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Elizabeth Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

**RE: Release Nos. 34-71120; 39-2493; File No. S7-11-13 (Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act)**

Dear Secretary Murphy:

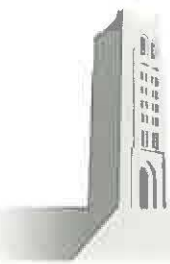
The Cornell Securities Law Clinic ("Clinic") submits this comment on the rule proposal ("Regulation A-Plus") of the Securities and Exchange Commission ("Commission") to implement Section 401 of the Jumpstart Our Business Startups Act ("JOBS Act"). The Clinic is a Cornell Law School curricular offering in which students provide representation to public investors and public education regarding investment fraud to the largely rural "Southern Tier" region of the upstate New York. For more information, please see: http://securities.lawschool.cornell.edu.

Regulation A-Plus aims to revise the existing, rarely-used Regulation A to ease small businesses' ability to access the public capital markets. The Commission proposes amending existing Regulation A by increasing the amount of securities that may be offered under it from $5 million to $50 million. To accomplish this, the proposed rules divide exempt offerings into two tiers: one tier for offerings up to $5 million ("Tier One Offerings") and a second tier for offerings up to $50 million ("Tier Two Offerings.")[1] Under the proposed rules, Tier Two offerings would be registered with the Commission through an expedited process and exempt from state law registration requirements.[2]

The Clinic appreciates the inherent challenge of creating rules that protect investors while keeping transaction costs low enough to make Regulation A-Plus a viable path for small business capital formation. However, as explained in greater detail below, the Clinic joins NASAA's concern that the proposed rules increase the potential for fraud by depriving states of the ability to review Regulation A-Plus offerings before they are sold to the public.[3]

Because the proposed rules neither insist on heightened investor sophistication nor provide commensurate investor protection to justify state law preemption, Regulation A-Plus offerings put less

[1] Regulation A-Plus at 8.
[2] *Id.*
[3] Letter from Andrea Seidt, President, NASAA to the SEC, February 19, 2014 ("NASAA Letter") at 1.



sophisticated investors at risk and create heightened potential for securities fraud if the Commission adopts the proposed rules in their current form.

Even without state law preemption, Regulation A-Plus provides a less expensive capital-raising alternative to the traditional public offering. Moreover, state law preemption is particularly unjustified in this context, since NASAA and the states are currently working together to create a coordinated review process designed to lower costs of compliance. The Commission should give NASAA and the states a reasonable amount of time to implement this proposed coordinated review program.

Thus, the Clinic expresses grave concern with the proposed rules to the extent they weaken investor protections. If the Commission does choose to preempt state law registration, the Clinic urges the Commission to adopt additional investor safeguards. In particular, the Commission should adopt more stringent investment limitations for purchasers who do not qualify as Accredited Investors,[4] and a definition of qualified purchaser that serves as a better proxy for assessing an investor's sophistication.

## I. The Commission Should Work With NASAA to Promptly Develop NASAA's Proposed Coordinated Review System.

NASAA has proposed a streamlined state-coordinated review system which would distribute an issuer's single filing to all states, enabling all states to comment on the issuer's offering circular through a single lead examiner who would interact with the issuer. The Clinic supports NASAA's position that this proposed system is the best way to balance the Commission's dual goals of protecting investors while reducing transaction costs for small businesses.

Commentators have argued that without preemption, blue sky law compliance costs would deter issuers from relying on Regulation A-Plus for capital formation.[5] Nonetheless, state law preemption is too drastic a measure because other proposed rules and the increased offering limit should sufficiently induce small businesses to use Regulation A-Plus.

First, state regulators are best suited to reviewing Regulation A-Plus offerings. Because states are geographically closer to both local businesses and investors, they have the expertise and familiarity to oversee the offerings and to monitor the offering's quality on behalf of both the issuer and investors. Indeed, states are often the "first responders" to investment fraud.[6] Although, as in Regulation D offerings states retain anti-fraud jurisdiction under Regulation A-Plus, the extent of Regulation D fraud

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[4] *See* Rule 501 of Regulation D of the Securities Act of 1933.

[5] *See, e.g.* Rutheford B. Campbell, Jr., Blue Sky Laws and the Recent Congressional Preemption Failure, 22 Journal of Corporation Law (Winter 1997), at 178.

[6] NASAA Release, Notice of Request for Public Comment: Proposed Coordinated Review Program for Section 3(b)(2) offerings, Oct. 30, 2013, at 2, *available at*: http://www.nasaa.org/27427/notice-request-public-comment-proposed-coordinated-review-program-section-3b2-offerings/ ("NASAA Release"); *see also* Letter to the SEC from Jesse White, Illinois Secretary of State, March 4, 2014 at 1.

shows that after the fact policing is insufficient and comes too late, when states could prevent fraud at the outset by overseeing the offering process.[7]

Second, adopting NASAA's proposed state coordinated review system would reduce transaction costs for issuers relying on Regulation A-Plus for capital formation. Under NASAA's proposed system, issuers would file Regulation A-Plus offerings in one place through an Electronic Filing Depository which would distribute the offering circulars to all states.[8] NASAA would appoint "lead examiners" to oversee the process.[9]

Each state would be given ten business days for review. Thus, with state-coordinated review, the timeline for an offering circular to qualify under Regulation A-Plus would not increase beyond the more than twenty-day period the Commission currently anticipates for Federal Regulation A-Plus review.[10] After receiving comments from states, lead examiners alone would interact with the issuer to resolve any deficiencies, and, once the lead examiner determines an application should be cleared, that decision would bind all participating states.

If properly implemented, NASAA's coordinated system would reduce transaction costs for issuers in comparison to existing Regulation A because issuers will no longer have to file their offerings with different states according to different procedural requirements. Also, it is unlikely that a state would opt out of NASAA's program because supporting NASAA's program would ensure state review. If states do choose to opt out, the Clinic would support a future rule preempting only the opted-out states.

Most importantly, NASAA's coordinated review system would provide another layer of protection for investors. States' localized focus has historically made states "first responders," especially regarding fraud where the original offerings were exempt from state review.[11] For example, in 2013, Regulation D offerings underpinned the majority of state-reported securities fraud.[12]

Thus, the Clinic urges the Commission to delay state law preemption until NASAA implements the proposed program. NASAA intends to implement it very soon. NASAA has already approved the coordinated review program.[13] Furthermore, at least 18 states have already approved the program.[14]

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[7] *See, e.g.* Jennifer J. Johnson, Private Placements: A Regulatory Black Hole 35 Del. J Corp. L.,151, 190–97, 2010 (arguing that Reg. D preemption should only apply to Accredited Investors or for offerings by public companies because the SEC lacks resources to adequately police smaller private offerings.)
[8] *Id.*
[9] *Id.*
[10] *See* Regulation A-Plus at 9, 9 n.23 (noting that the staff review period for Regulation A-Plus offerings will be as comprehensive as registration statement review, which on average exceeds the 20 calendar days provided by rule.)
[11] Letter from William F. Galvin, Secretary of the Commonwealth, Commonwealth of Massachusetts, December 18, 2013.
[12] NASAA Letter at 1.
[13] *NASAA Members Approve Streamlined Multi-State Coordinated Review Program*, NASAA (Mar. 11, 2014), http://www.nasaa.org/29699/nasaa-members-approve-streamlined-multi-state-coordinated-review-program/.
[14] NASAA Letter at 2.

## II. If the Commission Decides to Preempt State Law, It Should Incorporate More Stringent Investor Protection Rules.

Notwithstanding the Clinic's opposition to state law preemption, if the Commission opts for preemption it should continue to allow states to require notice of offerings, parallel to the notice system in force under Regulation D.[15] Moreover, in the event of decreased state oversight, the Commission should add rules to enhance investor protection.

### (a) The Commission Should Incorporate Additional Rules to Limit Unsophisticated Investors. (Requests for Comment 27 and 29)

The Commission proposes limiting investments in each Regulation A-Plus offering to 10% of the greater of an investor's net worth or annual income.[16] The Clinic believes that this proposed investor limitation, standing alone, offers insufficient protection for unsophisticated investors. Although this proposed limitation may approximate an individual investor's ability to bear loss, it does not constitute a proxy for investor sophistication.

Enhanced disclosure and ongoing reporting required under Regulation A-Plus are no substitute for other investor protections when it comes to less sophisticated purchasers. Indeed, since many issuers using Regulation A-Plus will be start-up companies, they will not have extensive operating histories or financials to disclose.

For this reason, the Commission should create various categories of investor sophistication with corresponding requirements and limitations for each. In its crowdfunding proposal, the Commission created tiers of investors according to net worth and commensurate investment limitations for each tier.[17] A similarly tiered system would better approximate an investor's ability to bear loss.

Moreover, the Clinic recommends accounting for additional factors which bear on an investor's existing risk exposure and sophistication to reduce the risk of securities fraud on unsophisticated investors. For example, the Commission should consider creating a separate limitation for institutional investors, and other types of non-retail investors laid out in the Regulation D, Rule 501 Accredited Investor definition.

Relatedly, the Commission should combine an investment limitation with other provisions that together would better separate investors according to their sophistication. Borrowing from Regulation D, the Commission should incorporate an individual's investment history and total amount invested to determine sophistication.

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[15] Even though filings under Rule 506 of Regulation D are exempt from state registration requirements, states may still require notice through a Form D filling. *See, e.g.* Johnson at 178–79 (noting that the impact of state notice requirements is unclear because NASAA does not track the filings across states.)

[16] Regulation A-Plus at 50.

[17] *See* Securities and Exchange Commission, Release Nos. 33-9740, 34-70741, Proposed Rules for Crowdfunding (Federal Register Version) at 22.

**(b) The Investment Limitation Should Apply to Investors Other than Accredited Investors On A Cumulative Aggregate Basis (Request for Comment 30.)**

The Commission proposes that the 10% investment limitation apply on a per-offering basis. The Clinic opposes this version of the investment limitation. An investment limitation would only protect investors if it is aggregated across all Regulation A-Plus offerings. Thus, the Commission should consider a cumulative investment limitation.

If, as the Commission proposes, the individual investment limitation merely applied to each offering rather than on an aggregate basis, the investment limitation would become toothless. Investors could ultimately commit a very significant percentage of their net worth and/or income to illiquid Regulation A-Plus offerings over time. For the same reason, applying the limitation annually would not sufficiently protect investors. Since the exemption does not apply to secondary sales, an investor subject to an annual cap could acquire a significant amount of Regulation A-Plus holdings over time. Thus, the Commission should consider a cumulative investment limitation.

Bolstering investor protection through an annual cap need not have a drastic impact on the issuer's ability to raise funds. The Clinic emphasizes that the annual cap is most essential for individual retail investors. As described above the Clinic supports a separate, higher investment limitation for institutional investors.

Without verified financials, the Commission should insist on an aggregate annual cap to limit an individual investor's exposure to Regulation A-Plus offerings. Although such a cap could not prevent an individual from misstating or overstating their financials, it could prevent an individual (or intermediary) from committing more than 10% of the misstated figure. Thus, an aggregate cap would minimize an individual's overall amount at risk in Regulation A-Plus investments and reduce an individual's amount tied up in securities that may be difficult to resell when that individual is better suited for a portfolio containing less risk, on balance.

The Clinic agrees that independently verifying all individual investor's financials would not be a feasible requirement for a regulation specifically aimed at creating quicker and less burdensome access to capital markets. Verification is particularly difficult for the individual investor's financials, as the Commission notes in its proposal, because of privacy concerns.[18]

Nonetheless, the Clinic proposes a revision or clarification regarding the issuer's ability to rely on investors' representations of financials (Request for Comment 30).[19] Currently the Commission proposes allowing issuers to rely on investors' representations after issuers make the investors aware of the relevant limitations.[20] The Commission should require not only actual knowledge to alleviate an issuer's burden but should also build a duty of inquiry into these rules, so that the issuer follows up on any red flags. A duty of inquiry would enhance investor protection for smaller, localized offerings where issuers may know their investors better and thus have reasons to request verification.

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[18] Regulation A-Plus, at 52.
[19] *Id.* at 52, 54.
[20] *Id.* at 52.

The Commission should also heighten the issuer's burden to emphasize limitations in its disclosure and supplementary educational materials should be a mandatory component of investor solicitation (Request for Comment 30). Optimally, the Commission should create an independent and secure means of verifying investor income. Short of that, the Clinic advocates a mandatory questionnaire for any individual to complete before buying a security issued under Regulation A-plus.[21] A questionnaire would at minimum lower the risk of misstatements if it could effectively lead an investor through key calculations. This questionnaire should be written in plain English and flag any potential remedy lost with regards to investments exceeding the limitation.

**(c) Regulation A-Plus Should Include A More Stringent Qualified Purchaser Definition.**

The proposed rules define qualified purchaser as any offeree in a Regulation A-Plus offering--a definition that likely exceeds the bounds of rulemaking authority that Congress delegated to the SEC. As a result, small businesses may be reluctant to use Regulation A-Plus in fear of litigation.

Additionally, the Commission should base its "qualified purchaser" definition on investor-based qualifications, rather than using a definition based on attributes of the offering. A narrower definition of qualified purchaser would enable more issuers to feel comfortable using Regulation A-Plus, thus promoting the JOBS Act's goal of rendering Regulation A a more practical and viable path for raising capital.

**Conclusion:**

The Clinic appreciates the opportunity to comment on proposed Regulation A-Plus and respectfully requests the Commission take the Clinic's comments into consideration.

Respectfully submitted,

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[21] *Id.* at 54.