The Future of California's Blue Sky Law

Therese H. Maynard
COMMENTARY:

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I. INTRODUCTION

During the 1995-1996 Session of the California State Legislature, Keith Paul Bishop, the Commissioner of the Department of Corporations (DOC), introduced a proposal to reform California's Corporate Securities Law of 1968. Although this legislation did not become law, it did generate considerable interest in a subject that had received scant attention in California despite numerous blue sky reform efforts undertaken by other states in recent years. As a result of this newly awakened interest in reforming California's blue sky statute, committees in both houses of the

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1. The DOC is headed by the Commissioner of Corporations (Commissioner), who is charged with the administration of the California Corporate Securities Law of 1968, as well as various other state laws. For a detailed description of the DOC and the general scope of this state agency's responsibilities in administering California's blue sky law, see 1 HAROLD MARSH JR. & ROBERT H. VOLK, PRACTICE UNDER THE CALIFORNIA SECURITIES LAWS § 2.01, at 2-3 to 2-24 (rev. ed. 1996).


3. See, e.g., infra notes 58-62 and accompanying text (describing recent blue sky reform measures adopted in other states).

4. The term "blue sky laws" refers to the securities laws of the 50 states. These state laws have generally become known as blue sky laws as a result of an early Supreme Court opinion describing the primary purpose of these statutes as preventing "speculative schemes which have no more basis than so many feet of "blue sky."" Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917) (citation omitted in original); see
state legislature conducted a joint interim hearing on November 7-8, 1996 (Joint Hearing). The purpose of this Joint Hearing was to provide the committee members with an opportunity to explore the current framework of statutory and administrative requirements which the California law imposes on the capital formation process in this state. During the course of this two-day Joint Hearing, the committee members heard testimony from a diverse group of individuals—all participants in California's capital formation process—including representatives of the following constituencies: entrepreneurs and other promoters of start-up business interests, large corporate issuers, small-business interests, state regulators, banks and other sources of investment capital, investors, academics, and other interested observers of the process of capital formation in California. The diversity of the speakers who testified clearly reflected the essential purpose of this Joint Hearing: to offer California legislators important background information with which to make fully informed decisions as they assess the need for legislative reform of California's securities laws.

This Commentary offers my reflections on the need for revision of California's Corporate Securities Law of 1968. The time is certainly ripe for this kind of thorough review, especially since California's blue sky law has not been subject to such comprehensive scrutiny since the statute was originally adopted. More im-

also LOUIS LOSS & EDWARD M. COWETT, BLUE SKY LAW 7 (1958) (providing a survey of the blue sky laws of the fifty states as well as the text of the Uniform Securities Laws, official comments on the laws, and the draftsmen's commentary).

5. This interim hearing, held in Los Angeles, was conducted jointly by the Senate Finance, Investment and International Trade Committee, and the Assembly Banking and Finance Committee. See Capital Formation and Securities Fraud Enforcement Act of 1996: Joint Hearing on AB 2465 Before the Senate Comm. on Fin., Inv. and Int'l Trade, and the Assembly Comm. on Banking and Fin., 1995-1996 Reg. Sess. (Cal. 1996) [hereinafter Joint Hearing on AB 2465].

6. I participated as a member of the opening panel on the first day of this Joint Hearing. Other members of the opening panel were: Stuart Buchalter, Buchalter, Nemer, Fields & Younger; Jere Glover, Federal Small Business Administration; and Harold Marsh, Professor Emeritus of securities law at the University of California, Los Angeles. This opening panel was asked to provide a general overview of the current regulatory framework, including a brief historical and contemporary perspective on the regulatory process used in this state and general observations regarding the future of blue sky regulation. This Commentary elaborates in greater detail on the views originally set forth in my testimony at the Joint Hearing.

7. California has not comprehensively examined the 1968 statute since its adoption almost thirty years ago, despite this statute being subject to numerous piecemeal amendments during this time period. See infra Part III (discussing some of the important legal changes implemented over the course of the last fifteen years).
importantly, however, dramatic changes have occurred over the last twenty-five years in our nation's capital markets as well as in the nature of the accompanying federal and state regulatory environments. Taken together, these changes call into question the continuing effectiveness of merit review, the regulatory philosophy forming the basis for the 1968 statute.

As I testified at the Joint Hearing, these dramatic changes in the financial markets and regulatory framework render merit review obsolete today. This Commentary elaborates on the reasoning I originally offered as part of my testimony in support of reforming California's blue sky statute. For the reasons set forth below, the state legislature should reform California's blue sky statute to eliminate merit review as the philosophical premise for regulation of the capital formation process in this state.

This Commentary maintains that merit review has outgrown whatever usefulness it may have had originally. Part II of this Commentary provides a brief overview of the competing regulatory approaches in this area: California's merit review standard on the one hand and, on the other hand, the disclosure philosophy that lies at the heart of the federal securities laws. Part III ad-

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8. This Commentary does not propose to offer a detailed description of the specific provisions that should be included in any legislative proposal for reform of California's blue sky statute. Rather, this Commentary analyzes the inadequacies inherent in California's current system of merit regulation to support the ultimate recommendation that California abandon blue sky regulation based on merit review.


The Securities and Exchange Commission (SEC) has been delegated the general authority of administering the various provisions of the federal securities laws. See 15 U.S.C. § 78d (1994) (providing for the creation of the Securities and Exchange Commission and prescribing procedures for its establishment and requirements of its members). See generally RICHARD W. JENNINGS ET AL., SECURITIES REGULATION, CASES AND MATERIALS 98-102 (7th ed. 1992) (discussing the SEC's organizational structure and the scope of its responsibilities in administering the federal securities laws). The SEC is an independent, bipartisan, quasijudicial government agency, which is comprised of five members appointed by the President with congressional approval. See 15 U.S.C. § 78d(a) ("There is hereby established a Securities and Exchange Commission . . . to be composed of five commissioners to be appointed by the President . . . . Not more than three of such commissioners shall be
ances the argument by describing several legal changes implemented over approximately the last fifteen years at both the state and federal levels. This Part demonstrates that these legal changes have substantially reduced the effectiveness of merit regulation. Part IV explains why the Legislature’s failure to eliminate merit regulation does a disservice to both California business interests and California investors. In light of the shortcomings of California’s merit review approach to securities regulation, this Part concludes that California’s scarce administrative resources would be better utilized by concentrating them on efforts to enhance the state’s current enforcement activities. By doing so, the state would be in a position to do that at which it can be most effective: promptly detecting and swiftly punishing promoters of fraudulent securities offerings.

In addition to an enhanced enforcement effort, state officials should devote more administrative resources to the development of programs to educate California investors so that they will be better able to recognize the deceptive practices of unscrupulous promoters before risking their life savings by investing in such fraudulent offerings. Part V describes the three-pronged regulatory approach that should become the central focus of any effort to reform California’s blue sky statute. Finally, Part VI concludes by urging California legislators to undertake a comprehensive review of the existing blue sky requirements and, at a minimum, to reform California’s Corporate Securities Law of 1968 to eliminate merit regulation.

II. STATE MERIT REGULATION VS. THE FEDERAL DISCLOSURE PHILOSOPHY

In general, federal securities laws and state blue sky laws require an issuer to register its securities prior to sale.¹⁰ Both the federal government and the states, however, have exempted certain types of securities transactions from their respective registration requirements. Generally speaking, an exempt offering can proceed much more quickly and at substantially less cost than a registered offering. These time and cost savings can be critical to

members of the same political party, and ... [n]o commissioner shall engage in any other business, vocation, or employment ... “).

the success of the proposed financing, especially for the small issuer.

Considerable differences do exist, however, in the registration and exemption provisions of the various blue sky statutes as compared to the corresponding requirements imposed at the federal level under the terms of the Securities Act of 1933 (1933 Act). These differences are largely the product of fundamental philosophical differences between federal and state law in the area of securities regulation.

At the federal level, the 1933 Act is primarily a disclosure statute, whereas many state blue sky statutes, including California's, rely on merit regulation. Merit regulation—or merit review—is the term used to describe the standard of review employed by many state securities administrators to evaluate the terms of an issuer's proposed offering of securities in that state. The purpose of this merit review is to determine whether the terms and manner of sale under the proposed offering are "fair, just and equitable" to prospective investors in that state. Thus, "[m]erit

12. The SEC insists that the issuer provide prospective investors with full and adequate disclosure of all material facts regarding its proposed offering of securities. See generally 1 LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 25-28 (3d ed. 1995) (citing the failure of underwriters and securities dealers to provide information to prospective investors as one of the primary factors leading to legislative regulatory reform efforts). State blue sky statutes also generally insist on full disclosure of all material facts as the basis for their local regulatory scheme. See generally id. at 92-109 (describing the range of statutory registration requirements imposed by those state blue sky statutes mandating registration of securities). However, many states, such as California, go beyond a standard of full disclosure and also apply a merit standard of review, thereby allowing state administrators the opportunity to examine the fairness of the terms of a proposed offering. See id. at 107-09; see also infra notes 14-17 and accompanying text (describing the exercise of merit review).
13. California has long been regarded as one of the leading examples of a merit jurisdiction. See MARSH & VOLK, supra note 1, § 1.03[5], at 1-17 ("It is fair to state that the overwhelming significance of securities regulation in the State of California has been through the 'fair, just and equitable' standard . . .").
14. Id. § 8.01[1], at 8-5 (Since 1913, "California has followed a substantive system of regulation of the offer and sale of securities through the requirement that such offer or sale may be effected only if found by the Commissioner of Corporations to be 'fair, just and equitable.'"). The current formulation of California's merit review standard is contained in three sections of the Corporate Securities Law of 1968, namely sections 25140, 25141, and 25151. See id. The most extensive treatment of this standard is contained in California Corporations Code § 25140, which provides: The Commissioner may issue a stop order denying effectiveness to, or suspending or revoking the effectiveness of, any qualification of an underwritten offering of securities . . . if he or she finds that the order is in the public
review refers to the discretion of a state securities commissioner to make qualitative decisions regarding the 'merits' of an offering or sale of securities in that state." Merit review statutes therefore vest state securities administrators with considerable discretionary authority, the exercise of which can result in a substantial restructuring of the proposed securities offering, including changes to such fundamental aspects as price, the number of units offered, and the manner of distribution.

The substantial difference in focus between the federal disclosure standard and California's merit review standard was dramatically emphasized in recent federal legislation reforming federal securities laws. This recent federal reform legislation made changes to, among other things, the requirements imposed by the 1933 Act on the capital formation process. This federal legislative reform effort, which, coincidentally, Congress passed on the eve of California's Joint Hearing, had two primary goals
(1) to improve mutual fund regulation by, among other things, preempting some state regulation and thereby substantially consolidating regulatory authority of the mutual fund industry at the federal level,20 and

(2) to reallocate responsibility between state and federal securities regulators by carving out defined roles for federal and state authorities.21

This second legislative objective—to define distinct and separate roles for state and federal regulators—is most relevant to the subject matter of the Joint Hearing. In drafting this major piece of reform legislation, Congress was seeking to promote investment by minimizing the issuer’s cost of raising capital without compromising the historic commitment of federal securities law to investor protection.22 Over the years, Congress became increasingly concerned that this nation’s system of dual state and federal regulation of securities transactions yielded duplicative and overlapping regulatory requirements.23

A similar set of concerns served as the genesis for the California Senate and Assembly committees to conduct an investigative hearing last November. The essential purpose of this Joint Hearing was to investigate and evaluate the continuing effectiveness of the current regulatory requirements that California blue sky law imposes on the capital formation process in this state.24

21. See id. (the legislation “designat[es] the Federal government as the exclusive regulator of national offerings of securities”). This reallocation was meant to address the problem of duplicative federal and state securities regulation, which resulted in higher costs to securities issuers without any commensurate protection to investors or markets. See id.
The starting point in any comprehensive evaluation of California’s blue sky statute, however, must be an assessment of whether the prevailing merit review approach remains the most effective regulatory philosophy, particularly in light of significant developments both in the regulatory environment and the world’s financial markets over the past three decades. These changes are examined in the next Part.

III. RECENT DEVELOPMENTS THAT UNDERMINE MERIT REGULATION

This Part addresses an important and fundamental issue that must be resolved as a threshold matter when considering any proposal to reform California’s blue sky law: is there any continued, meaningful role for merit review, the philosophical cornerstone of California’s existing blue sky statute? Specifically, we must ask if the costs imposed on an issuer’s capital formation process in complying with California’s current regulatory requirements yield sufficient benefits in the form of protecting our state’s investors against fraudulent securities offerings or if there is a more cost-effective way to provide adequate protection to investors in this state.

The Staff Briefing Paper prepared for the Joint Hearing described the dramatic changes that have taken place in capital markets over approximately the last fifteen years. According to this briefing paper, technological advances have had a substantial impact on both domestic and global capital markets. Technology has unleashed competitive forces that have compelled federal and
state regulators alike to respond through rule-making initiatives aimed at the regulatory burdens imposed on the capital-formation process. These regulatory initiatives have helped to maintain the vitality and preeminence of our nation’s capital markets in the global marketplace.

In addition to the impact of these technological developments, several legal changes at both the state and federal levels over the last fifteen years have substantially reduced the impact of merit regulation in California. This Part will describe briefly two of the more important of these legal developments first and will then conclude by discussing the impact of these developments on business interests in this state as well as on California investors. This Part concludes that all currently available evidence establishes that California’s merit review standard has been of declining significance for at least the last fifteen years and further is of no relevance in regulating modern financial markets.

A. State-Level Development of the Marketplace Exemption

The first legal change to be addressed is the development of the marketplace exemption in California.28 The impact of this important exemption on decreasing the importance of merit regulation cannot be overstated. Moreover, it bears emphasizing that this exemption was originally created by the states as the product of their ongoing concern for modernizing blue sky laws.29

As originally formulated, the marketplace exemption provided for a complete exemption from the requirements of state level registration for any offering of an issuer’s securities where such securities were listed for trading on either of the country’s two preeminent national exchanges, the New York Stock Exchange (NYSE) or the American Stock Exchange (AMEX).30 The exemption was later made available to securities listed or designated

28. See CAL. CORP. CODE § 25100(o) (West 1977 & Supp. 1997). For a general background and description of the origins and further evolution of this important California exemption, see MARSH & VOLK, supra note 1, § 4.03, at 4-30.6(10) to -30.8. A similar form of exemption has been implemented in other states as well. See generally Manning Gilbert Warren III, The Status of the Marketplace Exemption from State Securities Registration, 41 BUS. LAW. 1511 (1986) (surveying the recent developments affecting the marketplace exemption from state registration).


nated for listing on a national securities exchange. More recently, the marketplace exemption was expanded to exclude from the merit review process any issuer's offering of securities designated or approved for designation as a National Market System security on the National Association of Securities Dealers Automatic Quotation System/National Market System (NASDAQ/NMS). The overall effect of this marketplace exemption has been to reduce substantially the number of offerings by larger issuers that are made subject to merit review in California.

More importantly, the Commissioner's decision to expand the marketplace exemption to include NASDAQ/NMS-traded securities evidences the DOC's increasing confidence in the quality of the trading markets in general and in the regulatory improvements made in the standards administered by the self-regulatory organizations (SROs), including the enhanced listing requirements imposed by the National Association of Securities Dealers (NASD) for trading on the NASDAQ/NMS. The state's initiative in developing and expanding this marketplace exemption also reflects the increasing level of confidence that the states, including Cali-

31. See MARSH & VOLK, supra note 1, § 4.03, at 4-30.6(12) to -30.7 (describing scope of California's marketplace exemption, § 25100(o), to include issuance of additional shares of a class of stock that was already listed for trading on a national securities exchange certified by the DOC).


33. See generally MARSH & VOLK, supra note 1, § 4.03, at 4-30.6(11) to (12) (noting that, pursuant to § 25100(o), the Commissioner has presently certified for listing NASDAQ/NMS as well as the NYSE, AMEX, Tier I of the Philadelphia Stock Exchange, and Tier I of the Pacific Stock Exchange). With respect to SROs, the regulatory structure that Congress imposed on the domestic financial markets in the Securities Exchange Act of 1934 (1934 Act) contemplated a cooperative regulatory system that embraced SEC oversight of SROs, which included the major securities exchanges registered under section 6 of the 1934 Act such as the NYSE and the AMEX, as well as the NASD, which is registered under section 15A of the 1934 Act and which serves as the principal regulator of the over-the-counter market. For further discussion of the nature of this cooperative regulatory system and the allocation of responsibilities between the SEC and the SROs, see generally Richard W. Jennings, Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission, 29 LAW & CONTEMP. PROBS. 663 (1964); David A. Lipton, Governance of Our Securities Markets and the Failure to Allocate Regulatory Responsibility, 34 CATH. U. L. REV. 397 (1985); Therese H. Maynard, What Is an "Exchange?"—Proprietary Electronic Securities Trading Systems and the Statutory Definition of an Exchange, 49 WASH. & LEE L. REV. 833 (1992); Sam Scott Miller, Self-Regulation of the Securities Markets: A Critical Examination, 42 WASH. & LEE L. REV. 853 (1985); Marianne K. Smythe, Government Supervised Self-Regulation in the Securities Industry and the Antitrust Laws: Suggestions for Accommodation, 62 N.C. L. REV. 475 (1984).
fornia, now place in the SEC’s review of the quality and adequacy of the disclosures contained in the issuer’s registration statement.

Thus, well before Congress’s recent codification of the marketplace exemption, California, along with many other states, had moved to adopt and then later expand the scope of the marketplace exemption. More importantly though, the evolution of this exemption, particularly in California, clearly demonstrates the increased willingness on the part of California’s regulators to rely on SEC enforcement of the requirements of the federal securities laws. Such reliance reflects the belief that federal securities laws offer an adequate measure of protection to investors in this state, in lieu of the DOC conducting a merit review of the issuer’s proposed offering. The DOC’s increased confidence in the SEC’s administration of the disclosure standard imposed on the issuer under federal securities law is particularly noteworthy since this disclosure philosophy is markedly different from California’s merit review philosophy.35

In sum, the development of the marketplace exemption, and particularly the expansion of this exemption to include NASDAQ/NMS securities, reflects the increased confidence that California now places in both the SROs’ oversight of the markets and the offering process as well as in the adequacy of the federal disclosure standard as enforced by the SEC.

B. Federal and State Expansion of the Private Placement Exemption

The declining significance of merit review is likewise reflected in refinements California has made to the private offering exemption. The first step in the modern development of the private offering exemption was taken in 1982 by the SEC when it adopted Regulation D as a major reform initiative directed at the private placement market. Regulation D was intended to reduce the capital formation costs of both large and small issuers, while balancing the other competing objectives of the federal securities laws—

34. See supra note 29 and accompanying text (describing Congress’s adoption of the national marketplace exemption).
35. See supra note 12 and accompanying text (describing how at the federal level, the Federal Securities Act of 1933 protects investors by mandating full and adequate disclosure of all material facts in order to promote informed investment decisions).
While Regulation D continued to evolve at the federal level, the states, including California, responded by promulgating state-level exemptions for limited offerings that were intended to coordinate with the federal level exemptions contained in Regulation D. In an effort to simplify and streamline the requirements for exempting limited offerings at the state level, the North American Securities Administrators Association (NASAA) promulgated the Uniform Limited Offering Exemption (ULOE) in 1983. NASAA developed the ULOE as a standardized form of state-level exemption intended to coordinate substantially with Regulation D. Since NASAA's adoption of the ULOE is not binding on

37. See id.
38. In California the limited offering exemption is found in California Corporations Code section 25102(f). CAL. CORP. CODE § 25102(f) (West 1977 & Supp. 1997). For a general description of the development of the limited offering exemption available under California blue sky law, see MARSH & VOLK, supra note 1, § 4.02A, at 4-23 to -24.

Since Regulation D was adopted in March 1982, other states have been pressured to modify existing exemptions—or adopt new exemptions—in order to better align the state scheme of limited offering exemptions with the new streamlined federal exemptions under Regulation D. For example, California did not have an exemption for limited offering transactions until November 1981, when section 25102(f) became effective. As originally promulgated, the terms of section 25102(f) were very different from Regulation D or the ULOE. See generally MARSH & VOLK, supra note 1, § 4.02A[1][a], at 4-23 to -24 (discussing the history of California's limited offering exemption). However, since 1982 California has gradually modified the terms of the section 25102(f) exemption in order to bring the state exemption more into conformance with the requirements of Regulation D, although significant differences between these exemptions remain. See FRIEDMAN, 1 CAL. PRACTICE GUIDE—CORPS. § 5:256 (Rutter Group 1996).

39. NASAA is the oldest and largest association of state regulators. See Goodkind, supra note 15, at 85. It is comprised of securities regulators from 65 jurisdictions located in the United States, Puerto Rico, Canada, and Mexico. NASAA Rep. (CCH) § 1, at 11 (Mar. 1993). NASAA has been responsible for promulgating a number of statements of policy. See id. ¶ 351 (defining a statement of policy as “a statement of general and prospective applicability to implement, interpret or prescribe model laws, regulations, forms or policies pertaining to investor protection and securities regulation.”). However, the terms of any such NASAA statement of policy assume the force of law only if adopted at the individual state level. See generally id. (discussing the procedures for the adoption of NASAA statements of policy); Mark A. Sargent, The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform, 68 WASH. U. L.Q. 225, 248 (1990) [hereinafter Sargent, The New Regulation D].

its individual state members, each state administrator must decide whether to adopt the ULOE as promulgated by NASAA or to modify the terms of the ULOE prior to the adoption of this state-level coordinating exemption.\textsuperscript{42}

Not surprisingly, many states modified the terms of the ULOE before adopting some form of Regulation D coordinating exemption,\textsuperscript{43} thereby increasing the issuer's transaction costs in raising investment capital.\textsuperscript{44} Ironically, the promulgation of the ULOE—an exemption largely intended to relieve the issuers' burden, particularly the burden on small issuers—has not realized its desired goal of uniformity because of the numerous piecemeal changes made by the states.\textsuperscript{45} Generally speaking, states deviated from the specific terms of the ULOE in order to customize the terms of their form of limited offering exemption primarily as a result of the fundamental differences in regulatory philosophy between these

\textsuperscript{42} See Sargent, The New Regulation D, supra note 39, at 248.

\textsuperscript{43} See id. at 249. There is very little interpretive authority available with respect to the states' decisions either to adopt the ULOE or to vary its terms prior to adoption. This is not surprising, however, since it is generally acknowledged that there is very little authority in the form of administrative releases or opinions interpreting the provisions of state blue sky laws, and there is a paucity of judicial decisions interpreting state blue sky laws. See Mofsky, supra note 16, at 274 n.3; Mark A. Sargent, State Disclosure Regulation and the Allocation of Regulatory Responsibilities, 46 MD. L. REV. 1027, 1028 (1987) [hereinafter Sargent, State Disclosure Regulation] ("[Another] source of confusion is the relative inaccessibility of information about how state disclosure regulation works."). Additionally, the proper interpretation of and differences among the states' blue sky laws are "difficult to survey and catalog, not only because of the nuances of wording employed in various statutory and administrative code provisions, but also because many states employ informal registration standards which are essentially unwritten and/or inconsistently applied." Goodkind, supra note 15, at 85.

\textsuperscript{44} See Mark A. Sargent, A Future for Blue Sky Law, 62 U. CIN. L. REV. 471, 497 (1993) [hereinafter Sargent, A Future] ("The additional legal fees derived from managing compliance with blue sky law do not outweigh a widespread frustration with a system seen as costly, duplicative, superfluous, and highly annoying to manage.").

\textsuperscript{45} The modifications made by the states are realized generally at the expense of small issuers. In determining compliance with relevant state provisions for a limited offering exemption, the issuer's analysis of the states' varying requirements for this exemption is generally approached by examining these requirements on a state-by-state basis, which can often add considerably to the issuer's cost of capital formation, thereby disproportionately burdening the small issuer's effort to raise capital. See generally J. WILLIAM HICKS, LIMITED OFFERING EXEMPTIONS: REGULATION D §§ 9.01-.06 (1996-97 ed.) (surveying state blue sky laws and their coordination with the federal exemption scheme); A. Michael Hainsfurther, Summary of Blue Sky Exemptions Corresponding to Regulation D, 38 SW. L.J. 989 (1984) (discussing the various exemptions of the fifty states); Maynard, supra note 41, at 398-442 (discussing various state filing requirements).
Despite these numerous complications in developing a standardized form of limited offering exemption coordinated at both the state and federal levels, the private placement market nonetheless has grown into a viable and attractive alternative to registration. Private placements allow issuers to avoid the cost and delay inherent in the registration process. Thus, to the extent that capital can be raised outside of the scrutiny of merit review, all issuers benefit, including small-business interests who make relatively small offerings as well as the rather more substantial offerings made by larger issuers.

Indeed, the limited offering exemption was developed in California and in other states as a way of responding to pressure from small-business interests. Small issuers in particular complained bitterly that the cost of complying with California's merit review standard in order to register their securities offerings for sale in this state substantially raised their capital formation costs. These issuers, therefore, maintained that the merit review process as applied in California disproportionately impacted the small-business issuer's efforts to raise capital. Consequently, small businesses complained about the unfairness of subjecting offerings by small issuers to merit regulation while implementing a market-

46. Although little interpretive authority exists, it is generally acknowledged that states have modified the ULOE prior to adopting it in order to make the terms of the exemption comply with their own regulatory philosophy—the protection of investors in accordance with the merit standard of review. See Securities Act Release No. 6389, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. 84,910 (CCH) ¶ 83,106 (Mar. 8, 1982) ("Because of differences between federal and state securities regulation, complete uniformity may not be an attainable objective."); Michael J. Halloran & Robert Linderman, Coordinating State Securities Laws with Regulation D and Federal Integration Policy: State Limited Offering Exemptions and Integration Standards, in STATE REGULATION OF CAPITAL FORMATION AND SECURITIES TRANSACTIONS 155, 164-65 (D. Goldwasser & H. Makens eds., 1983).

47. As noted by one commentator:
   The "blue skying" of a Regulation D offering can be an extensive and time-consuming enterprise, but most states have adopted coordinating rules that allow limited and private offerings exempted under Regulation D to be exempted at the state level and hence to escape state registration and the application of merit standards.

Sargent, A Future, supra note 44, at 477.

48. See id. ("Much as the marketplace exemption has removed many of the larger offerings from [the scrutiny of state administrators applying merit review standards, the] ULOE has carved out offerings at the opposite end of the scale.").

49. See id. at 475 ("The net result is that larger public offerings, including initial public offerings as well as virtually all offerings by issuers already public, receive essentially no scrutiny from the blue sky regulators.")
place exemption that had the effect of removing most offerings by larger, more well-established issuers from the scope of merit regulation. Moreover, legitimate business concerns, small and large alike, pointed to California’s time-consuming and expensive regulatory requirements as further evidence that California’s burdensome regulations were driving business interests out of state.

As a direct result of the further refinement and expansion over the last fifteen years of California’s exemptions for private placements, many, if not most, offerings by small issuers have now been removed from the scope of California’s merit review process since they are no longer required to be registered at the state level. Similarly, from the perspective of larger, established business interests, the combined effect of California’s adoption and subsequent efforts to refine both the marketplace exemption and the private placement exemption has been to remove most larger offerings

C. The Impact of These Legal Changes on California’s Issuers and Investors

In developing these exemptions, California’s policymakers never lost sight of an important and long-standing objective of this state’s blue sky statute, the protection of California investors. Instead, specific requirements were included as part of the terms of both of these exemptions, requirements that were intended to protect investors in this state. For example, the marketplace exemption extends only to securities listed with NYSE, AMEX, and NASDAQ/NMS and does not extend to securities listed for trading on the other national or regional exchanges. This limitation was imposed because California’s regulators did not have the same level of confidence in the SROs’ oversight of these other exchanges nor in the quality of the issuer-listing criteria imposed by

50. See id. at 483.
51. See STAFF BRIEFING PAPER, supra note 24, at 25 (noting that state regulatory requirements which deviate from federal disclosure standards “may be seen as onerous to a foreign issuer and become an incentive to sell outside of California”).
52. “To some degree, the SEC may have deferred regulation of limited and private offerings to the caprices of state securities administrators, but through its support for coordinating state exemptions it did not abandon such offerings to the rigors of merit regulation—the most stringent aspect of state regulation.” Sargent, A Future, supra note 44, at 477.
53. Such larger offerings include initial public offerings as well as public offerings and private placements undertaken by established companies.
54. See Sargent, A Future, supra note 44, at 474-75.
On the other hand, in developing California Corporations Code § 25102(f)—California's form of limited offering exemption intended to coordinate with Regulation D at the federal level—the state took a slightly different approach in addressing its investor-protection concerns.\footnote{See supra note 38 (giving a general description of the development of California Corporations Code § 25102(f)'s limited offering exemption).} Probably the most significant investor-protection requirement that California blue sky law imposes on the private placement exemption is the suitability standard contained in § 25102(f)(2).

While California's formulation of the suitability requirement is fairly typical of the form used in other states' exemptions, it does not coordinate completely with the more relaxed federal standard set out in Rule 506 of Regulation D.\footnote{See supra Part III.A (discussing the development of California's marketplace exemption).} Although they differ in their specific requirements, the states generally tend to be more protective of their investors by imposing a stricter suitability standard than that required under Rule 506.\footnote{See Commodities and Securities Exchanges, 17 C.F.R. § 230.506 (1996). Over the years since California Corporations Code § 25102(f) was first adopted, California's Corporations Commissioners have gradually moved this state's formulation of the suitability standard into greater conformance with the standard imposed under Regulation D at the federal level. As a result of these piecemeal administrative reforms implemented through the exercise of rule-making authority delegated to the Commissioner, California's suitability standard has today been brought into substantial conformance with the federal standard as formulated under Rule 506 of Regulation D. See CAL. CODE REGS. tit. 10, § 260.102.13 (1996).} For example, the standard imposed by many states allows a presumption of suitability where the investor satisfies a net worth determination set out in an administrative regulation.\footnote{These variations and others in the terms of state limited offering provisions have been the subject of widespread criticism. See Maynard, supra note 41, at 362-63; Mark A. Sargent & Hugh H. Makens, ULOE: New Hope, New Challenge, 45 BUS. LAW. 1319, 1319-21 (1990).} Many states further qualify the investor's determination of net worth, however, by excluding from this calculation the value of the investor's primary residence, which is often the single most valuable asset held by a prospective investor.\footnote{See Maynard, supra note 41, at 453-54.} The primary justification for this standard seems to be rooted in the paternalistic nature of merit regulation: investors should not put at risk the most important asset in their personal estate. Many inves-
tors—especially small investors—complain, however, that this standard leaves them unable to participate in many very lucrative investment opportunities because of their failure to satisfy the net worth criteria or to otherwise demonstrate their suitability in satisfaction of the relevant state standard. Small investors, therefore, complain on fairness grounds about the terms of the suitability requirement as implemented by the DOC Commissioner because it limits many lucrative investments to wealthy individuals.

Notwithstanding the fact that the development of these exemptions from the obligation to register the issuer's proposed securities offering does result in shrinking the opportunity for the DOC to conduct a merit review of such offerings, these legal changes do not provide any cause for alarm. Rather, the legal changes previously described were implemented by the states to accommodate both the market and legal forces that have shaped the rapid pace of change and growth in our domestic capital markets over the last fifteen years. As such, these regulatory efforts to modernize the requirements of state blue sky laws simply evidence the rather obvious conclusion that merit regulation has been rendered irrelevant in light of the structure and operation of modern capital markets.

IV. THE CASE FOR ELIMINATING MERIT REGULATION

These legal changes, including the specific regulatory responses described in the last section, evolved piecemeal over time. Each regulatory response, however, demonstrates the Commissioner's ongoing commitment to reach an appropriate balance between the needs of legitimate businesses, both large and small, to raise capital in a cost-effective fashion while simultaneously protecting California investors from fraudulent securities offerings. Nonetheless, piecemeal regulatory reform efforts over the last fifteen years by DOC commissioners, both past and current, do implicitly recognize that merit review is of declining importance.

This does not mean that California has abandoned our state's

61. See id. at 452-53.

62. Such criticisms may have been blunted somewhat by the exemptive authority conferred on the SEC by Congress in the National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 1996 U.S.C.C.A.N. (110 Stat.) 3416. Any generalizations, however, as to the impact of this federal legislation on the terms of state-level limited offering exemptions remain uncertain, at least until such time as the SEC decides to exercise the rule-making authority delegated to it under section 102 of the National Securities Market Improvement Act of 1996.
investors. Rather, the Commissioner’s regulatory responses simply reflect that merit review has outlived its usefulness as the guiding principle for regulating securities transactions in this state. And, the time has now come for the California legislature to make express that which is implicitly reflected in California’s modern regulatory framework: merit review is no longer the guiding regulatory premise of this state’s blue sky law.

Therefore, this state’s securities law should be amended to reflect that California—like many other states—has responded to changes in the capital markets by adopting new and different approaches to regulating offers and sales of securities within this state. This type of reform effort, however, should not be interpreted as legislative abandonment of this state’s long-standing commitment to reach an appropriate regulatory balance between the capital formation needs of legitimate business interests and the investor-protection goals that have historically been the cornerstone of our state’s securities laws.

Instead, it is my view that our state government owes this degree of candor to the business interests of this state as well as to California investors. Indeed, I believe the state’s failure to candidly acknowledge that merit review has become irrelevant to the state’s ongoing efforts to regulate the modern capital markets actually does a disservice to both California issuers and investors. While other states have abandoned merit regulation, many of the participants in our nation’s capital markets continue to regard California as a merit review jurisdiction. To the extent California continues to be labeled a merit review state, however, we send the wrong signal to the business community because we are indicating to prospective issuers that California is more hostile to business interests than in fact the state’s current regulatory environment really is.

Furthermore, we are sending the wrong signal to investors in this state as well. By continuing to hold our state out as a merit review jurisdiction, we are suggesting to investors in this state that

63. For example, both Illinois and Louisiana have reformed their state’s blue sky laws and in the process have eliminated any further efforts to regulate based on merit review. See Sargent, A Future, supra note 44, at 480; Sidney Sosin & Roger G. Fein, The Landmark 1983 Amendments to the Illinois Securities Law, 72 ILL. B.J. 196 (1983) (discussing changes to Illinois blue sky laws); American Bar Ass’n Ad Hoc Subcomm. on Merit Regulation, State Regulation of Securities Comm., Report on State Merit Regulation of Securities Offerings, 41 BUS. LAW. 785, 786 (1986) (discussing changes to Louisiana blue sky laws).
there is a greater level of paternalism and protection than \textit{in fact} exists under the state's current regulatory framework. Indeed, many investors may be encouraged to rely on the Commissioner for a greater measure of protection than the state can actually provide—even if the Commissioner were to administer a fairly stringent system of merit review.\textsuperscript{64}

In the final analysis, I worry that conveying this misleading impression to California investors may cultivate a false sense of security on their part whereby they expect the Commissioner to be able to prevent fraudulent securities offerings from occurring before any California investors lose their hard-earned life savings to some unscrupulous promoter. Moreover, this kind of false sense of security may actively discourage investors in this state from diligently protecting their own best financial interests, which is exactly contrary to what should be expected of investors in this state, especially in light of the rapid pace of change occurring in the world's financial markets.

Moreover, this pace of change only promises to accelerate, further increasing the complexity of the financial markets and the products they offer for sale to prospective investors. For example, even as this Commentary is being written, the forces of the Internet are about to be unleashed on the world's capital markets. The impact of this technology on the continuing relevance of the established state and federal framework for securities regulation was reflected recently in the experiences of Spring Street Brewing Co. In early 1996, Spring Street Brewing Co., a microbrewery business, sought to use the technology of the Internet to make a direct, online offering of its securities to prospective investors without the assistance of a broker-dealer or other financial intermediary.\textsuperscript{65} This issuer's efforts to harness the forces of modern technology in order to raise investment capital forced the SEC to confront the continuing relevance of the 1933 Act's regulatory approach as applied to public offerings made through the media of modern

\textsuperscript{64}. \textit{See Staff Briefing Paper, supra} note 24, at 28. Critics of the merit review system contend that "the likely success of an issuer (and the investment) depends on matters that California's merit standards do not address: Is the product any good? Is there a market demand for the issuer's products? What are the competitive forces? How good is management?" \textit{Id.}

telecommunications and related computer technology.^{66}

This rapid pace of change is an inevitable development that no one—neither the state of California nor the SEC—can stop. Before long, indeed if not already, the State of California, like the SEC, will have to confront the regulatory issues posed by the Internet and the other modern forces of technological change. In the face of such powerful agents of change, the only sensible regulatory approach for our state to adopt as we move into the twenty-first century is to encourage investor diligence and not to continue fostering the notion that the state can prevent fraudulent offerings from occurring through the exercise of merit regulation.

For these reasons, I urge the California Legislature to reform California’s blue sky statute to eliminate merit review as the philosophical foundation for this state’s regulation of the capital formation process. This recommendation, however, does not imply any suggestion that state securities regulation has been rendered completely irrelevant or obsolete. The next Part briefly outlines the important role blue sky regulation should assume as we move toward the twenty-first century.

V. THE FUTURE OF CALIFORNIA BLUE SKY LAW: ENHANCED ENFORCEMENT AND EDUCATION EFFORTS

In considering the general question of the future of state blue sky regulation, California, as well as other states, must recognize that it cannot prevent securities fraud altogether. Rather, all that our state regulators can do is make every effort to minimize the incidence of securities fraud and vigorously enforce penalties for such fraud when it does occur. Furthermore, California’s investors

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^{66} See id.; SEC Halts Bid to Trade Brewer’s Stock on Internet, WALL ST. J., Mar. 21, 1996, at B6; Jeffrey Taylor, SEC Says Brewery May Use Internet to Offer Its Stock, WALL ST. J., Mar. 26, 1996, at C1. For another recent example of the complications created by introducing the forces of the Internet into the capital formation process, consider the difficulties experienced in the case of Wired, Inc.’s proposed public offering in late 1996. The technology of e-mail distribution was inadvertently used to effect wide dissemination of an e-mail message written by the company’s founder that was intended originally for distribution only to the company’s employees. See Deborah Lohse & Joan I. Rigdon, Wired Kills IPO amid Mishap with E-Mail, WALL ST. J., Oct. 25, 1996, at C1. These developments confounded both the SEC and the issuer and ultimately resulted in Wired, Inc. withdrawing its proposed offering. See id. The inadvertent distribution of this e-mail message has convinced many observers that the SEC will have to reassess the continued vitality of its “gun jumping” rules in the very near future. Cf. id. (discussing how the company may have unknowingly run afoul of federal securities law).
need to be made aware that it is not realistic for them to expect the state to completely eliminate all incidents of securities fraud.\textsuperscript{67} Only when we have acknowledged this inherent limitation on the general objectives that any form of state blue sky statute can reasonably be expected to accomplish can we realistically assess the efforts that the state can undertake to achieve the goal of minimizing the incidence of securities fraud in this state.

This Part will describe in very general terms the scope of regulatory efforts that modern blue sky statutes should adopt in order to protect investors against the incidence of fraudulent securities offerings.\textsuperscript{68} This Part will briefly describe the following three regulatory measures that our state regulators should be authorized by statute to implement and pursue:

1. \textit{Registration} of certain issuers' offers and sales of their securities;
2. \textit{Enforcement} activity concentrating the state's efforts on tracking down and punishing promoters of fraudulent offerings; and
3. \textit{Education} of investors so they will be better equipped to protect themselves from unscrupulous promoters of fraudulent securities offerings.

The remainder of this Part briefly outlines each of these measures.

\textbf{A. Registration}

First, as to state registration of an issuer's offerings, the analysis set forth earlier in Part IV regarding the general irrele-

\textsuperscript{67} As a direct result of these inherent limitations, it is necessary to educate our citizens so they understand the need for diligence in managing their financial affairs and the need to be always alert to the possibility of an unscrupulous promoter hawking a fraudulent securities offering. \textit{See infra} Part V.C (further describing the role of the states in educating our citizens so they are better able to protect themselves in the first instance).

\textsuperscript{68} This Part describes the future role of state blue sky regulation in quite general terms. In view of the fact that there is no specific proposal currently pending before the California Legislature, it seems inappropriate at this time to comment on any specific details to be included in any such reform legislation. Since these hearings are more general in their purpose, I have tried to keep the observations and suggestions included in this Commentary more general as well. At such future time as the California Legislature takes up a specific proposal, whether or not it takes the form of the bill that was introduced last session, A.B. 2465, 1995-1996 Reg. Sess. (Cal. 1996), I would welcome the opportunity to offer more specific comments and suggestions regarding the details of any such reform legislation.
vance of merit review applies with equal force to any proposal to expand the registration requirements for issuers' offerings at the state level. Indeed, expanding the scope of this state's registration requirements based on merit review will do more harm than good because it will disproportionately impact legitimate business activity occurring within California by unnecessarily raising the issuer's cost of capital formation. Any proposals for expanding the scope of California's registration requirements will likely result in costly duplication of the registration obligations under federal law and will also result in substantial overlap with other states' registration requirements. Ultimately, legitimate business interests will most likely migrate out of this merit review state to a more "user-friendly" regulatory environment to raise necessary capital.

Avoiding duplicative regulatory efforts becomes all the more important in light of the fact that legitimate business interests—in other words, those issuers who make every effort to comply with state blue sky registration or exemption requirements in order to make a valid offering in California—are not the primary source of fraudulent securities offerings. As Professor Harold Marsh, one of the leading authorities on blue sky regulation, observed during his testimony at the Joint Hearing, promoters of fraudulent stock offerings usually do not make any effort to comply with the registration or exemption requirements at either the state or federal level.

69. See supra Part IV (presenting the case for eliminating merit regulation). Likewise, I do not see much promise in any proposal to expand the opportunity for the Commissioner to apply a merit review standard, nor do I see any usefulness in returning to a more strict application of the merit review standard as an effective way of preventing fraudulent securities offerings in the future. Registration at the state level, however, may be warranted in the case of those public offerings left primarily to state regulation by the SEC. The SEC has broad rule-making authority to do so pursuant to the terms of the recent reform legislation, the National Securities Market Improvement Act of 1996.

70. See, e.g., Joint Hearing on AB 2465, supra note 5 (testimony of Stuart D. Buchalter, Buchalter, Nemer, Fields & Younger) (transcript on file with the Loyola of Los Angeles Law Review); id. (testimony of Jere W. Glover, Chief Counsel for Advocacy, U.S. Small Business Administration) (transcript on file with the Loyola of Los Angeles Law Review).

71. Again, for many of the same reasons described by Buchalter in his testimony—which I will not repeat at length here—expanding the opportunity for, as well as the scope of, merit review certainly will not result in enhanced protection for prospective investors in this state, or at least not enough to justify such an expansion on a cost-benefit basis—in other words, the issuer's cost of compliance will not be outweighed by a commensurate enhancement of protection for California investors. See id. (testimony of Stuart D. Buchalter, Buchalter, Nemer, Fields & Younger) (transcript on file with the Loyola of Los Angeles Law Review).
Consequently, any effort to expand California's registration or exemption requirements almost certainly will not eliminate the great preponderance of securities fraud schemes that target the unsophisticated, and often elderly, investors of this state. Thus, proposals that call for reform by expanding the scope of California's current merit regulation statute certainly do not represent the most efficient use of the limited resources available to curb securities fraud in this state. Moreover, such an approach may very well result in even more devastating consequences for capital formation in this state by further alienating legitimate business interests.

B. Enforcement

The second category where California could invest its scarce budgetary resources is enhancement of state enforcement efforts. Indeed, other commentators have suggested that enhanced enforcement activity at the state level should assume an increasingly important role in future blue sky regulatory efforts. At the out-


As noted by two influential commentators, "the problems at which modern securities regulation are directed are as old as the cupidity of sellers and the gullibility of buyers." 1 Loss & SELIGMAN, supra note 12, at 1 (describing the infamous South Sea Bubble scandal of the 18th Century in England and France wherein John Law and the South Sea Company fraudulently convinced the British Government to grant a monopoly on trading with South America and the Pacific Islands in order to pay off the French and British public debts; it was subsequently discovered that the venture was nothing more than a scam).

73. Indeed, imposing a registration obligation on an issuer at the state level—even if it included the opportunity for the Commissioner to apply merit review standards to the terms of the proposed offering—does not guarantee the state will be able to eliminate all possibility of a fraudulent securities offering.

74. See, e.g., Sargent, A Future, supra note 44, at 473-99 (discussing the challenges facing blue sky laws and their need to adapt radically to major structural changes in public markets and investing). Enhanced enforcement efforts is not a novel proposal at the state level. Indeed, all states currently have some form of broker-dealer registration system in place and the vast majority of states require registration of investment advisers as well. See 1 Loss & SELIGMAN, supra note 12, at 60-62, 79-92. Moreover, proposals to dedicate more of this state's administrative resources to policing the in-state activities of broker-dealers and investment advisers is entirely consistent with my recommendation to amend California's blue sky law to eliminate merit regulation of proposed offerings of securities to California investors.
set, however, it bears emphasizing that there is currently no evidence available suggesting that existing securities fraud prohibitions of California’s blue sky law are somehow inadequate or insufficient to allow the state’s aggressive pursuit of promoters of fraudulent securities offerings. Therefore, this recommendation does not include any legislative proposals to amend California’s existing antifraud provisions.

The state should invest its scarce regulatory resources to create an enhanced enforcement presence that would deter wrongdoing—something akin to a strong local “cop on the beat” presence. This enhanced presence would most likely take the form of aggressive investigation and enforcement of the various provisions of California’s blue sky statute and administrative rules in order to quickly shut down fraudulent schemes before too many investors fall victim to these unscrupulous promoters. This kind of increased presence should result in greater deterrence of financial fraud. In addition, these state-level enforcement activities should include efforts to make California investors more aware of the appropriate state and local offices to contact if they suspect ongoing investment activity that might possibly involve financial fraud. Likewise, California issuers should be made aware that the state’s response will be swift and decisive.75

C. Education

Closely related to enhanced enforcement activity is the last of the three regulatory measures to be implemented in any proposal

By doing so, state regulators will be free to target administrative resources to those areas which, generally speaking, offer the greatest opportunity for investors in this state to have direct contact with the investment world, and, as such, offer considerable opportunities for unscrupulous promoters to hawk fraudulent securities investment schemes.

75. Many investors who have lost their money will quite naturally be very upset and will often angrily demand that their state government officials answer the question, “Where were the regulators?” The state’s response has to be that its regulators cannot eliminate all securities fraud. Once investors are made aware of this inherent limitation, hopefully their more realistic expectations will temper their anger, or at least will temper the anger and resentment of the general populace of prospective investors, who will have been sensitized to appreciate the inherent limitations on any state’s blue sky regulatory efforts. Moreover, aggressive enforcement activity—and the state’s commitment of its budgetary resources to an increased enforcement presence—may ameliorate the inevitable anger on the part of the victims of a fraudulent securities scheme, while also allowing the state’s regulators to legitimately and convincingly maintain that the state did all it could do to prevent the fraudulent securities offering.
for reform of California’s securities laws: increase state efforts to educate prospective investors. California’s regulators should invest in efforts to educate our citizens so they will be able to recognize on their own the tell-tale signs of a fraudulent securities offering.76

This proposal starts from the basic observation that fraudulent securities investment activity of some variety has been going on since time immemorial, dating back to well before the time of the “traveling medicine man show,” continuing through today’s “boiler room operations,” and extending well into tomorrow’s “chat room on the Internet.”77 For example—harking back to a simpler time—think of the medicine man who hawked a vial of “hair tonic” guaranteed to restore hair to bald heads. Eventually, the townspeople realized there was nothing but blue water in the bottle and, in their anger, would run the traveling medicine man out of town! In the process they learned a valuable lesson, though many learned it the hard way. The “traveling medicine man” eventually would return to town, however, this time hawking some new “miracle” drug or some new “get rich quick” scheme—or, in modern context, some new “derivative financial product” that promises to yield a 300% return in sixty days—and inevitably the townspeople would fall victim all over again!

Once this reality is recognized, the importance of the state’s enforcement and education efforts becomes apparent. Likewise apparent is the declining value of allocating scarce regulatory resources to the expansion of state level registration requirements—as well as the accompanying merit review of a proposed securities offering. Instead, a much bigger “bang” for the “regulatory dollar” is obtained from enhancing the state’s enforcement efforts and educating our investors about who to contact if they suspect financial fraud in a securities offering and how to better protect themselves and their financial assets.

76. The Staff Briefing Paper prepared by John Decker mentions several suggestions on how to increase the investing public’s access to educative materials. Such suggestions include research partnerships with the state and organizations such as the American Association of Individual Investors, the National Council of Individual Investors, and the Mutual Funds Education Alliance. See STAFF BRIEFING PAPER, supra note 24, at 35-37. Moreover, special efforts may well be in order so as to educate those population groups that over the years have proven to be particularly vulnerable such as senior citizens and recent immigrants.

77. See id. at 24; Gupta, supra note 65, at C1.
VI. CONCLUSION

Changes in the regulatory framework that have been implemented piecemeal over the last fifteen years have rendered merit review obsolete as a practical matter. In addition, dramatic changes in the world’s financial markets since 1968 have further contributed to the substantial erosion of the value of merit regulation. More recently, fairness concerns have assumed greater importance as the costs of compliance with the requirements imposed by this state’s form of merit regulation have been increasingly perceived as disproportionately burdening the capital formation process for small-business interests.

Taken together, all of these developments ultimately serve to dampen, if not virtually eliminate, the attractiveness of California’s capital markets—to both large and small business interests alike—without producing any demonstrated enhancement in the protection of this state’s investors against fraudulent securities offerings. Even more importantly, these developments clearly establish that the time has come for our state legislature to reform California’s blue sky statute.

In conclusion, strong public policy considerations dictate that the California Legislature should reform this state’s blue sky statute to eliminate regulation based on merit review standards. Commissioner Keith Paul Bishop is to be commended for opening up this debate by authoring the reform legislation in the Legislature in 1996.78 Although there may be legitimate debate as to specific provisions to be included in any such reform legislation, there can be no doubt that the California Legislature should undertake a comprehensive review of the existing blue sky requirements and, at a minimum, reform California’s Corporate Securities Law of 1968 to eliminate merit regulation.

78. See A.B. 2465, 1995-1996 Reg. Sess. (Cal. 1996). Assemblymember Goldsmith introduced Assembly Bill 2465 on February 20, 1996. See STAFF BRIEFING PAPER, supra note 24, at 11. Commissioner Bishop was the principal drafter of this reform measure. See id. As this Commentary was going to press, however, Senate Bill 1205 was introduced by its co-sponsors Bruce McPherson and John Vasconcellos during the current 1997-1998 session of the California Legislature. See S.B. 1205, 1997-1998 Reg. Sess. (Cal. 1996). This most recent piece of blue sky reform legislation contains substantially the same provisions as its predecessor, A.B. 2465.