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NASAA

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By email to: rule-comments@sec.gov

Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

RE: File No. S7-05-20: Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets

Dear Ms. Countryman:

On behalf of the North American Securities Administrators Association, Inc. ("NASAA"),[1] I am writing in response to U.S. Securities and Exchange Commission (the "SEC" or "Commission") Release No. 33-10763, *Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets* (the "Proposal"),[2] in which the Commission proposes to harmonize certain differences in the rules governing exempt securities offerings.

NASAA has significant concerns with the Proposal. In general, we see it as yet another unnecessary policy choice by the Commission to expand the private securities market to the detriment of the public market. The Commission's stated goal is to facilitate capital formation by reducing complexity and "friction points" in the regulation of exempt offerings.[3] Yet, facilitating

[1] Organized in 1919, NASAA is the oldest international organization devoted to investor protection. NASAA's 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.

[2] The Proposal is available at https://www.sec.gov/rules/proposed/2020/33-10763.pdf.

[3] Proposal at 10. It should be recognized that certain features of the Proposal would introduce rules that run counter to existing statutory requirements under the authority provided by Section 28 of the Securities Act of 1933 (the "Securities Act"), which allows the Commission to exempt persons, securities, transactions and classes thereof from Securities Act requirements "to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." 15 U.S.C. § 77z-3. For the reasons explained in this letter, NASAA posits that parts of the Proposal are not consistent with the protection of investors. The Commission

more exempt offerings in the manner proposed will do nothing to promote or otherwise support capital formation in the public markets, and will ultimately have negative consequences for investors. The most likely outcome of the Proposal will be for more issuers to remain private, which will have the deleterious effect of depriving investors in those companies of the benefits of registration.

The types of companies that rely on private offerings are frequently not the sorts of companies in which non-accredited investors should be investing. As NASAA has stated previously, "the lack of transparency and liquidity in the private securities markets makes it ripe for bad actors. In fact, private offerings rank among the most common sources of enforcement actions brought by NASAA's member state securities regulators."[4] Aside from the risks of fraud, investing in private companies is also extremely risky because private issuers fail frequently, their securities are illiquid, and their governing documents often provide little or no protections for the rights of minority shareholders. In the current environment, with the economy itself reeling and vulnerable, investors need safe and transparent investments that have the best chance to build value. Now, perhaps more than at any time since the Great Depression, it is bad public policy to pursue rule changes that aim to encourage greater numbers of investors to look to private investments for financial security.[5]

Also, as NASAA and other commenters have stated repeatedly, the Commission should not pursue its current slate of deregulatory proposals especially in the absence of hard data about the exempt offering marketplace. The Commission has recognized this problem in the context of Regulation D offerings[6] – the largest segment of the exempt offerings market – but has nevertheless allowed it to persist by failing to take steps to gather more data, such as requiring pre-filing and post-closing Form D filings from issuers.[7] A previous Commission proposed to remedy this lack of data in 2013 pursuant to a companion release to amendments to Regulation D implemented in accordance with the Jumpstart Our Business Startups Act. In particular, that

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should therefore consider whether the invocation of exemptive authority is well-founded with respect to rules that can be abused by issuers in the manner described herein.

4 *See* Letter from NASAA President Christopher Gerold Regarding Concept Release on Harmonization of Securities Offering Exemptions, at 3 (Oct. 11, 2019), *available at* https://www.sec.gov/comments/s7-08-19/s70819-6288085-193367.pdf.

5 For this reason, I asked Congress to consider a pause on major SEC rulemakings, especially regarding the current efforts to expand private offerings and the private markets. *See* Statement of NASAA President Christopher Gerold on Behalf of the North American Securities Administrators Association, *Examining the Impacts of the COVID-19 Pandemic on U.S. Capital Markets*, House Financial Services Committee, Subcommittee on Investor Protection, Entrepreneurship and Capital Markets, Roundtable Discussion (May 26, 2020), *available at* https://www.nasaa.org/54987/examining-the-impacts-of-the-covid-19-pandemic-on-u-s-capital-markets/.

6 *See Concept Release on Harmonization of Securities Offering Exemptions*, SEC Release No. 33-10649, at 23 (Jun. 18, 2019), *available at* https://www.sec.gov/rules/concept/2019/33-10649.pdf ("Due to data limitations, it is difficult to draw rigorous conclusions about the extent of fraud in exempt securities offerings."); *id.* at 24 ("Due to data limitations, it is also difficult to draw rigorous conclusions about the average magnitude of investor gains and losses in exempt securities offerings."); *id.* at 36 ("We estimate households and not individuals due to data limitations because the database underlying our analysis measures wealth and income at the household level.").

7 *See* SEC Compliance and Disclosure Interpretation Question 257.07, *available at* https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm.

proposal would have required (i) the filing of a Form D in a Rule 506(c) offering before an issuer could engage in general solicitation, (ii) the use of written general solicitation materials in Rule 506(c) offerings, (iii) the submission of written general solicitation materials used in Rule 506(c) offerings to the Commission, and (iv) the filing of a post-closing Form D after completion of an offering.[8] These proposed amendments, unfortunately never adopted, would have provided the Commission with substantially greater visibility over the Regulation D market than it currently possesses. It is not sound to propose major changes to the federal securities laws based on assumptions, and then hope that they will operate as intended. The Commission should not move forward with the Proposal until it at least corrects this perennial problem and can root any rulemaking in objective data.

This letter first sets out our principal concerns with the Proposal, which are in the areas of integration, testing the waters communications, the proposed treatment of "demo days," the harmonization of Regulation A and Regulation D disclosure requirements, and exempt offering and investment limits. We believe these issues require substantial attention and revision if the Commission intends to move forward with the Proposal. We then discuss aspects of the Proposal for which we can offer our support.

I. **The Proposed 30-Day Integration Safe Harbor Is Too Short and Would Be Vulnerable to Abuse by Issuers.**

The Proposal would replace the existing integration safe harbors with a new safe harbor, proposed Rule 152, which would set forth the Commission's general integration principles and enumerate four specific safe harbor fact patterns.[9] The Commission's purported goal is to provide greater clarity for issuers regarding whether multiple offers would be integrated.[10] NASAA does not object to the goal of harmonizing the SEC's integration regime. However, the proposed 30-day integration safe harbor in proposed Rule 152(b)(1) goes too far. NASAA opposes a 30-day integration safe harbor because we believe that such a brief time period would render the integration doctrine a nullity.[11]

The Proposal would create a blanket 30-day integration safe harbor applicable to all exempt offerings. Any offering made more than 30 calendar days before the commencement of any other offering, or more than 30 calendar days after the termination or completion of any other offering, would not be integrated (provided that, for an exempt offering for which general solicitation is not permitted, purchasers were not solicited through a general solicitation or had a substantive

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8 *See Proposed Rule: Amendments to Regulation D, Form D and Rule 156*, SEC Release No. 33-9416 (Jul. 10, 2013), *available at* https://www.sec.gov/rules/proposed/2013/33-9416.pdf.

9 *See* Proposal at 30.

10 *Id.* at 27.

11 NASAA does not object to the other three integration safe harbors in proposed Rule 152(b)(2)-(4) regarding employee benefit plans and Regulation S offerings, registered offerings after an exempt offering for which general solicitations were not permitted, and exempt offerings conducted pursuant to general solicitations subsequent to other terminated or completed offerings. *See id.* at 46-54.

relationship with the issuer prior to the offering).[12] This change would dramatically truncate existing integration safe harbors, most of which require six months between offerings.

The Proposal's 30-day global integration safe harbor is simply too short. Current integration standards are appropriate for investor protection and provide sufficient capacity for issuers to conduct exempt offerings.[13] Previous Commissions have considered and rejected shortening the safe harbor. In 2007, the Commission (at the behest of the SEC Advisory Committee on Smaller Public Companies) proposed to shorten the integration safe harbor to 90 days. The Advisory Committee suggested a 30-day safe harbor. The Commission rejected this idea as potentially harmful to investors, and its analysis is worth quoting at length (emphasis supplied):

> *The current six-month time frame of the safe harbor in Rule 502(a) provides a substantial time period that has worked well to clearly differentiate two similar offerings and provide time for the market to assimilate the effects of the prior offering. The Advisory Committee has expressed concern, however, that such a long delay could inhibit companies, particularly smaller companies, from meeting their capital needs. We recognize that increased volatility in the capital markets and advances in information technology have changed the landscape of private offerings.* ***We remain concerned, however, that an inappropriately short time frame could allow issuers to undertake serial Rule 506-exempt offerings each month to up to 35 non-accredited investors in reliance on the safe harbor, resulting in unregistered sales to hundreds of non-accredited investors in a year. Such sales could result in large numbers of non-accredited investors failing to receive the protections of Securities Act registration.*** *Our proposal seeks to strike an appropriate balance between the number of non-accredited investors allowed in an offering relying on the integration safe harbor and the non-public nature of that offering. It would be an anomalous result that an issuer could make an offering to hundreds of non-accredited investors in reliance on the integration safe harbor, triggering reporting requirements under the Exchange Act, without a public offering.*[14]

The Commission's previous concern that a 30-day safe harbor will "result[] in unregistered sales to hundreds of non-accredited investors a year" remains equally valid today. A 30-day safe harbor would be just as vulnerable to abuse today as it was when the Commission rejected it previously. Issuers would have tremendous freedom to game the 30-day safe harbor, undermining the

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12 *See id.* at 37.

13 NASAA has advocated for maintaining six-month integration safe harbors previously. *See* Letter from NASAA President Karen Tyler Regarding SEC Release No. 33-8828, at 10-11 (Oct. 26, 2007), *available at* https://www.sec.gov/comments/s7-18-07/s71807-57.pdf.

14 *Revisions of Limited Offering Exemptions in Regulation D*, SEC Release No. 33-8828, at 59 (Aug. 3, 2007), *available at* https://www.sec.gov/rules/proposed/2007/33-8828.pdf.

integration doctrine,[15] because the SEC cannot possibly police compliance with it and investors would have little or no incentive to do so (absent fraud or a material misstatement in the offering) given that their only remedy would be to unwind the transaction pursuant to Securities Act Section 12(a)(1).[16] Commissioner Lee is correct when she predicts the Proposal will result in "a nearly wholesale importation of general solicitation into the private markets."[17] Under proposed Rule 152, the integration doctrine would decline into irrelevance, and the predictable effect would be the uncontrollable inclusion of large numbers of non-accredited investors in exempt offerings.

The integration doctrine is fundamental to securities regulation.[18] It has rightly been viewed as good policy by past Commissions, and it remains good policy today. NASAA is not persuaded that current integration safe harbors impede capital formation. We are also deeply concerned about the risks to investors and the overall public markets if the Commission were to adopt a blanket 30-day integration safe harbor as outlined in the Proposal. An issuer who sells securities to a large number of non-accredited investors in a short timeframe should be required to register those securities in order to provide investors the protections of the registration process as Congress and state legislatures intended.[19]

II. <u>The General Prohibition Against Testing the Waters in Exempt Offerings Is an Important Protection that Should Not be Abandoned</u>.

NASAA also opposes proposed Rule 241 and its expansion of "testing the waters"[20] authority to issuers of exempt offerings. Last year, the Commission proposed Rule 163B under the Securities Act.[21] Rule 163B would allow issuers in registered offerings to engage in testing the waters communications with qualified institutional buyers (as defined in Rule 144A) and

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15 This will be particularly true if the Commission opens the floodgates for issuers to test-the-waters by adopting proposed Rule 241, discussed *infra.*

16 15 U.S.C. § 77l(a)(1).

17 *See* Commissioner Allison Herren Lee, *Statement on Proposed Amendments to the Exempt Offering Framework*, text accompanying n. 10 (Mar. 4, 2020), *available at* https://www.sec.gov/news/public-statement/lee-statement-proposed-amendments-exempt-offering-framework. And, as Commissioner Lee pointed out, the Proposal is not even internally consistent on what standards will apply when an issuer conducts an exempt offering that prohibits general solicitation (*e.g.*, a Rule 506(b) offering) after conducting an exempt offering that allows for general solicitation (*e.g.*, a Rule 506(c) offering). *See id.*, text accompanying n. 7.

18 *See* Proposal at 23, n. 48 (citing SEC Release No. 33-97 (Dec. 28, 1933); *Section 3(a)(11) Exemption for Local Offerings*, SEC Release No. 33-4434 (Dec. 6, 1961); and *Non-Public Offering Exemption*, SEC Release No. 33-4552 (Nov. 6, 1962)).

19 *See SEC v. Ralston Purina Co.*, 346 U.S. 119, 120 (1953).

20 "Testing the waters" refers to communications between a prospective securities issuer and securities investors prior to the issuer's having undertaken to make a securities offering in order for the issuer to assess the potential level of investor interest in a potential securities offering. Such communications generally would be prohibited by Section 5 of the Securities Act absent an SEC exemptive rule to permit the communications.

21 *See Solicitations of Interest Prior to a Registered Public Offering*, SEC Release No. 33-10607 (Feb. 19, 2019), *available at* https://www.sec.gov/rules/proposed/2019/33-10607.pdf.

institutional accredited investors (as set forth in Rule 501 under Regulation D).[22] In effect, Rule 163B would extend to all issuers of registered offerings the same flexibility to test the waters that was previously afforded only to emerging growth companies.[23] NASAA did not oppose Rule 163B, and in September 2019 the Commission adopted the new rule.[24]

With the ink barely dry on new Rule 163B, though, the Commission now seeks to further expand instances of testing the waters through proposed Rule 241. Rule 241, which is based on the testing the waters provisions in Regulation A, would permit issuers to communicate about a prospective exempt offering with *any* investor.[25] To take advantage of proposed Rule 241, an issuer would merely have to provide investors a four-part disclaimer.[26] The Proposal asserts that this would be consistent with investor protection because proposed Rule 241 would not affect the availability of subsequent securities exemptions, and the general antifraud provisions of the securities laws would still apply.[27]

NASAA opposes proposed Rule 241 for the same reasons we oppose the 30-day integration safe harbor in proposed Rule 152: the new standard would not increase investor protection, and it would be evaded or exploited easily. Both proposed rules represent a diminution of the types of prophylactic measures built into the securities laws for investor protection. The antifraud provisions of the federal securities laws are not sufficient in and of themselves to protect investors. Congress included prophylactic measures (such as Section 5 of the Securities Act) to prevent fraud and forestall abusive practices.[28] Congress did not want investors to have to put their trust in securities issuers and rely on *ex post* antifraud actions in the event of issuer malfeasance. Further, given that the Commission's Division of Enforcement has been forced to allocate its resources carefully due to hiring freezes and a multi-year reduction in staff,[29] the Commission should understand that it may not be able to police a surge in fraudulent issuer activity. The Commission should therefore not weaken the longstanding prohibitions against testing the waters that undergird Section 5.[30]

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22 *See id.* at 5, 74.

23 *See id.* at 5-6. Issuers can also test the waters before making a Regulation A offering pursuant to Rule 255 thereof. *See* 17 C.F.R. § 230.255.

24 *See Solicitations of Interest Prior to a Registered Public Offering*, SEC Release No. 33-10699 (Sep. 25, 2019), *available at* https://www.sec.gov/rules/final/2019/33-10699.pdf.

25 Proposal at 76.

26 *See id.* at 73.

27 *Id.* at 74-75.

28 *See*, *e.g.*, *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963) ("A fundamental purpose [of the federal securities laws] was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.").

29 *See* SEC, Division of Enforcement, *2019 Annual Report*, at 22 (Nov. 6, 2019), *available at* https://www.sec.gov/files/enforcement-annual-report-2019.pdf.

30 NASAA of course would oppose any potential preemption of state regulatory authority with respect to the Commission's adoption of Rule 241. NASAA appreciates that the Commission has no intention of seeking to

III. **The Proposed "Demo Day" Rule Is Not Sufficiently Limited to Prevent General Solicitations or General Advertisements.**

As the Commission describes it, proposed Rule 148 seeks to balance issuer access and investor protection with respect to "demo days" and similar sorts of seminars and meetings by limiting the types of institutions that can hold such events, the manner in which event sponsors can be compensated, and the content that can be delivered.[31] Each of these aspects would need to be controlled more meaningfully than proposed in order to avoid concerns that such events would operate as acts of general solicitation or general advertisement.

First, the inclusion of "nonprofit organizations," "incubators," and "accelerators" in the proposed rule could be abused. As currently proposed, such entities could be affiliated with an issuer and still fall within the rule. If so, entities could be created under the proposed rule that are designed by issuers specifically to attract non-accredited investors. An amendment to the proposed rule that prohibits any form of control or affiliation with an issuer, or group of issuers, is therefore advisable.

Further, limiting the proposed compensation restrictions to "compensation for making introductions" and "compensation with respect to the event that would require registration of the sponsor as a broker or dealer," as proposed, again does not foreclose the creation or operation of entities designed to attract investors to private issuers, but who are compensated indirectly by issuers for doing so.[32] The questions in Request for Comment 19 recognize this possibility,[33] and the proposed rule should accordingly be revised to prohibit entities whose sole or primary purpose is to attract investors to private issuers.

Last, it is difficult to understand how an issuer does not in fact make an offer in such an event when it is allowed to (i) indicate that it is planning to make an offer, (ii) specify the type and amount of securities being offered, and (iii) describe the intended use of proceeds. There is nothing left for the investor to do but wait a short time to receive a direct solicitation. The Commission asserts that a communication may not be a general solicitation when an issuer engages in direct contact "outside of a public offering effort."[34] Yet, the amount of information permitted by the proposed rule, coupled with situations in which the Commission admits that it is "impractical for the organizer of the event to limit participation,"[35] can act precisely as a public offering effort. As proposed, it would be impossible to enforce such a fuzzy distinction between permitted and prohibited offer communications.

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preempt state registration or qualification requirements that may apply to offers made pursuant to Rule 241. *See* Proposal at 77.

[31] *See id.* at 65-68.

[32] *See id.* at 300 (text of proposed Rule 148).

[33] *See id.* at 69.

[34] *Id.* at 68.

[35] *See id.* at 65.

It is also unrealistic to expect that eager issuers will not go beyond the loosely prescribed bounds of the proposed rule, either in their presentations or in discussions that take place at an event. If a broad-based invitation to a demo day event brings non-accredited investors into direct contact with issuers who detail their offerings, that should be regarded as a general solicitation. The Proposal should be amended to specify that an issuer may provide factual business information about itself but issuers may not discuss any potential securities offers. This prophylactic measure would help ensure that a demo day event cannot become a *de facto* general solicitation. Another constructive limitation, as suggested in the questions posed in Request for Comment 21,[36] is to state that a pre-existing relationship cannot be based solely on an event in which an issuer has both described its business and conditioned attendees to anticipate an upcoming offer.

IV. **The Commission Should Not Harmonize Disclosure Standards Under Regulation D and Regulation A Downward but Should Instead Collect More Data Prior to Undertaking Substantive Rulemakings in this Area.**

The next part of the Proposal would seek to harmonize the differing disclosure standards between Regulation D and Regulation A.[37] Many of these proposed changes would be useful and pose no material risk to investors. NASAA cannot, however, support the proposed easing of financial disclosure obligations under Regulation D Rule 502.

Rule 502(b)(2)(B) requires issuers that do not file reports with the Commission pursuant to Section 13 or Section 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act") to provide certain financial disclosures to any non-accredited investor participating in a Rule 506(b) offering. Rule 502(b)(2)(B) sets forth a graduated scale of increasing financial disclosures as the size of the Rule 506(b) offering increases. At the top level, for offerings over $7.5 million, an issuer must provide non-accredited investors with "financial statement[s] as would be required in a registration statement" filed with the Commission.[38] The Proposal seeks to amend Rule 502(b)(2)(B) to align its disclosure obligations with those of Regulation A Tier 1 which, notably, can be up to $20 million and do not require audited financial statements. The Proposal argues that aligning these standards would expand investment opportunities for non-accredited investors.[39]

Setting aside for a moment whether it is good public policy to encourage greater non-accredited investor participation in unregistered offerings, lessening the financial disclosure obligations of smaller Rule 506(b) offerings to come into line with standards under Regulation A Tier 1 would be a step in the wrong direction. Rule 506(b) offerings differ from Tier 1 offerings in material ways. Most notably, Regulation A Tier 1 offering circulars generally must be filed with, and be subject to review and qualification by, the staff of the SEC and the state securities regulator in each state in which the securities will be offered. In contrast, Rule 506(b) offerings proceed with no regulatory review, and the only document filed with the SEC or with a state is a

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[36] *See id.* at 70.

[37] *See id.* at 92-114.

[38] 17 C.F.R. § 230.502(b)(2)(B)(3).

[39] Proposal at 94-95.

short notice of the offering on a Form D. It is thus entirely appropriate for Rule 502(b)(2)(B) to require audited financial statements in Rule 506(b) offerings over $7.5 million (and for Rule 502(b)(1) to require audited financial statements if any sales are made to non-accredited investors). If the Commission is interested in aligning disclosure standards, the Commission should heighten the standards under Regulation A Tier 1, not lower the standards under Regulation D.

What is more, the proposed rule change is unnecessary because the market is not lacking in Rule 506(b) offerings. Approximately $1.5 trillion was raised in 2018 through Rule 506(b) offerings, by far the largest exempt offering pathway.[40] Given this, NASAA is skeptical of claims that the financial statement requirements in Rule 502(b) are overly burdensome.[41] Clearly, this is not the case for many private issuers.

V. There Is No Need to Raise Offering and Investment Limits Because Issuers Are Nowhere Near Utilizing the Capacity That Already Exists.

The Proposal next would raise offering and investment limits of certain exemptions under Regulation A, Regulation Crowdfunding, and Regulation D Rule 504.[42] NASAA accepts that these pathways are used less frequently than Regulation D Rule 506. Our concerns with the Commission's agenda to expand the private markets aside, it is doubtful that raising the offering and investment limit ceilings would lead to greater usage of these exemptions.[43]

For example, Regulation A Tier 2 is not underutilized because the amount of capital that can be raised under the exemption is too small. The current ceiling, $50 million, is quite ample. Evidence indicates that Regulation A Tier 2 is underutilized because the issuers that use it are highly speculative and investors are wisely steering clear.[44] The staff of the SEC's Division of Corporation Finance researched Regulation A offerings and reported this past March that current offering limits are barely being scratched. The staff found that:

> *A typical Regulation A issuer sought to offer amounts that were substantially below existing offering limits. Reported proceeds were significantly smaller than the amounts sought and the existing offering limits, and only 10% of issuers reported*

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40 *See Concept Release*, *supra* note 6, at 19.

41 *See* Proposal at 98-99.

42 *See id.* at 114 (stating that out of the $2.9 trillion raised through exempt offerings in 2018, less than $3 billion – or 0.1% – was raised through Regulation A, crowdfunding or Rule 504).

43 For example, we are doubtful that increasing the Rule 504 offering limit to $10 million from $5 million as the Commission proposes will increase usage of this exemption. *See* Proposal at 122. Offerings over $5 million could no longer rely on exemptive authority of Section 3(b)(1) of the Securities Act but rather will have to comply with Section 3(b)(2), which carries with it obligations including mandatory filing of audited financial statements with the Commission. *See* 15 U.S.C. § 77c(b)(2). We suspect issuers will balk at the additional obligations necessitated by Section 3(b)(2).

44 *See*, *e.g.*, Bill Alpert *et al.*, *Most Mini-IPOs Fail the Market Test*, Barron's (Feb. 13, 2018), *available at* https://www.barrons.com/articles/most-mini-ipos-fail-the-market-test-1518526753 (finding that "the average Reg A+ stock fell 40% in the six months after its mini-IPO" and "most Reg A+ businesses haven't gotten beyond the startup phase known as the pipedream").

> *proceeds that in the aggregate (across the entire June 2015–December 2019 period) reached the respective 12-month offering limit.*[45]

It is axiomatic that raising the Tier 2 offering limits would allow a few issuers to raise a bit more capital through their offerings. However, this change would be detrimental to any retail investors that invest in these offerings. These offerings have often been made by companies that provide little corporate governance protections to shareholders and generally perform poorly. (As shown by the SEC staff's study discussed above, only 47% of Regulation A issuers reported receiving revenues and only 21% had positive net income.[46]) Given this track record, an issuer that believes it can use more than $50 million responsibly, and generate positive returns, should undertake a public offering and convince investors through full disclosure that it is ready do so.

Raising the offering limit is the wrong approach to increasing the use of Regulation A Tier 2. Rather, the Commission should instead focus its attention on measures that would make the issuers of these securities more attractive to and safe for investors. NASAA has previously described measures that would achieve this, notably strengthening corporate governance and disclosure obligations and rescinding preemption of state securities regulation to increase the regulatory oversight of these companies.[47]

VI. NASAA Supports the Proposed Amendments to the Regulation Crowdfunding and Regulation A Eligibility Restrictions with Revisions.

A. The Proposal to Allow Crowdfunding Through Special Purpose Vehicles Should Be Revised to Strengthen and Clarify Investor Rights.

Proposed Rule 3a-9 under the Investment Company Act of 1940 contemplates the use of an exempted investment company with limitations designed to protect investors and ensure their voting rights as if they were direct investors in a crowdfunding issuer.[48] While NASAA does not

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45 *See Report to the Commission - Regulation A Lookback Study and Offering Limit Review Analysis*, at 12-13 (Mar. 4, 2020), *available at* https://www.sec.gov/files/regulationa-2020.pdf.

46 *See id.* at 14. Further, given that much of the evident lack of strength for Regulation A Tier 2 offerings is due to the poor performance of the issuers and features in the offerings that make them unattractive to investors, NASAA believes it would not make sense to preempt secondary sales of such offerings. *See* Proposal at 137, Question 65. Doing so would do nothing to address the lackluster quality of the offerings themselves and it would remove a level of oversight that inures to the protection of investors either invested in, or contemplating investing in, these issuers. Likewise, there is no reason evident or offered by the Commission to suggest that preemption of secondary trading in Regulation Crowdfunding offerings would enhance their attractiveness. Indeed, the issues identified by the Commission are features of the offering mechanism that make them unattractive to issuers, not investors.

47 *See*, *e.g.*, Letter from NASAA President Christopher Gerold, *supra* note 4; Letter from NASAA President Andrea Seidt Regarding Proposed Rule Amendments for Small and Additional Issues Exemptions (Mar. 24, 2014), *available at* https://www.sec.gov/comments/s7-11-13/s71113-75.pdf.

48 Given that the driving concern behind this proposal is the difficulties that private companies face when dealing with multitudes of small investors, it would seem that a micro-offering exemption would exacerbate such problems and is therefore not advisable. *See* Proposal at 136-37, Question 64. However, NASAA would not support limitations on disclosures associated with small offerings.

oppose the concept of special purpose vehicles ("SPVs"), certain features of the proposed rule could frustrate investor protection and participation goals. In particular, the Proposal states that "any compensation paid to any person operating the crowdfunding vehicle must be paid solely by the crowdfunding issuer."[49] If so, the SPV's manager would be an employee or agent of the issuer, which would present a conflict of interest. This concern is exacerbated by the fact that the Proposal would not require the SPV manager to be a registered investment adviser. A registered investment adviser has fiduciary obligations to its investors. As proposed, the SPV manager would not. The Commission should revise the proposed rule either to require the SPV to be managed by a registered investment adviser or to require a fiduciary relationship between the SPV's manager and investors.

Further, proposed rule 3a-9 would require the SPV to seek investor input only for matters of voting the issuer's securities and participating in tender or exchange offers or similar transactions. It is not clear whether the SPV could ignore investor calls for such things as engaging in derivative litigation, participating in class actions, and offering proxy proposals. While proposed rule 3a-9(a)(9) would allow investors to direct the SPV to assert investor rights, it does not obligate the SPV to take specific actions on behalf of its investors, nor does it specify what the SPV will or will not do in order to assert investor rights. Given that the SPV's manager will be paid by the issuer, it is likely that the SPV will do only what is required. The current proposal is too limited with respect to the specific actions required, and too ambiguous with respect to what the SPV will do to assert investor rights. The Commission should therefore revise the proposed rule to fully articulate what actions the SPV will take on behalf of its investors. Alternatively, the Commission could add a principles-based rule that would require the SPV to take all actions directed by its investors collectively.

Last, while the proposed rule would require the SPV to follow investor directions regarding tender or exchange offers or similar transactions, the consequences of such events on the SPV itself are not clear. For instance, if the crowdfunding issuer became publicly-listed, it is not clear that the SPV investors would receive publicly-listed shares directly, or would instead remain investors in the SPV. In NASAA's view, once an issuer becomes a public company, the concerns behind creating an SPV, such as managing capitalization tables and remaining under registration thresholds, cease to exist. Likewise, if an issuer is acquired in a tender or exchange offer, the SPV will hold either cash or the acquirer's securities which again obviates the purpose of the SPV. The Commission should revise the proposed rule to clarify that such liquidity or exchange events would lead to the dissolution of the SPV.

B. The Proposals to Regulate Crowdfunding Eligible Securities, Extend Regulation A Ineligibility Restrictions for Delinquent Exchange Act Filers, and Extend Certain Bad Actor Disqualification Provisions Are Sound.

NASAA agrees with the Commission that offerings under Regulation Crowdfunding should be limited to equity securities, debt securities, and securities convertible or exchangeable to equity interests, including any guarantees of such securities. NASAA agrees that non-traditional securities, such as (but not limited to) Simple Agreements for Future Equity, "could result in harm

[49] *Id.* at 147.

to investors who may face challenges in analyzing and valuing such securities, or who may be confused by the descriptions of such securities on the funding portals."[50] Implicit in this portion of the Proposal is the recognition that Regulation Crowdfunding is the province of retail investors and traditional securities are the safest products to offer to them, especially in the context of these highly speculative investments. More generally, NASAA encourages the Commission to conclude that non-accredited investors should not be exposed to complex products that are more appropriate for accredited and institutional investors, or to innovative products whose features are untested and whose risks are not fully understood by either investors or regulators. Such products are commonly found in private offerings, and the same caution behind this portion of the Proposal should apply to the Commission's thinking about the private markets generally.

Also, the Commission's decision to extend ineligibility restrictions to would-be Regulation A issuers who are delinquent in their periodic filings is a logical extension of the requirements of Rule 257 under the Securities Act for issuers who, as a consequence of a Regulation A offering, become subject to periodic reporting requirements. By helping to make clear that issuers are expected to behave as public companies once they enter the public markets, even through the means of exempt offerings, the Commission is at least partly addressing the concern that the current proposals will cause even substantial companies to remain in the private markets permanently.

Finally, the Commission's proposal to harmonize the bad actor disqualification provisions in Rule 506(d) of Regulation D, Rule 262(a) of Regulation A, and Rule 503(a) of Regulation Crowdfunding by adjusting the look-back requirements in Regulation A and Regulation Crowdfunding to include the time of sale in addition to the time of filing is a positive enhancement. NASAA appreciates the Commission's effort to capture a wider array of circumstances under which disqualification events can occur, both during the offering process and in between filings.

VII. Conclusion

NASAA is unable to support much of the Proposal in its current form because, as proposed, it is designed to expand the private markets without any attempt to gain further information about these markets, it would leave the private markets open to greater levels of issuer abuse,[51] and it does nothing to support the public market. In broad brush, we see the Proposal as an unnecessary and potentially harmful expansion of the private securities market to the detriment of the public

[50] *Id.* at 156-57.

[51] Large private offering frauds include actions against the Woodbridge Group of Companies, Inc., in which the SEC charged the defendants with a $1.2 billion offering fraud (*see* SEC Press Release 2017-235, SEC Charges Operators of $1.2 Billion Ponzi Scheme Targeting Main Street Investors (Dec. 21, 2017)); Medical Capital Holdings, Inc., in which investors lost hundreds of millions of dollars (*see* Bruce Kelly, MedCap Trustee to Pay Investors $114m, Investment News (Apr. 29, 2013)); and Provident Royalties LLC, in which the SEC obtained an asset freeze of $485 million (*see* SEC Litigation Release No. 21118, SEC Obtains Asset Freeze in $485 Million Nationwide Offering Fraud (Jul. 7, 2009)). And, in an enforcement action just last week, the Massachusetts Securities Division filed fraud charges against GPB Capital and related respondents in connection with allegedly fraudulent private placements that harmed dozens of Massachusetts residents. *See In re GPB Capital Holdings et al.*, Docket No. E-2018-0100 (May 27, 2020), *available at* https://www.sec.state.ma.us/sct/current/sctgpb/2020-5-27-MSD-GPB-Complaint-E-2018-0100.pdf.

market. As explained above, our concerns include the Proposal's curbing of the integration doctrine, its expansion of permissible testing the waters communications, its lax treatment of "demo days," its downward harmonization of Regulation A and Regulation D disclosure standards, and its unnecessary expansion of exempt offering and investment limits. We believe these issues all require substantial revision if the Commission moves forward with the Proposal.

Thank you for considering these views. We look forward to continuing to work with the SEC on our shared mission of protecting investors. Should you have questions, please contact either the undersigned or NASAA's Executive Director, Joseph Brady, at (202) 737-0900.

Sincerely,

Christopher Gerold
NASAA President
Chief, New Jersey Bureau of Securities