

# Department of Corporations

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The Department of Corporations (DOC), part of the cabinet-level Business, Transportation and Housing Agency (BTH), is empowered under Corporations Code section 25600. The Commissioner of Corporations is appointed by the Governor to oversee and administer the duties and responsibilities of the Department. DOC maintains offices in Sacramento, San Francisco, Los Angeles, and San Diego. The rules promulgated by DOC are set forth in Division 3, Title 10 of the California Code of Regulations (CCR).

The Department administers several major statutes, including the Corporate Securities Law of 1968 (CSL), Corporations Code section 25000 *et seq.*, which requires the "qualification" of all securities offered and/or sold in California. "Securities" are defined quite broadly, and may include business opportunities in addition to more traditional stocks and bonds. Many securities may be qualified through compliance with the federal securities acts of 1933, 1934, and 1940. If the securities are not under federal qualification, the Commissioner may issue a permit for their sale in California.

Through DOC's Securities Regulation Division, the Commissioner licenses securities agents, broker-dealers, and investment advisers, and may issue "desist and refrain" orders to halt unlicensed activity or the improper sale of securities. Deception, fraud, or violation of any DOC regulation is cause for license revocation or suspension of up to one year. Any willful violation of the securities law is a felony; DOC refers these criminal violations to local district attorneys for prosecution.

The Commissioner also enforces a group of more specific statutes involving other business transactions: the California Finance Lenders Law (Financial Code section 22000 *et seq.*); the California Residential Mortgage Lending Act (Financial Code section 50000 *et seq.*); the Franchise Investment Law (Corporations Code section 31000 *et seq.*); the Security Owners Protection Law (Corporations Code section 27000 *et seq.*); the California Commodity Law of 1990 (Corporations Code section 29500 *et seq.*); the Escrow Law (Financial Code section 17000 *et seq.*); the Check Sellers, Bill Payers and Proraters Law (Financial Code section 12000 *et seq.*); the Securities Depository Law (Financial Code section 30000 *et seq.*); and the Capital Access Company Law (Corporations Code section 28000 *et seq.*).

Effective July 1, 2000, California's regulation of the managed health care industry was transferred from DOC to the Department of Managed Health Care (DMHC), a new agency within BTH. AB 78 (Gallegos) (Chapter 525, Statutes of 1999) created DMHC as part of a 21-bill package signed by Governor Davis in 1999 to reform the regulation of managed care in the state. [17:1 CRLR 7-9, 12-16] Cov-

erage of DMHC's activities is found above, under "Health Care Regulatory Agencies."

On January 29, 2001, Governor Davis announced the appointment of Demetrios A. Boutris as Corporations Commissioner and Special Counsel to the Governor. Commissioner Boutris previously served as Governor Davis' Legal Affairs Secretary and Counsel. In that capacity, Boutris was the administration's Chief Legal Officer and a senior member of the Governor's policy team. Before that, Boutris served as corporate vice president and special counsel to the chairman at the New York-based MacAndrews & Forbes Holdings, which controls several public companies, including Revlon, CalFed Bank, Panavision, Coleman, Sunbeam, and Meridian. Prior to that, Boutris served in the Executive Office of the President in Washington, D.C., as executive director and later as associate general counsel to the U.S. trade representative. As a member of the California, Washington, D.C., and U.S. Supreme Court bars, Boutris has practiced securities, banking, and corporate law with international firms in Los Angeles and San Francisco. Commissioner Boutris is a Phi Beta Kappa graduate of the University of California at Berkeley and Harvard Law School.

## MAJOR PROJECTS

### DOC Rulemaking Under the Corporate Securities Law

The following is a summary of rulemaking proceedings recently initiated by DOC under the Corporate Securities Law of 1968:

♦ **Exemption from Licensure Requirement for General Partners of Venture Capital Companies.** On March 16, 2001, DOC published notice of its intent to adopt new section 260.204.9, Title 10 of the CCR, to set forth an exemption from the licensure requirement for certain investment advisers with fewer than 15 clients.

Corporations Code section 25230 requires one who conducts business as an investment adviser in California to be licensed with DOC. The definition of "investment adviser" under Corporations Code section 25009 includes, with certain exceptions, any person who "for compensation, engages in the business of advising others...as to the advisability of investing in, purchasing or selling securities..." This definition arguably encompasses the general partner (GP) of pooled investment vehicles commonly referred to as "venture capital funds" or "venture capital companies" (VCCs). These pooled investment vehicles, which historically have been organized as limited partnerships (and, more recently, as limited liability companies or "LLCs"), raise funds from mul-

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multiple investors and use the funds to invest in (or acquire) start-up operating companies. In the typical VCC, the GP has the sole authority to make investment decisions. The limited partners are generally required to fund their capital contributions when and as requested by the GP, but are not permitted to make an investment decision with respect to any particular portfolio investment by the VCC. Over the last few decades, VCCs have played an increasingly significant role in the establishment and growth of start-up companies in California, particularly technology-based enterprises. A substantial number of VCCs—including many of the largest, oldest, and most recognized VCCs—are based in California.

In 1971, DOC issued Policy Letter No. 151, indicating that a GP of a single limited partnership would not have to be licensed as an investment adviser under the CSL. The basis of that policy was the Commissioner's view that a GP is, in effect, giving advice to itself rather than to "others," as required by Corporations Code section 25009. In April 1998, however, DOC issued Release No. 110-C, which essentially revoked the 1971 policy. In the Release, the Department indicated that the position taken in the 1971 policy letter is contrary to the treatment of investment advisers by the U.S. Securities and Exchange Commission (SEC). Under the Federal Investment Advisers Act of 1940 (FIAA), GPs of limited partnerships are treated as advising others, and thus are subject to registration requirements.

However, GPs who advise fewer than 15 VCCs are typically exempt from registration under section 203(b)(3) of the FIAA and certain SEC rules adopted thereunder and specifically tailored to VCCs.

Accordingly, proposed section 260.204.9, Title 10 of the CCR, would exempt from the CSL's investment adviser licensing requirement any person who does not hold himself out generally to the public as an investment adviser, has fewer than 15 clients, is exempt from registration under the FIAA, and either (a) has "assets under management" of not less than \$25 million or (b) provides investment advice only to VCCs. The proposed section reflects the Commissioner's view that, in light of the nature and structure of VCCs, requiring the GPs of VCCs to be licensed in California as investment advisers is unnecessary and unduly burdensome. More importantly, because Corporations Code section 25202(a) generally exempts from licensure in California any GP who does not have a place of business in California and has fewer than six California clients, requiring California-based GPs to be licensed as investment advisers could encourage such GPs to relocate from California to a state that does not require licensure or that imposes less onerous obligations on registered investment advisers.

DOC did not schedule a public hearing on this rulemaking proposal, but accepted written comments until April 30, 2001.

◆ **Affirmative Defense to Insider Trading Charge.** On March 14, 2001, the Commissioner adopted new section

260.402, Title 10 of the CCR, on an emergency basis, to conform California law to a new federal regulation establishing an affirmative defense to "insider trading."

In late October 2000, the SEC adopted a new regulation, Rule 10b5-1, which—among other things—provides for an affirmative defense to allegations of insider trading (*i.e.*, a corporate insider trading on the basis of material, non-public information) under the federal securities laws. Generally, new Rule 10b5-1 provides that a purchase or sale of a security is not "on the basis of" material, non-public information if the person making the purchase or sale demonstrates that before becoming aware of the information, he/she had: (1) entered into a binding contract to purchase or sell a security, (2) instructed another person to purchase or sell the security for his/her accounts, or (3) adopted a written plan for trading securities.

California's CSL prohibits insider trading. Section 25402 of the Corporations Code provides: "It is unlawful for an issuer or any person who is an officer, director or controlling person of an issuer or any other person whose relationship to the issuer gives him access, directly or indirectly, to material information about the issuer not generally available to the public, to purchase or sell any security of the issuer in this state at a time when he knows material information about the issuer gained from such relationship which would significantly

affect the market price of that security and which is not generally available to the public, and which he knows is not intended to be so available, unless he has reason to believe that the person selling to or buying from him is also in possession of the information." Thus,

the CSL prohibits insider trading when the following elements are present: (1) a relationship (*e.g.*, an officer, director, or control person) with the issuer that provides access to material facts; (2) knowledge of facts that are material at the time of the transaction, regardless of whether the person knows that the facts are material; (3) if publicly available, the facts would significantly affect the market price of the issuer's securities; and (4) knowledge that the facts are not available to the public.

New section 260.402, Title 10 of the CCR, recognizes the new federal defense in California. New section 260.402 states that for purposes of Corporations Code section 25402, an issuer or person described in section 25402 shall not be deemed to have purchased or sold an issuer's security at a time when that person knows material information about the issuer if the issuer or such person demonstrates that the purchase or sale of the issuer's security was in accordance with new Rule 10b5-1(c). As the basis for his adoption of an emergency regulation, the Commissioner found that neither the CSL nor DOC's regulations address the point in time at which non-public information becomes disqualifying for purposes of materiality; this conflict with federal law had created much

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confusion in the business community. According to the Commissioner, the uncertainty caused by the disparity between the existing California statute and the new SEC rule had an immediate adverse impact on the entire securities marketplace. According to the Commissioner, the conflict created a "trap for the unwary"—an issuer or insider may unwittingly rely on the SEC's new regulation in the purchase or sale of a security, unaware that California's statute may expose him/her to civil and criminal liability for the same act. The new regulation eliminates the trap. Furthermore, the Commissioner found that because of the manner in which securities exchanges and order executions take place, it is not possible for out-of-state issuers and insiders to simply direct that their securities not be offered or sold in California. Thus, according to DOC, this emergency regulation is necessary to eliminate the potential chilling effect on the implementation of the SEC's affirmative defense to insider trading.

At this writing, the emergency regulation is effective through July 13, 2001, and DOC is preparing to publish notice of its intent to permanently adopt the new rule.

◆ **Exemption from Qualification Requirements for Compensatory Benefit Plans Offered by LLCs.** On December 28, 2000, the Commissioner adopted emergency amendments to sections 260.102.19, 260.140.41, 260.140.42, 260.140.45, and 260.140.46, Title 10 of the CCR, to conform the Department's regulations with legislative changes that took effect on January 1, 2001 under SB 1837 (Figueroa) (Chapter 705, Statutes of 2000).

"Option and purchase plans" (also called "compensatory benefit plans") are securities offerings to employees, directors, and consultants of an issuing company that are used as incentives to acquire and retain such persons, not for capital-raising purposes. The offering of securities through "option and purchase plans" or "compensatory benefit plans" is statutorily exempt from the requirement that the offer or sale of the securities be qualified under the provisions of the CSL if: (1) the offering is exempt from registration under SEC Rule 701 (17 C.F.R. Part 230.701); and (2) the terms of the compensatory benefit plan comply with the fairness standards for compensatory benefit plans set forth in DOC regulations. SB 1837 (Figueroa) amended the statutory exemption to provide that offerings of interests in LLCs pursuant to a compensatory benefit plan are also exempt from the qualification requirements of the CSL if the above requirements are met (see 2000 LEGISLATION). However, DOC's regulations described fairness standards only for offerings of shares of stock, thereby creating confusion as to the precise standards to be met so that offerings of interests in LLCs are exempt from qualification.

Accordingly, the Commissioner adopted emergency amendments to DOC's regulations to clarify that the existing standards for securities offerings under compensatory benefit plans apply equally to all types of securities issued under such plans, not just shares of stock issued by corporations. Because SB 1837 became effective on January 1, 2001, DOC

found there was insufficient time for the normal rulemaking procedures, and "emergency regulations are necessary for the preservation of the public peace, health, safety, or general welfare" as DOC was already receiving inquiries as to the applicability and interpretation of the new statutory exemption before the statute went into effect.

As part of the same emergency rulemaking package, and in accordance with the changes made by SB 1837, DOC also amended section 260.102.19's procedure for filing the required notice of the issuance of securities under a compensatory benefit plan. Further, the emergency amendments clarify that the notice filing requirement is not triggered unless securities are issued in California.

At this writing, the emergency amendments are effective through May 1, 2001. Because DOC has not yet published notice of its intent to adopt the amendments permanently, DOC will likely readopt the emergency amendments for another 120-day period until it has an opportunity to undertake rulemaking in the normal course.

◆ **Licensure Exemption for Capital Access Company Fund Managers.** Corporations Code section 28152(e), part of the Capital Access Company Law, requires a person who makes recommendations regarding the investment of funds of a capital access company to be either registered or licensed under federal or California law as an investment adviser, or to be exempt from the registration or licensure requirement. However, the CSL does not contain a specific exemption from licensure for such an investment adviser. Accordingly, on December 15, 2000, DOC published notice of its intent to adopt new section 260.204.12, Title 10 of the CCR, to exempt an investment adviser from the licensure requirement of Corporations Code section 25230 when engaging in the activities outlined in section 28152(e) on behalf of a capital access company that is itself licensed under the Capital Access Company Law. [17:1 CRLR 145-46]

The Commissioner found that such an exemption is in the public interest because of the limited nature of the exemption (*i.e.*, the exemption is from licensure only, and not from the prohibited practices, anti-fraud, and other disciplinary provisions of the CSL), and because of the protective safeguards and procedures relating to the provision of investment advice to a capital access company and the requirement of "good character" on the part of the investment adviser, all contained in the Capital Access Company Law.

DOC did not hold a public hearing on the proposed regulation, but accepted written comments until January 29, 2001. Thereafter, the Department adopted new section 260.204.12; the Office of Administrative Law (OAL) approved it on April 2, 2001, and it becomes effective on May 2, 2001.

◆ **Canadian Tax-Deferred Retirement Savings Accounts and Canadian Broker-Dealers and Agents; Specialists, Market Makers, or Floor Broker-Dealers Who Are Members of the Pacific Exchange.** On November 3, 2000, DOC published notice of its intent to adopt new sections 260.105.40, 260.204.10, and 260.204.11, Title 10 of the CCR. This

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rulemaking relates to two separate subjects: (1) certain Canadian tax-deferred retirement savings accounts and Canadian broker-dealers and agents; and (2) specialists, market makers, or floor broker-dealers who are members of the Pacific Exchange.

On June 23, 2000, the SEC approved an exemption from registration for Canadian broker-dealers in regard to transactions involving self-administered, tax-advantaged retirement accounts of Canadian residents in the United States. This exemption was granted in tandem with new SEC rules permitting Canadian securities, including mutual funds, to be offered and sold in these particular retirement plans without the requirement for these securities to be registered under the federal Securities Act of 1933 or the federal Investment Company Act of 1940. Accordingly, the Commissioner proposed to adopt section 260.105.40, Title 10 of the CCR, to exempt from the qualification requirements of the CSL the offer and sale of Canadian securities to or for a "Canadian retirement account," as that term is defined by federal regulations adopted under either the Securities Act of 1933 or the Investment Company Act of 1940. The Commissioner also proposed to adopt new section 260.204.10, Title 10 of the CCR, to exempt completely from the CSL's licensure requirements those Canadian broker-dealers and agents conducting transactions in Canadian securities in California, subject to specified conditions and provisions. According to the Commissioner, given the limited nature of the transactions involved (*i.e.*, the offer or sale of Canadian securities to a "Canadian Retirement Account" and the Canadian residence of the investors on behalf of whom these transactions are executed), no public policy is served by requiring licensure of Canadian broker-dealers under the CSL. This limited exemption would not exempt Canadian broker-dealers and agents from DOC's authority under the CSL to investigate, examine, or initiate enforcement actions against them.

On a separate subject matter, the Commissioner proposes to adopt new section 260.204.11, Title 10 of the CCR, which would provide an exemption from the requirement for licensure to a person who is a member of the Pacific Exchange, Inc. when that person is engaged in the securities business solely as a specialist, market maker, or floor broker-dealer on that exchange. Such persons are engaged in the securities business solely as broker-dealers effecting transactions on behalf of other broker-dealers and are not making transactions on behalf of individual clients or customers. As members of the Pacific Exchange, these persons are subject to regulation by that organization, which is itself subject to supervision and regulation by the SEC. Given the limited and restrictive nature of the securities business engaged in by these broker-dealers, DOC found that no public purpose is served by requiring them to obtain a license under the CSL.

The Department did not hold a public hearing on these proposals, but it accepted public comment until January 8, 2001. Following the close of the comment period, DOC revised the proposed regulations on two occasions, each time

releasing the modified version for an additional 15-day comment period. At this writing, the proposed regulations are pending at OAL.

◆ **Broker-Dealer Regulations.** On January 28, 2000, DOC published notice of its intent to amend sections 260.210, 260.211, 260.211.1, 260.234, and 260.241, Title 10 of the CCR, dealing with the licensure, certification, compensation, transfer, and recordkeeping requirements for broker-dealers and the agents they employ. DOC held no public hearing on the proposed amendments, but accepted written comments until March 31, 2000. Thereafter, DOC adopted the amendments; OAL approved them on January 23, 2001.

Under Corporations Code section 25210, broker-dealers must be licensed by the Commissioner (unless they are exempt from the licensing requirement). Agents who act on behalf of a broker-dealer are not licensed by the state but must comply with regulations promulgated by the Commissioner for the qualification and employment of agents. Section 260.210, Title 10 of the CCR, requires broker-dealers to collect and maintain information on the character, business reputation, experience, and qualifications of agents they employ. Broker-dealers who register their agent with the National Association of Securities Dealers (NASD) must file a form on the agent with NASD's Central Registration Depository (CRD). The CRD then forwards information on the agent to the Commissioner, and the Commissioner is authorized to request additional information and/or deny or bar employment of an agent with a prohibited disciplinary history.

In 1998, California was reclassified by the CRD as an "automatic" state, which means that agents who do not have a disciplinary history can be automatically allowed to be employed by a broker-dealer in California. As a result, DOC is no longer reviewing the records of agents found by the CRD not to have a history of acts prohibited by Corporations Code section 25212. Thus, DOC amended section 260.210 to link its review of an agent's disciplinary history with the command instructions of the CRD system. DOC's amendments also permit the temporary transfer of an agent's CRD registration from one broker-dealer to another through the relicensing program of the North American Securities Administrators Association (NASAA).

Section 260.211 sets forth the procedures for applying for certification as a broker-dealer. DOC's amendments to section 260.211(b) instruct first-time applicants on how to answer questions regarding criminal history, and direct them to a special instruction sheet containing information to be used in completing the certification form. A broker-dealer applicant filing as an LLC must now include a copy of its articles of organization and amendments. DOC's amendments also notify broker-dealers who are registered with the SEC as investment advisers that the exemption in Corporations Code section 25205 is no longer available to them; such broker-dealers must make a "notice filing" as required by Corporations Code section 25230.1(b). These amendments instruct such dually-licensed broker-dealers on the components of the "notice filing."

Section 260.211.1 sets forth the procedures and application for licensure by notification for broker-dealers who are exempt from licensing by Corporations Code section 25211(b). DOC amended section 260.211.1 to make changes similar to those made to section 260.211 regarding broker-dealers who are also registered with the SEC as investment advisers.

DOC also amended section 260.234 pertaining to an investment adviser's compensation based on capital appreciation of clients' assets to conform to changes adopted by the SEC. The amended section now provides greater flexibility in structuring performance fee arrangements with clients who are financially sophisticated.

Finally, DOC amended section 260.241, which sets forth the books and records to be maintained by a broker-dealer, to clarify that DOC may have access to and make copies of any of the books and records maintained by a broker-dealer. References to the Pacific Stock Exchange were changed to refer instead to the Pacific Exchange.

◆ **Qualifications of Investment Advisers, Representatives, and Associates.** On December 17, 1999, DOC adopted emergency amendments to section 260.236, Title 10 of the CCR, which became effective on January 1, 2000. These amendments facilitate the use of new examinations used in DOC's licensure of investment advisers, investment representatives, and their associates. On December 31, 1999, DOC published notice of its intent to permanently adopt the emergency amendments. After a public comment period ending on February 18, 2000, DOC adopted the proposed changes; OAL approved them on June 6, 2000.

Under Corporations Code section 25236, the Commissioner is authorized to adopt standards regarding the training, experience, and other qualifications for investment advisers and their investment adviser representatives or associated persons. Section 260.236 sets forth those qualification requirements. Among other things, section 260.236 requires applicants to pass examinations created by NASAA. NASAA's Series 63/Uniform Securities Agent State Law Examination (Series 63 Exam) tests prospective broker-dealer agents on their knowledge of state securities laws. The Series 65/Uniform Investment Adviser Law Examination (Series 65 Exam) tests prospective investment adviser representatives on their knowledge of federal and state securities laws and regulations. The Series 66/Uniform Combined State Law Examination (Series 66 Exam) was created for individuals who are required or elect to take both the Series 63 and Series 65 Exams. The Series 66 Exam tests applicants on their knowledge of federal and state securities laws and regulations. NASD administers all three examinations.

In 1996, NASAA began a comprehensive review and modification of the Series 65 Exam. As a result of this review, the Series 65 and Series 66 Exams were modified. The old versions of these exams were retired on December 31, 1999, and—effective January 1, 2000—only the new Series 65 Exam and Series 66 Exam are administered. Thus, NASAA

requested that state securities regulators amend their regulations and requirements for licensure to reference the new versions of these exams and to ensure that the new exam requirements apply prospectively only.

Thus, DOC amended section 260.236(a) to require investment advisers and each investment adviser representative or associated person thereof (as defined in Corporations Code section 25009.5) to pass, within two years prior to the date of filing the application for an investment adviser certificate or becoming engaged as an investment adviser representative or associated person: (1) the Series 65 Exam in effect on January 1, 2000, or (2) the Series 7/General Securities Representative Examination (Series 7 Exam) and the Series 66 Exam in effect on January 1, 2000.

Amended section 260.236(b) waives subsection (a)'s exam requirements for any investment adviser or individual employed or engaged as an investment adviser representative or associated person registered, reported, or licensed in any state of the United States as of December 31, 1999. Amended section 260.236(b) also provides that investment advisers and investment adviser representatives or associated persons who previously passed a qualifying examination pursuant to former section 260.236 are not required to retake the new Series 65 and Series 66 Exams.

Amended section 260.236(c)(1) waives subsection (a)'s exam requirements for any person who has been registered as an investment adviser or employed or engaged as an investment adviser representative or associated person in any state for two consecutive years immediately before the date of filing an application or notice pursuant to Corporations Code sections 25230(b) or 25230.1(c) in California. Amended section 260.236(c)(2) waives subsection (a)'s exam requirements for any individual who, as of January 1, 2000, has been actively and continuously engaged in the securities business as a broker-dealer, agent of a broker-dealer, investment adviser, investment adviser representative or associated person, or has been employed in a similar capacity in the banking or insurance industries, without substantial interruption (two or more years) since passing the qualifying examination(s). Amended section 260.236(c)(3) exempts solicitors or other individuals who are engaged by an investment adviser solely to offer or negotiate the sale of investment advisory services of the employing investment adviser from the examination requirements based on their limited activity; these individuals are precluded from delivering any investment advice. Amended section 260.236(c)(4) exempts from subsection (a)'s exam requirements any individual who currently holds one of the following professional designations: Chartered Financial Analyst (CFA), Chartered Financial Consultant (ChFC), Certified Financial Planner (CFP), Chartered Investment Counselor (CIC), or Personal Financial Specialist (PFS); these individuals have already been determined by NASAA to meet the qualification requirements.

New section 260.236(d) clarifies that an individual who has not been registered in any jurisdiction in the United States

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for a period of two years and who is not otherwise exempt under subsections (c)(2), (c)(3), or (c)(4) must comply with the qualification requirements of subsection (a) of the rule. The text of former section 260.236(d), which defined the terms "securities analyst" and "portfolio manager," was deleted; those terms are no longer used in the rules and the definitions are unnecessary.

◆ **Non-Issuer Exemption for Securities of Foreign-Country Issuers.** In October 1999, DOC published notice of its intent to amend section 260.105.11,

Title 10 of the CCR, which provides a non-issuer exemption from the qualification requirements of the CSL for securities of foreign-country issuers where certain requirements are met. This non-issuer or "trading" exemption from the requirements of Corporations Code section 25130 applies to: (1) those issuers currently filing with the SEC information and reports pursuant to section 15(d) of the federal Exchange Act of 1934; (2) those securities appearing in the most recent Federal Reserve Board List of Foreign Margin Stocks; and (3) those issuers not subject to the reporting requirements of section 13 or 15(d) of the federal Securities Act of 1934 where the issuer meets certain "worldwide" issuer requirements. DOC amended section 260.105.11(a)(2)(i) to exempt from the qualification requirement a security that either appears on the most recent Federal Reserve Board List of Foreign Margin Stocks or is one deemed by the SEC to have a "ready market" for purposes of SEC Rule 15c3-1 (17 C.F.R. Part 240.15c3-1). A broker-dealer may rely on written "no action" or interpretive letters issued by the SEC or its staff regarding the SEC's "ready market" criteria. DOC proposed this amendment to take into account the method used by the Board of Governors of the Federal Reserve System to identify foreign margin stocks. [17:1 CRLR 146-47]

DOC held no public hearing, but accepted written comments until December 17, 1999. One commenter supported the proposal. Thereafter, DOC adopted the proposed change. OAL approved the regulatory change on May 9, 2000, and it became effective on June 8, 2000.

### DOC Rulemaking Under the Escrow Law

The following is a summary of rulemaking proceedings recently initiated by DOC under the Escrow Law:

◆ **Internet Escrow Agents' Payment of "Click-Through" Fees.** On March 16, 2001, the Commissioner published notice of his intent to adopt new section 1712, Title 10 of the CCR, to accommodate language in two 1999 bills—AB 410 (Lempert) (Chapter 253, Statutes of 1999) and AB 583 (Papan) (Chapter 441, Statutes of 1999)—that provide for the licensing and regulation of "Internet escrow agents" in Financial Code section 17004.5. [17:1 CRLR 147-48]

Financial Code section 17420 prohibits independent escrow agents licensed under the Escrow Law from paying fees

or other forms of compensation for referring, soliciting, handling, or servicing escrow customers and accounts. The public policy behind the prohibition is to prevent conflicts of interest for escrow agents, who are fiduciaries under the Escrow Law and are required to act as neutral third parties in accordance with the escrow instructions entered into by the parties to the transaction. At the time the 1999 legislation providing for the licensing and regulation of "Internet escrow agents" was passed, however, Internet escrow agents routinely

paid a fee to the owner of a Web site for a "click-through" option on the site. This option allows the public to directly access the services of the Internet escrow agent for a particular transaction by means of a hypertext link. The fee paid by the Internet escrow agent

for this convenience could be construed as a violation of the referral fee prohibition under Financial Code section 17420.

Thus, to acknowledge existing market practices, DOC proposed to adopt new section 1712, Title 10 of the CCR, to specify that section 17420's prohibition against the payment by an escrow agent of fees, commissions, or other consideration as compensation for referring, soliciting, handling, or servicing escrow customers or accounts does not apply to a written contract between an escrow agent licensed under the Escrow Law and an owner of an Internet Web site for the establishment of a hypertext link for the exclusive purpose of receiving personal property escrows for deposit or delivery by the Internet escrow agent pursuant to transactions on the Internet Web site, provided that the Internet escrow agent and the owner of the Internet Web site are doing business exclusively on the Internet. The proposed rule also preserves the Internet customers' existing option of choosing not to effect a personal property transaction through an Internet escrow agent by requiring an affirmative act on the part of the customer of clicking on the hypertext link icon in order to access the services of the Internet escrow agent.

At this writing, DOC has not scheduled a public hearing on this matter, and the 45-day public comment period ended on April 30, 2001.

◆ **Form and Amount of Fidelity Bond.** On December 27, 1999, the Commissioner adopted emergency amendments to section 1723, Title 10 of the CCR, to conform the Department's regulations with legislative changes that took effect on January 1, 2000 under AB 410 (Lempert) (Chapter 253, Statutes of 1999). Until January 1, 2000, the Escrow Law required every escrow agent licensee to participate as a member of the Escrow Agents' Fidelity Corporation (EAFC). EAFC was created by statute for the purpose of providing limited indemnification to member licensees against a loss of trust funds caused by fraudulent or dishonest abstraction, misappropriation, or embezzlement by an officer, director, trustee, stockholder, manager, or employee of the licensee. Effective January 1, 2000, AB 410 (Lempert) limits the EAFC mem-

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bership requirement to escrow agent licensees engaged in the business of receiving escrows in certain types of traditional escrow transactions, such as real property escrows and bulk sale escrows, as defined in Financial Code section 17312(c). AB 410 also limits EAFC's indemnity coverage to loss of trust obligations with respect to the types of transactions specified in section 17312(c), and requires escrow agents to provide indemnity coverage in accordance with Financial Code section 17203.1 for all other types of escrow transactions. [17:1 CRLR 147-48]

Financial Code section 17203.1 requires an indemnification bond of all officers, directors, trustees, and employees of an escrow agent who have access to trust funds or who draw checks upon the escrow agent or upon the trust funds of the escrow agent. The purpose of this bond is to indemnify the escrow agent against loss of money or property. Section 17203.1 requires the Commissioner to prescribe the aggregate amount and the terms of the bond. Section 1723, Title 10 of the CCR, implements Financial Code section 17203.1 by setting forth the form and amount of the fidelity bond.

Effective January 1, 2000, DOC amended section 1723, Title 10 of the CCR, to clarify that it applies only to escrow agents that (due to AB 410) are not required to be members of EAFC or that will engage in the business of receiving escrows for deposit or delivery of the types of transactions not specified in Financial Code section 17312(c). Under the December 1999 emergency amendments, such licensees were required to file with DOC a fidelity bond providing fidelity coverage on each officer, director, trustee, and employee of not less than \$1 million. Such escrow licensees were also required to maintain a minimum fidelity coverage of \$1 million for monthly average escrow liability of up to \$1 million, ranging up to \$5 million for monthly average escrow liability over \$7.5 million to \$10 million, with additional coverage at the rate of \$1 for every \$3 of average escrow liability in excess of \$10 million. The fidelity bond for these escrow licensees was required to contain a "California Escrow Rider" providing that the coverage of the bond extends to all officers, directors, trustees, and employees of the insured, whether or not such officers, directors, trustees, and employees were compensated by the insured; and to contain a provision prohibiting the insurer from cancelling the bond in whole or in part without 30 days' prior written notice to the DOC Commissioner. These changes were necessary to enable existing licensees who were no longer permitted to be members of EAFC to continue engaging in escrow transactions after January 1, 2000. These emergency amendments were effective through May 1, 2000. On April 20, 2000, the Commissioner extended the emergency amendments to section 1723 for an additional 120-day period, and also amended section 1722 and repealed section 1725, Title 10 of the CCR, on an emergency basis to further implement AB 410 (Lempert); these emergency changes became effective on May 1, 2000.

On June 9, 2000, the Commissioner published notice of his intent to adopt permanent changes to sections 1722 and

1723, and to repeal section 1725, Title 10 of the CCR. Following a 45-day public comment period, DOC adopted the following changes:

- The Department amended section 1722 to clarify that, except as otherwise provided in section 1723, a bond filed pursuant to Financial Code section 17203.1 must have at least the coverage provided in standard forms of fidelity bonds. According to the Commissioner, this change is necessary to recognize and allow for the coverage changes and additions to be made in section 1723 that may not be contained in standard fidelity bond forms.

- The Commissioner amended section 1723 to clarify that it applies only to applicants for an escrow agent's license and to licensees that are not required to be members of EAFC or that will engage in (or are engaged in) the business of receiving escrows for deposit or delivery of the types of transactions not specified in Financial Code section 17312(c); and to articulate the purpose of the fidelity bond consistent with the intent of AB 410, which is to provide similar indemnity coverage as provided by EAFC. DOC further amended section 1723 to increase the amount of the fidelity bond required to be filed with DOC to no less than \$125,000, and to revise the schedule to require a minimum fidelity coverage of \$125,000 for monthly average escrow liability of up to \$125,000 and ranging up to \$5 million for monthly average escrow liability of \$7.5 million to \$10 million, with additional coverage at the rate of \$1 for every \$3 of average escrow liability in excess of \$10 million. The Commissioner further adopted new subsection 1723(b), which recasts the rider and specifies additional provisions applicable to the rider for escrow agents that are not members of the EAFC; DOC also clarified that section 1725 does not apply to a bond under section 1723.

- DOC originally proposed to repeal section 1725, which provides that a bond shall contain the "California Escrow Rider" in effect on July 1, 1983. However, DOC decided not to repeal section 1725, and merely clarified within section 1723 that the rider described in section 1725 does not apply to bonds under section 1723 (see above).

OAL approved the final form of these regulatory changes on January 10, 2001.

### DOC Rulemaking Under the Franchise Investment Law

The following is a summary of rulemaking proceedings recently initiated by DOC under the Franchise Investment Law:

- ◆ **Registration Exemption for Minimal Franchise Fee.** On February 23, 2001, the Commissioner published notice of his intent to amend section 310.001, Title 10 of the CCR, which currently exempts from the registration requirements of the Franchise Investment Law any offer or sale of a franchise where the franchisee is required to pay an annual franchise fee that does not exceed \$100. The \$100 amount has not been changed since the initial adoption of this exemption in 1972.



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A regulation of the Federal Trade Commission (16 C.F.R. Part 436.2(a)(B)(iii)) provides for a similar exemption from the disclosure requirements of its Rule 436 if the fee the franchisee is required to pay to the franchisor, from any time before to within six months after commencing operation of the franchise, is less than \$500. Thus, DOC proposes to amend section 310.001 to increase the *de minimis* amount of the exemption from \$100 to \$500, thereby making its exemption consistent with the federal rule. The Commissioner determined that an annual franchise fee of \$500 or less will not pose a significant financial risk to the franchisee.

The Department scheduled no public hearing on this proposed amendment, but accepted written comment through April 9, 2001. At this writing, DOC is preparing the rulemaking file on the amendment for submission to OAL.

◆ **Notice of Claim of Registration Exemption for New Product or Service Line.** On May 12, 2000, the Commissioner published notice of his intent to amend section 310.101, Title 10 of the CCR, to conform DOC's regulations to SB 459 (Johnson) (Chapter 325, Statutes of 1999).

Effective January 1, 2000, SB 459 (Johnson) added section 31108 to the Corporations Code, which exempts from the Franchise Investment Law's registration requirements an offer or sale of a franchise in California that involves adding a new product or service line to an existing business of a prospective franchisee if the following requirements are met: (1) the prospective franchisee has been engaged in a business offering products or services substantially similar or related to those to be offered by the franchised business for at least the last 24 months; (2) the new product or service is substantially similar or related to the product or service being offered by the prospective franchisee's existing business; (3) the franchised business is to be operated from the same location as the prospective franchisee's existing business; (4) the parties anticipate in good faith that sales resulting from the franchised business will not represent more than 20% of the franchisee's total annual sales; and (5) the prospective franchisee is not controlled by the franchisor. [17:1 CRLR 149]

In order for a franchise transaction to qualify for this exemption, Corporations Code section 31108 requires the franchisor to file a notice of exemption with DOC prior to and within the same calendar year as the sale of the franchise. The filing fee of \$450, as prescribed by Corporations Code section 31500(f), must accompany the notice. Section 310.101, Title 10 of the CCR, sets forth the form of the notice to be used in claiming the exemption from registration under Corporations Code sections 31101 and 31104. Because the provisions of those two statutory sections are similar to the notice filing provision in Corporations Code section 31108, and in order to fully implement SB 459, the Commissioner amended section 310.101 to require the use of this notice of exemption form for the new exemption under Corporations Code section 31108.

As noted above, DOC formally published notice of its proposed amendment to section 310.101 in May 2000; how-

ever, the Department also announced its proposed modification in Release No. 14-F dated February 18, 2000, and attached the notice of exemption form to that Release "in order to make the filing requirements for the new exemption immediately available during the Administrative Procedure Act rulemaking process." Following a 45-day public comment period, DOC adopted the amendment to section 310.101; OAL approved it on October 12, 2000.

◆ **Registration Exemption for Internet Offers.** On January 28, 2000, DOC published notice of its intent to adopt new section 310.100.3, Title 10 of the CCR, to exempt from the registration requirement of the Franchise Investment Law the offer of a franchise over the Internet, under certain conditions.

Under the Franchise Investment Law, it is unlawful to offer or sell any franchise in California unless the offer has been registered with DOC or is exempt from registration under Corporations Code sections 31100-31104 or by rule of the Commissioner, or is excepted from the definition of a franchise under Corporations Code section 31005(c). Corporations Code section 31013 provides that an offer to sell a franchise is made in this state when the offer originates from California, or the offer is directed by the offeror to, and is received by, the recipient in California.

According to the Commissioner, the Internet has facilitated the ability of one person to communicate with a larger number of persons than other, more traditional methods of advertising. Internet communications offering to sell franchise rights will be received in California regardless of the intent of the person originating such communications. The statutory definitions of "offer" and "sale" of franchises are broad enough to include an attempt or offer to sell, or the solicitation to buy, a franchise in this state that is made on or through the Internet. Because of the uniqueness of Internet communications and because an Internet offer can benefit the prospective franchisees and the franchisor, the Commissioner concluded that the registration of Internet offers for the sale of franchises is not necessary or appropriate in the public interest or for the protection of investors.

Thus, under new section 310.100.3, a communication made through the Internet of an offer of a franchise is exempt from the registration requirements of the Franchise Investment Law provided that: (1) the offer indicates that the franchise is not being offered to California residents; (2) the offer is not otherwise directed to any person in California by or on behalf of the franchisor or anyone acting with the franchisor's knowledge; and (3) no franchises are sold in California by or on behalf of the franchisor until the offering has been registered with DOC and declared effective, and the disclosure requirements of the Franchise Investment Law fulfilled, prior to the sale of any franchise in California.

DOC scheduled no public hearing on the new regulation, but accepted written comments until March 24, 2000; thereafter, the Department adopted the proposed rule. OAL approved the regulation on January 25, 2001.



## DOC Rulemaking Under the Check Sellers, Bill Payers and Proraters Law

Under the Check Sellers, Bill Payers and Proraters Law, Financial Code section 12000 *et seq.*, DOC licenses and regulates check sellers (persons who sell checks or money orders to the public), bill payers (persons who, acting as agents and for a fee, accept funds from the public to pay bills, such as utility bills), and proraters (a "general prorater" contracts with delinquent debtors and intercedes with creditors to settle debts; a "special prorater" acts as a business agent or manager who contracts with an individual to pay non-delinquent bills). In 1999, the Department undertook a review of its regulations promulgated under the Check Sellers, Bill Payers and Proraters Law and made nonsubstantive changes by repealing section 1772.1 and amending sections 1781 and 1790.1, Title 10 of the CCR.

Repealed section 1772.1 required all check sellers and general and special proraters to be organized as California corporations. The section duplicated some requirements of Financial Code section 12200.1 and conflicted with that section's exemption of special proraters from the incorporation requirement. Section 1772.1 was also in conflict with Financial Code section 12200.2, which specifically authorizes an individual to hold a license as a business agent or special prorater. DOC deleted a provision in section 1781 that required all check sellers either to use their true names in the conduct of their businesses or to comply with statutory provisions to acquire a fictitious business name. That provision unnecessarily duplicated Financial Code section 12300.2. The Commissioner made only a minor grammatical change to section 1790.1.

OAL approved the regulatory action on February 28, 2000, and it became effective on March 29, 2000.

## DOC Halts Sales of Hotel Phone Service Investments

On March 2, 2001, Commissioner Boutris announced the completion of an enforcement sweep targeting the illegal offer and sale of investments in LLCs purporting to provide telephone service to hotels. The Department issued 270 orders to 135 insurance agents and financial planners in 25 states, including California, directing the recipients to stop selling the illegal investment opportunities and mandating a halt in unlicensed securities broker-dealer activities.

Investors were promised a 14-20% annual return on investments in ten Nevada LLCs claiming to be in the business of providing telephone services to hotel rooms. Revenue was supposed to be generated by fees charged to hotel guests for using their in-room phones. However, investors were not told that commissions of as much as 45% were being paid to the sales agents and that investments in the LLCs were being transferred to affiliated companies that were in financial trouble. Commissioner Boutris

cautioned: "While limited liability companies are a legitimate choice for many investors, these investments are only as good as the product or service that they are in business to provide. If that product is overvalued or speculative, or if the financial condition of the company is shaky, these investments are not appropriate for most investors. In fact, for small investors, they may be entirely inappropriate and unsuitable. These investors were expecting high profits with low risk, but got left with little value backing up their investments at the end of the day."

## Operation "Tough Call"

On January 8, 2001, DOC announced the conclusion of the first sweep of southern California telemarketing operations by "Operation Tough Call," a multi-agency task force set up to attack illegal and fraudulent telemarketing operations, usually referred to as "boiler rooms." This action was taken pursuant to a 1999 grant awarded to DOC by the Bureau of Justice Assistance of the U.S. Department of Justice (DOJ).

The targeted companies offered stock, partnership interests, and other investment opportunities in firms marketing electronic components, movie deals, auction Web sites, computer hardware and software, Internet products and services, auto accessories, medical devices, television "infomercial" products, travel services, e-commerce services, and others. The offerings sought over \$200 million in investor funds. From October through December 2000, teams of investigators from DOC, the Federal Bureau of Investigation, the Federal Trade Commission, the Commodity Futures Trading Commission, the San Diego Boiler Room Task Force, the County of Orange Boiler Room Apprehension Task Force, postal inspectors, and local law enforcement agencies fanned out throughout Los Angeles, Orange, and San Diego counties issuing warning letters and serving subpoenas, orders, and arrest warrants to active boiler room targets that DOC identified as potentially selling investments illegally and/or fraudulently.

In the sweep, the task force issued 92 desist and refrain orders to 20 entities and 30 individuals in California, Florida, Nevada, and Utah for the illegal and/or fraudulent offer and sale of securities and/or for acting a broker-dealer without a license. The teams also issued subpoenas for investor lists, offering materials, sales scripts, financial records, advertising, and telephone records to 20 entities and 26 individuals, and paid "knock-and-notice" visits to 74 companies warning them that they might be in violation of the state securities laws and seeking their voluntary cooperation in the investigations.

The sweep was the first phase of a two-year project that seeks to attack illegal and fraudulent telemarketing operations in southern California with all of the administrative, civil, and criminal remedies available to state and local law

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enforcement and regulatory agencies. The DOJ grant has funded a command center, a project coordinator, databases to track targets of investigations, and outreach programs to educate investors on how boiler rooms target seniors and other vulnerable communities and measures to avoid becoming fraud victims.

Follow-up actions will include analyzing the documents seized in the raids or provided voluntarily; issuing additional subpoenas, search warrants, and orders; and filing civil and criminal suits. The grant project is expected to provide a model for regulators in other parts of the country in which illegal telemarketing activity is a serious problem.

### DOC Issues Warnings to Consumers

The Department issued several "investor alerts" to consumers in recent months, including the following:

◆ **Energy Investment Scams.** On March 27, 2001, Commissioner Boutris issued a warning to California investors that one of the many unfortunate byproducts of the current energy crisis is likely to be a proliferation of investment scams offering opportunities to invest in energy products and services. The Department conducted an Internet search and found several examples of Web sites offering suspicious energy-related investments. At this writing, DOC is investigating 20 such cases.

◆ **Tips for Online Investors.** On June 16, 2000, DOC released its "Top Ten Tips for Online Investors." With some 200 securities firms offering online brokerage services and over ten million online accounts, the Department warns that it is critical for online investors to understand the playing field, including the risks and limitations of online investing and the differences between online and traditional brokerage accounts. Online trading represents a radical change in the relationship between brokerages and their customers.

DOC recommended that consumers who invest online make sure that they: (1) receive full disclosure, prior to opening an account, about the alternatives for buying and selling securities and how to obtain account information if they cannot access the firm's Web site; (2) understand that most likely they are not linked directly to the market, and that the click of the computer mouse does not instantly execute the trade; (3) receive information from the firm to substantiate any advertised claims concerning the ease and speed of online trading; (4) receive information from the firm about significant Web site outages, delays, and other interruptions to securities trading and account access; (5) obtain information before trading about entering and canceling orders (market, limit and stop loss), and the details and risks of margin accounts (borrowing to buy stocks); (6) determine whether they are receiving delayed or real-time stock quotes and when the ac-

count information was last updated; (7) review the firm's privacy and Web site security policies and whether their names may be used for mailing lists or other promotional activities by the firm or any other party; (8) receive clear information about sales commissions and fees and conditions that apply to any advertised discount on commissions; (9) know how to contact a customer service representative with concerns; and (10) contact DOC to verify the registration/licensing status and disciplinary history of the online brokerage firm (or file a complaint, if appropriate).

◆ **Promissory Note Fraud.** In News Release 00-09 dated June 1, 2000, DOC announced that it had issued a total of 433 orders for the illegal and fraudulent offer and sale of securities in connection with a national crackdown on sellers of promissory notes who pledge high returns and low risk to investors. Promissory notes pay a fixed rate of return and are typically secured by property or assets of the issuing company.

In many of the cases investigated by DOC, the notes were actually issued by shell companies with no assets or overvalued assets, or the notes were issued by new companies looking for start-up capital. DOC investigations showed that these promissory notes are often sold by independent life insurance agents who are lured by high commissions and who may know nothing about the promoters of the investments beyond what they are told. The agents also may not realize that they must be licensed as securities brokers with DOC in order to be authorized to sell the notes.

The Department offers the following tips on how investors in promissory notes can protect their money. First, before investing in any promissory notes, consumers should check with the nearest DOC office to confirm that the notes are properly registered or legally exempt from registration; check to see if the agent selling the notes is licensed as a securities broker by NASD and the state by calling either DOC or NASD's public disclosure hotline at (800) 289-9999; and exercise caution if notes have an above-market interest rate with a maturity of less than one year.

◆ **Foreign Currency Scams.** On March 22, 2000, DOC announced that it had taken enforcement action against 24 entities and 74 individuals throughout California for the illegal and fraudulent offer and sale of foreign currency investments. The sweep is the fourth in as many years, as foreign currency investment scams have proliferated. In the statewide dragnet, the Department also issued ten desist and refrain orders against 13 entities and 56 individuals in California for violation of the state's commodities and securities laws. DOC obtained stipulations to cease illegal operations against five entities and three individuals, and assisted district attorneys in bringing criminal cases in Santa Clara and San Francisco counties.

**With some 200 securities firms offering online brokerage services and over ten million online accounts, the Department warns that it is critical for online investors to understand the playing field, including the risks and limitations of online investing and the differences between online and traditional brokerage accounts.**

According to the Department, many foreign currency brokers in effect create their own market by setting prices and taking positions opposite to their customers, making the opportunity for fraud readily available. Such brokers frequently have neither federal nor state licenses and often make no trades at all; rather, they simply create fictitious account statements and steal their clients' money. Those operating on the Internet may use false identities and could be operating from any place in the world.

DOC warns investors that foreign currency investments are extremely risky because most of the investments are allegedly made in overseas markets such as Hong Kong, where it is nearly impossible to verify whether any trading is actually taking place. It is also difficult to obtain financial records in cases where foreign currency trading is often accomplished through informal interbank exchanges in which small investors can only participate through the accounts of brokers or banks.

## DOC Resumes Collection of Certain Fees

SB 1589 (Committee on Budget and Fiscal Review) (Chapter 328, Statutes of 1998) added Corporations Code section 25608.2, which temporarily suspended—effective July 1, 1998 through June 30, 2000—DOC's collection of fees for certain notice filings under the CSL, namely, Corporations Code sections 25100.1(b) (investment companies), 25102(f) (California limited offerings), 25102.1(a) (qualified purchasers), 25102.1(d) (Rule 506 offerings), and 25230.1(b) and (c) (federally registered investment advisers and investment adviser representatives). Beginning July 1, 2000, the Department resumed collection of those notice filing fees.

## Electronic Filing System for Investment Advisers

A new Web-based electronic filing system allows investment advisers to register with both the SEC and the various state securities regulators, and to file required applications, notices, reports, and renewals via the Internet. Called the Investment Adviser Registration Depository, or "Web IARD," this system is the result of a joint effort of the SEC and the NASAA, which contracted for Web IARD to be built and operated by the National Association of Securities Dealers Regulation, Inc. In Release No.114-C, dated November 3, 2000, DOC set forth the new procedures for SEC-registered investment advisers to file notices with the Commissioner through Web IARD.

## 2000 LEGISLATION

**AB 333 (Papan).** As noted above, the Escrow Law requires that any person who engages in business as an escrow agent, including an Internet escrow agent, within the state be licensed and regulated by DOC. As amended August 7, 2000, AB 333: (1) expands the definition of escrow transactions to include those taking place on the Internet for the sale or transfer of personal property or services, (2) permits Internet escrow transactions using Internet-authorized payment alter-

natives, and (3) allows the use of electronic transfers in place of traditional account transfers. The bill authorizes all records mandated by Escrow Law provisions to be retained and transmitted to the Commissioner in an electronic format. The bill also requires that a person possessing knowledge and understanding of the Escrow Law, regulations, and accounting procedures regarding personal property must be on duty at each business location of a licensed Internet escrow agent corporation during business hours for escrows involving personal property. AB 333 was signed by the Governor on September 13, 2000 (Chapter 437, Statutes of 2000).

**AB 2284 (Dutra).** As noted above, the Escrow Agents Fidelity Corporation is a nonprofit mutual benefit corporation created by statute to indemnify escrow agents that are members of the Corporation against specified kinds of loss; escrow agents engaging in certain types of traditional escrow transactions are required to be members of the EAFC. The expenses of the EAFC are paid from various funds, in which are deposited fees and assessments collected from members. AB 2284 amends the definition of real property escrows for the purpose of defining a type of business transaction that requires an escrow agent to be a member of the EAFC, and provides for refunds of a member's membership fee under certain circumstances and within a specified timeframe. AB 2284 was signed by the Governor on September 24, 2000 (Chapter 636, Statutes of 2000).

**AB 1962 (Lempert).** Until January 1, 2002, Financial Code section 17207 imposes upon each office or location of an escrow agent an annual licensing fee of \$2,000, and permits the Commissioner to levy an additional special assessment not to exceed \$500 if the expenses of administering the Escrow Law exceed the amount received through the annual licensing fees. Under existing law, beginning on January 1, 2002, the flat fee assessment will be repealed and escrow agents will be assessed a pro rata share of all costs and expenses reasonably incurred by DOC in administering the Escrow Law. Existing law also requires the Commissioner to conduct an examination of the business accounts and records of all escrow agents every other calendar year.

As amended August 7, 2000, AB 1962 would have raised the annual flat fee to a maximum of \$2,800; deleted the provision authorizing the Commissioner to levy the special assessment; and deleted the provision making the existing law inoperative as of January 1, 2002, thereby extending its operation indefinitely. AB 1962 would also have changed the frequency of the Commissioner's examination of escrow agents' business accounts and records, effective January 1, 2001, to once every fourth calendar year, or more frequently if the Commissioner determines it to be warranted.

On September 10, 2000, Governor Davis vetoed AB 1962. In his veto message, the Governor stated: "This bill will not provide the Department of Corporations with adequate funding to meet its existing regulatory responsibilities with respect to the escrow industry. In addition, doubling the length of the routine audit cycle from two to four years may jeopardize

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dize consumer protections. I am willing to consider legislation next year, which ensures adequate funding while addressing industry concerns about the cost of issuing licenses" (see AB 459 (Nation) in 2001 LEGISLATION below).

**SB 1837 (Figueroa)**, as amended August 18, 2000, clarifies that "viatical settlement contracts" (also called "life settlement contracts") are "securities" subject to the Corporate Securities Law. These contracts are agreements for the purchase, sale, assignment, transfer, devise, or bequest of any portion of the death benefit or ownership of a life insurance policy or certificate for consideration that is less than the expected death benefit of the life insurance policy or certificate. According to the Department, "viatical investments remain one of the hottest investment products in the marketplace, and also one of the riskiest." Viatical investment companies solicit investors to buy interests in the death benefits provided for in life insurance policies of terminally ill patients, including AIDS and cancer patients. The insured receives a discounted percentage of the death benefits, supposedly to improve the quality of his/her life in the final days; the investor gets the insured's share of the death benefit when the insured dies, less a brokerage fee for the viatical investment broker.

Subject to certain exclusions, SB 1837 classifies "a viatical settlement contract or a fractionalized or pooled interest in a viatical settlement contract" and "a life settlement contract or a fractionalized or pooled interest in a life settlement contract" as a security for purposes of the CSL, thus giving DOC responsibility and oversight for viatical investments. The bill also adds new subsection (q) to Corporations Code section 25102, which creates a new exemption to the qualification and registration requirements of the CSL for any offer or sale of any viatical or life settlement contract (or fractionalized or pooled interest therein) in a transaction where: (a) the sale is to "qualified purchasers," as specified; (b) each purchaser is purchasing for their own account and not with a view to resale; and (c) each natural person purchaser receives, at least five business days before the sale, certain information in writing about the issuer, the officers, and directors of the issuer, the insurance policy, the issuing insurance company, and the investment. SB 1837 also exempts from the broker-dealer licensing requirements of the CSL a licensed life agent when engaged in transactions exempted under the new exemption for viatical or life settlement contracts (or fractionalized or pooled interests therein). SB 1837 also permits a viatical or life settlement contract to be cancelled or rescinded for any reason within seven calendar days of remitting consideration for the transaction to the issuer or the issuer's agent.

Existing law exempts from the requirement of DOC qualification an offer or sale of any security issued pursuant to a

stock option or purchase plan or agreement when that plan or agreement is exempt pursuant to specified federal law and specified regulations are met. SB 1837 applies the exemption to any security issued pursuant to a purchase or option plan or agreement by an LLC. The bill clarifies that this exemption from qualification for an offer or sale of a security issued pursuant to a purchase or option plan or agreement applies when the security meets the conditions for the exemption at the time of issuance or grant (see MAJOR PROJECTS).

The California Commodity Law of 1990 prohibits a person from selling or purchasing (or offering to do so) any commodity under any commodity contract or option unless the person is exempted from this prohibition. Under existing law, a person who is a member of a contract market designated by the Commodity Futures Trading Commission or any clearinghouse thereof is exempt from the prohibition. This bill specifies that for the member to come within the exemption, the commodity transaction at issue must require membership in and be subject to the regulatory jurisdiction of that contract market. SB 1837 was signed by Governor Davis on September 25, 2000 (Chapter 705, Statutes of 2000).

**AB 2032 (Leach)**. Corporations Code section 25102(o) exempts from the qualification and registration requirement of the CSL the offer or sale of any security issued pursuant to a stock purchase plan or agreement, or issued pursuant to a stock option plan or agreement, when the stock purchase or

option plan or agreement is exempt pursuant to specified federal law and specified state regulations are met. As amended June 27, 2000, AB 2032 would have applied the exemption to any security issued pursuant to a purchase or option plan or agreement by an LLC. Governor Davis vetoed AB 2032 on September 30,

2000. In his veto message, the Governor stated: "I have already signed a bill that makes the exact same changes to this law as AB 2032. A few days ago I signed Senate Bill 1837 (Chapter 705, Statutes of 2000). I therefore find this bill to be duplicative and unnecessary."

**AB 1894 (Ackerman)**, as amended June 12, 2000, adds new subsection 25103(i) to the Corporations Code, which exempts from the qualification requirement of the CSL equity conversion transactions and any exchange of securities in connection with a merger, consolidation, or sale of assets in consideration wholly or in part of the issuance of securities or any equity conversion transaction pursuant to a plan of reorganization under the U.S. Bankruptcy Code. AB 1894 was signed by the Governor on July 24, 2000 (Chapter 201, Statutes of 2000).

**AB 1895 (Ackerman)**, as amended August 10, 2000, makes various technical changes relating to corporations and securities. The legislation: (1) adds a definition of "cumula-

**Subject to certain exclusions, SB 1837 classifies "a viatical settlement contract or a fractionalized or pooled interest in a viatical settlement contract" and "a life settlement contract or a fractionalized or pooled interest in a life settlement contract" as a security for purposes of the CSL, thus giving DOC responsibility and oversight for viatical investments.**

dividends in arrears" for shareholder distributions (Corporations Code section 163.5); (2) revises Corporations Code section 202 regarding professional corporations; (3) changes a reference to securities listed on the National Market System of the NASDAQ Stock Market in various provisions of law; (4) specifies the conditions regarding election of a director to fill a vacancy not created by removal of a director; (5) authorizes a superior court to appoint directors of various types of nonprofit corporations if the corporation has no shareholders or initial directors have not been named and all of the directors die, resign, or become incompetent; and (6) specifies the conditions of a board's approval of business items if members leave before a vote. Governor Davis signed AB 1895 on September 16, 2000 (Chapter 485, Statutes of 2000).

**AB 2403 (Maddox)**, as amended July 5, 2000, amends Financial Code section 50302 to require DOC to examine each of its licensees under the California Residential Mortgage Lending Act (CRMLA) at least once every four years (instead of once every two years, as specified in prior law). Under the bill, a licensee must pay DOC the reasonable expenses of any regulatory examination of the licensee undertaken by DOC (under the former method, all such examination expenses were averaged and then rolled into the assessments paid by all licensees).

AB 2403 also modifies the method by which annual CRMLA licensing fees are calculated. AB 2403 lowers the required minimum assessment from \$5,000 to \$1,000 plus a factor based on the amount of loans originated and serviced; under AB 2403, the maximum assessment is \$5,000 annually. The new law also reduces the requirement for DOC's reserve fund to cover DOC's costs and expenses of administering the CRMLA by specifying that the reserve should contain a maximum of 90 days' costs and expenses (prior law required the reserve to contain a minimum of 90 days' costs and expenses).

AB 2403 was sponsored by the California Mortgage Bankers Association (CMBA). According to an Assembly analysis, the purpose of this bill is to make the funding mechanism to support DOC's administration of the CRMLA more equitable to the industry. DOC assesses the industry for complete support to administer the CRMLA. The administration of this program includes four major components: (1) regulatory exams; (2) enforcement activities; (3) investigations; and (4) administrative costs. However, CMBA contended that the funding structure to determine these assessments created inequities within the industry. This is because exam costs paid by a company seldom reflected the actual costs of the audit. Instead, these costs were averaged and then folded into assessments paid by all licensees; as such, increases in program costs were borne mainly by the largest companies. According to CMBA, this bill resolves these inequities by expanding the time frame from two to four years that a licensee must be examined and by requiring the costs of these exams to be billed directly to the examined company. Thus, this bill separates exam costs from the assessment formula, thereby scal-

ing these costs more appropriately to the company's own audit needs.

AB 2403 also prohibits a licensee from requiring a borrower to pay interest on a mortgage loan for a period in excess of one day prior to the recording of the mortgage, with certain exceptions based on the day agreed to for the recording. CMBA maintains that this bill clarifies when lenders can begin charging interest on loans. According to the industry, lenders generally begin charging interest when, at the request of the borrower, they pay funds into escrow; at this point, the lender has relinquished control of the money. On December 22, 1999, however, the Attorney General issued Opinion No. 99-307 suggesting that interest should not be charged until the loan is recorded and escrow closed. Typically, the borrower requests that funds be deposited into escrow the day before the scheduled closing date. (This is because most county recorders record loans at 8:00 a.m.) Thus, CMBA believes this bill is necessary to clarify that interest may be charged one day before a loan records. AB 2403 was signed by the Governor on September 29, 2000 (Chapter 968, Statutes of 2000).

**AB 996 (Papan)**. Existing law provides that when any mortgage has been satisfied, the mortgagee or its assignee shall execute and record or "cause to be recorded" a certificate of discharge, except as specified. Existing law also provides that when an obligation secured by a deed of trust has been satisfied, the beneficiary or its assignee shall execute a full reconveyance and record it or "cause it to be recorded," except as specified. As amended August 25, 2000, this bill defines the phrases "cause to be recorded" and "cause it to be recorded" for these purposes to include sending by certified mail with the United States Postal Service or by a courier service, as specified, the full reconveyance or certificate of discharge in a recordable form, together with payment for all required fees, in an envelope addressed to the county recorder's office in which the deed of trust or mortgage is recorded. The bill requires the county recorder to stamp and record the full reconveyance or certificate of discharge within two business days from the day of receipt. AB 996 only applies to a mortgage or an obligation secured by a deed of trust satisfied on or after January 2, 2001. AB 996 was signed by Governor Davis on September 29, 2000 (Chapter 1013, Statutes of 2000).

## 2001 LEGISLATION

**AB 459 (Nation)**, as amended March 27, 2001, is a reintroduction of the concept in AB 1962 (Lempert), which was vetoed by Governor Davis in 2000 (see above). AB 459 would eventually restructure the scheme under which escrow company licensees pay annual licensing fees to DOC, converting it from a flat fee to a pro rata assessment on January 1, 2006.

AB 459 would extend from January 1, 2002 to January 1, 2006 the current annual \$2,000 license fee and assessment procedure, but would authorize DOC to increase the flat fee up to \$2,800 annually. AB 459 would correspondingly delay

## BUSINESS REGULATORY AGENCIES

until January 1, 2006 the imposition of a pro rata share method of calculating annual escrow agent fees, and require DOC to conduct examinations of its escrow agent licensees as often as deemed necessary and appropriate, but not less than once every four years. Furthermore, the bill would require new escrow agent licensees to be examined within two years of the original issuance of the license. [A. *Appr*]

**AB 544 (Maldonado)**, as introduced February 21, 2001, would clarify that the protection provided by the EAFC does not extend to any transaction involving a branch or business location of a member outside of California. AB 544 would also increase to 100% the amount of the deductible applicable to a member who suffers a loss of trust obligations caused by a person who is required to have the certificate from the EAFC but has failed to obtain one or has had a certificate denied, suspended, or revoked. [A. *B&F*]

**AB 392 (Maddox)**, as amended April 23, 2001, would require the Corporations Commissioner, the Real Estate Commissioner, and the Insurance Commissioner to notify each other when taking enforcement or disciplinary action related to certain escrow services (see LITIGATION). The bill would require DOC, the Department of Real Estate, and the Department of Insurance to each maintain a Web site that displays a database of individuals who have been subject to disciplinary action related to the escrow industry. [A. *Appr*]

**AB 489 (Migden)**, as amended April 19, 2001, would prohibit real estate brokers or agents, commercial or industrial banks, savings associations, finance lenders and residential mortgage lenders from originating any high-cost loan by means of any manipulative, deceptive or other fraudulent scheme, device, or contrivance (known as "predatory loans") prohibited by regulations adopted by the BTH Secretary; and require the BTH Secretary to develop regulations defining the prohibited practices in consultation with the Commissioner of Corporations, the Real Estate Commissioner, the Commissioner of Financial Institutions, and the Attorney General. The regulations would be enforced by the agencies charged with the regulation of specified persons and entities involved in the making of loans secured by real property, including DOC. [A. *B&F*]

**SB 400 (Ackerman)**, as amended April 16, 2001, pertains to certain offers and sales of securities issued by a corporation or LLC that are exempt from the requirement of DOC qualification under Corporations Code section 25102(o). The bill would provide that the failure of the corporation or LLC initially to file a notice of transaction does not limit the availability of the exemption if the notice is subsequently filed within 15 business days after a demand is made by the Commissioner. [S. *BC&IT*]

**AB 119 (Chavez)**, as amended April 5, 2001, would authorize a licensed broker-dealer, affiliate, or any officer or employee thereof to submit fingerprints of an employment applicant to the Department of Justice for the purpose of obtaining information on whether that applicant has a conviction or active summary arrest events. The bill would allow

for the use of live-scan fingerprint technology; and establish specified criteria that DOJ would be required to follow in providing conviction and summary arrest event information. [A. *Appr*]

**AB 1048 (Frommer)**, as amended March 29, 2001, would authorize DOC to participate in the Central Registration Depository (CRD) and the Investment Adviser Registration Depository (IARD) to facilitate electronic filing for investment advisers (see MAJOR PROJECTS), and make other technical changes to the licensing and registration laws for investment advisers and securities broker-dealers. [A. *Appr*]

**AB 1230 (Papan)**, as amended April 24, 2001, would streamline the licensing process administered by DOC under the Finance Lenders Law. Specifically, this bill would clarify that the scope of DOC's investigation of the officers of a corporate applicant for a finance lenders license is limited to the principal officers of the corporation, defined as the president/chief executive officer, treasurer/chief financial officer, and any other officer with direct responsibility for the conduct of the applicant's lending activities. The bill would also require DOC to act on a license application within 45 days instead of the 60 days permitted by existing law. [A. *Appr*]

**AB 795 (Dutra)**, as amended April 16, 2001, would amend Business and Professions Code section 10177 to eliminate DOC's disciplinary jurisdiction over real estate licensees who arrange multi-lender loans under Business and Professions Code section 10229 (loans in which more than one private investor has a partial ownership interest in a mortgage note secured by real property). [A. *Appr*]

## LITIGATION

*People v. Fidelity National Title Insurance Co., et al.*, No. 99AS02793 (Sacramento County Superior Court), is a class action filed in May 1999 by Attorney General Bill Lockyer on behalf of State Controller Kathleen Connell and Department of Insurance (DOI) Commissioner Chuck Quackenbush against most DOC-licensed escrow companies and DOI-licensed title insurance companies doing business in California. The Attorney General alleges that, starting in 1970 and continuing to the present, the defendant escrow and title insurance companies: (1) "intentionally took millions of dollars of escrow funds, which remained unclaimed in escrow accounts, that should have escheated to the State of California;" (2) "charged home buyers and other customers improper fees for services that defendants did not and never intended to provide" (including fees for reconveyances that never occurred, delivery services that were not performed, and illegal administration fees); and (3) "collected millions of dollars in interest payments, or payments in lieu of interest, from banks. None of this interest was paid to escrow depositors, as required by Insurance Code section 12413.5 and Financial Code section 17409." According to State Controller Connell, "as much as \$500 million is owed to Californians for the mishandling and diverting of escrow funds to industry profit...." [17:1 CRLR 149-50]

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At this writing, the lawsuit is tolled while the Controller's Office continues to audit the books of 114 title insurance and 477 escrow companies in California. Since the lawsuit was filed, the amount of unclaimed property remitted to the Controller's Office by the defendant companies has increased substantially, indicating that they are apparently taking steps to identify and remit escheatable funds. Although DOC administers the Escrow Law and the vast majority of the defendants in the civil suit are DOC licensees, the Department has not been directly involved in this litigation.

However, a DOC attempt to address one of the abuses alleged in the Attorney General's class action was shut down by the escrow industry in *Escrow Institute of California v. Kenefick*, No. 815359 (Orange County Superior Court), in late 1999. As noted above, one of the Attorney General's allegations concerns the receipt by title insurers and escrow agents of non-interest payments from banks; in the industry, these payments, services in lieu of payments, or discounts (which are sometimes based upon the amount of client funds deposited by an escrow company or title insurer in the bank) are known as "earnings credits." While California law (Financial Code section 17409 and section 1737, Title 10 of the CCR) prohibits such escrow funds from earning interest, it does not speak specifically to the issue of earnings credits.

Prior to the filing of the Attorney General's class action, DOI Commissioner Quackenbush filed charges against Old Republic Title Company, alleging that it used customer escrow deposits to reap more than \$30 million for itself over the prior ten years, in part by taking "earnings credits" from banks. In its February 1999 *Escrow Monthly Bulletin*, DOC reported on the DOI Commissioner's action and reminded its escrow agent licensees that they are "not permitted to earn interest or gain any benefit from...escrow trust funds." After the filing of the Attorney General's class action, DOC officials conducted an in-depth discussion of the lawsuit with the Department's Escrow Law Advisory Committee at its June 1999 meeting. DOC explained that the Attorney General had asked it for confidential information about its escrow agent licensees, and that it had decided to send letters to its licensees asking them to voluntarily provide information "on any benefits received by the licensees from their banks that are based on the balances in the escrow trust accounts." According to the minutes of the meeting, the advisory committee members (who are defendants in the Attorney General's class action) objected to that plan, and asked what code section prohibits an escrow agent from receiving a benefit from a bank that is based on the balances in escrow trust accounts. DOC officials responded that "it is a violation of section 17409 of the California Financial Code and section 1737 of the California Code of Regulations." Committee members protested, contending that DOC had been aware that escrow agents have

been receiving earnings credits from banks for a number of years. According to the minutes, DOC officials noted that "DOC has always taken the position that it is illegal for an escrow agent to earn interest on its escrow trust accounts or to receive any benefits that are based on the balances in the escrow trust accounts. This position has been noted periodically in the Escrow Newsletters to the industry and numerous times during the Escrow Law Advisory Committee meetings."

Alarmed at what it contended was a new interpretation of the law by DOC, the escrow industry filed *Escrow Institute of California v. Kenefick* in October 1999, accusing DOC of underground rulemaking by creating and attempting to enforce a policy prohibiting escrow agents from receiving earnings credits. EIC, a nonprofit trade association of more than 180 independent escrow firms in California, sought a temporary restraining order (TRO) and preliminary injunction (PI) preventing DOC from enforcing the policy. EIC contended that, before June 1999, both DOC and escrow firms had interpreted the law to prohibit only the payment of interest by banks, thus permitting earnings credits. According to EIC, in June 1999 DOC "unilaterally reinterpreted, redefined and sought to make specific the word 'interest' as it is used in [Financial Code section 17409] so that 'interest' suddenly includes other benefits that may be received by escrow agents, including 'earnings credits.'... Nothing in the legislative history of [section 17409] even remotely suggests an intent on the part of the Legislature to prohibit or even regulate the provision of earnings credits."

According to EIC's motion, DOC issued a memorandum to escrow firms requiring them to "disclose any cash or credits in lieu of cash that you receive from your bank from the last 48 months arising from the trust funds held at the bank...." Then in August 1999, the Department initiated disciplinary action against several firms for failure to comply with the request—which prompted EIC's lawsuit. On October 29, 1999, Judge Randell L. Wilkinson granted a TRO and PI barring DOC from enforcing any prohibition against earnings credits. The court also prohibited DOC from investigating or disciplining any escrow firm for a violation of DOC's interpretation of "interest."

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In February 2000, DOC and EIC settled the lawsuit. Under the terms of the settlement agreement, the Department agreed to dismiss any pending proceedings against escrow firms for accepting earnings credits. Further, DOC cannot stop escrow firms from accepting such credits. However, the agreement permits the Department, in the future, to adopt and carry out any regulations with respect to earnings credits that are "in compliance with Escrow Law." At this writing, the Department has yet to initiate any such rulemaking. In 2000, DOI initiated rulemaking to clarify the issue for its licensees, but that rulemaking was abandoned during the furor over

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Commissioner Quackenbush's June 28, 2000 resignation (see agency report on DOI for related discussion).

In *Roskind v. Morgan Stanley Dean Witter & Co.*, 80 Cal. App. 4th 345 (Apr. 27, 2000), *pet'n for review denied* Aug. 16, 2000, *cert. denied*, 531 U.S. 1119 (Jan. 16, 2001), the First District Court of Appeal held that federal securities violations may be challenged in state court under California's Unfair Competition Law (UCL), Business and Professions Code section 17200.

In this matter, appellant Roskind instructed his stock broker, respondent Morgan Stanley, to sell 14,000 shares of Roskind's Netscape stock. Instead of selling Roskind's stock in a timely fashion, at the higher price at which the stock was trading at the time of Roskind's instruction, Morgan Stanley delayed the sale for 77 minutes, during which time Morgan Stanley "traded ahead" by selling its own large block of Netscape stock first, then selling Roskind's stock at a lower price, causing Roskind to lose more than \$34,000—the difference between the trading price at the time Roskind placed his sell order and the price he actually realized from the sale after the delay. Roskind brought this class action lawsuit seeking restitution and injunctive relief for himself and all other similarly situated customers of Morgan Stanley who had lost money as a result of the broker's practice of trading ahead.

Roskind's complaint stated two causes of action arising under California law. The first cause of action, brought under section 17200, alleged that the practice of trading ahead is an unfair and unlawful business practice. The second cause of action alleged a breach of fiduciary duty by Morgan Stanley in trading ahead of its clients. Morgan Stanley filed a demurrer contending that federal law generally preempts Roskind's claims. The trial court sustained the demurrer without leave to amend. Roskind appealed.

On the question of federal preemption, the First District Court of Appeal concluded that "Congress contemplated that federal law would generally only supplement, not replace, state laws that would otherwise apply in this area of securities regulation." Further, "application of state laws such as the UCL to forbid the practice of trading ahead would not impair or conflict with any provision of federal law, but would be consistent with the purposes and aims of federal law. In fact, since trading ahead constitutes the crime of mail fraud under federal law, it is actionable under the UCL, which borrows other law, including federal law, to define the 'unlawful' practices that are UCL violations."

Concerning the applicability of the UCL (which generally prohibits unfair business practices), the court stated that "the Legislature intended by this sweeping language to per-

mit tribunals to enjoin ongoing wrongful business conduct in whatever context such activity may occur. Indeed, the section was intentionally framed in its broad, sweeping language precisely to enable judicial tribunals to deal with the innumerable

new schemes which the fertility of man's invention would contrive." Having held that the UCL is applicable and is not preempted, the court remanded the case back to the trial court with instructions to overrule Morgan Stanley's demurrer and continue the proceedings.

In *Cariveau v. Halferty*, 83 Cal. App. 4th 126 (Aug. 18, 2000), the First District Court of Appeal held that securities agents may not prohibit their customers from reporting their misconduct to regulatory authorities by using confidentiality/nondisclosure clauses in settlement agreements.

In November 1992, Loralynn Halferty began consulting with Marion Hixon, an NASD-registered agent and staff member of The Equitable Life Assurance Society of the U.S. (Equitable), about investing a sum of money Halferty had inherited.

In 1993, Hixon persuaded Halferty to invest approximately \$90,000 in two real estate limited partnerships (of which Hixon was general partner) and one Nevada corporation (of which Hixon was president). Hixon failed to obtain a waiver from Halferty concerning Hixon's

conflict of interest with regard to these investments.

After seeking advice from other investment advisers, Halferty became concerned about the risk involved in these investments and demanded the return of her money. Hixon told Halferty that the only way she could get her money back was to sign a release agreement providing that Halferty would not disclose any information about her dealings with Hixon to anyone, including regulatory and law enforcement authorities. In order to have her funds returned, Halferty eventually signed a settlement agreement with Hixon, one provision of which stated: "The terms and conditions of this Forbearance Agreement and Mutual Release and each and all of the underlying events resulting in the negotiation of this Agreement shall remain private and confidential in all respects and shall not be disclosed by any party hereto...for any reason whatsoever, to any public or private person or entity, or to any administrative, law enforcement or regulatory agency."

Nevertheless, in February 1994, Halferty wrote a letter to Equitable management recounting Hixon's conduct and demanding \$5,000 as compensation for the legal fees Halferty incurred in attempting to get her money back. Although Equitable responded to Halferty by claiming that Hixon had done nothing improper, Equitable subsequently fired Hixon. Then in a written decision issued April 18, 1996, NASD fined and censured Hixon and barred her from associating with any NASD member in any capacity. The NASD sanctions were

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based on Hixon's improper actions with respect to her dealings with Halferty.

On June 6, 1994, Hixon sued Halferty, alleging breach of contract and other causes of action related to Halferty's disclosure of the information regarding the investments in violation of the confidentiality clause of the Forbearance Agreement. In a curious twist of events, Hixon was shot to death on March 2, 1997 while this case was pending. The trustee of her estate, Tom Cariveau, was substituted as plaintiff. The Sonoma County Superior Court ruled that the forbearance agreement was void as against public policy. Cariveau appealed.

The First District Court of Appeal affirmed the lower court's ruling that the nondisclosure clause is unenforceable as a public policy violation of the NASD's rules and the Securities Exchange Act of 1934. Justice James Marchiano wrote: "The only interest appellant identifies in support of the contract term is the general public policy in favor of promoting the settlement of disputes....Refusing to enforce the confidentiality clause does not affect the settlement of the dispute between Hixon and Halferty, but merely declines assistance to Hixon's concealment of her wrongdoing....The inclusion of a restrictive confidentiality clause in the Forbearance Agreement is not only directly connected to Hixon's misconduct, but is an instance of misconduct in itself....To permit Hixon's violations of rules and shield them from administrative review in an agreement to silence wrongdoing would undermine the public's confidence in the integrity of securities oversight. This type of secret settlement should not be left in some dark oubliette, leaving investors unprotected. To countenance this agreement would encourage future NASD violators to hide their misdeeds in a secret agreement free from the light of regulatory scrutiny."

As part of a settlement agreement in six-year-long litigation against it, DOC agreed in October 2000 to improve its Web site so as to assist investors who believe they are victims of securities fraud in filing complaints with the Department. In *Farrar v. Department of Corporations*, No. BC137842 (Los Angeles County Superior Court), DOC was sued by investors of First Pension Corporation; the plaintiffs alleged that DOC had been given information regarding First Pension's long-running unlawful activities but failed to take action until the fraud scheme was detected by federal authorities. *Farrar* was later transferred to Orange County and consolidated with other civil fraud proceedings pending against First Pension, most of which settled after a jury found that First Pension's auditor, Coopers & Lybrand (now PricewaterhouseCoopers), was liable for misrepresenting First Pension's financial condition, concealing material information, and abetting the company's managers in the fraud; in related criminal action, three of the company's managers who admitted swindling 8,000 investors out of their savings are in federal prison. Under the settlement (in which DOC admitted to no wrongdoing), DOC agreed to inform the public on how to file complaints about suspected securities fraud and to maintain information on its Web site to help investors detect and report fraudulent investment schemes. Pursuant to the settlement, DOC has added links enabling consumers to download its complaint forms (thereafter, those forms must be completed and mailed to DOC); further, DOC's Web site links to the databases of national organizations, enabling investors to attempt to check out the disciplinary histories of their brokers, investment advisers, financial planners, and other money managers.

## Department of Insurance

Commissioner: Harry W. Low ♦ (415) 538-4500 ♦ (916) 492-3500 ♦ (213) 897-8921 ♦  
Toll-Free Consumer Hotline: 1-800-927-4357 ♦ Internet: [www.insurance.ca.gov](http://www.insurance.ca.gov)



Insurance is the only interstate business wholly regulated by the several states rather than the federal government. In California, this responsibility rests with the Department of Insurance (DOI), organized in 1868 and headed (as of 1988) by an elected Insurance Commissioner. Insurance Code sections 12919 through 12938 set forth the Commissioner's powers and duties. Authorization for DOI is found in section 12906 of the 800-page Insurance Code; the Department's regulations are codified in Chapter 5, Title 10 of the California Code of Regulations (CCR).

The Department's designated purpose is to regulate the insurance industry in order to protect policyholders. Such regulation includes the licensing of agents and brokers, and the admission of companies to sell insurance products in the state. In California, the Insurance Commissioner licenses approximately 1,500 insurance companies that carry premiums of approximately \$65 billion annually. Of these, 600

specialize in writing life and/or accident and health policies.

In addition to its licensing function, DOI is the principal agency involved in the collection of annual taxes paid by the insurance industry. The Department also collects more than 175 different fees levied against insurance producers and companies.

The Department also performs the following functions:

- (1) it regulates insurance companies for solvency by tri-annually auditing all domestic insurance companies and by selectively participating in the auditing of other companies licensed in California but organized in another state or foreign country;
- (2) it grants or denies security permits and other types of formal authorizations to applying insurance and title companies;
- (3) it reviews formally and approves or disapproves tens of thousands of insurance policies and related forms annu-