitalists] and the investment banking community . . . seem to be well covered in the $5,000,000 range and up, but it's in the middle range and down that we really should be concentrating."[29]

Entrepreneur Pat Clawson addressed the shortcomings in Virginia's market for early-stage capital. At the Northern Virginia hearing, Clawson recounted his difficulties in raising capital for his company, TeleGrafix. Clawson detailed his experience with venture capitalists, who were "more interested in mezzanine financing"[30] than providing funds for seed and development. He also recalled his attempt to secure funding from the Governor's Opportunity Fund, which turned out to be available only to Fortune 500 companies.[31] Finally, Clawson noted that commercial banks typically deny credit to "risky start-up enterprises or for research and development companies."[32]

Don Fisher, President of a small audio speaker manufacturer in Virginia Beach, testified on the difficulties he encountered in raising money for his business. Speaking of the limitations on sources of capital for small businesses, Fisher explained that he approached venture capitalists and broker-dealers to underwrite and sell his offering. Both of these avenues were closed

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[26] CUED REPORT, *supra* at 20.
[27] CAPITAL MARKETS REPORT, *supra* at 1.
[28] CAPITAL MARKETS REPORT, *supra* at 2.
[29] No. Va. Transcript, *supra* at 116.
[30] *Id.* at 36.
[31] *Id.* at 37.
[32] *Id.* at 39.

because the company lacked an acceptable history of revenue.[33] Echoing other individuals and reports, Fisher noted that the venture capitalists and underwriters were not interested in his company because they profit more by doing larger deals.

Committee members provided additional insight into the capital markets for small businesses. Sarah Williams, senior vice president at First Union Bank, confirmed that lending to start-up and development stage companies is not the domain of commercial banks. These companies typically present too much risk for commercial lenders. One local commercial lender noted that he had never seen a loan to a small business go through without a personal guaranty from a principal with sufficient funds to cover a default.

THE COMPLEXITY OF THE CURRENT SECURITIES LAWS

Another obstacle in the way of small companies seeking capital in Virginia is the complexity of the current securities law. The intricate set of federal and state laws and regulations, and the lack of any plain-English explanations forces most issuers to hire securities specialists to handle their offerings.

In an attempt to ease this regulatory burden, Virginia created the Issuer limited transactional exemption in 1995.[34] At the Northern Virginia forum, Thomas Hicks discussed the difference in the intention behind the new exemption and the resulting regulation. Hicks stated that the supporters of the amendment intended that small offerings, offerings under $1,000,000, would be exempt from registration in Virginia. Issuers using the exemption would be subject only to a simple notice filing. Unfortunately, Mr. Hicks claimed, the Issuer limited transactional exemption is so complicated that companies using the exemption to issue securities must "go out and hire a lawyer and an accountant in order to do it right."[35] Hicks summarized the matter, "what we ended up with . . . was something that was considerably more constrictive than what we thought that Senator Saslaw and Delegate Callahan and the others in the General Assembly had intended when adopting that [Issuer limited transactional exemption] legislation."[36] Neither the Committee nor the Commission reached a consensus on the severity of the burdens imposed by the new 13.1-514 B 7 b exemptions. The Committee did resolve to review the provisions and propose any changes necessary.

Relating his experiences raising equity capital under a federal Regulation D exemption, Don Fisher of Virginia Beach pointed out that in the current regulatory environment, a company wanting to use Regulation D must hire an attorney experienced in this area. "[T]he securities law is so complex, it's very difficult for a small business person . . . to really get a good handle on what the law is."[37] Even after the money had been raised there were regulatory dangers to address. Speaking of the thirty-five investor limitation, Fisher remarked, "I was really struggling

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[33] Transcript of Public Hearing on Small Business Capital Formation, Tidewater Virginia Forum, Apr. 6, 1998, pp. 40-41 [hereinafter, Tidewater Transcript].
[34] VA. CODE ANN. § 13.1-514 B 7 b. *See also*, 21 VAC 5-40-100 (outlining the rules for the exemption promulgated under the statute).
[35] No. Va. Transcript, *supra* at 101.
[36] *Id.* at 96.
[37] Tidewater Transcript at 33.

in talking with different people, attorneys primarily, in trying to get an understanding of what we could and couldn't do, and as a result we went . . . a couple of shareholders over [the limit] before we realized that we were doing something we weren't supposed to do."[38]

Pat Clawson also testified that Virginia's securities laws are complex and difficult for non-professionals to navigate. Clawson advocated creating some plain-English guides for small issuers.[39] Consultant Brad Smith also encouraged state regulators to issue laymen's guides to their securities laws. On the theory that most small-business owners are relatively unsophisticated with respect to securities laws, a state-issued roadmap would improve access to capital markets.

THE LACK OF LIQUIDITY IN THE MARKET FOR SMALL COMPANY ISSUES

Currently, small company offerings have a limited secondary market. This discourages investors who would be more willing to invest with the knowledge that they can sell their positions in the future without undue burden or effort.

Consultant Smith offered several methods of addressing the lack of liquidity. First, he suggested making the regulatory requirements uniform across the states. States could achieve uniformity by adopting "best practices" as designed by organizations such as NASAA and the SBA. The uniformity would allow a company to broaden the market for its securities by offering in multiple states without significantly increasing the cost or time to prepare the required documentation. Smith also suggested using the Internet as an inexpensive means of communicating information about microcap offerings.

The SBA, too, suggested that the liquidity problem could be alleviated by employing "controlled access through the Internet . . . for exchanging investor and investment opportunity information."[40] The Enterprise Corporation of Pittsburgh presented a study which suggested working to enhance the secondary market for SCOR offerings. The report proposed setting up an Internet site as one means to make SCOR securities more attractive by increasing their liquidity.[41]

THE EXCESSIVE COSTS AND DELAYS ASSOCIATED WITH SMALL STOCK OFFERINGS

The costs associated with small stock offerings often prohibit some companies from raising money in the capital markets. These costs come from such things as hiring accountants to audit a company's past and present financial statements, hiring attorneys to negotiate the complex state and federal securities laws, and the time spent identifying and completing registration procedures necessary to sell the issuances. Numerous sources have indicated that

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[38] *Id.* at 33.
[39] No. Va. Transcript, *supra* at 59.
[40] CAPITAL MARKETS REPORT, *supra* at 1.
[41] WHAT'S THE SCOR, Report by Nick Frollini prepared for The Enterprise Corporation of Pittsburgh, 1996.

these costs are often unnecessary, and that reducing these costs would facilitate access to capital markets.

Several individuals testified on the costs of issuing securities and the results of those costs. Pat Clawson detailed his company's experience in trying to do a SCOR offering, which (in Virginia) requires audited financial statements. The plan stalled when "the accounting firms that [the company] talked to generally wanted $15,000 to $20,000 to do an audit of one year's statements so that [the company] could include those in any kind of an offering prospectus."[42] Clawson noted, "[t]his could have been avoided if we could have used the procedures that are on the books in other states here. In almost any other state that uses a SCOR program, small companies can do an offering without having to have audited financial statements."[43]

Robert Webb, a business and corporate attorney in Fairfax for the past nineteen years, supported this argument and suggested another solution. Because a typical start-up company has limited staff and accounting resources, often their only financial statements are their tax filings. Webb suggested that tax statements, which are filed under penalty of perjury, might serve in place of audited financial statements. This substitution would reduce the significant burden associated with auditing financial records.[44]

Alan Witt, managing director of a regional public accounting firm, spoke of his experiences helping businesses raise capital. In addition to his professional career, Witt also serves as a Newport News City Councilman. His civic experience includes positions as former chairman of the Newport News Industrial Development Authority and former chair of the Virginia Peninsula Chamber of Commerce. Among the problems noted by Witt were the complexity of the laws and the extent to which investor protection undermined small companies' ability to find affordable financing. Speaking of a small, $500,000 offering, Witt stated, "under the complexity of the rules . . .the cost-benefit relationship is such that it isn't worth incurring the cost to raise that moderate amount of capital."[45] He further remarked, "I think the scales [of the balance between access to capital and investor protection] are currently tipped to the extent that small business and access to capital is virtually nonexistent."[46]

Don Fisher also added his experience with the significant costs incurred in offering securities in the Commonwealth. When Sound Related Design undertook its offering under the Regulation D exemption, it endured costs "somewhere around the $70,000 to $75,000 range. . . in legal fees, printing, and . . . the internal time." Of a five-person staff, "three of these people actually worked on the offering almost full time for two months, and that's a pretty extensive cost, too, that [the company] didn't factor in."[47]

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[42] No. Va. Transcript, *supra* at 41-42.
[43] *Id.* at 46-47. The SCOR format allows a company to register an offering up to $1 million without filing audited financial statements. The Commission survey indicates that only Virginia and South Carolina require audited financial statements for SCOR offerings.
[44] *Id.* at 8-9.
[45] *Id.* at p. 24.
[46] Tidewater Transcript, *supra* at 25.
[47] *Id.* at 32-33.

MICROCAP SECURITIES FRAUD

Along with the rise in share prices and attention to stocks resulting from the recent bull stock market, incidents of securities fraud have also increased. Much of this fraud occurs in the thinly-traded, not well known issues of small and developing companies, commonly known as the microcap or penny stock market.

A common microcap scheme occurs when a penny stock broker approaches a small company with promises of quickly raising capital. The broker will walk the company through the registration process, in many instances structuring the deal around exemptions to avoid federal or state registration requirements. When the securities are offered, the broker purchases the issue from the company at a low price. The broker then uses high pressure, boiler-room tactics to push the stocks on unsuspecting investors. The broker cold calls potential clients (often names from "sucker lists" purchased from other scam artists) and coerces them into purchasing the shares using detailed scripts and hard sell pitches. The broker pushes the shares on investors to drive up the price. During this time, the broker refuses to execute customers' sell orders, and instead the broker sells its own shares. When the broker has unloaded its cheaply acquired stock for enormous profits, it abandons the campaign and the stock price collapses. The investors are stuck holding shares worth far less than they paid, and often worth nothing at all.

Investors are not the only ones injured in these "pump and dump" schemes. Often the issuing company is so devastated by the process that it fails as a going concern. Additionally future small issuers are injured by the public's hesitance to invest in such deals. Microcap fraud damages issuing companies, swindles investors, and undermines public confidence in the financial markets.

Two Committee members representing consumer advocacy groups expressed concern over relaxing regulations and thus potentially inviting increased securities fraud in the Commonwealth. The Committee also noted that states whose regulatory shortcomings led to excessive fraud made it difficult for legitimate businesses in those states to raise capital because of the tarnished reputation surrounding offerings in those states. These states' reputations have not completely recovered decades after they amended their Blue Sky Laws.

Reservations were expressed particularly with respect to the adoption of SCOR and its provision allowing companies to register offerings with reviewed, not audited, financial statements. The Study determined, however, that the adoption of SCOR would not expose Virginia investors to a substantial increase in microcap fraud. First, reviewed financial statements are subject to an opinion of a certified professional accountant (CPA). Second, SCOR offerings are registered with the state; SCOR is not an exemption from registration.

Although SCOR offerings need not be accompanied by audited financial statements, registration does require reviewed financials. Reviewed financial statements are subject to scrutiny by an independent CPA. While not as detailed as an audit, a review is done by an accountant with knowledge of the industry and the business who will "make inquiries as to record keeping practices, accounting policies, actions of the board of directors, changes in business activities, and subsequent events. Then [the CPA] will apply 'analytical procedures' designed to identify unusual items or trends in the financial statements that may need

explanation."[48] Thus, the review process does not involve the same depth of background investigation as an audit, but reviewed financial statements are studied by professional accountants and conform to recognized standards.

Microcap fraud schemes have not been associated with registered offerings such as SCOR offerings. The study suggests two reasons for this. First, SCOR offerings are small--under $1,000,000. A securities fraud scheme stands to make more money by attacking offerings that are larger, but not so large as to attract much market attention. Second, a securities criminal will be reluctant to target an offering that is already subject to regulatory scrutiny. The fact that state securities administrators must register SCOR offerings and impose detailed disclosure requirements on these offerings deters manipulation by criminals. By adopting the SCOR process, Virginia will not be inviting an increase in microcap fraud.

Despite the possible dangers associated with easing the restrictions on small offerings, the Commission and the Committee determined that models do exist for successful deregulation of securities offerings in the $250,000 to $3,000,000 range. In determining whether to adopt SCOR, the Commission spoke with representatives from the securities administrators in the other forty-nine states. Of all the states who had adopted SCOR either formally or informally, none reported any instance of fraud arising out of these offerings. It was also determined that investors and small business are best served by adhering to proven deregulatory practices. Accordingly, this study focuses on these best practices.

[48] "Compilation & Review" pamphlet published by the American Institute of Certified Public Accountants.

IV. DIFFERENT APPROACHES TO SECURITIES REGULATION

Although the federal government has jurisdiction over virtually the entire securities industry, the SEC has chosen to exempt some aspects of securities regulation, primarily in the arena of small offerings. The areas exempted by the SEC are almost always governed at the state level, and each state has adopted some means of regulating these securities. This section of the report compares different approaches to securities regulation of several areas of state securities laws. This information is summarized in detail in charts at Appendix C.

AUDITED FINANCIAL STATEMENTS

Many states have requirements for the financial statements filed when registering securities by qualification. States generally fall into one of three categories: (1) financial statements must be audited, (2) audited financial statements are not required, or (3) audited financial statements are required but may be waived on a case-by-case or provisional basis.

1. Financial statements must be audited

Presently 31 states require companies registering securities by qualification to provide audited financial statements. Among these states are Virginia, Pennsylvania, Maryland, New York, and Georgia.

Although a company registering with the SEC must typically file audited financial statements with any other registration forms, small business offerings, the subject of this report, usually fall under a federal exemption. These exemptions allow small business issuers to file only notice filings with the SEC. Because the scope of these offerings is more local than national, oversight of these offerings is managed primarily at the state level.

2. Audits are not required

Two states have no audit requirements for companies registering by qualification. They are North Carolina and Mississippi, both of which require only reviewed financial statements rather than audited or certified statements. Compliance at the federal level generally does not require audited financial statements for offerings up to $5,000,000, but GAAP statements are required for Regulation A offerings. Thirty-two states allow unaudited financial statements for SCOR offerings.

3. Audits are required, but may be waived

Four states waive their audit requirements for offerings under a certain limit. For example, California and Oregon only require audits for offerings over $500,000. Washington and Kansas only require audits for offerings over $1,000,000. Ohio allows an issuer's chief financial officer to verify the company's financial statements rather than require an independent audit. Texas waives the audit provision for small business issuers. North Dakota does not require audited financial statements of new companies. Seven states have provisions by which

the securities administrator may waive the audit requirements at the issuer's request. These states include Idaho, Iowa, Michigan, Nebraska, Vermont, West Virginia, and Wisconsin.

ADOPTION OF SCOR

Federal Regulation A, Rule 504 of Regulation D, and SEC Rule 147 exempt certain small business offerings from federal registration. In 1989 NASAA designed the Small Corporate Offering Registration (SCOR) and the Form U-7 to simplify state registration under certain of these federal exemptions. SCOR filings are designed to be completed by companies' attorneys and accountants without the help of securities specialists.[49] The Form U-7 is the primary registration document for SCOR offerings. The form is designed in a "fill-in-the-blank" format, and when completed, the U-7 may also serve as an offering circular or prospectus.

Thirty-six states have formally adopted SCOR, and eleven others accept registration filings using the SCOR format. Simplified documentation, reviewed financial statements, and the ability to participate in Regional Review are among the benefits of adopting SCOR.

States adopting SCOR as it was proposed by NASAA include Maryland, Massachusetts, North Carolina, Pennsylvania, Washington, and Wisconsin. Eleven states, including Virginia, accept filings on the U-7 form although they have not formally adopted the provision. Virginia also requires audited financial statements to be presented with SCOR filings.

Three states, Hawaii, Nebraska, and New York, do not allow filings in the SCOR, U-7 format.

LIMITED OFFERING EXEMPTIONS

In the interest of promoting uniformity among the states, NASAA proposed a Uniform Limited Offering Exemption (ULOE). The ULOE is designed to correspond directly with the federal Regulation D, Rule 505 exemption (which allows offerings up to $5,000,000 to not more than thirty-five non-accredited investors and unlimited sales to accredited investors). Many states have adopted this exemption or created their own version of the exemption. Additionally, some jurisdictions allow exemptions for sales to very few purchasers as well as other non-uniform exceptions for small offerings. Virginia offers several of these small business exemptions, including the ULOE.

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[49] *See, generally,* "Small Company Offering Registration Form (Form U-7) as adopted by NASAA on April 29, 1989," available at the NASAA's website at <http://www.nasaa.org/helpsmallbusiness/scor/formu7/Default.htm> (visited 9/9/98).

1. Uniform Limited Offering Exemptions

Forty states have adopted exemptions which correspond to the federal Rule 505 exemption, and the majority of these exemptions follow NASAA's ULOE. Distinctions between the ULOE and the state exemptions include:

- Requiring filings to be submitted prior to the first sale, instead of after the sale as in the ULOE.
- Requiring documentation in addition to the Form D required by the ULOE. For example, four states require the offering circular or other offering material to be filed with the state. Other states require their own registration forms, exemption claim forms, or Form D supplements in addition to the Form D.

Virginia's version of the ULOE is comparable to the NASAA model.

2. Other Limited Offering Exemptions

Most states offer small offering exemptions that are limited in some way. These offerings are usually limited in the number of purchasers, and they are generally prohibited from including general solicitation or advertising. Such exemptions are useful for companies whose securities may have been registered in other states but who receive expressions of interest from an investor in a state where the offering is not registered. Rather than incurring the expense and inconvenience of preparing a registration by qualification, the issuer may make the sale under this type exemption.

Maryland has a self-executing "Local Issuer Exemption" for offers and sales from Maryland companies to up to ten investors during any twelve months.[50] The company may not have more than fifty security holders after the offering, and the exemption is not available for offerings greater than $150,000. All offerings made under the Local Issuer Exemption exclude such investors as institutions and accredited investors from the counting provision.

The Maryland Limited Offering Exemption is open to non-resident companies provided that notice filings are provided to the state. Under the MLOE, a non-Maryland company may sell up to $1,000,000 to up to thirty-five non-accredited investors in the state and to an unlimited number of accredited or otherwise qualified investors.

North Carolina provides a limited offering exemption whereby sales to not more than twenty-five persons during any twelve-month period are free of registration requirements. The North Carolina code requires that these issuances be preceded by a notice filing including federal Form D, copies of any prospectus or offering circulars, and other general information about the offering, but these filings are waived if sales are made to not more than five investors.[51]

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[50] MD. CODE ANN., §11-602(9) (1998), MARYLAND REGS. CODE tit. 2, § .09-.12 (1998).
[51] *See*, N.C. GEN. STAT. §78A-17(9)(1998) and N.C. ADMIN. CODE tit. 18, r. 18.1205 (July 1998).

Virginia has two other small offering exemptions. The first provision exempts sales by an issuer where there are not more than thirty-five total investors following the issuance. The second provision exempts the sale of securities to not more than thirty-five purchasers in a twelve month period, but it requires that the purchasers are purchasing for investment. Both exemptions prohibit general advertisement or public solicitation.

COUNTING PROVISIONS FOR LIMITED OFFERING EXEMPTIONS

In addition to the Uniform Limited Offering Exemption, which coordinates with the federal Rule 505 of Regulation D, many states have other limited offering exemptions which allow companies to offer and sell securities to a small number of investors (usually thirty-five or fewer) during a twelve-month period.

In determining the number of investors who may participate in a limited offering, most states exclude classes of investors such as institutional investors or accredited investors. Virginia does exclude accredited investors from the count in its ULOE exemption, however, like eleven other states, Virginia, does not exclude any investors from the count of investors purchasing under other limited offering exemptions.

Of the states that do exclude some investors, twenty-three states exclude only institutional investors. Eight states exclude accredited investors, and three states exclude both institutional and accredited investors. Other states exclude varying classes of investors such as officers of the issuing company or investors who purchase large amounts of the offering. California, for example, has a detailed regulation listing excluded investors including accredited investors, investors who invest less than ten percent of their net worth, employees and promoters of the issuing company, and other investors.

ISSUER-AGENT REGISTRATION

Many times a small company will sell its securities directly to investors rather than hiring a professional broker-dealer or agent to sell the securities. An employee of a company who sells his own company's securities is known as an issuer-agent. Some states require issuer-agents to register as if they were professional securities sales agents. This registration often includes passing the sales agent exam.

Thirty-three states require issuer-agents to register as securities sales agents. Of these thirty-three states, all but Washington, Utah, Vermont, Montana, and Florida[52] require the sales agents to pass the NASD exam as a prerequisite to registration.

Twenty-two of the states requiring issuer-agents to pass the exam have regulations in place by which an issuer-agent may apply for a waiver of the examination requirements. Maryland, for example, may waive the issuer-agent requirement when the issuer-agent

[52] Florida allows up to five issuer-agents to sell a company's securities without passing the exam.

demonstrates an adequate knowledge of the securities industry.[53] Virginia is among the nine states that require issuer agents to register and pass the NASD exam, and that have no waiver provisions for the exam requirement.

Seventeen states, including Arizona, California, Massachusetts, North Carolina, Georgia, Pennsylvania, and Wisconsin, allow issuer-agents to sell securities of their companies without registration or examination. In order to sell his own securities, the issuer-agent in these states must comply with certain restrictions. For example, an issuer-agent may not take commissions on the sale, and the privilege is unavailable to issuers who have been disciplined by securities regulators in the past.

EMPLOYEE BENEFIT PLAN EXEMPTIONS

Many states have exemptions that cover transfers of securities related to employee benefit programs. The language of these statutes is generally derived from the '56 Act, but many states have expanded the coverage of this exemption to include transfers to directors of the issuing company.

Different states have used different means to include non-employee directors under this exemption. For example, Pennsylvania's securities administrators created a rule exempting sales of securities to principals of the issuing company, then goes on to define "principal" to include directors of the company. On the other hand, Washington state's statutes and regulations include the language from the Uniform Act, but the state has written a policy statement declaring that "employee benefit plans" means "any written purchase, savings, option, . . . plan solely for employees, directors, general partners. . ."[54]

During the course of this study, the Staff contacted representatives from several state securities administrators to discuss the effects of exempting from registration transfers to non-employee directors. None of the administrators polled indicated that their state had suffered from fraud or other problems resulting from the exemption.

Like the majority of states, Virginia's regulation and statute also use the language from the '56 Act. Unlike most states, however, the Commission's current policy does not consider securities transferred to non-employee directors eligible for exemption as part of an employee benefit plan.

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[53] MD. REGS. CODE tit. 02, § .11 (1998). Initial and renewal registration as issuer agent.
[54] *See,* Blue-Sky Policy, Blue Sky Law Rep. ¶61,808 (CCH), RCW 21.20.310(10) (1998).

ACCREDITED INVESTOR EXEMPTIONS

Many states have a transactional exemption for securities offered and sold only to accredited investors. Most states with accredited investor exemptions have modeled their regulation on the NASAA Model Accredited Investor Exemption. This promotes uniformity across states, which increases efficiency for small issuers.

Over half of the states have accredited investor exemptions in place. Of the twenty-one states that do not, Alaska, Idaho, Kentucky, New Mexico, Ohio, and Virginia are currently considering adopting some form of accredited investor exemption.

Thirteen states have adopted the NASAA model accredited investor exemption. Sixteen other states have written their own versions of the exemption.

Most of these sixteen track closely the NASAA model, but there are differences. For example, California's regulation is very detailed. The California exemption is so exacting that the SEC created an exemption at the federal level specifically to correspond with California's exemption. Differences among the state-created accredited investor exemptions include provisions such as:

- The definition of accredited investor (for example, to qualify as an accredited investor in Michigan, a person must be financially sophisticated enough to evaluate the risks of investing in a small business. This is in addition to the net worth or income standards in the NASAA model.)

- Filings required (Oregon's and Illinois's exemptions are self-executing and do not require any filings to be made at the state level.)

V. SECURITIES REGULATORY ENVIRONMENT IN VIRGINIA

Companies offering or selling securities in Virginia must register the securities with the Commission unless the security or transaction is exempt from registration or unless the security is a federal covered security. Securities may be registered by notification, coordination, or qualification.[55]

Registration by notification is the simplest of the three registration options. It is available to seasoned Virginia companies possessing sufficient financial histories and meeting specified asset and net worth requirements. It is considered a "blue-chip" registration. The issuer must file a registration statement and pay a filing fee, and the Commission may require that a prospectus be delivered with any offer.

Registration by coordination streamlines the registration process for offerings that must be registered with both the SEC and the Commission. A company registering with the SEC will submit copies of the federal filings along with a fee to the Commission. The Commission may require additional documentation in addition to the federal filings. Under most circumstances, when the registration is declared effective by the SEC, it will be declared effective in Virginia. In some cases, however, the Commission may deny effectiveness despite the SEC's approval. For example, an offering cleared by the SEC might be stopped by the Commission because the offering doesn't satisfy Virginia's qualification requirements. Similarly, an offering cleared by the SEC might not meet the NASAA statements of policy incorporated into Virginia's regulations.[56]

Registration by qualification is a comprehensive registration process available to any security offering in Virginia. This is the means used by most small businesses registering offerings in the Commonwealth The offering company must satisfy state disclosure and merit requirements in order to have the registration declared effective. A registration by qualification only becomes effective by order of the Commission. Virginia requires a detailed registration statement which includes:

- The name and address of the offeror
- Information about the directors, officers, promoters, and substantial owners of the offering entity, including payment history and their participation in any transactions with the offeror or its affiliates
- Information on the capital structure of the offeror and its subsidiaries
- Description of the type and amount of the offering, the expected proceeds and proposed use of the proceeds from the offering

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[55] VA. CODE ANN. § 13.1-507 (1998). The Virginia Securities Act provisions for registration by notification, coordination, and qualification are listed at §§ 13.1-508, 509, and 510, respectively.

[56] *See*, 21 V.A.C. 5-30-80 (stating that, "[i]t will be considered a basis for denial of an application if an offering fails to comply with an applicable statement of policy.") Currently, the following NASAA statements of policy are listed as being adopted by the Commonwealth: Options and Warrants; Underwriting Expenses, Underwriter's Warrants, Selling Expenses and Selling Security Holders; Real Estate Programs; Oil and Gas Programs; Cattle-feeding Programs; Unsound Financial Condition; and Real Estate Investment Trusts.

- The number and recipients of any options outstanding or created by the offering
- Material contracts and potential litigation involving the company
- A copy of any sales literature and a specimen of the security
- A legal opinion concerning the securities
- Audited financial statements including a recent balance sheet and three years of income statements
- Any other information required by the Commission.

For offerings up to $1,000,000 Virginia accepts SCOR documentation in lieu of the above requirements (with the added requirement that the company present an audited balance sheet).

Additionally, the Commission may require the issuer to escrow the securities issued to insiders or in exchange for intangible assets[57] or impound the offering proceeds until a specified minimum amount of the offering is complete.[58] These restrictions deter misappropriation of funds, prevent insiders from cashing out their equity stakes before other investors, and discourage other fraudulent insider trading activities. Generally, funds may be escrowed until subscriptions paid reaches a level at which the offering's purposes can be achieved and insider's shares may be escrowed until a company achieves thirty-six consecutive months of average annual earnings per share equaling six percent of the public offering price, or until the Commission otherwise feels the escrow is no longer necessary.

Exemptions from Registration in Virginia

Like the federal system, Virginia allows a number of exemptions from registration.[59] Exemptions from registering a security include generally:

- Securities issued by U.S. or Canadian federal, state, and local governmental bodies
- Some securities issued by national banks, savings & loans, insurance companies, and regulated public service companies
- Securities listed on national markets such as the NYSE, AMEX, and NASDAQ's National Market System
- Short-term commercial paper
- Securities issued by Virginia cooperative associations
- Securities offered by foreign country issuers.

Other provisions exist which exempt the issuer from the securities, broker-dealer, and agent registration requirements. These exemptions include generally:

- Sales or distributions by parties other than the issuer of the security ("non-issuer transactions")
- Unsolicited transactions
- Debt secured by property

[57] *See*, VA. CODE ANN. § 13.1-510 16 h (1998).
[58] VA. CODE ANN. § 13.1-510 (1998).
[59] *Id.* at § 13.1-514.

- Transactions ordered in bankruptcy proceedings
- Sales to corporations, trusts, investment companies, or broker-dealers
- Offerings restricted to thirty-five or fewer purchasers
- Transactions and securities dividends to existing shareholders
- Limited number of shares issued in the formation of a company
- Offerings to limited numbers of shareholders of bonds secured by real property; securities issued to build residential housing
- Securities issued by a Virginia church to its members; securities issued by a professional business entity licensed to render services in Virginia.

The Commission is authorized by statute to create certain exemptions by rule. Four such exemptions include:

- Issuer Limited Transactional Exemption: 21 VAC 5-40-100
- Uniform Limited Offering Exemption: 21 VAC 5-40-30
- Internet offer transactional exemption: 21 VAC 5-40-110
- Solicitation of Interest ("Testing the Waters"): 21 VAC 5-40-7.

Several of Virginia's statutory and regulatory exemptions simplify the registration and offering process for small businesses. These small business exemptions allow new and growing companies to tap the Commonwealth's investor markets without spending excessive time and money raising the funds. Virginia also allows companies to determine whether there is interest in a proposed offering prior to incurring the expense of registration.

Small business exemptions in Virginia include the Uniform Limited Offering Exemption[60], the Issuer Limited Transactional Exemption[61], and the Solicitation of interest prior to the filing of a registration statement.[62] Virginia also has exemptions for certain private offerings[63] and allows simplified filings for some federally exempt offerings.[64]

[60] 21 V.A.C. 5-40-30.
[61] *Id.* at 5-40-100.
[62] *Id.* at 5-40-70.
[63] *See, e.g.*, VA. CODE ANN. § 13.1-514 B 7 a (1998).
[64] Virginia accepts the NASAA Form U-7 for offerings made under Federal Rule 504 of Regulation D when the offerings are filed for registration by qualification.

VI. FINDINGS AND RECOMMENDATIONS

Summary of Findings

This study found that Virginia's capital markets function well at the mezzanine and IPO level and that capital flows freely to the viable public offerings in these ranges. The findings of the study suggest that no modifications are warranted in this sector of small business capital formation. The Commission and the Committee support these findings and recommend no changes in this area of Virginia's laws and regulations.

The study found that capital markets for small offerings (up to $3,000,000) in Virginia and nationally were frequently awkward, expensive, and not cost-effective. The study highlighted the following four problem areas:

Lack of uniformity among state Blue Sky Laws

Most states based their Blue Sky Laws on the Uniform Securities Act of 1956, however, many states added unique modifications when adopting the act. These initial modifications and subsequent amendments to these acts have resulted in a multitude of differences from state to state.

The number of states in which a company seeks to register, and the variations between the laws of those states, directly affect the cost of registering an offering. An issuer who seeks a broad market for its securities faces considerable delay and expense arising from the effort required to comply with each state's Blue Sky Laws. Issuers frequently hire securities law professionals to guide them through each state's compliance requirements, limit their offerings to a fewer number of states, or risk violating Blue Sky Laws. Progress toward a more uniform standard will ease the regulatory burden imposed on issuers.

Virginia's Act stands within the mainstream of Blue Sky Laws, but several notable exceptions exist which are peculiar to the Commonwealth. These exceptions include issuer-agent registration and examination requirements, audit requirements for SCOR offerings, and the types of investors counted for purposes of limited offering exemptions. Virginia may approach uniformity without sacrificing investor protection by adopting models that have been proven effective in other states.

The complexity of securities law and expense related to compliance

The cost to comply with Virginia's current regulatory framework chills small company stock offerings. A typical small business owner may lack the time and expertise to navigate the Commonwealth's registration requirements and exemptions. Expenses associated with compliance include hiring attorneys to interpret the relevant statutes and rules, and hiring accountants to audit the company's financial statements and bring them up to Generally Accepted Accounting Principles. If the company wishes to sell its own securities, an employee must register as a securities sales agent and pass an NASD exam. If the company is selling under an exemption, it must make certain that the number of investors does not exceed the limit imposed by the exemption and that each purchaser meets the class restrictions of the exemption.

The gap in financing available to small companies

In Virginia, and in the nation as a whole, there is a shortcoming in the capital markets for offerings in the range of $250,000 to around $3,000,000. Small companies can typically raise start-up capital from friends and relatives, and established small businesses may raise funds from venture capitalists. But small offerings offer too much risk and too little profit to attract bank financing, and these small offerings will not generate enough fees to attract professional broker-dealers or underwriters. Small companies are attempting to fill this gap by selling their securities themselves instead of through professionals. Several aspects increase the time and expense of these direct public offerings. This study showed that Virginia can modify the current regulatory environment to encourage direct public offerings without exposing investors to significantly increased risk.

Lack of liquidity in the market for small company offerings

The lack of a secondary market for small company stocks often deters would-be investors. Two factors affecting liquidity in this market are uniformity among state Blue Sky Laws and the regulatory burdens of establishing a private "market" for these securities. Promoting uniformity among the states would allow a company to widen its investor pool, and increase the number of potential traders in an aftermarket by registering the securities in multiple states. Additionally, by adopting such models as NASAA's accredited investor exemption, states can encourage the development of private accredited investor markets for small company offerings. While developing secondary markets is beyond the authority of the Commission and the scope of this research, modifying current regulations to allow these markets to form might improve the flow of capital to small companies

* * *

The study also identified best practices in the regulation of small company securities offerings. These practices were analyzed and focused on the following eight areas:

1. Financial statement audit requirements

Considering the expense of hiring professional accountants to perform these audits, many states have provisions to waive audit requirements for small issuers. Methods of providing waivers include: waiving audits for offerings under a certain dollar amount, waiving audits based on the size or age of the company, allowing an officer of the company to certify the financial statements rather than requiring a professional auditor, or allowing for waiver on a case-by-case basis. Virginia requires at least an audited balance sheet for every registration, and there is no provision to waive this requirement.

2. Accredited Investor Exemptions

Over half of all states allow an exemption from registration for issuers who offer and sell securities only to accredited investors. (Federal regulations define an accredited investor as a person with a net worth of at least $1,000,000 or an income of at least $200,000 in each of the past two years and reasonably expecting to earn as much in the current year.) The premise underlying this exemption is that these investors do not need the benefit of state registration as a means of protection. Most states' accredited investor exemptions are based substantially on the NASAA model, however, some states have modified the model. For example, some states'

exemptions require the investor to possess a certain level of financial sophistication and investing knowledge in addition to wealth. Virginia has no accredited investor exemption.

3. Uniform Limited Offering Exemption (ULOE)

The NASAA model ULOE was designed to correspond on the state level with offerings exempt under federal Rule 505 of Regulation D. (Rule 505 exempt offerings are limited to $5,000,000. Securities offered under Rule 505 may be sold to an unlimited number of accredited investors, but they may be sold to no more than thirty-five non-accredited investors.) The purpose of the exemption is to standardize the state regulation of these federally exempt offerings. Virginia currently allows an exemption comparable to the NASAA model, and the exemption appears to operate effectively.

4. Other Limited Offering Exemptions (LOE's)

In addition to the ULOE, some states offer other exemptions for issues limited to very few investors or not involving public solicitation. Examples include exemptions for sales to fewer than ten, twenty-five, or thirty-five investors in any twelve-month period, or exemptions for small offerings by in-state issuers. Currently, Virginia has two exemptions of this type. The first exemption limits the total number of security-holders after the offering to thirty-five; the second exemption allows a Virginia company to sell up to $1,000,000 in securities to not more than thirty-five investors in a twelve-month period. This study determined that other states offer exemptions that are more liberal than those allowed in Virginia.

5. Counting Provisions for Limited Offering Exemptions

Limited offering exemptions restrict the number of purchasers who may invest in an offering. Many states allow an issuer to exclude certain investors (usually wealthy or financially sophisticated investors) from the number of investors counted under a limited offering exemption. These exclusions allow the issuer to sell its securities to a broader base of investors without violating the exemption. For example, twenty-three states do not include sales to institutional investors in the total, and eight states exclude accredited investors from the count. Other states have provisions to exclude such investors as officers of the issuing company or investors who purchase large percentages of the issue. Virginia counts every purchaser (including institutional and accredited investors) when totaling the number of purchasers of an offering.

6. Issuer-agent Registration

A growing number of small companies chooses to sell their securities themselves rather than through a professional broker-dealer. Companies may do this to control costs or because the offering is too small to attract the services of a professional broker-dealer. Most states require a person who sells securities to register as an agent. Absent an exemption, the employees of an issuer who actually sell the securities must register as agents; this registration often requires passing an NASD examination. This registration and examination is another source of added time and expense for small issuers. Currently seventeen states exempt issuer-agents from the NASD examination or from registration. These exemptions usually require the issuer-agent to forego any sales commission and are typically not available to anyone who has been disciplined for violating securities laws. In non-exempt offerings, Virginia requires issuer-agents to register as agents of the issuer and requires the NASD examination.

7. Employee Benefit Plan Exemptions

A popular form of compensating directors is by paying them in shares of stock of the company. This method of payment is seen to motivate directors and, more importantly, to ease the pressure on the company's cash-flow. Transfers to directors are exempt from registration at the federal level. The majority of states offer a similar exemption for "qualified employee benefit plans." This exemption is interpreted to include transfers to non-employee directors of the issuer. Virginia takes the position that non-employee directors are not covered by the exemption. Thus, in Virginia, a company must register securities transferred to non-employee directors.

8. Small Company Offering Registration (SCOR)

The SCOR was designed by NASAA to standardize state regulation of small companies offering securities under certain federal exemptions. A primary benefit of a SCOR offering is that it does not require audited financial statements. SCOR has been formally adopted by thirty-six states, and eleven states have adopted the program informally. Virginia accepts the SCOR documentation for small offering registrations, but the company must provide an audited balance sheet in addition to the SCOR documentation.

Another benefit of a SCOR offering is the Regional Review process. Regional Review allows a company doing a SCOR offering in several states to answer questions to one or two lead states instead of responding to each state's questions individually. Because no such group exists among local states, Virginia does not currently participate in any Regional Review program.

Recommendations

After evaluating the research and considering the policy implications, the Commission, with the input of the Advisory Committee, recommends making several changes to the Virginia Securities Act and the corresponding regulations. The proposed statutory amendments and regulatory changes are presented in Appendix B and are discussed below.

The recommended changes to the Virginia Securities Act and Regulations are:

1. In order to alleviate the expense for small issuers, the Commission recommends eliminating the audit requirement for some SCOR offerings. The Commission proposes to implement this change by adopting the NASAA model into its regulations. Under the proposed regulation, offerings under $1,000,000 would require only a reviewed (unaudited) balance sheet. Although less stringent than a full audit, a review nevertheless entails an inspection by a Certified Professional Accountant to verify that the statements are prepared according to GAAP, and that nothing out of the ordinary appears in the statements.

This change will bring Virginia closer to uniformity with her sister states. Because reviewed statements must be examined by an objective professional, the Commission believes that the exemption will maintain an adequate level of investor protection.

These proposals will modify the rule found in 21 VAC 5-30-40 and will add a new rule to Title 21 of the Virginia Administrative Code. The text of these changes appears in Appendix B, pages B-9 - and B-10.

2. To broaden the current exemption offered under §13.1-514 B 7 b, the Commission recommends adopting language to exclude accredited and institutional investors from the thirty-five investor count allowed under the exemption. This change will widen the market for small issuers, thus enabling them to sell their securities more easily. This change will not place investors at great risk because institutional and accredited investors are seen as financially sophisticated enough to comprehend and bear the risk. Similarly, spreading the offering over a wider base of investors reduces the risk undertaken by any single investor. To better monitor the use of these offerings, the Commission will require periodic sales reports.

This proposed change would amend § 13.1-514 B 7 b and create a new rule at Title 21 of the Virginia Administrative Code. The text of these changes appears in Appendix B at pages B-1 - B-2 and pages B-3 -B-4.

3. To reduce the gap in financing available to small and development-stage companies, the Commission recommends raising the offering amount allowed under the §13.1-514 B 7(b) exemption from $1,000,000 to $2,000,000. This change would increase companies' ability to raise additional early-stage capital.

This proposed change would modify the rule found at 21 VAC 5-40-100. The text of this change appears in Appendix B at page B-12.

4. To reduce the time and expense involved with direct public offerings, the Commission recommends adoption of a rule permitting the waiver of the issuer-agent examination requirement under certain conditions. To ensure that this change does not place Virginia investors at risk, issuer-agents should be prohibited from receiving commissions on sales of securities, and the waiver should not be granted to individuals who have previously violated securities laws. These stipulations will reduce the incentive for aggressive sales and prevent known violators from receiving a waiver. Additionally, an issuer-agent will be required to distribute a copy of NASAA's "Guide to Small Business Investment" to each purchaser prior to the sale. This guide warns purchasers of the increased risk associated with investing in developing companies, encourages the reader to request information about the company, and warns the prospective purchaser not to invest what he cannot lose.

This proposed change will modify the rule found at 21 VAC 5-20-220. The text of these changes appears in Appendix B at page B-11.

5. The Commission recommends statutory and regulatory changes to reverse Virginia's current stance against including non-employee directors in the employee benefit plan exemption. Allowing a company to compensate directors with shares of the company's stock will increase the company's ability to attract talented directors while reducing the strain on the company's cash flow. Allowing the company to transfer these shares without registration will

decrease the time and expense to the company and will not add significant new risks to the investing public.

These proposed changes will amend statute § 13.1-514 A 10 and will create a new rule, at Title 21 of the Virginia Administrative Code. The text of these changes appears in Appendix B at page B-17.

6. In order to improve small issuers' access to capital markets, the Commission proposes adopting an exemption based on the NASAA Model Accredited Investor exemption. This exemption will allow companies to sell securities to wealthy individuals and institutions without the expense and delays associated with registration. In order to assure that the company sells only to investors capable of bearing the associated risks, Virginia's exemption should specify that the seller reasonably believe that the investor or his representative possesses the financial sophistication and ability to evaluate the business risk and withstand any losses resulting from the investment.

These changes will add subdivision 19 to § 13.1-514 B and a new rule at Title 21 of the Virginia Administrative Code. The text of these changes appears in Appendix B, pages B-4 - B-8.

The Commission, through its Securities Division, has also undertaken three proposals that do not require regulatory or statutory change. Each proposal is being handled according to its individual requirements and the study findings. These include (1) creating a business owner's guide to small stock offerings in Virginia, (2) establishing liaisons between the Division and Virginia's Center for Innovative Technology, the Department of Business Assistance, and the Virginia Economic Development Partnership, and (3) establishing a relationship among neighboring states with the goal of creating and participating in a Regional Review program for SCOR offerings in these states.

APPENDICES

Appendix A: House Joint Resolution 665

Appendix B: Recommended Statutory Amendments to the Virginia Securities Act and Recommended Changes to the Virginia Administrative Code

Appendix C: Highlights from the Division Survey of the Fifty States' Securities Laws

Appendix D: Statements of support or non-support from the Committee

Appendix E: Glossary

APPENDIX A

HOUSE JOINT RESOLUTION NO. 665
Requesting the State Corporation Commission to study the effectiveness of the Commonwealth's securities laws.

Agreed to by the House of Delegates, February 20, 1997
Agreed to by the Senate, February 19, 1997

WHEREAS, Virginia's requirements that securities be sold through registered broker-dealers and agents of the issuer, even in many cases when the offering itself is exempt from registration, and other regulatory requirements applicable to small issues of securities in the Commonwealth, significantly increase the cost of issuing securities in the Commonwealth; and

WHEREAS, because the costs of issuing small issues of securities are so high, few small or early development companies can afford to finance their growth in this manner; and

WHEREAS, federal securities laws and the trend of securities laws in the states favor a less restrictive and less costly regulatory environment for small issues of securities; and

WHEREAS, impediments to capital growth exist in the Commonwealth since its securities regulatory requirements are not consistent with the trends in many other states and federal securities regulations; and

WHEREAS, the National Securities Markets Improvement Act of 1996, which was passed by the 105th Congress, preempts certain state requirements, including Virginia's, regarding the offer and sale of securities; and

WHEREAS, House Bill No. 1957 introduced in the 1997 Session of the General Assembly is intended to conform Virginia's securities laws to the National Securities Markets Improvement Act of 1996; and

WHEREAS, the State Corporation Commission, through its Division of Securities and Retail Franchising, participates in the United States Securities and Exchange Commission's Annual Government-Business Forum on Small Business Capital Formation; and

WHEREAS, the Joint Subcommittee Studying Capital Access and Business Finance in its 1996 report urged that the State Corporation Commission undertake a review of its regulations, but little progress on removing regulatory barriers to small issues of securities has been achieved; and

WHEREAS, a thorough examination of the Commonwealth's securities laws may be necessary to determine what changes, if any, are appropriate to enable small business enterprises to issue securities and raise necessary capital; now, therefore, be it

RESOLVED by the House of Delegates, the Senate concurring, That the State Corporation Commission be requested to study the effectiveness of the Commonwealth's securities laws. The Commission shall conduct a "best practices study" to evaluate the appropriateness of the Commonwealth's existing securities laws, in view of the trends of federal and other states' securities regulations to simplify and reduce the costs of compliance for small issues of securities, and to determine whether the Commonwealth should adopt legislation that would create a securities regulatory framework to encourage capital formation for small and early development companies while maintaining appropriate protection for the investing public.

The State Corporation Commission should develop a technical advisory committee as it deems appropriate, utilizing volunteers from members of the Virginia State Bar and the investment banking industry as well as consumers and members of the business community, including representatives of the Northern Virginia Technology Council and members of the Venture Capital Roundtable convened by the Secretary of Commerce and Trade, among others. The Department of Business Assistance, the Virginia Economic Development Partnership, and all other agencies of the Commonwealth shall provide assistance to the State Corporation Commission, upon request.

The State Corporation Commission shall complete its work in time to submit its findings and recommendations to the Governor and the 1999 Session of the General Assembly as provided in the procedures of the Division of Legislative Automated Systems for the processing of legislative documents.

APPENDIX B
RECOMMENDED AMENDMENTS TO THE VIRGINIA SECURITIES ACT
PROPOSED AMENDMENTS TO THE VIRGINIA ADMINISTRATIVE CODE

Proposed amendments to § 13.1-514 B 7

Purpose: To allow the Commission to broaden, narrow, or further condition the -514 B 7 b limited offering exemption. To allow the Commission to exclude by rule certain categories of investors from the "35" purchaser count of -514 B 7 b. Also, to clarify that registered broker-dealers may participate on behalf of the issuer of the security.

The change to the last paragraph of -514 B 7 allows the Commission to exclude by rule--from the "35" purchaser count of -514 B 7 b-- all owners of an equity interest in an entity formed to raise capital for the issuer, so long as the entity is an "accredited investor" under federal Regulation D. This means that unless each member of the entity meets the Regulation D "accredited investor" standards for individuals, every member of the entity is counted toward the "35" limit. Also, the new opening phrase of this paragraph is added for clarification purposes.

7. a. Any sale of its securities by an issuer or any sale of securities by a registered broker-dealer and its registered agent acting on behalf of an issuer if, after the sale, such issuer has not more than thirty-five security holders, and if its securities have not been offered to the general public by advertisement or solicitation; or

b. To the extent the Commission by rule or order permits, any ~~offer or~~ sale ~~in a transaction involving the sale~~of its securities by an issuer or any sale of securities by a registered broker-dealer and its registered agent acting on behalf of an issuer to not more than thirty-five persons in the Commonwealth during any period of 12 consecutive months, whether or not the issuer or any purchaser is then present in the Commonwealth, if the issuer or broker-dealer reasonably believes that all the purchasers in the Commonwealth are purchasing for investment, and if the securities have not been offered to the general public by advertisement or general solicitation~~, and the Commission may assess and collect in connection with any filing required by the rule or order a nonrefundable fee not to exceed $250~~. The Commission may, by rule or order, as to any security or transaction or any type of security or transaction, withdraw or further condition this exemption, increase or decrease the number of purchasers permitted, or waive the condition relating to their investment intent. The Commission may assess and collect in connection with any filing pursuant to this exemption a nonrefundable fee not to exceed $250.

~~The~~ With respect to this subdivision 7, and except to the extent the Commission by rule or order may otherwise permit, the number of security holders of an issuer or the number of purchasers from an issuer, as the case may be, shall not be deemed to include

the security holders of any other corporation, partnership, limited liability company, unincorporated association or trust unless it was organized to raise capital for the issuer. Notwithstanding the provisions of subdivision 15, the merger or consolidation of corporations, partnerships, limited liability companies, unincorporated associations or other entities shall be a violation of this chapter if the surviving or new entity has more than thirty-five security holders or purchasers and all the securities of the parties thereto were issued under this exemption, unless all of the parties thereto have been engaged in transacting business for more than two years prior to the merger or consolidation;

Proposed new regulation relating to § 13.1-514 B 7 b:

Purpose: To specify excluded purchasers from the "35" purchaser count under § 13.1-514 B 7 b.

21 VAC 5-40-130 Calculation of the Number of Purchasers under § 13.1-514 B 7(b).

A. For the purpose of calculating the number of purchasers in the Commonwealth under § 13.1-514 B 7 b of the Act, the following persons are excluded:

1. A relative, spouse, or relative of the spouse of a purchaser, who has the same principal residence as the purchaser;

2. A trust or estate in which a purchaser and any of the persons related to the purchaser as specified in subdivisions 1 or 3 of this subsection collectively are beneficial owners of more than 50 % of the interests, excluding contingent interests;

3. A corporation, limited liability company, partnership, or other entity of which a purchaser and any of the persons related to the purchaser as specified in subdivisions 1 or 2 of this subsection collectively are beneficial owners of more than 50 % of the equity interests (excluding directors' qualifying shares); and

4. A person who comes within one of the categories of an "accredited investor" in Rule 501(a) of Regulation D (17 CFR §§ 230.501-230.508) adopted by the SEC under the Securities Act of 1933.

B. A corporation, partnership, limited liability company, unincorporated association or trust is considered one purchaser unless it was organized to raise capital for the issuer.

C. If a purchaser that is a corporation, partnership, limited liability company, unincorporated association or trust was organized to raise capital for the issuer and is not an "accredited investor" under Rule 501(a)(8) of Regulation D (17 CFR §§ 230.501-230.508), then each beneficial owner of an equity interest in the corporation, partnership, limited liability company, unincorporated association or trust is considered a separate purchaser.

D. A noncontributory employee benefit plan within the meaning of Title I of the Employee Retirement Income Security Act of 1974 is considered one purchaser, if the plan's trustee makes all investment decisions for the plan.

Proposed new statutory accredited investor transactional exemption

Purpose: To add a provision to subsection B of Va. Code § 13.1-514 that authorizes the Commission to create by rule an exemption for offers and sales solely to "accredited investors."

Va. Code § 13.1-514 B:

19. To the exent the Commission by rule or order permits, any offer or sale to an accredited investor, as defined by the Commission, if the issuer reasonably believes before the sale that the accredited investor, either alone or with the accredited investor's representative, has such knowledge and experience in financial and business matters as to be capable of evaluating the merits and risks of the prospective investment. The Commission may assess and collect in connection with any filing pursuant to this exemption a nonrefundable fee not to exceed $250.

Proposed new regulation: Accredited Investor Exemption

Purpose: The NASAA Model, except for investor suitablity language in subdivisions A 1 and A 2. Provides a transactional exemption from the registration requirements of the Securities Act for offers or sales made solely to accredited investors, as defined. Exemption permits general solicitation of prospective investors.

21 VAC 5-40-140 Accredited investor exemption

In accordance with § 13.1-514 B 19 of the Act, any offer or sale of a security by an issuer in a transaction that meets the requirements of this rule is exempt from the securities, broker-dealer and agent registration requirements of the Act.

A. Sales of securities shall be made only to persons who are or the issuer reasonably believes are "accredited investors," as that term is defined in 17 CFR 230.501(a), and:

1. Have sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the prospective investment, and are able to bear the economic risks of the prospective investment; or

2. Together with a purchaser representative or representatives, have sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the prospective investment, and are able to bear the economic risks of the prospective investment.

B. The exemption is not available to an issuer that is in the development stage that either has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies, or other entity or person.

C. The issuer reasonably believes that all purchasers are purchasing for investment and not with the view to or for sale in connection with a distribution of the security. Any resale of a security sold in reliance on this exemption within 12 months of sale shall be presumed to be with a view to distribution and not for investment, except a resale pursuant to a registration statement effective under §§ 13.1-508 through 13.1-510 of the Act or to an accredited investor pursuant to an exemption available under the Act.

D. 1. The exemption is not available to an issuer if the issuer, any of the issuer's predecessors, any affiliated issuer, any of the issuer's directors, officers, general partners, beneficial owners of 10% or more of any class of its equity securities, any of the issuer's promoters presently connected with

the issuer in any capacity, any underwriter of the securities to be offered, or any partner, director or officer of such underwriter:

a. within the last five years, has filed a registration statement which is the subject of a currently effective registration stop order entered by any state securities administrator or the SEC;

b. within the last five years, has been convicted of any criminal offense in connection with the offer, purchase or sale of any security, or involving fraud or deceit;

c. is currently subject to any state or federal administrative enforcement order or judgment, entered within the last five years, finding fraud or deceit in connection with the purchase or sale of any security; or

d. is currently subject to any order, judgment or decree of any court of competent jurisdiction, entered within the last five years, temporarily, preliminarily or permanently restraining or enjoining such party from engaging in or continuing to engage in any conduct or practice involving fraud or deceit in connection with the purchase or sale of any security.

2. Subdivision D 1 shall not apply if:

a. the party subject to the disqualification is licensed or registered to conduct securities related business in the state in which the order, judgment or decree creating the disqualification was entered against such party;

b. before the first offer under this exemption, the state securities administrator, or the court or regulatory authority that entered the order, judgment, or decree, waives the disqualification; or

c. the issuer establishes that it did not know and in the exercise of reasonable care, based on a factual inquiry, could not have known that a disqualification existed under this section.

E. 1. A general announcement of the proposed offering may be made by any means.

2. The general announcement shall include only the following information, unless additional information is specifically permitted by the Commission:

a. The name, address and telephone number of the issuer of the securities;

b. The name, a brief description and price (if known) of any security to be issued;

c. A description of the business of the issuer in 25 words or less;

d. The type, number and aggregate amount of securities being offered;

e. The name, address and telephone number of the person to contact for additional information; and

f. A statement that:

(1) sales will only be made to accredited investors;

(2) no money or other consideration is being solicited or will be accepted by way of this general announcement; and

(3) the securities have not been registered with or approved by any state securities agency or the SEC and are being offered and sold pursuant to an exemption from registration.

F. The issuer, in connection with an offer, may provide information in addition to the general announcement under subsection E, if such information:

1. is delivered through an electronic database that is restricted to persons who have been pre-qualified as accredited investors; or

2. is delivered if the issuer reasonably believes that the prospective purchaser is an accredited investor.

G. No telephone solicitation shall be permitted unless prior to placing the call, the issuer reasonably believes that the prospective purchaser to be solicited is an accredited investor.

H. Dissemination of the general announcement of the proposed offering to persons who are not accredited investors shall not disqualify the issuer from claiming the exemption under this rule.

I. The issuer shall file with the Commission a notice of transaction on Form (to be determined), a consent to service of process, a copy of the general announcement, and a nonrefundable fee of $250 within 15 days after the first sale in this Commonwealth.

Proposed new regulation relating to adopting SCOR:

Purpose: To add an official reference to NASAA's Small Corporate Offering Registration procedure in the Virginia Securities Act rules. Also, to specify the financial statements required for a SCOR issuer and the conditions when reviewed statements are acceptable.

21 VAC 5-30-90 Small Corporate Offering Registration

A. A registration statement on Form U-7 (Small Corporate Offering Registration Form), as amended by NASAA on April 28, 1996, may be used to register securities by qualification under § 13.1-510 of the Act, provided the conditions set forth in subsection B of this section, and the instructions to Form U-7, are satisfied.

B. Required Financial Statements. The financial statements included in the application for registration shall be those required under the instuctions to the Form U-7. Financial statements shall be prepared in accordance with either U.S. or Canadian generally accepted accounting principles. Interim financial statements may be unaudited. All other financial statements shall be audited by independent certified public accountants; provided, however, that if each of the following four conditions are met, such financial statements in lieu of being audited may be reviewed by independent certified public accountants in accordance with the Accounting and Review Service Standards promulgated by the American Institute of Certified Public Accountants or the Canadian equivalent:

1. The issuer shall not have previously sold securities through an offering involving the general solicitation of prospective investors by means of advertising, mass mailing, public meetings, "cold call" telephone solicitation, or any other method directed toward the public;

2. The issuer has not been previously required under federal, state, provincial or territorial securities laws to provide audited financial statements in connection with any sale of its securities;

3. The aggregate amount of all previous sales of securities by the issuer (exclusive of debt financing with banks and similar commercial lenders) shall not exceed $1,000,000.00; and

4. The amount of the present offering does not exceed $1,000,000.00.

Proposed amendment to 21 VAC 5-30-40

Purpose: To allow an issuer to submit a reviewed financial statement if it is conducting a SCOR offering that satisfies the Form U-7 instructions and complies with subsection B of a proposed new rule referencing NASAA's SCOR program.

Changes to subsections B & C are suggested improvements but are not material.

21 VAC 5-30-40. Requirements for registrations filed pursuant to §§ 13.1-508 and 13.1-510 of the Code of Virginia.

A. ~~The~~ Except as provided in subsection B of 21 VAC 5-30-90, the balance sheet required by §§ 13.1-508 and 13.1-510 of the ~~Code of Virginia~~ Act must be examined and reported upon with an opinion expressed by an independent accountant and shall include the information described in 21 VAC 5-30-10 in the definition of "certified financial statements" (See 21 VAC 5-30-40 B and C).

B. In lieu of the financial information required by ~~these Code Sections~~ §§ 13.1-508 and 13.1-510 of the Act, the registration statement may contain certified financial statements for the issuer's and/or any predecessor's three most recent fiscal or calendar years preceding the date of filing the registration statement. If the issuer's or any predecessor's existance is less than three years then the registration statement may contain certified financial statements for the issuer's or any predecessor's most recent fiscal year preceding the date of filing the registration statement.

C. If the certified financial statements ~~as outlined by~~ described in subsection B are as of a date in excess of four months prior to the filing of the registration statement, then an unaudited balance sheet (as of a date within four months prior to the filing of the registration statement together with a profit and loss statement and analysis of surplus for the period between the close of the latest fiscal year and the date of the balance sheet) must be filed in addition to the certified financial statements.

Proposed amendment to 21 VAC 5-20-220

Purpose: To allow the Commission to waive the examination requirements for an agent of the issuer who receives no commission or special compensation and who agrees to distribute disclosure materials developed by NASAA called: "A Consumer's Guide to Small Business Investments."

21 VAC 5-20-220. Examination/qualification.

A. ~~An~~ Except as described in subsection B of this rule, an individual applying for registration as an agent of the issuer shall be required to provide evidence in the form of a NASD exam report of passing the Uniform Securities Agent State Law Examination, ~~(USASLE~~ Series 63~~)~~, the Uniform Combined State Law Examination, Series 66 ~~exam~~, or a similar examination in general use by securities administrators which, after reasonable notice and subject to review by the Commission, the Director of the Division of Securities and Retail Franchising designates, with a minimum grade of 70%.

B. Waiver of examination requirement. The Commission may waive the examination requirement for an officer or director of an issuer that is a corporation, or a general partner of an issuer that is a limited partnership or a manager of an issuer that is a limited liability company who:

1. Will receive no commission or similar remuneration directly or indirectly in connection with the offer or sale of the issuer's securities; and

2. Agrees to deliver to each prospective purchaser of a security to be issued by such issuer, at or before the time the offering document is required to be delivered, a copy of "A Consumer's Guide to Small Business Investments" prepared by NASAA (see CCH NASAA Reports ¶3676).

Proposed amendments to 21 VAC 5-40-100 Issuer Limited Transactional Exemption

Purpose: To raise the maximum offering amount from $1,000,000 to $2,000,000.

To require issuers who rely on this exemption to file a report of sales with the Commission not later than 30 days after the completion of the offering.

To make changes that illuminate the requirement that the issuer must be based in Virginia in order to qualify for the exemption.

21 VAC 5-40-100. ~~Issuer~~ Domestic issuer limited transactional exemption.

A. In accordance with §13.1-514 B 7 b of the Act, an offer or sale by the issuer of any of the following securities issued by a corporation, partnership, limited liability company, or real estate investment trust, as the case may be: note, stock, bond, debenture, evidence of indebtedness, partnership interest, share of beneficial interest in a real estate investment trust, a warrant or right to purchase or subscribe to any of the foregoing or a security convertible into any of the foregoing, shall be exempt from the securities, broker dealer and agent registration requirements of the Act, provided the following conditions are met:

1. In connection with an offering pursuant to this rule, there shall be no more than 35 purchasers in this Commonwealth during any period of 12 consecutive months;

2. In connection with an offering pursuant to this rule, the issuer shall:

   a. Deliver Form VA-1 and in certain prescribed circumstances, Part 2 of Form VA-1 or a disclosure document containing the information required by Form VA-1 and Part 2, if required, to each prospective purchaser prior to a sale to a purchaser; and

   b. Sell securities only to purchasers, each of which the issuer shall, after reasonable inquiry, believe either:

      (1) Has sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the prospective investment, and is able to bear the economic risks of the prospective investment; or

      (2) Together with a purchaser representative or representatives, has sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the prospective investment, and that the purchaser

is able to bear the economic risks of the prospective investment; and,

3. No commission or similar remuneration is paid or given, directly or indirectly, for soliciting a prospective purchaser, or in connection with sales of securities in reliance on this rule, unless paid to a broker-dealer and its agent who are registered under the Act and the securities are offered only to persons whose investing history demonstrates an ability to evaluate the merits and risks of the investment and who are capable of bearing the economic risks of the investment;

B. This exemption is not available with respect to an offering:

1. Pursuant to a registration statement or Regulation A (17 CFR §§ 230.251-230.263) notification which has been filed under the ~~federal~~ Securities Act of 1933;

2. Pursuant to an exemption under Regulation D (17 CFR §230.505 or 17 CFR §230.506), which offering may be exempted in Virginia only by Article 5, 21 VAC 5-40-30 of these rules (uniform limited offering exemption);

3. If the amount of money to be raised from the offering exceeds ~~$1000,000~~ 2,000,000;

4. If the issuer has offered for sale or sold its securities which are of the same or a similar class as that to be offered for sale or sold under this rule within 180 days prior to this offering or if the issuer offers for sale or sells its securities that are of the same or a similar class as those offered and sold under this rule within 180 days after this offering; or

5. If the issuer does not have ~~a~~ its principal place of business in this Commonwealth.

C. An exemption under this rule is not available if the issuer, its directors, officers, partners, members, trustees or beneficial owners of 10% or more of a class of its voting securities, or its promoters or agents connected with it or a person offering or selling the securities for or on behalf of the issuer:

1. Has been convicted (or has pleaded nolo contendere) within five years prior to reliance on this rule of a felony or a misdemeanor in connection with the purchase or sale of a security, or in connection with making a false filing with the ~~United States Securities and Exchange Commission~~ SEC or a state securities administrator or of a felony involving fraud or deceit, including but not limited to, forgery, embezzlement, obtaining money under false pretenses, larceny, conspiracy to defraud, or theft;

2. Is subject to an order, judgment or decree of a court of competent jurisdiction that temporarily or preliminarily restrains or enjoins, or is subject to an order, judgment or decree of a court of competent jurisdiction, entered within five years prior to reliance on this rule, which permanently restrains or enjoins a person from engaging in or continuing a practice or conduct in connection with the purchase or sale of a security, or involving the making of a false filling with the ~~United States Securities and Exchange Commission~~ SEC or a state securities administrator;

3. Is subject to a United States Postal Service false representation order entered within five years prior to reliance on this rule; or

4. Is subject to a state administrative order entered within five years prior to reliance on this rule by a state securities administrator in which fraud or deceit was found.

D. The issuer shall file with the ~~State Corporation~~ Commission 15 days prior to the first sale in this Commonwealth in reliance on this rule:

1. A copy of Form VA-1, including Part 2, if applicable or a disclosure document containing the information required by the Form;

2. An executed Consent to Service of Process on Form U2 appointing the Clerk of the ~~State Corporation~~ Commission as its agent for service of process;

3. An undertaking to promptly provide to the ~~State Corporation~~ Commission, upon request, additional information as the ~~State Corporation~~ Commission may require; and

4. A non-refundable filing fee of $250.

E. The issuer shall, within 30 days after the completion of the offering, file with the Commission a report of sales indicating the number of purchasers in this Commonwealth, a description of the securities sold to such purchasers, and the total dollar amount raised.

~~E.~~F. This rule does not exempt persons or transactions from the anti-fraud provisions of the ~~Virginia Securities~~ Act (§13.1-501 et seq. of the Act).

~~F.~~G. The ~~State Corporation~~ Commission may deny the exemption if it determines that a particular transaction or offering is not in the public interest.

~~G.~~H. For purposes of this rule and §13.1-514 B 7 b of the Act, the following shall apply:

1. Neither the issuer nor persons acting on its behalf shall offer or sell the securities by form of general solicitation or advertising, including but not limited to, the following:

   a. "Cold" calls by telephone or other means, advertising, article, notice, or other communication published in a newspaper, newsletter, magazine, mass mailing, electronic media, or similar media or broadcast over television or radio; or

   b. Seminars or meetings whose attendees have been invited by general solicitation or general advertising.

2. Securities acquired in a transaction under this rule shall not be resold without registration under or exemption from the ~~Virginia Securities~~ Act. The issuer or a person acting on its behalf shall exercise reasonable care to assure that the purchasers of the securities in an offering under this rule are purchasing for investment and not with a view to distribution of the securities. Reasonable care shall include, but not be limited to, the following:

   a. Reasonable inquiry to determine whether the purchaser is acquiring the securities for himself or for other persons;

   b. Placement of a restrictive legend on the certificate or other document evidencing the securities. The legend shall be in the following form:

      THE SECURITIES REPRESENTED BY THIS CERTIFICATE (OR OTHER DOCUMENT) HAVE BEEN ISSUED PURSUANT TO A CLAIM OF EXEMPTION FROM THE REGISTRATION OR QUALIFICATION PROVISIONS OF FEDERAL AND STATE SECURITIES LAWS AND SHALL NOT BE SOLD OR TRANSFERRED WITHOUT COMPLIANCE WITH THE REGISTRATION OR QUALIFICATION PROVISIONS OF APPLICABLE FEDERAL AND STATE SECURITIES LAWS OR APPLICABLE EXEMPTIONS THEREFROM;

   c. Issuance of stop-transfer instructions to the issuer's transfer agent with respect to the securities, or, if the issuer transfers its own securities, notation in the appropriate records of the issuer; and

   d. Obtaining from the purchaser a signed agreement that the securities will not be sold unless they are registered under the ~~Virginia Securities~~ Act or exempted from registration.

3. All sales that are part of the same offering under this rule shall meet all the conditions of this rule. Offers and sales that are made more than six months before the commencement of an offering under this rule or are made more than six months after completion of an offering under this rule will not be considered part of that offering, so long as during those six-month periods there are no offers or sales of securities by or on behalf of the issuer that are of the same or a similar class as those offered or sold under this rule. If securities of the same or a similar class as those offered pursuant to this rule are offered or sold less than six months before or after an offer or sale pursuant to this rule, those offers to sell or sales, will be deemed to be "integrated" with the offering.

~~H.~~I. In proceedings involving this rule, the burden of proving the exemption or an exception from a definition or condition is upon the person claiming it.

~~I.~~J. The exemption authorized by this rule shall be known and may be cited as the "Domestic Issuer Limited Transactional Exemption."

Proposed Amendment to § 13.1-514 A 10

Purpose: To authorize the Commisssion to broaden the exemption established by § 13.1-514 A 10 to allow participation of directors (including nonemployee directors) in a covered benefit plan.

§ 13.1-514 A. Exemptions

10. Any security issued in connection with an employee's stock purchase, savings, pension, profit-sharing or similar benefit plan. The Commission may by rule or order, as to any security issued pursuant to such plan, specify or designate persons eligible to participate in such plan;

Proposed New Regulation

Purpose: To include transfers of securities to nonemployee directors under § 13.1-514 A 10.

21 VAC 5-40-150

The term "employee" as referred to in § 13.1-514 A 10 of the Act shall include all directors of the issuer regardless of whether the director is employed by the issuer. This exemption shall not apply to transfers of securities to individuals who are appointed directors for the purpose of avoiding registration under the Act.

APPENDIX C
HIGHLIGHTS FROM THE DIVISION SURVEY OF THE FIFTY STATES' SECURITIES LAWS

Chart A.
Registration By Qualification;
Issuer-Agent Registration and Examination Requirements

	Issuer-Agent Registration		Issuer-Agent Examination		
	Required	Not Required	Required	Not Required	Waiver Avail.
AL	yes		yes		NO
AK	yes		yes		yes
AZ		yes	yes		yes
AR	yes		yes		NO
CA		yes		yes	
CO		yes	yes		yes
CT		yes		yes	
DE	yes		yes		yes
FL	yes			yes	
GA		yes	yes		yes
HI	yes		yes		yes
ID	yes		yes		yes
IL		yes	yes		yes
IN	yes		yes		yes
IA	yes		yes		yes
KS	yes		yes		yes
KY		yes	yes		NO
LA		yes	yes		yes
ME	yes		yes		yes
MD	yes		yes		yes
MA		yes		yes	
MI		yes	yes		yes
MN		yes	yes		yes
MS	yes		yes		NO
MO	yes		yes		NO
MT	yes			yes	
NE	yes		yes		yes
NV	yes		yes		yes
NH	yes		yes		NO
NJ	yes		yes		yes
NM	yes		yes		NO
NY	yes		yes		NO
NC		yes	yes		yes
ND	yes		yes		yes
OH		yes	yes		NO
OK	yes		yes		yes
OR	yes		yes		yes
PA		yes		yes	
RI	yes		yes		NO
SC	yes		yes		NO
SD		yes	yes		yes
TN		yes	yes		NO
TX	yes		yes		yes
UT	yes			yes	
VT	yes			yes	
VA	**yes**		**yes**		**NO**
WA	yes			yes	
WV	yes		yes		yes
WI		yes		yes	
WY	yes		yes		yes
totals	33	17	40	10	27

Chart B.

	Limited Offering Exemptions			
	Exceptions to Counting Provisions			
	No exceptions, all investors are counted	Accredited Investors are not counted	Institutional Investors are not counted	Others not counted
Alabama			yes	
Alaska			yes	
Arizona	yes			
Arkansas		yes	yes	
California			yes	yes
Colorado			yes	
Connecticut	yes			
Delaware			yes	
Florida				yes
Georgia				yes
Hawaii			yes	
Idaho			yes	
Illinois		yes		
Indiana		yes	yes	
Iowa			yes	
Kansas	yes			
Kentucky			yes	
Louisiana	yes			
Maine			yes	
Maryland		yes		
Massachusetts			yes	
Michigan	yes			
Minnesota		yes		
Mississippi	yes			
Missouri		yes		
Montana			yes	
Nebraska			yes	
Nevada			yes	
New Hampshire			yes	
New Jersey				yes
New Mexico	yes			
New York		yes		
North Carolina			yes	
North Dakota			yes	
Ohio			yes	
Oklahoma			yes	yes
Oregon			yes	
Pennsylvania	yes			
Rhode Island			yes	
South Carolina			yes	
South Dakota	yes			
Tennessee			yes	
Texas		yes		
Utah			yes	
Vermont	yes			
Virginia	yes			
Washington		yes		
West Virginia			yes	
Wisconsin		yes	yes	
Wyoming			yes	
totals	11	10	29	5

Chart C.
Accredited Investor Exemption

	Follows NASAA Model	Differs from NASAA Model	A.I. Exemption
Alabama			No
Alaska			No
Arizona		yes	
Arkansas			No
California		yes	
Colorado	yes		
Connecticut		yes	
Delaware	yes		
Florida			No
Georgia			No
Hawaii			No
Idaho			No
Illinois		yes	
Indiana	yes		
Iowa		yes	
Kansas	yes		
Kentucky	yes		
Louisiana			No
Maine	yes		
Maryland			No
Massachusetts		yes	
Michigan		yes	
Minnesota		yes	
Mississippi			No
Missouri		yes	
Montana			No
Nebraska		yes	
Nevada	yes		
New Hampshire		yes	
New Jersey	yes		
New Mexico			No
New York			No
North Carolina			No
North Dakota			No
Ohio			No
Oklahoma			No
Oregon		yes	
Pennsylvania		yes	
Rhode Island	yes		
South Carolina		yes	
South Dakota	yes		
Tennessee			No
Texas		yes	
Utah	yes		
Vermont			No
Virginia			No
Washington	yes		
West Virginia			No
Wisconsin		yes	
Wyoming	yes		
totals	13	16	21

Chart D.
SCOR Provisions

	SCOR Adopted Formally	SCOR Adopted Informally	SCOR Prohibited
Alabama		yes	
Alaska	yes		
Arizona	yes		
Arkansas	yes		
California		yes	
Colorado	yes		
Connecticut	yes		
Delaware	yes		
Florida	yes		
Georgia		yes	
Hawaii			yes
Idaho	yes		
Illinois	yes		
Indiana	yes		
Iowa	yes		
Kansas	yes		
Kentucky	yes		
Louisiana		yes	
Maine	yes		
Maryland	yes		
Massachusetts	yes		
Michigan	yes		
Minnesota	yes		
Mississippi		yes	
Missouri		yes	
Montana		yes	
Nebraska			yes
Nevada	yes		
New Hampshire	yes		
New Jersey	yes		
New Mexico	yes		
New York			yes
North Carolina	yes		
North Dakota	yes		
Ohio	yes		
Oklahoma	yes		
Oregon	yes		
Pennsylvania	yes		
Rhode Island	yes		
South Carolina		yes	
South Dakota		yes	
Tennessee	yes		
Texas	yes		
Utah	yes		
Vermont	yes		
Virginia		yes	
Washington	yes		
West Virginia		yes	
Wisconsin	yes		
Wyoming	yes		
totals	36	11	3

Chart E.
Details her
Limited Offer. emptions

This chart describes each states Limited Offering Exemptions. Some states have as many as three of these exemptions, others have none.

	Issuer-Agent Registration Required, may not waive testing			Dollar Limit on Offerings			Limit on Total Number of Investors Allowed			Limit on Number of Investors Allowed Each Year			Accredited Investors Counted?			Solicitation Allowed			Open to Out of state Issuers?		
	exemption #			*exemption #*			*exemption #*			*exemption #*			*exemption #*			*exemption #*			*exemption #*		
	1	*2*	*3*	*1*	*2*	*3*	*1*	*2*	*3*	*1*	*2*	*3*	*1*	*2*	*3*	*1*	*2*	*3*	*1*	*2*	*3*
Al	no	no	no	none	500m	no	-	-	-	10	-	25	yes	yes	yes	no	yes	no	yes	no	yes
Ak	no	no	no	100m	500m	no	-	-	-	10	25	-	yes	no	yes	no	no	no	yes	no	no
Az	no	no	no	100m	500m	1mm	-	35	-	10	-	-	yes	no	yes	yes	no	yes	yes	yes	yes
Ar	no	yes	no	none	1mm	no	-	-	-	35	-	-	no	no	yes	no	yes	no	yes	yes	no
Ca	no	no	no	none	none	no	-	10	35	35	-	-	yes	no	yes	no	no	no	yes	yes	yes
Co	no	yes	-	no	1mm	-	10	no	-	10	no	-	yes	-	-	yes	yes	-	yes	yes	-
Ct	no	no	-	no	no	-	no	10	-	no	10	-	yes	yes	-	no	no	-	yes	yes	-
De	no	no	-	no	no	-	no	35	-	25	35	-	yes	yes	-	no	no	-	yes	yes	-
Fl	no	-	-	no	-	-	no	-	-	35	-	-	yes	-	-	no	-	-	yes	-	-
Ga	no	-	-	no	-	-	15	-	-	15	-	-	yes	-	-	no	-	-	yes	-	-
Ha	no	-	-	no	-	-	25	-	-	25	-	-	yes	-	-	no	-	-	no	-	-
Id	no	no	-	no	no	-	no	no	-	10	no	-	yes	-	-	no	no	-	yes	yes	-
Il	no	-	-	1mm	-	-	no	-	-	35	-	-	no	-	-	no	-	-	yes	-	-
In	no	-	-	no	-	-	35	-	-	35	-	-	no	-	-	no	-	-	yes	-	-
Ia	no	-	-	no	-	-	36	-	-	36	-	-	yes	-	-	no	-	-	yes	-	-
Ks	no	-	-	no	-	-	20	-	-	20	-	-	yes	-	-	no	-	-	no	-	-
Ky	no	-	-	no	-	-	no	-	-	25	-	-	yes	-	-	no	-	-	yes	-	-
La	yes	-	-	no	-	-	no	-	-	35	-	-	yes	-	-	no	-	-	yes	-	-
Me	no	no	-	no	no	-	no	10	-	no	10	-	yes	yes	-	no	no	-	no	no	-
Md	no	no	-	150m/12	no	-	no	-	-	10	35	-	no	no	-	no	no	-	no	yes	-
Ma	no	no	-	no	no	-	no	10	-	25	10	-	yes	yes	-	no	no	-	yes	yes	-
Mi	no	no	no	no	no	no	10	no	35	10	15	35	yes	yes	yes	no	no	no	yes	yes	yes
Mn	no	no	-	no	no	-	10	25	-	10	25	-	no	no	-	no	no	-	yes	yes	-
Ms	no	no	-	no	no	-	10	35	-	10	35	-	yes	yes	-	no	no	-	yes	no	-
Mo	no	no	no	no	no	500m	25	15	no	25	15	no	no	no	yes	no	no	some	yes	yes	no

Chart E.
Details of Other
Limited Offering Exemptions

	Issuer-Agent Registration Required, may not waive testing			Dollar Limit on Offerings			Limit on Total Number of Investors Allowed			Limit on Number of Investors Allowed Each Year			Accredited Investors Counted?			Solicitation Allowed			Open to Out of state Issuers?		
	exemption #			*exemption #*			*exemption #*			*exemption #*			*exemption #*			*exemption #*			*exemption #*		
	1	***2***	***3***	***1***	***2***	***3***	***1***	***2***	***3***	***1***	***2***	***3***	***1***	***2***	***3***	***1***	***2***	***3***	***1***	***2***	***3***
Mt	no	no	-	no	no	-	10	25	-	10	25	-	yes	yes	-	no	no	-	yes	yes	-
Ne	no	no	-	no	500m	-	15	no	-	15	no	-	no	yes	-	no	no	-	yes	no	-
Nv	no	-	-	no	-	-	no	-	-	25	-	-	yes	-	-	no	-	-	yes	-	-
Nh	no	-	-	no	-	-	5	-	-	5	-	-	yes	-	-	no	-	-	yes	-	-
Nj	no	no	-	no	no	-	20	35	-	10	35	-	yes	yes	-	no	no	-	yes	yes	-
Nm	no	-	-	no	-	-	25	-	-	25	-	-	yes	-	x	no	-	-	no	-	-
Ny	yes	-	-	no	-	-	40	-	-	40	-	-	no	-	-	no	-	-	yes	-	-
Nc	no	-	-	no	-	-	25	-	-	25	-	-	yes	-	-	no	-	-	yes	-	-
Nd	no	no	-	no	500m	-	no	no	-	25	no	-	yes	no	-	no	yes	-	yes	no	-
Oh	no	no	-	no	no	-	40	no	-	10	no	-	yes	no	-	no	no	-	yes	yes	-
Ok	no	no	no	1mm	no	no	no	25	32	no	25	32	yes	yes	yes	no	no	no	yes	yes	yes
Or	no	-	-	no	-	-	no	-	-	10	-	-	yes	-	-	no	-	-	yes	-	-
Pa	no	no	no	no	no	no	no	35	no	25	35	no	yes	yes	yes	no	no	no	yes	yes	no
Ri	no	-	-	no	-	-	25	-	-	25	-	-	yes	-	-	no	-	-	yes	-	-
Sc	no	no	-	no	no	-	25	10	-	25	10	-	yes	no	-	yes	no	-	yes	no	-
Sd	no	no	-	no	no	-	5	35	-	5	35	-	yes	no	-	no	no	-	no	no	-
Tn	no	no	-	no	250m	-	15	no	-	15	no	-	yes	yes	-	no	yes	-	yes	no	-
Tx	no	no	no	no	no	no	35	no	no	35	15	35	no	no	no	no	no	no	yes	yes	yes
Ut	no	-	-	500m	-	-	15	-	-	15	-	-	yes	-	-	no	-	-	yes	-	-
Vt	no	no	-	500m	no	-	no	no	-	50	25	-	yes	yes	-	yes	no	-	no	yes	-
Va	no	no	-	no	1mm	-	35	no	-	35	35	-	yes	yes	-	no	no	-	yes	no	-
Wa	no	-	-	500m	-	-	20	-	-	20	-	-	no	-	-	no	-	-	yes	-	-
Wv	no	-	-	no	-	-	no	-	-	10	-	-	yes	-	-	no	-	-	yes	-	-
Wi	no	no	no	no	no	1mm	no	15	100	10	15	100	no	no	yes	yes	no	yes	yes	no	no
Wy	no	-	-	no	-	-	no	-	-	15	-	-	yes	-	-	yes	-	-	yes	-	-

Chart F.
State Provisions to Coordinate With Regulation A

	Registration by Qualification (q), Coordination (c), or Exempt (e)	Regional Review Available	Issuer-Agent Registration Required (different from Reg. A)
Alabama	q	no	
Alaska	c	yes	
Arizona	q	no	
Arkansas	q	no	
California	c	no	
Colorado	(notice/exempt)	n/a	
Connecticut	q	yes	
Delaware	c	no	
Florida	q	no	
Georgia	(notice/exempt)	n/a	yes
Hawaii	q	no	
Idaho	c	no	
Illinois	q	yes	
Indiana	q	no	
Iowa	c	no	
Kansas	q	yes	
Kentucky	q	no	
Louisiana	q	no	
Maine	q	no	
Maryland	c	no	
Massachusetts	q	yes	
Michigan	q	no	
Minnesota	q	no	
Mississippi	q	no	
Missouri	q	no	
Montana	q/c	no	
Nebraska	q	no	
Nevada	q	no	
New Hampshire	q	no	
New Jersey	q	no	
New Mexico	q	no	
New York	q	no	
North Carolina	q	no	
North Dakota	q	no	
Ohio	c	no	
Oklahoma	q	no	
Oregon	q	yes	
Pennsylvania	c	no	
Rhode Island	q	no	
South Carolina	q	no	
South Dakota	q	no	
Tennessee	c	no	
Texas	q	no	
Utah	c	no	
Vermont	q	no	
Virginia	q	no	
Washington	q	no	
West Virginia	q	no	
Wisconsin	q	yes	
Wyoming	q	no	

Sheet G.
State Provision to Coordinate with Rule 505

	Follows Uniform Provisions	Issuer-Agent Examination Not Required Or Waived
Alabama	Yes	Yes
Alaska	No Exemption	N/A
Arizona	Yes	Yes
Arkansas	No Exemption	N/A
California	No Exemption	N/A
Colorado	No Exemption	N/A
Connecticut	Yes	Yes
Delaware	Yes	Yes
Florida	No	Yes
Georgia	Yes	Yes
Hawaii	Yes	Yes
Idaho	Yes	Yes
Illinois	Yes	Yes
Indiana	Yes	Yes
Iowa	Yes	Yes
Kansas	Yes	Yes
Kentucky	Yes	Yes
Louisiana	Yes	No
Maine	No Exemption	N/A
Maryland	Yes	Yes
Massachusetts	Yes	Yes
Michigan	Yes	Yes
Minnesota	Yes	Yes
Mississippi	Yes	Yes
Missouri	Yes	Yes
Montana	Yes	Yes
Nebraska	Yes	Yes
Nevada	Yes	Yes
New Hampshire	Yes	Yes
New Jersey	No Exemption	N/A
New Mexico	Yes	Yes
New York	No Exemption	N/A
North Carolina	Yes	Yes
North Dakota	No Exemption	N/A
Ohio	Yes	Yes
Oklahoma	Yes	Yes
Oregon	No Exemption	N/A
Pennsylvania	Yes	Yes
Rhode Island	Yes	Yes
South Carolina	Yes	Yes
South Dakota	No	Yes
Tennessee	Yes	Yes
Texas	Yes	Yes
Utah	Yes	Yes
Vermont	Yes	Yes
Virginia	Yes	Yes
Washington	Yes	Yes
West Virginia	Yes	Yes
Wisconsin	Yes	Yes
Wyoming	Yes	Yes

APPENDIX D
LETTERS OF SUPPORT AND CONCERN FROM THE COMMITTEE; RESPONSES FROM THE DIVISION

The Division and the Commission offers its gratitude to those members of the Committee whose participation and input helped complete the Report.

(Response to Letter from Robert Gregg)

Point 1: The Division has reevaluated the position on the level of reviewed financial statements allowable under SCOR. After renewed consultation with the securities administrators in other states, the Division agrees to recommend raising the level under which reviewed statements will be allowed to $1,000,000.

Point 2: The Division agrees that more detail is warranted and has supplemented the sections on the non-statutory and non-regulatory suggestions arising from the study.

Point 3: In response to this suggestion, the Division has requested that each Committee member submit a statement of support or non-support of the recommendations included in the Report. Until these statements are received, the Division cannot elaborate further on the level of support from the Committee. The final Report will include an appendix of Committee support, concerns, and other comments.

Point 4: The Division has included a statement recognizing the members of the Committee and thanking them for their dedication and work on this study. The final Report will include this statement.

Point 5-7: The necessary corrections has been made to the Report.

(Response to Letter from Carter Scott)

Paragraph 2: "by registration" added

Paragraph 3: clarified to indicate that private as well as public offerings will benefit

Paragraph 4: the Division feels that the referenced section applies to unregistered as well as registered offerings

Paragraph 5: the Division chooses to omit the reference to the federal Rule 501(e)

Paragraph 6: the necessary correction has been made to the Report

Paragraph 7: the Division believes that paragraph B of the Accredited Investor Exemption would not preclude use of the exemption for the formation of a venture capital fund. Applicability of the exemption would depend on the particular facts and circumstances.

Paragraph 8: the Division feels that the proposed language is sufficiently clear.

(Response to Letter from Brian Farmer)

Point 1: The Division has reviewed the regulatory systems in place in the other states, and has contacted the securities administrations of the states. In doing so, the Division has determined that it will be more beneficial to the Commonwealth to allow reviewed financial statements for SCOR offerings up to $1,000,000. Based on the reports from the other states, this change should not significantly increase risk to Virginia investors.

Point 2: The Division believes that it is in the interest of the Commonwealth to reserve the right to deny effectiveness based on a offeror's negative net worth. The Division feels that the discretionary language in the statute in question does not preclude negative net worth companies from offering securities, and allows the Division to deny effectiveness when doing so serves the public interest.

Point 3: The Division feels that the proposed language in the Model Accredited Investor Exemption is sufficiently clear.

Points 4 and 5: The Division has incorporated the suggested changes and corrections into the Report.

(Response to Letter from Jean Ann Fox)

Comment 1: The Division feels that the implementation of the SCOR regulations will provide a net benefit to the Commonwealth. This belief is based on the several facts. First, reviewed (by a CPA) financial statements and the U-7 document required for SCOR offerings provide a significant amount of detailed information regarding the issuing company. Second, securities fraud is most prevalent in the area of unregistered securities offerings and in initial public offerings much larger than the SCOR variety. The study found no instances of microcap fraud in SCOR offerings. Third, the SCOR regulations are widely accepted and have a positive history as a means of small capital formation without compromising investor protection. Given that SCOR offerings are registered with the State Corporation Commission and are for relatively small offerings, the Division feels that allowing reviewed financial statements will not significantly increase the potential for fraud.

Comment 2: The Division believes that allowing sales to accredited and institutional investors will not significantly increase risk to these investors. In addition to the net worth and income requirements, Virginia's statutes and regulations require each investment to be suitable for each investor.

The Division also wishes to note that, while only three states explicitly state that their limited offering exemptions do not count sales to accredited or institutional investors, thirty-two states currently offer accredited investor exemptions which exclude all sales to accredited investors. None of these states has reported problems resulting from allowing these sales to proceed without registration. The Division feels that the

benefits resulting from reducing these registration requirements outweigh any risks resulting from the change.

Comment 3: The Division feels that the increase in the Issuer limited transaction exemption is justified for the reasons stated in the Report.

Comment 4: The Division wishes to note that the waiver will be allowed at the discretion of the Division based on the circumstances in each case. This discretion will allow the Division to require issuer-agent registration and testing in situations where doing so provides investor protection.

Comment 5: The Division feels that the addition of the sophistication requirement to the accredited investor exemptions, as well as existing agent (know-your-customer) regulations serve to put the selling company or individual on notice that they must, indeed, know the purchaser or risk violating the regulation.

The Division also feels that in the absence of a federal definition of "qualified purchaser," the Commonwealth will benefit from the adoption of the accredited investor exemption. If and when the federal "qualified purchaser" becomes a reality, Virginia will reconsider its accredited investor exemptions.

(Response to Letter from Catherine Renault)

The Division thanks you for your support and valuable contributions to the study.

APPENDIX E

GLOSSARY

Accredited Investor: An investor whose net worth or income indicate that he is financially sophisticated enough to participate in riskier investments without the benefit of government protection. The term is defined federally at 17 CFR § 230.501 as an individual or entity with a net worth of at least $1 million, or income of at least $200,000 for each of the past two years and a reasonable belief of maintaining this income level in the current year.

Angel, Angel Investor: A wealthy individual who provides capital for small and development-stage companies; angel investing is characterized by high risk of loss and potentially high returns.

Broker-dealer: "any person selling any type of security other than an interest or unit in a condominium . . . for the account of others or for his own account otherwise than through a broker-dealer or agent" (defined in the Virginia Securities Act, § 13.1-501)

CIT: Virginia's Center For Innovative Technology, a state-sponsored body that describes their mission to "increase the Commonwealth's economic competitiveness and quality of life by advancing the development of Virginia as a technology state and by creating and retaining technology-based jobs and businesses." (For more information about the CIT, visit them on the web at <www.cit.org>.)

Exemption: A provision in the laws and regulations that excuses an issuer from fulfilling the registration requirements of a securities offering. Exemptions exist for different types of securities and for different types of transactions

GAAP: Generally Accepted Accounting Principles, the standard to which public accountants must present an entity's financial statements.

Issuer-agent: A person who sells the securities of his own company, typically an officer or director of the company issuing the stock.

Micro-cap: Companies with a market capitalization under $50 million

Mezzanine Financing: Intermediate-level financing for companies beyond the start-up and development stage, but not yet mature enough to go public.

NASAA: North American Securities Administrators Association, Inc.: non-profit body organized in 1919 representing 65 state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, Canada, and Mexico. In the United States, NASAA is the voice of the 50 state securities agencies responsible for efficient capital formation and grass-roots investor protection. (For more information about NASAA, visit them on the web at <www.nasaa.org>.)

NASD: National Association of Securities Dealers, Inc.: A securities-industry self-regulatory organization that, through its subsidiaries, NASD Regulation, Inc., and The Nasdaq Stock Market, Inc., the NASD develops rules and regulations, conducts regulatory reviews of members' business activities, disciplines violators, and designs, operates, and regulates securities markets and services all for the ultimate benefit and protection of the investor. (For more information about the NASD, visit their web site at <www.nasd.com>.)

Private Offering: An offering of securities that is made to specific individuals or institutions rather than through advertisements or general solicitation

Public Offering: A new issuance of securities to the general public for the purpose of raising capital

Restricted Security: A security that may not be freely resold by an investor for a specified amount of time; during the restricted period, a security may generally only be sold after first being registered with the applicable securities regulators or under a statutory or regulatory exemption.

SCOR: Small Company Offering Registration

Seed Capital: Typically the first investment in a prospective business, these initial funds are used to set up a company including developing a business plan, exploring markets, and developing products

ULOE: Uniform Limited Offering Exemption