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September 17, 2013

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

Re: Comments on Proposed Amendments
to SEC Regulation D and SEC Form D

Dear Ms. Murphy:

I appreciate the opportunity to comment on the Commission's proposed amendments to Regulation D and Form D, contained in Release No. 33-9416.[1] The Proposing Release requests comment on well over 100 different questions. I confine my comments to two general topics.

Rule 508 and "Insignificant Deviations"

The Commission's proposal would add a number of new procedural requirements to the Rule 506 safe harbor exemption, including:

Rule 503: advance filing of Form D, *closing amendments for Form D, Form D content changes, increased penalties for Form D procedural and content deficiencies,*

Rule 509: mandated legends and other disclosures for written solicitation materials,

Rule 510T: mandatory submission of written solicitation materials.

Many of these pertain only to Rule 506(c) offerings, involving communications deemed to constitute "general solicitation or general advertising" within the meaning of Rule 502(c). But others (shown above in *italics*) would equally apply to "traditional" Rule 506(b) offerings.

In evaluating comments about proposed Rules 503, 509, and 510T, the Commission in my view should give further consideration to Rule 508, which is mentioned only once in the Proposing Release. As stated in footnote 101 of the Release:

> Under Rule 508, the failure to comply with a term, condition or requirement of Rule 504, Rule 505 or Rule 506 will not result in the loss of the exemption from the

[1] *Amendments to Regulation D, Form D and Rule 156 under the Securities Act*, 78 Fed. Reg. 44806 (July 24, 2013) (the "Proposing Release").

> registration requirements of Section 5 for any offer or sale of securities to a particular individual or entity, if the person relying on the exemption shows the failure to comply did not pertain to a term, condition or requirement directly intended to protect that particular individual or entity; the failure to comply was insignificant with respect to the offering as a whole; and a good faith and reasonable attempt was made to comply with all applicable terms, conditions and requirements of Rule 504, Rule 505 or Rule 506.

No requirements of proposed Rules 503, 509, or 510T are within the stated "general conditions" or "specific conditions" of Rule 506. Thus, technically, Rule 508 would not apply to those amendments. However, I consider the *principles* of Rule 508 instructive here, for reasons stated below.

1. Filing Deficiencies. For nearly 24½ years, the Commission has made it abundantly clear that a late or omitted filing of Form D does not disqualify the issuer from relying on a Regulation D exemption.[2] Proposed Rule 507(b) would dramatically alter current practice for all Rule 506 offerings, by automatically imposing very significant adverse consequences for any failure to meet the (heightened) Form D requirements under Rule 503.

The following illustrates one aspect of this proposal. Amended Rule 503 would require an issuer to file an initial notice on new Form D "no later than 15 calendar days prior to the first use of general solicitation or general advertising for [an offering under Rule 506(c)]." Under new Rule 507(b), failure to file that notice in a timely fashion would generally disqualify that issuer and each of its promoters or other affiliates from relying on Rule 506 until 12 months after curative filings have been made for all relevant offerings. In the absence of sufficient curative filings, the Rule 506 disqualifications for those persons could last for five years after the end of the latest nonconforming offering. These disqualifications could be triggered even by a Rule 506 offering that (i) included just one communication deemed to constitute a general solicitation and (ii) failed to raise any capital.[3] [4]

The Commission has been careful to provide in Rule 507(b) that the disqualification does not apply to the current offering,[5] but instead applies only to future offerings. However, because

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[2] The sole exception has been the (exceedingly rare) case in which the Commission obtains "an order, judgment, or decree of any court of competent jurisdiction temporarily, preliminary or permanently enjoining such person for failure to comply with [Rule 503]." Under Rule 507, such an order not only terminates continued reliance on the exemption for that offering, but also permanently disqualifies the issuer (and certain other affiliated issuers) from relying on any Regulation D exemptions in future offerings, except as the Commission otherwise determines upon a showing of good cause.

[3] In theory, if the prospective Rule 506 issuer fails to make all required Form D filings, a *different but related issuer* (and perhaps the control persons of that second issuer) could be liable for a Section 12(1) rescission claim by a disappointed investor in the *later* offering, based on filing defects in the *prior* offering, up to six years after the end of the *prior* offering (five-year lookback, plus one-year statute of limitations).

[4] An issuer can apply to the Commission for a waiver of the disqualification, but this process of course is not self-executing. See discussion *infra*.

[5] The phrasing in Rule 507(b) is interesting: ". . . except that such exemption shall be available for offers and sales in connection with offerings that commenced before the failure to comply occurred." In the case of a failure to

its relevant triggers are so fact-intensive, Rule 507(b) creates a due diligence nightmare for nearly any Rule 506 offering where the issuer or some current affiliate is known, or thought, to have engaged in a Rule 506 offering within the prior five years. Counsel for the issuer will need to evaluate whether all such prior Rule 506 offerings were conducted in perfect compliance with Rule 503. As challenging as it might be in close cases to confirm that a Form D was filed within 15 days after the actual first sale date, it could be a Herculean task to prove that an initial Form D was filed within 15 days before the first offering-related communication that might be deemed a "general solicitation or general advertisement" of that offering. In the absence of obvious Rule 503 defects, issuers will be tempted to take their chances that all relevant predecessor Rule 506 offerings were perfectly timely, accurate, and complete in meeting all relevant filing requirements. Under the Securities Act, it remains the issuer's burden to prove that it qualified for an exemption from Section 5. A Rule 506 issuer that has not actually run all prior offering questions to ground takes a leap of faith that no purchaser will become disenchanted with the new investment within the relevant federal (or state) limitations period following sale of the securities.[6]

Rule 507(c) would preserve the possibility of seeking a determination from the Commission, upon good cause shown, that "it is not necessary under the circumstances that the exemption be denied." Seeking such determination involves uncertainty, expense, and delay, however. Whether the Commission would choose to waive a defect in the face of a pending rescission claim remains to be seen.

In the Proposing Release, the Commission cited improved data collection as the "primary reason" for its proposed amendments to Form D and related filing requirements. This is a worthy objective, but <u>not</u> one that – in the language of Rule 508 – is "directly intended to protect" the particular purchaser of the securities, and <u>not</u> one that (since April 1989) was previously considered a "significant" element of the safe harbor's boundaries. Especially where a late or missing filing results from good faith uncertainty over whether a "general solicitation" was even made, it is easily argued that the notion of a "safe harbor" is better advanced by applying the principles of Rule 508 to filing deficiencies.

I would urge the Commission to abandon the proposed *per se* disqualification penalty and consider (i) whether the Staff, academics, or investor trade associations can, by statistical sampling or other means, gather information that would be sufficient to evaluate and monitor

file a Form D at least 15 days prior to the first use of general solicitation, the offering might not actually commence "before the failure to comply occurred." If the initial Form D is filed within 30 days after the pre-offering due date, then (assuming it is the first filing for such offering) there is a one-time exception under proposed Rule 507(b) which causes the late filing to be "deemed timely." The law school hypothetical, of course, is this: if the issuer doesn't file the initial Form D until the 35th day after its first (general) solicitation communication seeking investment (*i.e.*, 50 days late), but otherwise complies perfectly with Rule 503, does the resulting disqualification include the current offering?

[6] Some have called the 12-to-60 month penalty box provision a *virtual death sentence* for any startup issuers that depend on being able to raise capital in small, frequent offerings. Rhetorical flourishes aside, that viewpoint understates the issue in important respects. Because the disqualification extends to future affiliates, the due diligence problem insidiously infects future offerings, especially in the case of the classic "serial entrepreneur," who may have been affiliated with multiple companies seeking capital over the prior five years.

how well Rule 506(c) is working and/or (ii) alternative inducements to file, such as imposing modest fines for late filings.

2. Standard Legends. For offerings conducted in reliance on Rule 506(c), proposed Rule 509 requires an issuer to include standard (133-word) legends in *each and every* written communication that constitutes a general solicitation or general advertising. According to the Commission, the requirement of standard legends is intended to "address investor protection concerns arising from the ability of issuers to engage in general solicitation in these offerings."

At first blush, "investor protection concerns" make the principles of Rule 508 inapplicable. However, Rule 506(c) offerings must be limited to accredited investors. In 30 years of dealing with Regulation D, I have never once heard an accredited investor say that a standard legend made him or her feel any safer or wiser about a possible investment. The fact is that the accredited investor population neither asked for, nor thinks it needs, this "protection."

The Commission cites potential utility of these legends to *non*offerees who encounter a general advertisement or general solicitation. But effective constraints against sale to nonaccredited investors provide better protection to that population than any standard legends.

Applying the principles of Rule 508, I believe an issuer's failure to provide the proposed Rule 509 legends on prior general communications would almost never be prejudicial to the particular purchaser. It also seems that a Rule 507(a) *disqualification by court order* would nearly always be a wholly disproportionate remedy for a legending defect and thus unlikely to be sought, much less granted.[7]

It might be argued that mandatory legends make it easier for the SEC and state regulators to troll the Internet for general advertisements, through simple word searches. However, a legend search only works for posted advertisements by knowledgeable and compliant issuers, and does not reach those from issuers that incompetently or deliberately omit the legends. Moreover, if word searchability is a key rationale, then the Commission could shorten the required legends considerably and mandate verbatim use. As it is now, a 133-word insertion is awkward to include in brief communications, and impossible to include in a Twitter posting.

My own view is that Rule 509 should either be deleted or be made advisable but not mandatory. Under the latter approach, an issuer's utter failure to provide similar legends or warnings might be some evidence of intent to mislead, especially when coupled with other examples of inaccurate or incomplete communications to prospective purchasers. Moreover, if misleading advertisements result in sales to nonaccredited investors, federal or state regulators may be able to cite the absence of standard legends as evidence of intent to entice and confuse unqualified investors.

3. Filing of Offering Materials. Proposed Rule 510T requires an issuer to submit to the Commission "any written communication that constitutes a general solicitation or general

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[7] If granted, the order would also disqualify all future Rule 506 offerings by that issuer or its future affiliates (potentially to the end of time) unless under Rule 507(c) the Commission terminates the restriction.

advertising in any offering conducted in reliance on § 230.506(c) no later than the date of first use." According to the Proposing Release, this filing requirement is intended to "facilitate the Commission's understanding of the market practices relating to how issuers solicit potential purchasers through written general solicitation materials for their Rule 506(c) offerings." Again, this is a worthy objective, but not one that is "directly intended to protect" the particular purchaser of the securities.

Without doubt, many startup companies will find burdensome a requirement to contemporaneously file each new written communication that could be deemed to constitute a general solicitation or general advertisement. The Commission estimates that this will consume, on average, two hours of effort per issuer per offering.[8] I do not understand what methodology was used to derive such an average, especially since the mechanism for uploading those documents has not yet been specified and since Rule 506(c) would encompass such a potentially wide range of issuers and offering styles. Even if the upload mechanism is simple, I can guarantee that some issuers will take longer than two hours just to figure out how to get a filing authorization number. (At the risk of branding myself an idiot, I will confess to once having spent way more time than that dealing with a botched online application to get a CIK number for a Form D filing.) Moreover, although the Proposing Release suggests that the issuer's own personnel will handle this without assistance from outside counsel or outside contractors, not every issuer's personnel are competent or confident enough to make good decisions about what communications meet the legal definition of "general solicitation" or "general advertising" (terms that remain largely undefined), nor about how to deal with a prior failure to make a timely upload of covered materials or how to deal with prior erroneous uploading of unauthorized or legally privileged materials.

Before settling on a mandatory upload requirement and on remedies for noncompliance, the Commission in my view should consider (i) whether the Staff, academics, or investor trade associations can gather, by statistical sampling or other means, information that would be sufficient to evaluate and monitor solicitation practices under Rule 506(c) and/or (ii) alternative inducements to file, such as access to SEC "help desk" personnel for startup companies with questions about legal and technical requirements for Rule 506 offerings and/or (iii) random or selective audits (by the SEC or state securities administrators) coupled with requirements that issuers must maintain copies of all relevant, material communications.

If filing of such communications is to be made mandatory, then I would urge the Commission to publish *de minimis* exceptions for communications not worth filing. Otherwise, the Commission risks both (i) a "file everything" inundation from many issuers and (ii) generating a confusing body of inconsistent rulings from different judges if the Commission regularly seeks Rule 507(a) *disqualifications by court order* for Rule 510T violations.

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[8] The estimate actually also includes the time needed to affix standard legends to all such written materials, and even the time needed for private funds to explain complex performance data.

Release No. 33-285, *Ralston Purina*, and
<u>Basic Concepts of a Non-Public Offering</u>

Since first taking effect in 1982, the Rule 506 safe harbor has been conditioned upon compliance with Rule 502(c) which provides in pertinent part as follows:

> neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following: (1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and (2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising . . . .

Rule 506(c) will soon free issuers from that limitation if the offered securities are sold only to persons who meet one or more of the accredited investor tests (or are reasonably believed by the issuer to do so) and if the issuer has taken reasonable steps to verify the accredited investor status of all purchasers. However, the Proposed Amendments would add a number of additional requirements under Rules 503, 509, and 510T, as discussed above. Although none of the proposed additions are *per se* conditions of the Rule 506(c) exemption for the particular offering, each has significant potential future ramifications under proposed expansions of Rule 507.

Because the proposed requirements for Rule 506(c) offerings would be more extensive and burdensome than for "traditional" Rule 506(b) offerings, the Proposing Release has sparked increased anxiety over the question of what exactly is "general solicitation or general advertisement."

Many commentators have expressed concern over whether Rule 502(c)(2) – which, in circular fashion, defines general solicitation to include a seminar or meeting whose attendees have been invited by any general solicitation or general advertising – reaches "pitch contests" and other widely-publicized forums by which startup companies offer brief, tantalizing descriptions of their future plans for success. Nearly every one of those companies is in need of more capital, and presumably all are in full "investor networking" mode. Forums of this type have become trendy in many cities, finding support not only from angel capital-types but also from the broader business and civic-development communities. Simply put, does participation in these activities disqualify the startup company from Rule 506(b)?

It had become almost axiomatic that solicitation-related publicity directed to a large, undifferentiated audience was inconsistent with the concept of a private placement.[9] Quite obviously, Section 201 of the JOBS Act blows a hole in that theory. But I would argue that early foundation precedents under the Securities Act support the view that solicitation-related publicity

[9] Publicity concerns in the "gun-jumping" context have perhaps taught securities lawyers to view a public offering as being just a hair trigger away. I would argue that even in the special case of a registered offering (where extensive sales efforts will soon be aimed at the general public, whether sophisticated or not), the SEC Staff has not applied a hair trigger standard in deciding what publicity incidents warrant a delay in the registration statement effective date.

does not equate to a public offering, and that the phrase "general solicitation or general advertisement" should be construed accordingly.

The SEC's earliest general guidance on the meaning of a "public offering" is Release No. 33-285, issued on January 24, 1935. Discussing the new exemption in Section 4(1) of the Securities Act of 1933 (now found in Section 4(a)(2)), the first SEC Chief Counsel, John J. Burns, wrote "I conceive that the following factors in particular should be considered in determining whether a public offering is involved in a given transaction." He then discussed the following four factors:

1) The Number of Offerees and Their Relationship to Each Other and to the Issuer;

2) The Number of Units Offered;

3) The Size of the Offering; and

4) The Manner of the Offering.[10]

On that last factor, here is the entirety of his advice: "I have already indicated my opinion that the purpose of the exemption of non-public offerings is largely limited to those cases wherein the issuer desires to consummate a few transactions with particular persons. Consequently, I feel that transactions which are effected by direct negotiation by the issuer are much more likely to be non-public than those effected through the use of the machinery of public distribution." This discussion of the manner of offering makes no mention of publicity *per se* as a factor.

Consider *Shark Tank*. Every week, in front of 7 million eager viewers on ABC – *none* of whom are prescreened for accredited investor status and *all* of whom have been targeted by the most enticing general advertising that money can buy – a handful of entrepreneurs deliver brief investment pitches to five angel (?) investors. States Wikipedia, no less: "<u>TV Guide</u> reported in December 2012 that the show's panel members had invested $12.4 million in the business opportunities presented to them during that season and those whose business ideas did not result in an investment from the sharks still benefited from the publicity generated by that contestant appearing on the *Shark Tank* show." Can anyone explain how this could possibly be a non-public offering?

The reason is that those 7 million viewers are not offerees. It is abundantly clear (at least to all non-securities lawyers) that the offerees are the five sharks, and that these five offerees are not in need of a 250^+ page prospectus that has been or will be subject to detailed SEC review.

The potential disconnect between publicity and public offering is fully consistent with *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124-25 (1953):

> The design of the statute is to protect investors by promoting full disclosure of information thought necessary to informed <u>investment decisions</u>. The natural way to interpret the private offering exemption is in light of the statutory purpose. Since exempt transactions are those as to which "there is no practical need for . . . [the bill's] application," the applicability of § 4(1) should turn on whether <u>the particular</u>

[10] *Cf.* Rule 502(c) (entitled "Limitation on manner of offering").

> class of persons affected need the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction "not involving any public offering."

What counts for these purposes is whether the targets of the solicitation are truly limited to a "particular class of persons" who "are shown to be able to fend for themselves." In *Shark Tank*, the identity of the true offerees is known in advance and the prospective issuer can reasonably assume that all five sharks are equipped to conduct their own investigation and/or negotiate over terms. The number of bystanders is irrelevant.

This is not to say that an announced intent to sell securities only to a limited number of wealthy, sophisticated investors means a general solicitation is never present. As Chief Counsel Burns stated in the above-referenced Release,

> I have very serious doubts as to whether in many of those cases where it is stated that an offering is to be made only to an insubstantial number of persons, there may not be preliminary conversations for the purpose of ascertaining which of various possible purchasers would be willing to accept an offer of the security in question if it were made to them. Any such preliminary negotiations or conversations with a substantial number of prospective purchasers would, in my opinion, cause the offering in question to be a public offering, thereby necessitating prior registration of the security in question.

I consider that a key insight – how does the issuer go about finding target offerees?

Assume the issuer both has and makes clear a bona fide intent to accept investment only from a limited number of sophisticated accredited investors. Here are examples of what I feel should be treated as general solicitation in that particular context, and what should not:

a. If an issuer embarks on a broadly disseminated publicity campaign in order to identify prospective investors (even if purportedly just for wealthy, sophisticated investors), this clearly constitutes general solicitation. The capital-related purpose and number and indiscriminate nature of the recipients are controlling here.

b. If an issuer sends business plans to several dozen venture capital firms the entrepreneur has never met, this clearly does not constitute general solicitation, even if some of the mailings happen to end up in the hands of nonaccredited investors. Despite the capital-related purpose, the targeted nature of the recipients is controlling here.

c. If an issuer makes, or even pays for, a posting on some legitimate angel group website where the group takes pains to limit its membership to accredited investors, this should not constitute general solicitation, even if the postings can be seen by some nonaccredited investors who happen to have access to the site. Despite the capital-related purpose, the targeted nature of the recipients is controlling here.

d. If an issuer attends some other organization's pitch contest where (despite attendant publicity) the audience is expected to be modest in size and is expected to include at least some sophisticated accredited investors, then I would argue that this should not be treated as a general solicitation. Despite the capital-related purpose and indiscriminate audience, the limited number of recipients should be controlling here.

e. If an issuer buys a mailing list and indiscriminately sends a blast email to personal or business email addresses and in that message mentions (with or without details) that it is seeking capital, this clearly constitutes general solicitation. The purpose and number and indiscriminate nature of the recipients are controlling here.

f. If the issuer pays for broadcasted media whose content it controls, such as an infomercial or a print ad, and mentions (with or without details) that it is seeking capital, this clearly constitutes general solicitation. The purpose and number and indiscriminate nature of the recipients are controlling here.

g. If the issuer is actively promoting its products and services, is the subject of unpaid media such as a local TV show discussing the company and those products and services, and mentions (but without details) that it is seeking capital, then I would argue that this should not be treated as a general solicitation. The largely non-capital purpose and lack of content control are controlling, despite the number and indiscriminate nature of the recipients.

h. If an issuer is garnering publicity through a non-securities Kickstarter campaign and simultaneously is pursuing sophisticated accredited investors through traditional networking activities, I would not consider this to be general solicitation. The targeted nature of the recipients is controlling here, despite the simultaneous presence of other publicity which is raising capital by other means.

i. If an issuer mentions on its website that it is seeking investment from accredited investors (without details) and is not taking significant steps to drive investor traffic to its website, then I would argue that this should not be treated as general solicitation. Having a website that promotes products and services is now the norm and not the exception, and without more is not a sufficiently active solicitation to put significant numbers of unqualified investors at risk.

On the other hand, if the issuer is either vague about or less discriminating about prospective offerees with whom it is willing to discuss investment terms, then I would argue that all of the foregoing examples constitute general solicitation except for (b), (c), (g), (h), and (i).

The terms "solicitation" and "advertisement" both entail the element that the sender intentionally seeks to entice the recipient to do something. If action sought from recipients is to have them consider a prospective investment and contact the issuer, and if the communication is disseminated to a sufficiently large and undifferentiated group, then the communication should be treated as a general solicitation that is inconsistent with a Rule 506(b) private placement. On the other hand, if the communication is well-targeted to a narrow pool of qualified investors, and if other incidental recipients as a group are not left with reason to think the issuer is seeking capital from them, then the other recipients are bystanders to a solicitation and do not require the protections of the 1933 Act. Just as in *Shark Tank*, the mere fact that incidental recipients saw the capital-soliciting communication is not, in my view, sufficient to cause the communication to be treated as a general solicitation or general advertisement under Regulation D.

I would urge the Commission to acknowledge that Rule 502(c) is circular and not well-defined, and that publicity alone in a capital-raising context is not sufficient to turn a communication into general solicitation or general advertisement for purposes of Rule 506 if the evident targets of the communication are a "particular class of persons" who "are shown to be able to fend for themselves." Providing this guidance would be consistent with the foundational precedents Release No. 33-285 and *Ralston Purina*.

I would also urge the Commission, consistent with its regulatory mandate under the JOBS Act, to either include within Rule 502(c) a set of "safe harbor" communications deemed not to constitute a general solicitation or general advertisement even if widely distributed, or else include within Rule 502(c) some exception for immaterial communications that, although broadly disseminated, did not put prospective purchasers at meaningful risk.

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In closing I want to commend the Commission and the Staff for a very intelligent and thought-provoking set of proposals in the Proposing Release. In particular, I applaud and encourage efforts to avoid layering additional burdens on top of the "traditional" Rule 506(b) exemption, which has long been such a valuable workhorse for capital formation in the United States.

Very truly yours,

Gregory S. Fryer

Gregory S. Fryer

GSF/aeb