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August 28, 2013

Via Electronic Mail at rule-comments@sec.gov

Honorable Mary Jo White, Chairperson
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Comments on Proposed Rule: Amendments to Regulation D, Form D and Rule 156 under the Securities Act of 1933; Release Nos. 33-9416, 34-69960, IC-30595; File No. S7-06-13

Dear Chairperson White:

The undersigned submits the following comments to the Commission in respect of "*Proposed Rule: Amendments to Regulation D, Form D and Rule 156 under the Securities Act of 1933*;" (Release Nos. 33-9416, 34-69960, IC-30595; File No. S7-06-13). In particular, these comments are intended to address the Commission's request for comment on the following:

1. The Initial Regulatory Flexibility Analysis set forth in Section XI of the Release, presented by the Commission pursuant to Section 603 of the Regulatory Flexibility Act of 1980, as amended (the "RFA"), and

2. Whether, in respect of a "small business", "differing compliance, reporting or timetable requirements, a partial or complete exemption, or the use of performance rather than design standards would be consistent with the **main goal of improving the Form D data collection process** with respect to Rule 506 offerings." [Emphasis added.]

Scope of Comments

Though many of these comments may have applicability to issuers of all sizes, the focus of these comments is on the class of entities which Congress determined in1980 are entitled to the statutory protection of the RFA, "small businesses", as defined by the RFA, *i.e.* businesses with total assets of $5 million or less and who are engaged in an offering raising no more than $5 million. This is done for the following reasons:

- Title II of the JOBS Act is intended to primarily benefit this same category of small businesses, which have limited resources, cannot readily access the SEC registration process and cannot afford the cost of unfettered access to securities lawyers throughout the course of the financing process.
- It is widely known and accepted in the financial community that the greatest deficiency in capital formation in the debt and equity markets is experienced by businesses who are seeking to raise up to $5 million and who, by reason of the absence of a history of profitability and bankable hard assets, have limited ability to access private capital. [1]
- The undersigned has extensive experience representing the interests of small business as a securities attorney and business advisor since 1978, predating the adoption of Regulation D.

My comments also mirror concerns of former Commissioner Paredes, as expressed at the Commission's Meeting on July 10, 2013, with regard to the proposals' effects on "small issuers":

> "I am keenly interested in hearing commenters' views on how the proposal could impact capital formation, ***especially for smaller issuers***, and what that impact on capital formation could mean for issuers, investors, innovation, and jobs. It will be troubling, to say the least, if the Commission ends up responding to the JOBS Act by imposing a regulatory regime on the private securities market that actually detracts from economic growth and job creation in contravention of the legislation's purpose." [Emphasis added]

<u>Recommendations</u>

As discussed in detail below, I respectfully submit that:

- The Commission's cost-benefit analysis required by the Regulatory Flexibility Act of 1980, as set forth in the Proposing Release, is deficient, in terms of both the substance and the spirit of the RFA.[2]
- The Proposed Rules, as applied to small business, undermine the goals of Congress in enacting the JOBS Act.

Accordingly, if the proposed rules are adopted by the Commission:

[1] Indeed, as the Commission noted in the Proposing Release, " . . . information [regarding the size of issuers utilizing Regulation D] would be particularly useful in better understanding the effects of general solicitation on capital formation by small businesses, a set of issuers that otherwise face significantly greater challenges than larger issuers in finding investors. <u>Proposing Release</u>, at page 140.

[2] *See also*, Comment Letter of Rep. Patrick McHenry and Rep. Scott Garrett to the Commission dated July 22, 2013, regarding deficiencies in the Commission's RFA analysis.

- Small entities should be *exempt* from proposed Rule 507(b), which would bar issuers from using Rule 506(b) and (c) for a period of at least one year.
- Small entities should be *exempt* from the provisions of proposed Rule 503 to the extent it requires any filing in advance of the commencement of an offering and prior to an initial sale.
- Small entities should be *exempt* from proposed temporary Rule 510T requiring the immediate posting of all written general solicitation and advertising materials.

These proposed rules, though well intentioned, send the wrong message to a new generation of entrepreneurs with limited resources, who require capital to develop and implement new ideas – these rules will burden entrepreneurs with unnecessary complexity and "monitoring" tactics more akin to a police state than a free market economy. Moreover, these rules are in direct conflict with the stated objectives of Congress, embedded in legislation that had overwhelming bi-partisan support.

I am mindful of the importance that the Commission has placed on the long inviolate and absolute goal of investor protection. I am also mindful of the dramatic and historic nature of the change imposed by Congress in enacting Title II, and the additional risks this may pose to investors. But, wisely or not, Congress has spoken. Indeed, it may very well need to speak again. But unless and until it does, it is the responsibility of the Commission to carry out Congressional mandates with appropriate dispatch, whether or not these mandates are ill-conceived, and not to thwart those goals, either wittingly or unwittingly, through discretionary rulemaking which undermines a clearly articulated legislative objective.

If investors lose confidence in our markets, capital formation will be jeopardized. However, if the public loses confidence in our government and its institutions, this country cannot succeed.

The proposed rules also present troubling ironies, particularly as applied to "small issuers." Most glaring is the Commission's stated concern underlying all of the proposed rules, that allowing general solicitation and advertising in unregistered offerings, albeit to accredited investors, risks turning the securities markets into the "Wild West"[3] absent intense policing of these offerings by the Commission. The proposed rules go so far as to require all those who seek to utilize the new Congressionally mandated exemption to upload all written materials to the Commission in real time on a daily basis, and to file Form D no less than 15 days before any

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[3] At the Commission's open meeting on July 10, 2013, Commissioner Walter stated: "It is imperative that investors have confidence that the private offering marketplace has not turned into the Wild West. And it is important that investors know and understand that we are monitoring the marketplace and stand ready to implement any further appropriate protections. If investors lose confidence, then the market cannot succeed."

general solicitation commences – the latter at the risk of losing the use of any Rule 506 exemption for at least one year.

It is incongruous that the Commission is proposing rules dramatically impacting the availability of Rule 506(c) to small entities, driven largely by fears of an onslaught of unbridled fraudulent investment activity and the erosion of investor safeguards, when on the very same day that the proposing Release is issued, and despite another clear Congressional mandate, Section 926 of the Dodd-Frank Act, and the Commission's own initial judgment on the matter in 2011, the Commission issued a final rule allowing convicted felons, fraudsters and other known "bad actors" in the securities arena to line up at the Rule 506(c) starting gate on September 23, 2013, on equal footing with honest, law abiding entrepreneurs, and enter the new, historic frontier of unregistered private placements utilizing public solicitation and advertising. If there are any avoidable negative elements reflective of the "Wild West" in this scenario, they appear to the creation of the Commission, and not Congress.[4]

It is also ironic that the Commission, through proposed rules, now seeks to step up "data collection" to bolster policing and oversight efforts, backed by penalties for non-compliance as draconian as forfeiture of the private placement exemption. Under the Regulatory Flexibility Act of 1980 the SEC has defined a "small entity" as one with not more than $5 million in total assets who seeks to raise up to $5 million. The proposed rules are purportedly driven, *as to these small issuers*, by "the main goal of improving the uniformity and completeness of the Form D collection process with respect to Rule 506 offerings," However, for more than 30 years, since the adoption of Regulation D and Form D in 1982, the SEC has yet to collect data regarding this category of issuers as it relates to the use of Regulation D – something seemingly required by the Regulatory Flexibility Act[5]. And nowhere in the proposed changes to Form D does the Commission require an issuer who is not an investment company to provide any information regarding its total assets – the RFA's statutory measurement of "small entities."[6]

[4] Under the rule as originally proposed by the SEC in 2011, "bad actors" would have been disqualified from using Rule 506 if the "triggering event" occurred within the relevant look-back periods, regardless of whether the event occurred before enactment of the Dodd-Frank Act, or the date of the proposal or effectiveness of the amendments to Rule 506. Under the final rules enacted on July 10, 2013, issuers would not be disqualified from relying on Rule 506 for triggering events of "bad actors" occurring before the effective date of the rule, September 23, 2013.

[5] Under Section 603(c) of the RFA, the regulatory analysis by the SEC is required to state the number of "small entities to which the proposed rule applies" unless such an estimate is not feasible.

[6] Notwithstanding that the SEC's definition of "small business" has been measured in terms of total assets ($5 million), it has never required companies other than investment companies to provide any information regarding total assets. Instead, it has buried this omission in Footnote 236 appearing on page 161of the 178 page Proposing Release, and then asked the public to weigh in on the issue by *the public* informing it how many small entities may be affected. If there truly is a need by the Commission for "completeness of data set" and advancing the interests of "small entities", I propose that the Commission first amend Form D to inquire as to *the total asset size of the small entity*. *See* Note 236, at page 161 of the Proposing Release.

DISCUSSION

I. LOSS OF FUTURE USE OF EXEMPTION FOR NON-TIMELY FORM D FILING.

Proposed Rule 507(b) purports to *automatically* disqualify issuers from future use of Rule 506(b) and (c) for a period of not less than one year if they fail to timely comply with any of the Form D filing requirements, including the proposed expanded 15 day advance pre-filing requirements. Such a rule is unnecessary to accomplish its stated purposes, as there are adequate *existing* alternatives which will accomplish the stated objective, *i.e. regulatory oversight*, and the rule as proposed will be unduly burdensome to small entities.

Section 603(c) of the Regulatory Flexibility Act is clear in its mandate:

> "Each initial regulatory flexibility analysis shall also contain *a description of any significant alternatives* to the proposed rule which accomplish the stated objectives of applicable statutes and which minimize any significant economic impact of the proposed rule on small entities. Consistent with the stated objectives of applicable statutes, *the analysis shall discuss significant alternatives* . . . ". [Emphasis added.]

The Commission acknowledges in the Proposing Release that "The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objectives of our amendments, while minimizing any significant adverse impact on small entities." However, no such alternatives have been considered by the Commission. The Commission has failed to discuss, let alone identify, other alternatives. The Commission's sole articulated reason for not considering differing requirements for small entities is that other approaches "would detract from the completeness and uniformity of the Form D dataset and, as a result, reduce the expected benefits of more consistent submission of Rule 506 information and improved collection of data form Commission enforcement action."

The Commission nowhere discusses why, under current rules, adequate data collection is unattainable. It is simply stated as a conclusion. Ample tools currently exist to collect data and deter issuers from avoiding mandatory filing requirements, which would impose little, if any, burden on small entities. As discussed below, the Proposing Release gives short shrift to the usefulness of these tools in general, and in particular with respect to small entities protected by the RFA.

Any theoretical benefit that might be obtained in furtherance of the Commission's self-proclaimed goal of obtaining "completeness" of data, as regards small entities, would be outweighed by the negative impact that would surely flow from the adoption of this rule – a number of small entities would in fact be disqualified from relying on Rule 506(c) (and Rule 506(b)) for *at least* one year – the same class of entities who are the principal intended beneficiaries of Title II of the JOBS Act. The effects of this would hit small entities the hardest – those with the least resources and the least access to alternative sources of capital – precisely the class intended to be the beneficiary of Title II – and a protected class under the RFA.

The Commission should reconsider its Proposed Rules, as they affect small entities, not only from the perspective of the JOBS Act of 2012, but also the Regulatory Flexibility Act of 1980, whose purpose and intent is closely aligned with the goals of the JOBS Act:[7]

Accordingly, as discussed below, to the extent that proposed Rule 507(b), has vitality for any issuer, small entities should be exempted from this proposed rule in its entirety.

A. <u>New Rules Requiring Pre-Filing of Form D Add to Complexity, and Therefore Increase Likelihood of Late Filing by Small Entities</u>

For the first time in the 30 year history of Regulation D the Commission proposes to require the filing of an initial Form D *before* an offering begins, *i.e.* "no later than 15 calendar days *prior* to the first use of general solicitation or general advertising for such offering." Under current rules, no filing is required until 15 days after the first sale in an offering. The change, and the related proposed Rule 510T, appears to be motivated by a desire to identify fraudulent or illegal offerings before a sale takes place, rather than waiting until after investors have parted with their money. Although this approach is clearly sensible, and normally would be well within the scope of the Commission's discretionary rulemaking powers, it is, at the very least, inconsistent with the fundamental philosophy which has guided Regulation D since its inception – to create a *safe harbor* for issuers, especially small issuers, as an alternative to the uncertainties of determining whether an unregistered offering met the statutory requirements of then Section 4(2) of the Securities Act of 1933. This new proposed approach, if implemented, would turn what has historically been a safe harbor into a quagmire for small entities, which often do not have the sophistication and financial resources to assure timely compliance with this requirement.

The only significant benefit of a "pre-offering" filing requirement is that this information, coupled with a daily "data dump" of solicitation activity under Rule 510T, would allow federal and state enforcement agencies to thwart fraudsters before a first sale has occurred. While certainly a sensible goal, it seems likely that the group of people most sought to be targeted by enforcement activity are the same ones most likely to avoid the public spotlight, either by not

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[7] *See, e.g., the Preamble to the Regulatory Flexibility Act, which provides in part:*

> *Congressional Findings and Declaration of Purpose:*
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> * * *
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> (3) uniform Federal regulatory and reporting requirements have in numerous instances imposed unnecessary and disproportionately burdensome demands including legal, accounting and consulting costs upon small businesses, small organizations, and small governmental jurisdictions with limited resources;
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> (4) the failure to recognize differences in the scale and resources of regulated entities has in numerous instances adversely affected competition in the marketplace, discouraged innovation and restricted improvements in productivity;
>
> (5) unnecessary regulations create entry barriers in many industries and discourage potential entrepreneurs from introducing beneficial products and processes;

filing at all, or by carefully concealing the fraudulent nature of their activity. And often, the most pernicious frauds are carried out in the light of day, in front of the trained eyes of enforcement personnel, by well-credentialed and seemingly credible individuals. What is certain, however, is that small issuers will be trapped by the complexity of these rules, jeopardizing their ability to raise capital and, for some, their willingness to even attempt to navigate complex SEC rules.

Moreover, the Commission's articulated position that the disqualification's harsh impact is somehow cushioned by the notion that it would disqualify only *future* offerings, and not a current offering, does not detract from the punitive and certain adverse effects of the proposed disqualification. It also ignores the day-to-day reality of the financing world of small entities. Unlike institutionally managed offerings, financing activities of small entities often do not typically present themselves in neat packages. And entrepreneurs do not typically surround themselves with securities lawyers to monitor their day-to-day activities. In this Internet age many informal communications by small entities will innocently and unknowingly fall into the broad category of "general solicitation or general advertising," as will seemingly innocuous communications such as presentations at trade shows or conferences.

There is also the issue of determining when an offering begins and ends.[8] Sometimes two "offerings" might be ongoing simultaneously. Or one offering might quickly end and another begin. This is particularly true with small entities, where capital needs, and thus offerings, are often ongoing, and terms of the offering, including the type of security offered, can quickly change to reflect the market place. For example, an issuer might start out with a common stock offering which falls short of its mark, and quickly pivot to a convertible note offering. Thus, the proposed rule which the Commission has described as only affecting a "future" offering could quickly and unknowingly disqualify a current offering, with all of its attendant consequences, some of which the Commission has noted in the Proposing Release (*e.g.* investor rights of rescission against the issuer and affiliates, and resulting disclosure to potential investors of this contingent liability of the issuer).

Thus, the proposed pre-filing requirement is likely to result in a number of inadvertent, late filings, with the negative attendant consequences visited by the newly proposed *minimum* one year financing bar.

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[8] Regulation D does not define when an "offering" begins or ends – nor can it. Instead, Regulation D refers issuers to a 50 year old SEC release and states that "the following factors should be considered in determining whether offers and sales should be integrated for purposes of the exemptions under Regulation D:

(a) Whether the sales are part of a single plan of financing;
(b) Whether the sales involve issuance of the same class of securities;
(c) Whether the sales have been made at or about the same time;
(d) Whether the same type of consideration is being received; and
(e) Whether the sales are made for the same general purpose.

B. Completeness and Uniformity of Data Cannot Justify Use of Loss of Exemption as a Deterrent to Late Filers

The potential value of either a pre-filing requirement or any other filing requirement to foster regulatory oversight does not outweigh the detriment to small entities which would result from the loss of the Rule 506 exemptions. Perfection in data collection ought not be allowed to justify any rule whose consequences for non-compliance are punitive in nature, particularly where the rule thwarts the very goal intended by the statute or rule it is monitoring or policing – enhanced capital formation for small businesses and other job creators.

As the Commission notes in the Proposing Release, there is significant use of Regulation D and Rule 506 by small businesses. Existing data provided by the Commission indicates that half of the offerings relying on Rule 506 are at or under $1.5 million – with a substantial number of issuers reporting annual revenues of under $25 million. There is no doubt that Rule 506 is, and will continue to be, a significant tool for capital raises by small businesses. The Commission also advises that a great deal of data has been collected for businesses with under $25 million in annual revenues. And though the Commission believes that there has been a great deal of underreporting by small businesses who simply fail to file Form D, necessitating stronger measures to enforce Form D filing requirements, no empirical evidence is marshaled for this contention. Moreover, "completeness" of data, while a worthy goal, will never be attainable, nor is it necessary. Given that the Commission does not cite to an absence of data, no reason is presented as to why it cannot extrapolate from a subset of data, rather than creating a new rule designed to discourage non-compliance.

Nor is it necessary that every small business be penalized by the loss of use of an important exemption in order to achieve the goal of "completeness" of data collection. Current Rule 507(a) already provides an effective incentive to encourage timely filings of Form D. Specifically, it provides that no exemption under Regulation D shall be available for an issuer if such issuer, any of its predecessors or affiliates have been subject to any order, judgment, or decree of any court of competent jurisdiction temporarily, preliminary or permanently enjoining such person for failure to comply with any of the Form D filing requirements contained in Rule 503.

The Commission's analysis of this existing rule as an effective deterrent to late filing or non-filing is superficial and incomplete. The Commission simply states that the current rule requires the Commission to first institute a civil proceeding in federal court, and that in fact few such proceedings have been instituted. The Commission ignores the availability of a powerful weapon to benefit from this existing rule – the U.S. Mail. Undoubtedly, both the Staff and state regulators will be able to obtain information regarding ongoing offerings from public sources, including potential investors who are targeted by these solicitations. If an offering is ongoing, or completed, presumably a letter from the SEC (or even a state regulator) inquiring about the availability of Form D, and requesting that it be filed, ought to be sufficient to incentivize most delinquent issuers to make the required filing – particularly in view of the ability of the SEC to back up this request with enforcement proceedings, if necessary, under current rules.

II. **PROPOSED RULE 510T – "THE DAILY DATA DUMP"**

Rule 510T represents one of the more troubling overreaches of government into the U.S. financial markets in recent memory. Under the guise of a temporary rule, it purports to turn Regulation D into Regulation DDD – "Daily Data Dump." – a new daily routine for entrepreneurs seeking to raise capital from accredited private investors.

Proposed Rule 510T requires that an issuer submit to the Commission any written communication that constitutes a general solicitation or general advertising in any offering conducted in reliance on Rule 506(c) no later than the date of first use. The communication is to be submitted using the intake page designated on the Commission's website. Congressmen McHenry and Garret framed the issue succinctly and eloquently.

> If, however, the Commission seeks to utilize Rule 510T disclosure as part of an enforcement program, then it is not appropriate to demand that the entire population of private issuers report every advertisement in real-time to catch those few that commit a violation. Demanding that the entire population of Rule 506(c) issuers submit to this search is an overreach that cannot be justified under any meaningful cost-benefit analysis. Furthermore, Rule 506(c)-based general solicitations will be public, enabling the Commission or private vendors to collect this information from the locations where it is posted.[9]

This new proposal, coupled with the 15 day pre-filing requirement, appears to reflect a fear by enforcement personnel that allowing public solicitation and advertising in unregistered offerings will result in rampant fraud, which must be rooted out before it can take hold. Whether or not this proposed rule is within the discretion of the Commission, it is short sighted and improvident, especially as applied to small entities.

Existing securities laws and regulations, including the anti-fraud provisions of Rule 10b-5, provide meaningful protections for investors, as do enforcement powers of the Commission. And in the Commission's proposing release, it appears to acknowledge that in the past fraud in private placements has historically not been a major problem for Rule 506 offerings.

Notwithstanding the current state of the private placement market, the Commission seeks to require every issuer to file every piece of paper which might fall into the broad category of "general solicitation" or "general advertising" in real time. Compliance with this proposed regulation is not only disruptive to the day-to-day activities of small businesses, but compliance will also likely necessitate the involvement of securities lawyers at an early stage of a financing, before any capital has been raised. This type of regulatory zeal is precisely the reason why Congress enacted the Regulatory Flexibility Act of 1980, to protect small businesses from

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[9] Comment letter, Note 2 *supra.*

regulations which impose unnecessary and disproportionate costs and burdens on small businesses, stifling innovation.[10]

CONCLUSION

The proposed regulations are sending the wrong message to entrepreneurs with limited resources, whose ideas and businesses require capital outside the circle of immediate friends and family – and whose businesses are not suited for a registered offering, with its attendant costs and burdens.

The government should in the first instance be a partner with small business, not a policeman. And to the extent the government must be a policemen, it ought not be giving a pass to known fraudsters on the same day it is proposing discretionary regulations which burden all small businesses.[11] And the agencies that are charged by Congress to implement legislation towards facilitating capital formation by small business should take their direction from Congress, and not well intentioned state regulators with priorities that conflict with those of Congress.

We can learn a great deal from recent regulatory action in Kansas. Merit review and registration was first introduced into this country in 1911 by the Great State of Kansas, long before there were any federal securities laws enacted in 1933. These "Blue Sky" laws were intended to prevent unsuspecting residents in outlying rural areas from being victimized by fraudsters selling investments with promises of blue sky. It is ironic, and telling, that in 2011, before the JOBS Act was even a gleam in the eyes of Congress, Kansas also became the first state in this country with merit review to allow general solicitation and advertising for unregistered offerings to unaccredited investors.[12]

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[10] *See* Note 7 *supra*, regarding the purposes and goals of the Regulatory Flexibility Act.

[11] *See* Note 4 *supra*, regarding the SEC's implementation through rulemaking of Section 926 of the Dodd-Frank Act.

[12] The Invest Kansas Exemption, K.A.R. 81-5-21, which may be characterized as a crowdfunding exemption for both accredited and unaccredited investors, allows for public solicitation for capital raises of up to $1 million in an unregistered offering.

The world has changed a great deal in the past 100 years. We are no longer dependent on the pony express, as we once were in the days of the Wild West. Technological changes ought to facilitate positive changes in securities regulation which will facilitate capital formation and protect the integrity of the marketplace.

I would be pleased to discuss these matters further at your convenience.

Respectfully submitted,

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Office of Advocacy