



NASAA

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April 10, 2013

*Submitted electronically to rule-comments@sec.gov*

Elizabeth M. Murphy, Secretary  
Securities and Exchange Commission  
100 F Street NE  
Washington D.C. 20549-1090

**Subject: Comments on SEC Regulatory Initiatives under the Jumpstart Our Business Startups Act: Title IV – Small Company Capital Formation**

Dear Ms. Murphy:

The North American Securities Administrators Association, Inc. (“NASAA”)<sup>1</sup> submits the following advance comments concerning the adoption of an exemption under Section 3(b)(2) of the Securities Act of 1933 (“Act”), as authorized by Title IV of the Jumpstart Our Business Startups Act (“JOBS Act”).<sup>2</sup>

NASAA members have a strong interest in facilitating capital formation in Section 3(b)(2) offerings. Moreover, because these are public offerings that will not be subject to federal registration, the role of NASAA member jurisdictions in the regulation of these offerings is essential to investor protection. Ultimately, oversight by state regulators will contribute to the success of a public marketplace for these offerings. Therefore, in adopting rules applicable to Section 3(b)(2) offerings, we urge the Commission to be mindful of the important role of the states in regulating this new market.

The members of NASAA’s Small Business/Limited Offerings Project Group met in January to design a protocol for the coordinated multi-state review of Section 3(b)(2) offerings. The project group also met with members of the ABA Business Law Section’s working group on Section 3(b)(2) offerings to discuss the need for a coordinated review program and the guidelines that would be appropriate for 3(b)(2) offerings. NASAA members are committed to designing and implementing an efficient review program that facilitates capital formation in these offerings while providing an appropriate level of investor protection.

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<sup>1</sup> The oldest international organization devoted to investor protection, the North American Securities Administrators, Inc. was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

<sup>2</sup> Pub. L. No. 112-106, 126 Stat. 306 (2012), available at <http://www.gpo.gov/fdsys/pkg/PLAW-112publ106/pdf/PLAW-112publ106.pdf>.

We suggest that the federal and state requirements for these offerings should be harmonized to the fullest possible extent. Toward that end, the comments set forth below are intended to assist the Commission in designing and implementing a Section 3(b)(2) exemption that is compatible with the state review program. We also request the cooperation of the Commission staff to work with NASAA to implement a “one-stop” electronic filing system for state review of Section 3(b)(2) offerings.

**1. NASAA strenuously objects to suggestions to define “qualified purchaser” in Section 3(b)(2) or any other offerings based on whether or not the sale was effected through a registered broker-dealer or based on investor qualifications that are commensurate or inferior to current “accredited investor” thresholds.**

Section 401 of the JOBS Act provides that a security sold to a “qualified purchaser” in a 3(b)(2) offering will be treated as a covered security under Section 18 of the Securities Act of 1933. Because states are preempted from requiring registration of covered securities, the definition of a qualified purchaser is a matter of great importance to state regulators and the investors we strive to protect.

NASAA is deeply disturbed by the advance comments of the ABA Federal Regulation of Securities Committee<sup>3</sup> and others<sup>4</sup> suggesting that the Commission define “qualified purchaser” in a manner that is commensurate with or even less stringent than<sup>5</sup> the criteria for an “accredited investor,” or to define it in such a manner that would render any sale of securities through a registered broker-dealer a covered security. In the debate and eventual passage of the JOBS Act, calls to broadly preempt state securities registration requirements with respect to securities offered under Section 3(b)(2) were rejected. Instead, recognizing the important role of states in the regulation of these offerings, Congress limited the preemption to two narrowly-tailored conditions.

In addition, the suggestions of the ABA and others would make it easier for fraudsters to utilize this exemption due to the lack of rigorous federal or state review. The fraud that would result would undermine the market for these types of offerings and hamper the ability of legitimate issuers to raise capital under the exemption. The fact that the securities will be freely tradable, unlike those issued in Rule 506 and other exempt offerings, exacerbates the potential for fraud and abuse and increases the importance of state regulation.

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<sup>3</sup> Letter from Catherine T. Dixon, Chair, Federal Regulation of Securities Committee, Business Law Section, American Bar Association, to SEC (Sept. 7, 2012), at <http://www.sec.gov/comments/jobs-title-iv/jobstitleiv-13.pdf> (hereinafter ABA Comment Letter).

<sup>4</sup> See, e.g., Letter from William R. Hambrecht, Chairman and CEO, WR Hambrecht+Co., to SEC (Jan. 4, 2013), at <http://www.sec.gov/comments/jobs-title-iv/jobstitleiv-21.pdf>.

<sup>5</sup> Letter from Ruthford B. Campbell, Jr., William L. Matthews Professor of Law, University of Kentucky, to Elizabeth M. Murphy, Secretary, SEC (Nov. 13, 2012), at <http://www.sec.gov/comments/jobs-title-iv/jobstitleiv-18.pdf> (suggesting that the Commission define “qualified purchaser” as any investor who purchases securities in a Section 3(b)(2) offering).

As pointed out by NASAA in the past,<sup>6</sup> when Congress enacted the National Securities Markets Improvement Act of 1996 (“NSMIA”) and defined “covered security” to include sales to “qualified purchasers,” it clearly intended for the definition of qualified purchaser to require greater investor qualifications than those of “accredited investors.” The legislative history indicates that qualified purchaser was to be defined to include “sophisticated investors, capable of protecting themselves in a manner that renders regulation by State authorities unnecessary.”<sup>7</sup> In both legislation and Commission rule-making, it has been recognized that while accredited investors may not need all the protections afforded by the registration process, offerings to those types of investors remain subject to specific limitations designed to provide some minimal level of investor protection. For example, notice filings containing specified information about the offering are required to be filed with the Commission in sales to accredited investors under Rule 506. In addition, Congress mandated the adoption of disqualification provisions under Rule 506 to protect accredited investors from offerings by “bad actors” in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

The suggestion that investors who purchase securities through registered broker-dealers should not be afforded the protections of either federal or state registration defies registration requirements under the Securities Act of 1933, the Investment Company Act of 1940, and all state securities laws. One need only look as far as the enforcement orders of the Commission, FINRA, and the states to discover the unfortunate reality that registration as a broker-dealer fails to provide the same investor protection that is provided by the securities registration process. Never has the registration of a broker-dealer alone been recognized as an adequate substitute for the investor protections provided by the registration process, and recent history affirms the fallacy of such recognition.<sup>8</sup>

While NASAA does not object to the adoption of rules to define a qualified purchaser, the definition must be based on qualifications that are sufficiently greater than the definition of an accredited investor whereby the benefits of further limitation on sales to these types of investors are far outweighed by the associated burdens. In this regard, if the Commission pursues defining qualified purchaser under the Securities Act of 1933, NASAA again suggests the adoption of the same thresholds as those contained in the definition of “qualified purchaser” under the Investment Company Act of 1940 (‘40 Act).<sup>9</sup> To be deemed a qualified purchaser under the ‘40

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<sup>6</sup> Letter from Patricia D. Struck, NASAA President and Wisconsin Securities Administrator, to Nancy M. Morris, Federal Advisory Committee Management Officer, SEC (Mar. 28, 2006), at <http://www.sec.gov/rules/other/265-23/rastaples1692.pdf>. See also, Letter from Joseph P. Borg, NASAA President and Director of the Alabama Securities Commission, to Jonathan G. Katz, Secretary, SEC (Mar. 4, 2002), at <http://www.sec.gov/rules/proposed/s72301/borg1.htm> (hereinafter NASAA Qualified Purchaser Letter).

<sup>7</sup> H.R. Rep. No. 622, 104<sup>th</sup> Cong. 2d Sess. at 31 (1996).

<sup>8</sup> See, e.g., Press Release, SEC, SEC Charges J.P. Morgan and Credit Suisse With Misleading Investors in RMBS Offerings (Nov. 16, 2012), at <http://www.sec.gov/news/press/2012/2012-233.htm>; Press Release, FINRA, FINRA Sanctions Eight Firms and 10 Individuals for Selling Interests in Troubled Private Placements, Including Medical Capital, Provident Royalties and DBSI, Without Conducting a Reasonable Investigation (Nov. 29, 2011), at <http://www.finra.org/newsroom/newsreleases/2011/p125193>; Press Release, NASAA, State Securities Regulators Announce \$1.3 Billion Settlement with Wells Fargo Investors in Auction Rate Securities Investigations (Nov. 18, 2009), at <http://www.nasaa.org/2171/state-securities-regulators-announce-1-3-billion-settlement-with-wells-fargo-investors-in-auction-rate-securities-investigations/>.

<sup>9</sup> See NASAA Qualified Purchaser Letter, *supra* note 6.

Act, a natural person must generally own not less than \$5,000,000 in investments and an entity must generally own and invest on a discretionary basis not less than \$25,000,000 in investments.<sup>10</sup> Investors who meet these thresholds have been recognized by Congress as not generally needing the protections afforded by registration of investment companies under the '40 Act. These established thresholds are sufficiently high that “there is a reasonable probability that the investors included in the definition would be financially sophisticated and capable of assuming risk” as contemplated by Congress in enacting NSMIA.<sup>11</sup>

In the alternative, we would again propose that the term be defined consistent with the thresholds established in the Investment Advisers Act of 1940 for “qualified clients.” While inferior to the qualified purchaser standard under the '40 Act, the qualified client definition attempts to define those clients of an investment adviser more likely to be financially sophisticated and capable of evaluating and assuming the risks of performance based fee arrangements. The qualified client definition is subject to adjustments for inflation and generally requires that a natural person have either (i) \$1,000,000 under the management of the investment adviser, or (ii) net worth of more than \$2,000,000 exclusive of the investor’s primary residence.<sup>12</sup> As we suggested in our 2002 comment letter on the definition of qualified purchaser, we urge that both of these thresholds be satisfied for qualified purchasers. While either of these thresholds may be sufficient to allow clients to enter into performance based fee arrangement with investment advisers, they are not as effective in the case of the definition of qualified purchaser in light of the absence of the fiduciary relationship that exists between an investment adviser and its clients.<sup>13</sup>

## **2. An exemption adopted under Section 3(b)(2) must require fulsome disclosure and the format for disclosure should follow the format of the Form 1-A.**

In adopting an exemption under Section 3(b)(2), it is imperative that the Commission mandate the use of an offering statement and its contents to provide fulsome disclosure to prospective investors. Congress clearly intended such a mandate when it required 3(b)(2) issuers to:

prepare and electronically file with the Commission and distribute to prospective investors an offering statement, and any related documents, in such form and with such content as prescribed by the Commission, including audited financial statements, a description of the issuer’s business operations, its financial condition, its corporate governance principles, its use of investor funds, and other appropriate matters.<sup>14</sup>

Not only did Congress express its intent for the Commission to mandate specific disclosure requirements, but the need for mandated disclosure to protect investors is magnified by several factors, including: (1) the fact that issuers will be able to sell to investors regardless of their qualifications; (2) the ability to engage in general solicitation; (3) the higher permitted offering

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<sup>10</sup> 15 USC 80a-2(a)(51).

<sup>11</sup> *Id.*

<sup>12</sup> 17 CFR § 275.205-3.

<sup>13</sup> NASAA Qualified Purchaser Letter, *supra* note 6.

<sup>14</sup> Section 401 of the JOBS Act.

amount as compared to Reg. A offerings; and (4) the ability to solicit indications of interest prior to ever filing the offering statement with the Commission. For these reasons, we urge the Commission to mandate the use and filing of a fulsome disclosure document.

NASAA members have long accepted the disclosure mandated in Form 1-A for Regulation A offerings, and we believe Form 1-A provides an appropriate level of disclosure for offerings exempt under Section 3(b)(2). NASAA was also responsible for the drafting of the question and answer style disclosure format of Model B of Form 1-A, and we believe the Model B disclosure format facilitates capital formation by small business issuers whose officers and directors may be the primary drafters of the disclosure document.

In drafting its rules, we further encourage the Commission to accept the question and answer disclosure format of the latest Small Company Offering Registration (SCOR) form, which was promulgated by NASAA in 1989 and has been updated since that time. NASAA is committed to further updating the SCOR form in cooperation with the Commission staff to ensure a mutually acceptable question and answer disclosure document that is designed for Section 3(b)(2) offerings and facilitates robust and adequate disclosures.

**3. NASAA strongly urges the Commission to proscribe offerings under Section 3(b)(2) by blank check companies and SPACs.**

Offerings by blank check companies and special purpose acquisition companies (SPACs)<sup>15</sup> are generally prohibited as fraudulent offerings under state securities laws.<sup>16</sup> NASAA members have found that “sales of blank check blind pool securities contain inadequate disclosure of facts about the issuer and the offer, tend to work a fraud upon the purchasers thereof and cannot be justified for any useful economic purpose.”<sup>17</sup> For these reasons, we urge the Commission to proscribe these types of offerings under Section 3(b)(2), which if permitted at all, would be more appropriately conducted in an offering subject to federal registration.

**4. NASAA strongly urges the Commission to proscribe the use of financial projections in Section 3(b)(2) offerings in the absence of their review and expression of an unqualified opinion thereon by a licensed certified public accountant.**

State law may not permit the use of financial projections in registered offerings due to the inherent potential for fraud and abuse and the possible lack of any reasonable bases for the projections. The higher offering amount permitted under Section 3(b)(2) as compared to Regulation A elevates these concerns, and the freely tradable nature of the securities contributes to the need for such a prohibition in the interest of investor protection. Thus, NASAA strongly urges the commission to proscribe the use of financial projections in Section 3(b)(2) offerings. As an alternative, NASAA urges the Commission to allow the use of financial projections only if

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<sup>15</sup> See Blank Check Company, SEC, at <http://www.sec.gov/answers/blankcheck.htm>.

<sup>16</sup> Resolution of the North American Securities Administrators Association, Inc., Declaring Blank Check Blind Pool Offerings to be Fraudulent Practices (Apr. 29, 1989), available at <http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Resolution-Regarding-Blank-Check-and-Blind-Pool-Offerings.pdf>.

<sup>17</sup> *Id.*

they are reviewed or compiled and contain the the expression of an unqualified opinion thereon by a licensed certified public accountant.

**5. NASAA strongly urges the Commission to appropriately condition the ability of issuers to solicit indications of interest prior to the filing of an offering statement.**

Section 401 of the JOBS Act will allow issuers to solicit indications of interest in an offering prior to the filing of any offering statement with the Commission. This raises concerns that issuers may pre-condition the market with potentially false or misleading statements, effectively negating the likelihood of investors reviewing final offering materials that may contain substantially different terms or revised disclosures. For this reason, we urge the Commission to place appropriate conditions on the ability to solicit indications of interest prior to the filing of an offering statement in Section 3(b)(2) offerings. In this regard, we believe it is appropriate to restrict the ability to solicit indications of interest prior to the filing of an offering statement to those solicitations conducted by registered broker-dealers or to solicitations in firmly underwritten offerings. The involvement of a registered broker-dealer or an underwriter will provide a minimal degree of assurance that the risk of pre-conditioning the market with potentially false or misleading statements is mitigated.

We further recommend that the Commission adopt specific disclosure requirements in any solicitations of interest to ensure that prospective investors are appropriately advised of the tentative nature of the offering and are urged to read the final offering statement. At a minimum, these advisements should include those prescribed by Rule 254(b)(2).<sup>18</sup>

**6. NASAA urges the adoption of a uniform disqualification provision for offerings under Regulation D, Section 4(a)(5), Regulation A, and Section 3(b)(2).**

As urged by NASAA in the past, we continue to advocate for the adoption of a uniform disqualification provision for “bad actors” that would apply to all offerings under Regulation D, Section 4(a)(5), Regulation A, and the new exemption under Section 3(b)(2).<sup>19</sup> The creation of a different disqualification provision for Section 3(b)(2) offerings, in addition to those that already exist, would only serve to create confusion and increase compliance costs.

**7. Should the Commission permit the use of Section 3(b)(2) by Real Estate Investment Trusts (REITs) and Business Development Companies (BDCs), NASAA urges the Commission to consider tailored disclosure requirements.**

Real Estate Investment Trusts (REITs) and Business Development Companies (BDCs) currently register their securities using Form S-11 and Form N-2, respectively. The unique nature of REITs and BDCs with respect to, among other things, the nature and timing of their capital formation and investment strategies, fee structures, and liquidity, necessitate disclosure fitting for

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<sup>18</sup> 17 CFR § 230.254(b)(2).

<sup>19</sup> Letter from David S. Massey, NASAA President and Deputy Securities Commissioner, North Carolina Department of the Secretary of State, to Elizabeth M. Murphy, Secretary, SEC (July 25, 2011), at <http://www.sec.gov/comments/s7-21-11/s72111-35.pdf>.

these specific entities. Should the Commission permit the use of Section 3(b)(2) by Real Estate Investment Trusts (REITs) and Business Development Companies (BDCs), NASAA would appreciate the opportunity to work with the Commission to develop appropriate disclosure requirements for REITs and BDCs.

**8. NASAA urges the Commission to restrict the ability of selling security holders to rely on Section 3(b)(2) in the absence of the approval of the offering by a majority of an issuer's independent directors upon a finding that the offering is in the best interests of both the selling security holders and the issuer.**

In its present form, Regulation A limits the amount of securities that may be offered by selling security holders and prohibits resales by affiliates “if the issuer has not had net income from continuing operations in at least one of its last two fiscal years.”<sup>20</sup> This limitation protects the investing public from selling security holders who may have superior information about the issuer from dumping their investments in the public markets.

NASAA members are disturbed by recent offerings whose sole purpose is to provide liquidity to venture capital and private equity investment firms, which have better negotiating power and access to information than the average investor in a public offering. We are concerned these offerings may be abusive of not only investors that purchase securities in the resale, but also of the issuers themselves. For example, in a recent application by Applied Medical Corporation, the company is seeking registration of outstanding securities held by a venture capital firm pursuant to demand registration rights. The prospectus discloses in no uncertain terms that the issuer's board of directors and executive officers believe the offering, which will not provide any proceeds to the issuer, is not in the best interests of the company.<sup>21</sup> We do not believe these offerings are what Congress contemplated when passing the JOBS Act because these offerings do not provide capital to the issuers or otherwise contribute to job creation. Accordingly, the Commission should not allow the market for Section 3(b)(2) offerings to be muddied with offerings by selling security holders such as venture capital and private equity firms who had superior negotiating power at the time of their investment, have greater access to information, and seek to offload their investments on public investors. For these reasons, we urge the Commission to restrict the ability of selling security holders to use the exemption.

In the alternative, we urge the Commission to require the approval of a majority of an issuer's independent directors as a condition of Section 3(b)(2) for offerings involving selling security holders. While such a provision would not protect public investors from venture capital and private equity firms with superior negotiating positions and access to information, it would at least serve to mitigate the risk of offerings that are not in an issuer's best interests and do nothing to increase an issuer's access to capital or facilitate job creation. These offerings would instead

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<sup>20</sup> 17 CFR § 230.251(b).

<sup>21</sup> The prospectus further discloses that the underwriter selected by the venture capital firm may not be acting in the best interests of the company, its existing stockholders, or its potential investors. Shockingly, the prospectus goes on to suggest that information posted on the underwriter's website may contradict the disclosure set forth in the prospectus, which we understand may mean that misleading statements and omissions are being made in connection with this offering.

be subject to SEC registration and would therefore be more likely to be listed on an exchange, providing greater protection to public investors than that provided in an offering exempt from federal registration. We note that such a provision would need to provide that demand registration rights cannot form the basis for the approval of the offering by independent directors.

**9. NASAA urges the Commission to adopt meaningful reporting requirements for Section 3(b)(2) issuers to protect the investing public and facilitate secondary trading.**

As we have suggested previously,<sup>22</sup> we continue to urge the Commission to adopt meaningful reporting requirements for offerings conducted under Section 3(b)(2) offerings to facilitate secondary trading. In this age of internet communications, social media, and online trading, meaningful reporting requirements are essential to provide a level of investor protection for securities that are not federally registered.<sup>23</sup> The reporting requirements ultimately adopted must be fulsome enough to mitigate potential fraud in this area in light of the fact that the securities offered under Section 3(b)(2) are not subject to federal registration and will not necessarily be subject to exchange listing requirements, but will be freely tradable nonetheless.

**Conclusion**

NASAA appreciates the opportunity to provide these comments to the Commission. We look forward to working with the Commission staff to ensure maximum coordination of a the exemption under Section 3(b)(2) with state law requirements and to facilitate a “one-stop” filing system. Should you have any questions regarding the comments in this letter, please contact the undersigned; Rick Fleming, Deputy General Counsel for NASAA, at rf@nasaa.org or (202) 737-0900; or Bill Beatty, Securities Administrator for the State of Washington and Chair of NASAA’s Corporation Finance Section at bill.beatty@dfi.wa.gov or (360) 902-8760.

Sincerely,



A. Heath Abshure  
President

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<sup>22</sup> Letter from Jack Herstein, NASAA President and Assistant Director, Nebraska Department of Banking & Finance, to Elizabeth M. Murphy, Secretary, SEC (July 3, 2012), at <http://www.sec.gov/comments/jobs-title-ii/jobstitleii-40.pdf>.

<sup>23</sup> See, e.g., Eleazar David Melendez, Twitter Stock Market Hoax Draws Attention of Regulators, TheHuffingtonPost.com, Inc., Feb. 1, 2013, at [http://www.huffingtonpost.com/2013/02/01/twitter-stock-market-hoax\\_n\\_2601753.html](http://www.huffingtonpost.com/2013/02/01/twitter-stock-market-hoax_n_2601753.html).