

NOTICES OF PROPOSED RULEMAKING

Unless exempted by A.R.S. § 41-1005, each agency shall begin the rulemaking process by 1st submitting to the Secretary of State's Office a Notice of Rulemaking Docket Opening followed by a Notice of Proposed Rulemaking that contains the preamble and the full text of the rules. The Secretary of State's Office publishes each Notice in the next available issue of the *Register* according to the schedule of deadlines for *Register* publication.

Under the Administrative Procedure Act (A.R.S. § 41-1001 et seq.), an agency must allow at least 30 days to elapse after the publication of the Notice of Proposed Rulemaking in the *Register* before beginning any proceedings for adoption, amendment, or repeal of any rule. A.R.S. §§ 41-1013 and 41-1022.

NOTICE OF PROPOSED RULEMAKING

TITLE 14. PUBLIC SERVICE CORPORATIONS; CORPORATIONS AND ASSOCIATIONS; SECURITIES REGULATION

CHAPTER 4. CORPORATION COMMISSION - SECURITIES

PREAMBLE

- | | |
|--------------------------|--------------------------|
| <u>Sections Affected</u> | <u>Rulemaking Action</u> |
| R14-4-145 | New Section |
- The specific authority for the rulemaking, including both the authorizing statute (general) and the statutes the rules are implementing (specific):

Constitutional authority: Arizona Constitution, Article XV §§ 4, 6, and 13

Authorizing statute: A.R.S. §§ 44-1821(A), 44-1941(C), 44-1945(B), and 44-3152(B)

Implementing statute: A.R.S. §§ 44-1941(C), 44-1945(B), and 44-3152(B)
- The name and address of agency personnel with whom persons may communicate regarding the rulemaking:

Name: Marcia G. Kwasman, Special Counsel

Address: Arizona Corporation Commission, Securities Division
1300 West Washington, 3rd Floor
Phoenix, Arizona 85007

Telephone: (602) 542-4242

Fax: (602) 594-7470
- An explanation of the rule, including the agency's reasons for initiating the rule:

Proposed R14-4-145 (the "Rule") provides an exemption from the dealer and salesman registration requirements of A.R.S. § 44-1842 and from the investment adviser licensure or notice filing requirements and investment adviser representative licensure requirements of A.R.S. § 44-3151. The Rule will allow a computer network or operator to provide information to certain sophisticated investors regarding various companies, provided certain conditions are met. A "network" is defined as a computer matching or listing service or system that facilitates the matching of businesses in need of capital to investors by enhancing the flow of information between businesses and investors. An "operator" is 1 who owns or conducts a network or is a network employee.

There are several restrictions and requirements that a network or operator must meet before being eligible to use the Rule. For example, a network or an operator may not: (1) provide advice about particular opportunities or make recommendations regarding any companies; (2) receive compensation other than flat fees to cover administrative costs; (3) participate in any negotiations between investors and any companies; (4) directly or indirectly assist any investor or company with any transaction; (5) handle funds or securities involved in any transaction; or (6) hold themselves out as providing any securities-related services other than a listing or matching service. By imposing these conditions on the networks and the operators, the Rule mandates that only those entities that are truly matching services are exempt from dealer and salesman registration and investment adviser and investment adviser representative licensing and notice filing requirements.

The Rule also restricts the companies that may be listed on the network. For example, a company may not be listed on the network if it is the subject of certain judicial or administrative actions. These restrictions prohibit so-called "bad boy" companies from participating on the network, lessening the likelihood of illegal or fraudulent activity. Under the Rule, the network may not list a company if it is in the Development Stage, meaning that the company's annual net earnings for the last 2 consecutive years, or the average annual net earnings for the last 5 years prior to the offering, were less than 5% of the offering. This require-

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ment increases the probability that the companies on the network have a more stable financial background and thus pose less risk to potential investors. Another restriction the Rule imposes on the listed companies is that the offering may not exceed an aggregate of \$5,000,000 in any consecutive 12-month period. This restriction limits the availability of the Rule to smaller offerings.

Finally, the Rule provides that access to the network be limited to accredited investors. These investors generally include certain types of institutional investors and individuals with substantial net worth or substantial income. This provision provides for investor protection by limiting the pool of investors to only those that have the financial capability to invest.

If the network or operator fails to comply with any of the Rule's restrictions, it is in violation of the Securities Act of Arizona. Civil and administrative liabilities may attach. In addition, the Commission may, by order, revoke or suspend the availability of the Rule with respect to a particular network or operator, if it finds that the operation of the network or operator would work or tend to work a fraud or deceit upon investors or potential investors.

It is the Division's opinion that it is necessary and desirable to adopt R14-4-145 to assist in capital formation. The Rule will aid businesses by allowing them to convey their company information to certain sophisticated investors via a network for potential investment opportunities. The Rule allows this conveyance of information without requiring the network or operator to be registered as a dealer or salesman pursuant to Article 9 of the Securities Act. In addition, the Rule does not require the network or operator to be licensed or file a notice as an investment adviser or investment adviser representative pursuant to Article 4 of the Arizona Investment Management Act. The Rule carves out an exemption from Arizona's registration and licensing requirements which could not have contemplated the technological advances that are now available to assist small businesses. The Rule creates a "virtual" investment community that is beneficial to companies and sophisticated investors, but is still regulated. Thus, the Division believes that the Rule should significantly benefit capital formation and stimulate economic growth.

5. A showing of good cause why the rule is necessary to promote a statewide interest if the rule will diminish a previous grant of authority of a political subdivision of this state:

The Rule is desirable to assist businesses in capital formation in a manner which does not impose unnecessary expenses. The Rule significantly benefits businesses by allowing them to convey their information to accredited investors for potential investment opportunities without requiring the network or operator to be registered as a dealer or salesman pursuant to Article 9 of the Securities Act. In addition, the Rule does not require the network or operator to be licensed or file a notice as an investment adviser or investment adviser representative pursuant to Article 4 of the Arizona Investment Management Act. These exemptions promote cost savings for the network and the operators as they do not have to pay registration or licensing fees to the Division. In addition, they do not have to spend time and money taking the necessary tests to qualify to be a registered salesman or licensed investment adviser representative. At the same time, since network information is only made available to accredited investors, the risk of substantial harm to the general investing public is limited. In addition, the Commission retains anti-fraud jurisdiction over any offering under the Rule. Therefore, the significant statewide interest in promoting capital formation for businesses should be advanced without any significant loss of authority to the Commission.

6. The preliminary summary of the economic, small business and consumer impact:

Pursuant to A.R.S. § 41-1055(D)(3), the agency is exempt from providing an economic, small business, and consumer impact statement.

7. The name and address of agency personnel with whom persons may communicate regarding the accuracy of the economic, small business, and consumer impact statement:

Not applicable.

8. The time, place, and nature of the proceedings for the adoption, amendment, or repeal of the rule or, if no proceeding is scheduled, where, when, and how persons may request an oral proceeding on the proposed rule:

Date: March 3, 1998

Time: 10 a.m.

Location: Arizona Corporation Commission
1200 West Washington Avenue
Phoenix, Arizona 85007

Nature: Oral Proceeding

Close of Record: Open meeting of the Arizona Corporation Commission at which the Commission takes final action with respect to the adoption of the Rule.

Prior to the oral proceeding, any person may submit written comments to the person listed in question #3.

9. Any other matters prescribed by statute that are applicable to the specific agency or to any specific rule or class of rules:

None.

10. Incorporations by reference and their location in the rules:

None.

11. The full text of the rules follows:

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SECURITIES REGULATION

CHAPTER 4. CORPORATION COMMISSION - SECURITIES

ARTICLE 1. IN GENERAL RELATING TO THE
ARIZONA SECURITIES ACT

Section

R14-4-145. Exemption for electronic venture capital networks

ARTICLE 1. IN GENERAL RELATING TO THE
ARIZONA SECURITIES ACT

R14-4-145. Exemption for electronic venture capital networks

A. Definitions and terms. As used in this section, the following terms shall have the meaning indicated:

1. "Accredited Investor" shall have the meaning provided in A.A.C. R14-4-126.
2. "Development Stage Company" shall mean a company or issuer whose annual Net Earnings for each of the last 2 consecutive fiscal years, or whose average annual Net Earnings for the last 5 fiscal years prior to the offering have been less than 5 percent of the aggregate offering.
3. "Listed Company" shall mean a business that maintains a listing on the Network.
4. "Net Earnings" shall mean the after-tax earnings of a company or issuer that are derived from its normal operations, exclusive of extraordinary and nonrecurring items, determined according to generally accepted accounting principles.
5. "Network" shall mean a computer matching or listing service or system that facilitates the matching of businesses in need of capital to investors by enhancing the flow of information between businesses and investors.
6. "Affiliate" shall mean a person or entity that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person or entity specified.
7. "Operator" shall mean the person or entity that owns, operates, sponsors, or conducts a Network and any employees. An Operator shall not include a dealer, an affiliate of a dealer, an investment adviser, or an affiliate of an investment adviser.
8. "Securities Act" shall mean the Securities Act of Arizona, A.R.S. § 44-1801 et seq.

B. No Network or Operator shall be required to register as a dealer or salesman pursuant to Article 9 of the Securities Act, nor shall a Network or Operator be required to be licensed or file a notice as an investment adviser or investment adviser-representative pursuant to Article 4 of the Arizona Investment Management Act (A.R.S. Title 44, Chapter 13), provided that the Network or Operator complies with the following conditions:

1. The Network or Operator shall not provide advice about any particular opportunities or ventures or make recommendations concerning any Listed Company;
2. The Network or Operator shall not receive compensation other than flat fees to cover administrative costs and such fees will not be made contingent upon the outcome or completion of any securities transaction resulting from a listing on the Network;

3. The Network or Operator shall not participate in any negotiations between investors and any Listed Company;

4. The Network or Operator shall not directly or indirectly assist any investor or Listed Company with any transaction;

5. The Network or Operator shall not handle funds or securities involved in any transaction;

6. The Network or Operator shall not hold themselves out as providing any securities-related services other than a listing or matching service;

7. The Network or Operator shall not accept listings of companies that fall within the disqualification provisions listed in Subsection (C);

8. The Network or Operator shall limit access to information on Listed Companies to Accredited Investors only;

9. Information contained on the Network shall not be organized or presented in a manner that suggests or recommends the purchase, holding or sale of any security;

10. Any information contained on the Network concerning any Listed Company will be readily available in documents from the Listed Company or its agents and, where required by law, will be filed with the appropriate state and federal authorities;

11. A Listed Company shall not be a Development Stage Company and must have a specific written business plan or purpose;

12. Listed Company offerings may not exceed an aggregate of \$5,000,000 in any consecutive 12-month period;

13. Operator or Network officials, participants, and employees with direct or indirect operating or supervisory control over Network operations will not participate as investors in any Listed Company unless such participation is in compliance with securities laws and such participation is disclosed on the Network.

C. This exemption is not available for any Network, Operator, or Listed Company if such entity or predecessor or any of its officers, directors, 10% stockholders, promoters or any selling agents of the securities to be offered, or any officer, director or partner of such selling agent:

1. Has filed a registration statement which is the subject of a registration stop order entered pursuant to any state's securities law within 5 years of the proposed offering;

2. Has been convicted within 5 years of the proposed offering of any felony or misdemeanor in connection with the offer, purchase or sale of any security or any felony involving fraud or deceit, including, but not limited to, forgery, embezzlement, obtaining money under false pretenses, larceny, or conspiracy to defraud;

3. Is subject to any state administrative enforcement order or judgment entered by that state's securities administrator within 5 years of the proposed offering, or is subject to any state's administrative enforcement order or judgment in which fraud or deceit, including, but not limited to, making untrue statements of material facts and omitting to state material facts, was found and the order or judgment was entered within 5 years of the proposed offering;

4. Is subject to any state's administrative enforcement order or judgment which prohibits, denies or revokes the

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- use of any exemption from registration in connection with the proposed offer, purchase or sale of securities:
5. Is subject to any order, judgment or decree of any court of competent jurisdiction temporarily or preliminarily restricting or enjoining, or is subject to any order, judgment or decree of any court of competent jurisdiction, permanently restraining or enjoining such party from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security or involving the making of any false filing with the state entered within 5 years of the proposed offering.
- D. The Commission or the Director of Securities, at their discretion, may waive any disqualification caused by Subsection (C).
- E. Any disqualification caused by Subsection (C) shall cease to exist if any of the following occurs:
1. The basis for the disqualification has been removed by the jurisdiction creating it;
 2. The jurisdiction in which the disqualifying event occurs issues a written waiver of the disqualification;
 3. The jurisdiction in which the disqualifying event occurred declines in writing to enforce the disqualification.
- F. The Commission may by order revoke or suspend this exemption if it finds that the operation of the Network or Operator would work or tend to work a fraud or deceit upon investors or potential investors.