August 3, 2020

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U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets

Dear Sir or Madam:

I write to offer comments on the Commission's Release, *Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets*, Release 33-10763 (Release).

My comments focus, at least primarily, on the special problems small businesses face when they attempt to access external capital.

There are more than five million small businesses in this country. Small businesses are vital to our national economy, accounting, for example, for more than 20% of all employment in our country.

These small businesses face structural and economic disadvantages when they attempt to secure the vital external capital necessary for them to compete and survive. Financial intermediation is rarely available, and relative offering costs (offering costs/size of the offering) often foreclose them from the capital markets.

What makes matters worse – indeed, substantially worse – for small businesses seeking external capital is that federal and state rules governing capital formation significantly, inefficiently and unfairly impose additional barriers to their access to external capital.

I heartily welcome the Commission's Release, which deals with some but not all of the problems small businesses face when they seek external capital.

I hope my comments are helpful to the Commission.

A. Overture

I offer the following broad comments regarding the Release.

1. Fundamentally, the Titles II, III, and IV of the JOBS Act make sense: the Rule 506(c) exemption (Title II) is predicated on investors' cheap access to investment information or ability to bear the risk; the Crowdfunding exemption (Title III) is predicated on the availability of electronically accessible investment information); and the Regulation A exemption (Title IV) is predicated on the more traditional forms of access to investment information.

2. Notwithstanding, data demonstrate that the Crowdfunding exemption and the Regulation A exemption in their present forms are failures. Primarily, Regulation A failed as a result of state registration requirements and the failure properly to scale disclosure requirements. The Crowdfunding exemption failed because of the strict limitation on offering strategies and inefficient and overly burdensome disclosure requirements. The Release addresses some but not all of these problems.

3. The integration doctrine should be eliminated. The doctrine makes no sense. It drives up offering costs and provides no protection for investors. It applies to issuers of all sizes but its pernicious effects fall most heavily on small issuers. Many of the problems with the proposals in the Release are generated by an attempt to preserve some vestige of that broken doctrine.

4. The Commission's proposed Rule 227.206, which permits a testing of water in crowdfunding offers, is a good proposal that offers significant hope for more use of the crowdfunding exemption, and it should be adopted by the Commission. The Commission's proposed Rule 230.241, which permits a more general testing of water in registered and exempt offerings, is also a good proposal, and it too should be adopted by the Commission.

5. The Commission should exercise its very broad, delegated authority to preempt state registration authority. State registration requirements under state blue sky laws continue to be a major barrier for small businesses' access to potentially efficient exemptions from federal registration requirements.

B. Integration

The integration concept often generates problems for companies engaged in capital formation. It is especially vexing for small companies that rely on important exemptions from registration, such as the exemptions provided by Section 4(a)(2), Rule 504, or Rule 506(b) .

Offerings under these particular exemptions are vitally important to capital formation by small businesses. In data I put together for my article, *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions*, 66 Bus. Law. 919 (2011), data showed, for example, that over a 25 month period there were nearly 15,000 offerings under Regulation D of $5 million or less. Data also showed that, although many those smaller offerings were made under Rule 504 or Rule 505, a majority of those smaller offerings were made under Rule 506.

It seems highly unlikely that the integration protection of Rule 152(a) – the "General principle of integration" – would be available if the offering – or any part of the offering – relies on Section 4(a)(2), Rule 504, or Rule 506(b).

Integration protection under the "General principle of integration" of Rule 152(a) requires that the issuer using any of those three important exemptions from registration (Section 4(a)(2), Rule 504 or Rule 506(b)) must reasonably believe that the "purchasers in each exempt offering were not solicited through the use of general solicitation" (Rule 152(a)(1)(i)) or that the "purchasers in each exempt offering established a substantive relationship with the issuer . . . prior to the commencement of the offering not permitting general solicitation." (Rule 152(a)(1)(ii)).

An example will demonstrate why the requirements for protection from integration under the terms of this "General principle of integration" rarely will be met for offerings under Section 4(a)(2), Rule 504, or Rule 506(b).

Assume, for example, that the first tranche of an "offering" is made under Section 4(a)(2) (transaction by an issuer not involving a public offering) and shortly thereafter a second tranche is made compliant with Rule 147 (the intrastate exemption). It is difficult – impossible for me – to imagine a situation in which the purchasers in the Rule 147 tranche are "not solicited through the use of a general solicitation (or "had a prior substantive relationship with the issuer"). Imposing those additional conditions on a Rule 147 offering destroys the benefit of the exemption for the issuer. I base my conclusion in this matter, at least to a degree, on my own experience in practice. It would not have worked for my deals.

The foregoing example also demonstrates the nonsense of the integration concept. There is utterly no policy reason to deny an issuer the right to make a combined offering under Section 4(a)(2) and Rule 147. It enhances the issuer's access to precious capital and does not in any material way harm investors. Investors in the Section 4(a)(2) tranche are protected by the common law requirements of investor sophistication and access to the same information that would be contained in a registration statement. The investors in the Rule 147 tranche are protected by the geographic proximity between the issuer and investors, which promotes cheap access to investment information by investors.

The “Safe harbor” of proposed Rule 152(b)(1) similarly offers little protection from the integration concept in situations in which the issuer relies on Section 4(a)(2), Rule 504, or Rule 506(b).

That proposed “Safe harbor” offers protection from integration for offers that are more than 30 days apart “provided that for an exempt offering for which general solicitation is not permitted [e.g., Section 4(a)(2), Rule 504, or Rule 506(b)], the “purchasers” either: (“i) Were not solicited through the use of general solicitation; or (ii) Established a substantive relationship with the issuer prior to the commencement of the offering for which general solicitation is not permitted.”

For the same reasons as described above, those conditions will almost certainly eliminate the “Safe harbor” protection of Rule 152(b)(1) for offerings that involve Section 4(a)(2), Rule 504, and Rule 506(b). Referring back to the prior example, if the issuer first offers securities under the exemption provided by Section 4(a)(2) and then a couple of months later offers securities under Rule 147, it is highly unlikely that the issuer would be able to meet the requirement that the “purchasers” in both tranches were not solicited by a general advertisement or that the issuer had a substantive relationship with all purchasers.

Proposed Rule 152 should be amended to provide clear and complete two-way safe harbor integration protection for all exemptions. This is especially important for the exemptions used by small businesses, including the exemptions provided by Section 4(a)(2), Rule 504 and Rule 506(b).

Without the effective integration protection of proposed Rule 152, issuers appear to be relegated to the common law of integration as a way to deal with the problem. All seem to agree that the criteria for the common law solution are essentially unintelligible. Generally I believe that practice has been to rely on a couple of heuristics inferred from SEC no action letters, which suggest that the effective separation of tranches may be based on either one year separation between the two tranches or offering different classes of securities in the two tranches.

In the real world, therefore, this means that the issuer is incentivized to take steps that are expensive (delay or change the nature of the investment contracts), and even in that case the rules for separating two tranches are unclear.

The real world risks in such cases – indeed, the real world risks in any situation where the integration concept is involved – are significant and amount to an unnecessary detriment to small business capital formation.

For the issuer, there inevitably is a lot of “money on the table.”

Section 12(a)(1) is a plaintiff friendly civil liability provision that creates big risks for issuers. The recovery for plaintiffs under that section *does not* depend on any culpability, materiality, etc. Essentially, all that is required for the plaintiff to recover is that unregistered securities were sold without an exemption. Even with good legal planning, the present negative value of the residual risk of monetary damages may amount to an unacceptable cost to an issuer and its competent legal counsel.

It is also relevant to risk that selling unregistered securities without an exemption amounts to a crime with a maximum five year prison penalty. While a stiff prison penalty is generally considered unlikely, a small probability of prison and the possibility of criminal (and civil) fines and other reputational costs are likely important factors to a rational and honest issuer.

Even if the issuer is willing to take an aggressive position regarding an integration question and accept the risk "as a business matter", the lawyer for the issuer may face an ethical problem and a business problem of her or his own.

Ethical duties of a lawyer forbid her or his facilitation of a transaction that is crime. Legal uncertainty regarding the application of the integration concept to a particular transaction, therefore, creates another significant problem for a lawyer advising an issuer in a transaction of uncertain legality. The lawyer is especially vulnerable here because as a business matter, the lawyer is most likely a repeat player providing advice for numerous transactions. The probability of a lawyer's finding herself or himself a defendant in a very expensive and professionally risky piece of litigation increases as his or her number of risky deals increase. My experience in practice was that my clients generally considered themselves to be a one time players who reap the full benefit of the risk taking. My clients generally seemed less risk adverse than I. In short, the professional risk for ethical and competent counsel may cause counsel to be reluctant or even unwilling to represent an issuer that prefers to take the risk of a criminal violation in a "close case".

I use these real world considerations to support this point: It makes no sense to create these types of risks – which, of course, raise the costs of capital formation – to protect a doctrine as misdirected as integration.

C. Testing the Water

(i) Preemption

Rule 241 is a sound provision, essentially allowing issuers first to solicit broadly for potential investors (i.e., to conduct what would amount to a public "offer" under the 1933 Act) and then – assuming there is demand for the offered securities – to complete the offering by meeting the requirements of registration or an exemption from the registration requirement.

Testing the water is based upon an important and sound concept: That it promotes efficient capital formation by reducing offering costs for an issuer, and that it causes no material harm to investors, so long as the investors are protected at the purchase stage of the offering.

Unfortunately, Rule 241 will be impossible (or at least nearly so) for an issuer to use. This outcome is a result of the failure of the Commission to exercise its delegated authority to preempt state registration requirements for an issuer's testing the water under Rule 241. Release, p. 77.

Without complete preemption of all state registration authority, any broad electronic or print publication in connection with the test of the water under Rule 241 would likely involve illegal "offers" under state registration requirements, which in turn would likely subject the issuer to civil and criminal liabilities under all state blue sky laws. Also, as described above, under usual professional ethical rules, counsel for the issuer would not be able to participate in the transaction, since it would amount to facilitating a crime, which violates applicable professional responsibility rules.

In order for Rule 241 to work, the Commission must preempt all state (and territory and the District of Columbia) registration authority.

(ii) Integration

Issuers relying the exemptions provided by Section 4(a)(2), Rule 504 or Rule 506(b) have another problem in using the test the water provisions of Rule 241. The problem is, once again, the integration concept under proposed Rule 152, as described above.

The normal sequence for using test the water would be for an issuer first to test the water with a broad solicitation and then, after having identified potential investors to make an exempt or registered offering of its securities.

For the reasons described above, however, the issuer could not rely on proposed Rule 152 for integration protection, if the offer were pursuant to an exemption provided by Section 4(a)(2), Rule 504 or Rule 506(b).

To meet the requirements for protection from integration under the general principles of Rule 152(a)(1), the issuer would have to show that the "purchasers" in, for example, the Section 4(a)(2) offering "were not solicited through the use of general solicitation" or that the "purchasers . . . established a substantive relationship with the issuer . . . prior to the commencement of the offering not permitting general solicitation."

For the same reasons as described above, those conditions will almost certainly eliminate the safe harbor protections of Rule 152(b)(1) for offerings that involve Section 4(a)(2) (or Rule 504, and Rule 506(b)). It is highly unlikely that an issuer that solicits broadly with a test the water announcement could find the assurance necessary to conclude that the purchasers in the Section 4(a)(2) offering were not solicited by a general advertisement or that the issuer had a substantive relationship with all purchasers.

D. Crowdfunding

(i) Generally

It was clear from the beginning that crowdfunding, as initially conceived and then implemented by Commission regulations, would amount to little help for small businesses that were searching for efficient access to external capital. In fact, data demonstrate that this has been the case. The crowdfunding exemption has been unused by the vast majority of the more than five million small businesses in this country. Myself, I can only characterize it as a gross failure.

The irony here, however, is that the core notion of the crowdfunding statute and regulations – an exemption based on the issuers' delivering electronically prescribed and mandated investment information to investors – is a sound concept.

One problem with the crowdfunding exemption was the extreme limitation on the issuer's selling efforts and strategies: Essentially issuer was limited to posting the offer and investment information on the intermediary's website and providing a "notice" directing investors to the intermediary's website.

Contrary to the "if you build it they will come" assumption that underlies the crowdfunding statute and rules, securities must be sold the old fashioned way via some efficient path of communication between the issuer and the investor, a path that allows the issuer to identify potential investors, make its case to those potential investors, provide information to investors, answer questions, and generally have direct access to investors.

(ii) Limit on Advertising

The proposed amendment to Rule 204 ("Advertising") and the new proposed Rule 206 ("Solicitations of interest and other communications") amount to an important and positive breath of life for the crowdfunding exemption. The proposals should be adopted.

Under the proposed amendments, the issuer can <u>broadly</u> test the water and take indications of interest under new Rule 206. It can then, under revised Rule 204, direct interested investors the intermediary's website, having previously in its testing of the water provided potential investors with investment information that is limited only by antifraud provisions.

The Commission should, however, reconsider carefully Rule 204, adjusting the revised rule as necessary to ensure an efficient path of communication between the issuer and investors, once the offer is posted on the intermediary's website.

(iii) Disclosure and Reporting Obligations

Another glaring problem with the original crowdfunding rules was the disclosure requirements for the exemption. The Commission – with the proposed increase in the upper limit of crowdfunding – needs better to scale the disclosures to ensure that – especially at the lower offering amounts – the obligations do not become so expensive as to eliminate small offers from using crowdfunding.

The single most important disclosure adjustment that the Commission could make is essentially to eliminate the burden of ongoing reporting requirements for small crowdfunding offers.

15 U.S.C Section 77d-1(b)(4) provides broad discretion for the Commission to determine the content of the reports, and always the filing is "subject to such exceptions and termination dates as the Commission may establish by rule." That rule gives the commission broad authority to eliminate the needless and pernicious burden imposed on small issuers using the crowdfunding exemption.

Section 12(g) of the Securities and Exchange Act of 1934 establishes traditional and sensible rules regarding periodic reporting obligations by companies. It makes no sense to apply periodic reporting requirements to very small crowdfunding offerings. It is a major disincentive for small companies to use the crowdfunding exemption.

(iv) Integration

Integration has always been a major problem for crowdfunding offerings. Notwithstanding "guidance" from the Commission, my view has always been that there was a significant likelihood that the common law integration rules applied to crowdfunding offerings.

The Commission, to its credit, attempts in its proposals to remedy that problem by applying proposed Rule 152 (described above) to crowdfunding offerings.

For the same reasons as described above, that is a seriously incomplete solution for crowdfunding offerings. An issuer combining a crowdfunding offering with, for example, an offering under Section 4(a)(2) would not be entitled to the integration protection of proposed Rule 152 for the reasons discussed above.

This has always for me been an especially acute problem, since I believe that a crowdfunding offering viewed essentially as the equivalent of a shelf registration and combined with another exempt offering may be especially attractive strategy for small issuers. For example, an issuer may, at the same time it is making its initial sale of securities to promoters and initial investors under Section 4(a)(2), benefit from simultaneously (or nearly so) filing for and starting a crowdfunding offering that it will sell over time, similar to selling off the shelf. Personally, I would have found that very attractive when I was in practice.

Please notice how all investors are protected: Those purchasing in the 4(a)(2) offering are protected because they are sophisticated and have access to information, and those purchasing in the crowdfunding offering have access to information on the intermediary's website.

E. Regulation A

Title IV of the JOBS Act, which is entitled "Small Company Capital Formation", is the basis for the Commission's revised Regulation A rules. The rules governing Tier I offerings – presently, offerings of up to $20 million – were designed for use by small businesses.

Data show, however, that Tier 1 is almost never used by the more than 5 million small business in the United States. In data I collected through the Mosaic website, which covered the first 33 months following the Commission's revised Regulation A rules, the total number of Forms 1-A filed for Tier 1 Regulation A offerings was 141. That amounts on average to 4.3 Regulation A offerings per month and 51.6 Regulation A offerings per 12 months. In considering this data, one should remember that nearly all of the 5 million-plus small businesses must have external capital to survive and compete.

A major cause of the failure of Tier 1 is that the Commission did not exercise its delegated authority to preempt state registration authority over Tier 1 offerings. One of the principal benefits of a Regulation A offering is that it permits a broad solicitation and a large number of purchasers. Without preemption of state registration authority, however, that benefit evaporates.

Another look at the Mosaic data for the 33 month period provides more evidence of the adverse impact of state registration provisions on small businesses offering their securities under Regulation A. During that 33 month period, there were in fact a total of 238 Regulation A offerings of $20 million or less. As state above, 141 of those offerings were made under Tier 1 provisions, but 97 of the offerings migrated to Tier 2. That means that 41% of all Regulation A offerings of $20 million or less migrated from Tier 1 to Tier 2, even though Tier 2 offerings involve significantly more costs for the small issuer. The reason for this is clear: Tier 2 offerings preempted state registration requirements.

This migration, which amounts to a failure of the Tier 1 regime, was predictable. In a prior article, *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions*, 66 Bus. Law. 919 (2011), I put together data (again using the Mosaic website) on small Regulation D offerings over a 25 month period. Over that period, 78.6% of all Regulation D offerings of $1 million or less – offerings that could have been made under the less burdensome terms of Rule 504 – were instead offered under the more burdensome (expensive) provisions of Rule 506. The apparent reason for that migration was that Rule 506 preempted state registration authority.

The Commission should preempt state registration authority for Tier I offerings. Without preemption, the beneficial impact of Tier 1 offerings for small issuers – and for our economy – will be insignificant.

There can be no question of the Commission's authority to preempt state registration authority over Tier 1 offerings. Indeed, Congress has *twice* enacted statutes (15 U.S.C. 77r(b)(3); and 15 U.S.C. 77r(b)(4)(D)) delegating broad authority to the Commission to preempt state registration authority over Regulation A offerings, and in *Lindeen v. Securities and Exchange Commission*, 825 F. 3d 646 (216), the Appellate Court confirmed in the strongest terms this broad delegation of authority to the Commission.

The Commission should also revisit the filing and disclosure requirements for small Regulation A offerings and re-scale disclosure requirements in a manner that does not allow relative offering costs (offering costs as a percentage of the size of the deal) to foreclose small issuers from using Regulation A for their small capital needs.

The core of Title IV and the Commission's implementation make sense. Nonetheless, for Regulation A to reach its full potential as a vehicle for small business capital formation, the Commission must preempt state registrations authority and rescale disclosure requirements for small offerings. An exemption that enables small businesses to solicit broadly for investors and that is predicated on mandated disclosure of prescribed, efficiently scaled investment information is an attractive alternative for small businesses searching for external capital. It also provides appropriate protection for investors.

Sincerely,

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