BETTER MARKETS
TRANSPARENCY · ACCOUNTABILITY · OVERSIGHT

September 23, 2013

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

Re: Amendments to Regulation D, Form D and Rule 156; File No. S7-06-13

Dear Ms. Murphy:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules ("Proposed Rules") of the Securities and Exchange Commission ("SEC"). The Proposed Rules would amend Regulation D primarily to enhance the SEC's ability to oversee Rule 506 private offerings and to understand the impact of the SEC's recent rule lifting the ban against general solicitation in Rule 506 offerings. The Proposed Rules also include modest proposals to strengthen enforcement of the Form D filing requirement and to ensure that investors receive additional disclosures.

Protecting investors and markets is why the SEC exists. That, presumably, is also why the Proposed Rules were issued, but if they are to be more than ineffective window dressing, they must be substantially strengthened and then adopted without delay. Investors in the private offering market are now exposed to a fresh wave of investment offerings through general solicitation and they deserve to be protected. Moreover, the Commission must act quickly to strengthen the accredited investor definition, which is one of the most effective ways to safeguard investors against fraud and abuse in Rule 506 offerings.

## INTRODUCTION

Regulatory oversight and investor protection in the private offering market, especially the Rule 506 arena, has been inadequate for years and steadily deteriorating. Over time,

- the applicable rules have been weakened;

[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

1825 K Street, NW, Suite 1080, Washington, DC 20006 TELEPHONE (1) 202.618-6464 FAX (1) 202.618.6465 WEBSITE bettermarkets.com

- the SEC has devoted virtually no resources to monitoring Rule 506 offerings; and

- state securities regulators have been preempted from regulating these offerings with the sole exception of after-the-fact anti-fraud oversight.

And, as many have recognized, passage of the Jumpstart Our Business Startups Act ("JOBS Act") has threatened to make matters far worse by further deregulating these offerings and requiring the SEC to lift the ban on general solicitation—all in the guise of "job creation."

Compounding all of these setbacks, the SEC has committed a number of serious missteps in the implementation of the JOBS Act and other rules in the area of Rule 506 offerings:

- It failed to establish specific methods that issuers must apply when verifying whether investors are accredited under Rule 506, contrary to the explicit statutory directive in the JOBS Act;

- Although the SEC did adopt a rule applying the "bad actor" disqualifications to Rule 506 offerings, as required by the Dodd-Frank Act, it indefensibly grandfathered **all** those who committed crimes before adoption of the rule, regardless of how serious or repeated those violations may have been (a decision that the SEC should immediately correct, in conjunction with the other recommendations in this comment letter); and

- The SEC adopted its rule lifting the ban on general solicitation without simultaneously adopting measures that would help mitigate the heightened risk to investors arising from repeal of the ban.

As a result of these regulatory actions and omissions, among others, the SEC has made an already weak investor protection regulatory regime even weaker. To reverse this trend, and to establish new and necessary protections for investors, the SEC must act quickly to strengthen the Proposed Rules and then adopt them. And, it must update and strengthen the accredited investor definition, which represents the best single defense against the potentially massive exploitation of investors that the general solicitation rule now threatens.

## SUMMARY OF COMMENTS

Private offerings under Rule 506 are widely used to raise capital but also to exploit investors. With the recent addition of 506(c), which repealed the ban on general solicitation, there is an even greater threat of fraud and abuse. Because the SEC lifted the ban on general solicitation without simultaneously adopting necessary investor protections, time is of the essence and the SEC must quickly adopt the Proposed Rules, as appropriately strengthened.

While specific provisions of the Proposed Rules are beneficial, they must be improved to enhance the SEC's oversight of Regulation D offerings and to better protect investors in those offerings. Specifically, the SEC must:

- Require, as proposed, the advanced filing of Form D in 506(c) offerings before the issuer engages in general solicitation, but expand that advanced filing requirement to all Rule 506 offerings;

- Provide that compliance with all Form D filing requirements in a Rule 506 offering is a precondition to claiming the exemption under Regulation D, or at a minimum, require that issuers who fail to comply with the filing requirements be subject to the proposed automatic 1-year disqualification from using Regulation D, which should be appropriately strengthened; and

- Include oral solicitations in the proposed requirement that general solicitation materials in a 506(c) offering be submitted to the SEC, and make that filing requirement permanent.

In addition, the SEC must act now to redefine and strengthen the definition of "accredited investor," which is one of the most effective ways to safeguard investors against fraud and abuse in Rule 506 offerings.

Finally, the SEC fulfilled its limited duty under the applicable provisions of the securities laws to consider whether the Proposed Rules promote efficiency, competition, and capital formation. However, the SEC can and should do more in the final rule release to clarify the nature of its obligation to conduct economic analysis, to limit the consideration of costs and benefits, and to appropriately emphasize the overarching goal of the securities laws to protect investors—the SEC's primary and overriding mission.

## OVERVIEW OF PROPOSED RULES

The Proposed Rules include some provisions applicable to all offerings under Rule 506, and others specifically related to Rule 506(c), which allows the use of general solicitation provided that all investors are accredited. In particular, in all 506 offerings the Proposed Rules would require an issuer to include additional information in its Form D filing, would require an issuer to file a closing amendment to Form D after the termination of the offering, and would disqualify an issuer from relying on Rule 506 for one year if the issuer, or any predecessor or affiliate of the issuer, had not complied, within the last five years, with the Form D filing requirements.

In 506(c) offerings, where general solicitation is permitted, the Proposed Rules would also require: the filing of Form D at least 15 days before the issuer engages in general solicitation; the inclusion of certain disclosures and legends in the written general solicitation materials used in the offering; and, for two years, the submission to the SEC of the written general solicitation materials used in the offering.

**COMMENTS**

## I. Rule 506 offerings are widely used to raise capital but also to exploit investors.

Rule 506 is just one of several exemptions from registration for limited or private offerings under the securities laws, but it is the most widely used. It has undoubtedly served as a cost-effective way to raise significant amounts of capital for legitimate businesses. At the same time, however, it has been an attractive vehicle for fraud and abuse by unscrupulous issuers preying on investors.

The reasons for this pattern of fraud and abuse in Rule 506 offerings are clear. Rule 506 offerings allow issuers to raise unlimited amounts of money, yet they are subject to relatively few regulatory requirements and they receive minimal regulatory oversight. By its own admission, the Commission has not had the resources to review Rule 506 offerings to any significant degree, and state securities regulators have been preempted from doing so under the National Securities Markets Improvement Act of 1996.

These circumstances have led to widespread use of Rule 506, which accounts for 94 percent of all offerings under Regulation D[2] and 99 percent of all amounts sold under Regulation D.[3] Furthermore, issuers relying on Regulation D, primarily Rule 506, raised a reported $863 billion in capital in 2011 and $903 billion in 2012.[4] Along with this increased reliance upon Rule 506 there has been a steady increase in the number of those offerings that have proven to be fraudulent.[5]

Indeed, the opportunity for issuers to raise unlimited funds, coupled with weak regulatory standards and oversight, has for years created a toxic mix for investors. Just this spring, four of the top executives at DBSI Inc., "one of the big-three syndicators of phony private placements that decimated independent broker-dealers in the past decade," were indicted on fraud charges related to offerings under Regulation D.[6] Similar large scale abuses in Regulation D offerings include the billion dollar fraud at Medical

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2 Vladimir Ivanov & Scott Bauguess, Division of Economic and Risk Analysis, SEC, *Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption 2009-2012: An update of the February 2012 study*, at 7 (July 2013), *available at* http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf ("July 2013 DERA Study").

3 *Id.* at 3.

4 *Id.*

5 Dan Jamieson, *Con Artists Use Reg D Pre-emption as Way to Hold off State Regulators*, INV. NEWS, Oct. 16, 2006.

6 *United States v. Swenson*, No. 13-0091-SBLW (D. Idaho Apr. 10, 2013). The indictment, which includes a list of the 83 charges, is available online at http://posting.boiseweekly.com/images/blogimages/2013/04/10/1365631612-dbsi_indictment.pdf.

Capital Holdings Inc. and the million dollar fraud and Ponzi scheme run by Provident Royalties LLC.[7]

Additionally, Rule 506 offerings continue to be the leading source of enforcement actions brought by state securities regulators, whose sole authority with respect to Rule 506 offerings is anti-fraud. According to NASAA enforcement reports: "The single most reported violation and a longstanding problem in the area of securities fraud: **Rule 506 or Reg D offerings**."[8] In 2011 state securities regulators brought over 200 enforcement actions and over 400 investigations related to Rule 506.[9] In Virginia alone, 24 enforcement actions were brought in 2010 and 2011 in Rule 506 offerings, representing a total of **$12 million** in investor losses.[10]

This pattern of abuse will almost surely continue and intensify with the recent adoption of Rule 506(c), which permits issuers to engage in general solicitation, unless the SEC fulfills its duty to establish countervailing safeguards, more vigorous oversight, and meaningful enforcement.

## II. Time is of the essence, since the SEC lifted the ban on general solicitation without simultaneously adopting necessary investor protections.

On July 10, 2013, the SEC, acting pursuant to the JOBS Act, promulgated rules eliminating the ban on general solicitation in Rule 506 offerings. However, it did so without providing sufficient protections to investors and without at least requiring information necessary for effective regulatory oversight. In effect, the SEC declared open season on investors.[11]

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7 Bruce Kelly, *Risks of Reg D deals worry state regulators*, INV. NEWS, Sept. 27, 2009, *available at* http://www.investmentnews.com/article/20090927/REG/309279956.

8 NASAA Enforcement Report, at 3, Oct. 2012, *available at* http://www.nasaa.org/wp-content/uploads/2012/10/2012-Enforcement-Report-on-2011-Data.pdf (emphasis in original).

9 *Id.* at 11; *see also* NASAA Comments on SEC Release No. 33-9354, at 2-3 (Oct. 3, 2012), *available at* http://www.sec.gov/comments/s7-07-12/s70712-92.pdf. And, this data is likely to be under-inclusive, as it relies on surveys of state regulators, which do not always report this specific data.

10 Commonwealth of Virginia Comments on SEC Release No. 33-9354 (Oct. 4, 2012), *available at* http://www.sec.gov/comments/s7-07-12/s70712-102.pdf.

11 The SEC also promulgated a rule disqualifying issuers from utilizing Rule 506 if felons or "bad actors" are participating in the offering. Although that rule is a necessary component of robust regulation of Rule 506 offerings, it was insufficient by itself and weak, in part, because of the SEC's decision to limit its application to prospective violations.

For example, the SEC failed to determine the specific methods that issuers must use to verify that all investors who are exposed to general solicitation are in fact accredited investors. Instead, it simply provided that the issuer take "reasonable steps" to verify that the purchaser was an accredited investor, and have a "reasonable belief" that such purchaser was an accredited investor at the time of sale.[12] This approach simply ignored one of the few express statutory directives in Section 201 of the JOBS Act: "Such rules shall require that issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, **using such methods as determined by the Commission."** This disregard of the statutory mandate is critically important, since the basic safeguard against abuse that was built into the general solicitation provision was the condition that all investors must be accredited and therefore presumptively less prone to fraud, abuse, and exploitation.

In addition, the Commission failed to apply other safeguards or information-gathering measures such as those included in the Proposed Rules. All of this should have been timed to prevent any gap between repeal of the general solicitation ban and the counterbalancing investor protections.

Indeed, while the ostensible purpose of the JOBS Act is to "improve[e] access to the public capital markets for emerging growth companies," this goal did not displace or subordinate the SEC's primary duty under the securities laws to protect the public and investors. Thus, even though the SEC was required to permit general solicitation in Rule 506 offerings, it was also required to do so in a manner that ensured sufficient SEC oversight and adequately safeguarded investors in those offerings. Specifically, the SEC has a duty to monitor the new 506(c) offering market for fraud and abuse; to prevent non-sophisticated, non-accredited investors from investing in those offerings; and to see that investors are appropriately apprised of the risks of their investments prior to purchasing securities in those offerings.

Having promulgated Rule 506(c) without these additional investor protections, it is crucial that the SEC now act as quickly as possible to remedy this failure. Additionally, the SEC should take this opportunity to address the investor protection concerns and oversight problems that are common to all Rule 506 offerings. As noted above, Rule 506 offerings are riddled with fraud and abuse, which existed well before the SEC lifted the ban on general solicitation and adopted Rule 506(c). Therefore, the SEC should expand the Proposed Rules so that information submitted to the agency covers all Rule 506 offerings, and so that investors receive the same disclosures and protections. Furthermore, and most importantly, the SEC should revise the definition of accredited investor to make certain that those who purchase securities in Rule 506 offerings actually have the level of sophistication and wealth necessary to invest in these offerings, which lie outside the purview of full-scale federal and state regulation.

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[12] Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,783 (July 24, 2013).

## III. While specific provisions of the Proposed Rules are beneficial, they must be strengthened to enhance the SEC's oversight of Regulation D offerings and to better protect investors in those offerings.

The Proposed Rules would enable the SEC to gather more information about Rule 506 offerings so that it can more effectively oversee that market. For example, the Proposed Rules require certain important disclosures in an issuer's Form D, including the types of investors; the issuer's plans to engage in general solicitation; the issuer's methods used to determine accredited investor status; whether the issuer used a broker dealer; and the types of general solicitation materials used and whether they were filed with FINRA. Additionally, if the offering was conducted under 506(c), any written general solicitation materials must include a legend identifying the basic characteristics and risks of any 506(c) offering.[13] These are positive measures, but, as detailed below, the Proposed Rules must be strengthened to better equip the SEC to oversee Rule 506 offerings, to strengthen investor protections, and to promote more effective enforcement.

### A. Requiring the filing of Form D in Rule 506(c) offerings before the issuer engages in general solicitation is clearly necessary, but the requirement must be expanded to all Rule 506 offerings.

Under the Proposed Rules, the SEC would amend Rule 503, which currently requires an issuer to file Form D within 15 days **after** the first sale of securities in a Regulation D offering. The amendment would, instead, require that an issuer in a 506(c) offering file Form D 15 days **before** commencing general solicitation and amend the Form D within 15 days of its first sale.[14] This initial Form D would include basic information material to investors and the SEC, including information on the issuer, the type(s) of securities being offered, and the use of the proceeds from the offering.

The Release appropriately notes that this proposed initial Form D would "assist the Commission's efforts to evaluate the use of Rule 506(c)" and would provide the SEC with information it would not otherwise have on unsuccessful offerings.[15] According to the SEC, the form would also "be useful to state securities regulators and to investors in gathering timely information about Rule 506(c) offerings and the use of 506(c)."[16] This is important for investors in 506(c) offerings, because, as accredited investors, they will not

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[13] Specifically, the legend must include the following: "The securities may be sold only to accredited investors, which for natural persons, are investors who meet certain minimum annual income or net worth thresholds; The securities are being offered in reliance on an exemption from the registration requirements of the Securities Act and are not required to comply with specific disclosure requirements that apply to registration under the Securities Act; The Commission has not passed upon the merits of or given its approval to the securities, the terms of the offering, or the accuracy or completeness of any offering materials; The securities are subject to legal restrictions on transfer and resale and investors should not assume they will be able to resell their securities; and Investing in securities involves risk, and investors should be able to bear the loss of their investment." 78 Fed. Reg. 44,821-822.

[14] 78 Fed. Reg. 44,810-11.

[15] 78 Fed. Reg. 44,811.

[16] *Id.*

receive the benefit of the Rule 502(b) disclosures.[17] Further, because there are no non-accredited investors in a Rule 506(c) offering, an issuer has little incentive to undertake to make these or similar disclosures in the first place.[18]

The proposed initial Form D filing is an important step toward better informing investors, the SEC, and other enforcement bodies about 506(c) offerings, where general solicitation that is not appropriately monitored creates the opportunity for fraud and abuse. However, the SEC should expand the initial Form D requirement to cover **all** Rule 506 offerings. The benefits associated with the application of the proposed form to Rule 506(c) are no less important to all private offering under Rule 506.[19]

Indeed, fraud and abuse in offerings under Regulation D occurred long **before** the SEC lifted the ban on general solicitation and adopted Rule 506(c).[20] And, most of the capital raised in those 506 offerings occurred within 15 days of the first sale.[21] Requiring a disclosure that can be filed 15 days **after** the first sale in 506 offerings is simply too late.

Accordingly, investors in **any** Rule 506 offering should have the same public disclosures **prior to** any offer so that they may be better informed about the nature of the offer. Likewise, by expanding the proposed amendment to all Regulation D offerings, the SEC, state securities regulators, and FINRA[22] may be appropriately alerted to an offering, before the first sale, so that they may monitor the offering and address investor concerns. The SEC may also be able to better analyze the interplay between new 506(c) and 506(b), and address any unintended consequences that may arise.

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[17] Those disclosures depend on the size of the offering and the nature of the issuer. Reporting issuers must provide purchasers with certain SEC filings, while non-reporting issuers must generally provide, to the extent material to investors, information about the issuer's business and securities being offered, as well as financial statement information and non-financial statement information. 17 C.F.R. § 230.502(b).

[18] According to the Note to Rule 502(b), "When an issuer provides information to investors pursuant to paragraph (b)(1), it should consider providing such information to accredited investors as well, in view of the anti-fraud provisions of the federal securities laws." Moreover, the concern that accredited investors in Rule 506(c) offerings will not get appropriate disclosures is of even greater concern given the outdated and over-inclusive definition of accredited investor, as discussed below.

[19] In addition, requiring an advanced Form D before an offer in any Regulation D offering would address commenters concerns that "an issuer may not be certain of whether it will rely on Rule 506(b) or Rule 506(c) ahead of time." 78 Fed. Reg. 44,811.

[20] Christopher P. Parrington, Skjold Parrington, *Cracking the Whip: FINRA Enforcement Action and Rule Changes Involving Private Placement in Outside Business Activities*, DRITODAY, July 18, 2011, *available at* http://dritoday.org/feature.aspx?id=78.

[21] According to the July 2013 DERA Study, "63% of capital sought since 2009 is reported as sold within 15 days of the first sale," and offerings under Rule 506 account for "99% of amounts sold though Regulation D." July 2013 DERA Study at 3.

[22] As stated by FINRA's former executive vice president and executive director of enforcement, James Shorris, the monitoring Regulation D offerings is a "major, major initiative" at FINRA. Bruce Kelly, *Private deals at top of Finra's hit list*, INV. NEWS, Feb. 2, 2011, *available at* http://www.investmentnews.com/article/20110202/FREE/110209961.

B. Requiring the filing of a closing amendment to Form D after the termination of any 506 offering would provide important information to regulators and should be implemented without delay.

Because Regulation D does not currently impose a requirement that issuers file a final amendment to Form D, the SEC does not have complete information about Rule 506 offerings, including, importantly, the total number of offerings and the actual amount of capital raised through an offering. To remedy this, the Proposed Rules would amend Rule 503 to require the filing of a final, closing amendment to Form D within 30 days of terminating any Rule 506 offering (unless the issuer has previously provided the information).[23]

This common sense requirement should be implemented without delay. Being able to understand the extent of Rule 506 offerings, which occur generally outside of federal and state securities regulation, is crucial for effective oversight. As argued below, this filing requirement should be a condition of claiming the Rule 506 exemption.

C. Compliance with all Form D filing requirements, in particular the advanced filing requirement, in a Rule 506 offering should be a precondition to claiming the exemption under Regulation D.

Under current law, incentives for full compliance with Regulation D requirements are minimal since none of the filing requirements are a precondition for claiming the exemption. Rather, an issuer is only disqualified from claiming the exemption in **future** offerings under Regulation D when an issuer, or its predecessor or affiliate, has previously been enjoined by a court for violating the filing requirements in Rule 503. This longstanding and weak-to-nonexistent enforcement regime essentially allows every issuer at least one free pass. They can ignore the filing requirement, and still benefit from the exemption.

Moreover, the current rule places the burden on the SEC to act and to do so using its limited resources and staff hours by commencing a legal action in court. The Commission admits this is a rare occurrence.[24] As stated by the SEC Inspector General, "there are simply no tangible consequences when a company fails to file a Form D."[25] As a result, the SEC is not even aware of the total number of issuers that fail to file Form D.[26]

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23 78 Fed. Reg. 44,812.

24 78 Fed. Reg. 44,818 n. 84 ("The Commission has brought few such enforcement actions.").

25 SEC INSPECTOR GENERAL REPORT NO. 459, REGULATION D EXEMPTION PROCESS, at 10 (March 31, 2009), *available at* http://www.sec-oig.gov/Reports/AuditsInspections/2009/459.pdf. As of that statement in March 2009, the Inspector General reported that "no issuers have been enjoined for violating Rule 503." *Id.* The Release itself only lists one such action, brought in 2011. 78 Fed. Reg. 44,818 n. 84 (citing *SEC v. Printz Capital Management*, No. 10-7379 (E.D. Pa. Mar. 15, 2011)).

26 78 Fed. Reg. 44,846 (stating that "we could not locate Form D filings for approximately 10% of Regulation D offerings where broker-dealers or registered investment advisers were involved," and "we cannot estimate the rate of compliance among the issuers of the remaining 89% of Rule 506 offerings that do not use a registered investment adviser or broker-dealer, [but] it may be reasonable

To adequately incentivize full compliance, the SEC should make adherence to the Form D filing requirements a precondition for an issuer to claim the exemption from the normal securities registration regime. Under this approach, issuers who fail to comply with the very minimal filing requirements would face real consequences: they would be in violation of the federal and state securities laws for selling unregistered securities, and they would be subject to purchasers' rights of rescission. Such consequences would ensure that all issuers relying on Rule 506 take care to comply with the negligible conditions of the exemption. [27]

The Release notes that conditioning use of the registration exemption on compliance with the Form D filing requirements **may** have excessive or unfair consequences, especially if the violation were truly the result of an innocent mistake. But the concern that an "innocent mistake" might occur and might lead to unfair consequences is of little weight. It improperly ranks the speculative and occasional harm to a market participant far above the well-documented and frequent risks that investors face in a poorly regulated private offering market. The rationale set forth in the Release is particularly weak since the filing of the Form D is such a simple task.

Moreover, the filing of the Form D is more important than ever with the repeal of the ban on general solicitation. Formerly, the presence of general solicitation in a Rule 506 offering served as one of the few methods that would alert regulators to potentially unlawful offerings. Without the ban against general solicitation, this early warning system is gone. A meaningful, enforceable Form D filing requirement is now the only realistic mechanism for alerting regulators that a private offering is about to occur.

D. At a minimum, issuers who fail to comply with the filing requirements should be subject to the proposed automatic one-year disqualification from using Regulation D, but it too should be strengthened.

The Proposed Rules would amend Rule 507 to establish an automatic one-year disqualification from Regulation D if the issuer, or any predecessor or affiliate of the issuer, did not comply, within the past five years, with the Form D filing requirements in a Rule 506 offering.[28] The one-year ban would begin upon the filing of all the required Form D filings or upon the filing of a closing amendment, if the offer has been terminated. The SEC is also proposing a one-time 30-day cure period and is further proposing to provide the SEC with the ability to waive a violation for good cause shown.

The proposed ban appropriately covers not only the issuer, but also its predecessor or affiliate and has a look-back period of five years. However, the waiver

to assume that they are no more likely to file a Form D, particularly to the extent that they undertake an offering without the assistance of a regulated entity").

27 Requiring the filing of advanced Form D as a precondition to claiming the exemption is even more important given the SEC's persistent refusal to amend the definition of accredited investor, as discussed below.

28 78 Fed. Reg. 44, 818.

provision and the cure period afforded to issuers to fix errors in its filings must be reconsidered. First, the SEC should take precautions in implementing the waiver provision so that the waiver does not become perfunctory, as has been the case in other circumstances.[29]

Second, it is not clear why the cure period is even necessary, especially in light of the waiver provision. Rather it seems to give repeat users of Rule 506, who are familiar with the rules, the ability to game the system and intentionally fail to comply with a deadline when it suits their needs. It is the small issuers that do not regularly use Rule 506, that do not use the assistance of a regulated entity, and that are less familiar with the rules who are more likely to make inadvertent errors. However, these small issuers are less likely to care about a one-year ban in the future, and even if they needed to make a Rule 506 offering in that year, they could simply apply for a waiver with the SEC.

E. The proposed requirement that written general solicitation materials in a 506(c) offering be submitted to the SEC must include oral solicitations and must be made permanent.

Proposed Rule 510T would require issuers to submit to the SEC any written general solicitation materials used in their 506(c) offerings no later than the date of their first use. The Release notes the importance of this requirement to the SEC, which would obtain the ability to assess "the market practices through which issuers would solicit potential purchasers of securities offered in reliance on Rule 506(c)."[30]

Indeed, this proposed rule is an important tool for the SEC, necessary to effectively oversee 506(c) offerings and to protect investors in those offerings. However, there are several limits placed on Proposed Rule 510T which must be changed.

First, and most important, it would exclude from the submission oral communications used in 506(c) offerings. The SEC reasons that this exclusion is acceptable because most of the general solicitations are written due to the "potentially greater reach and lower costs of such solicitation."[31] That may be true today, but if this exclusion is adopted it is not likely to be true in the future.

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29 For example, Securities Act Rules 262 and 505, 17 C.F.R. § 230.262; 505(b)(2)(iii), bar an issuer from using Regulation A and Rule 505 of Regulation D if it has been temporarily or permanently enjoined within the past five years for violating the securities laws. The SEC, however, routinely grants waivers from these offering bars. Large, recidivist banks, such as Citigroup, are frequent beneficiaries of this policy and consistently obtain these waivers from the SEC's Office of Small Business Policy. *See, e.g.*, Letter from Gerald J. Laporte, Chief, Office of Small Business Policy, SEC, to Gail S. Ennis, Counsel for Citigroup Inc. (Oct. 19, 2010); Letter from Gerald J. Laporte, Chief, Office of Small Business Policy, SEC, to Kevin P. McEnery, Counsel for Citigroup Global Markets Inc. (Dec. 23 2008); Letter from Gerald J. Laporte, Chief, Office of Small Business Policy, SEC, to Francis P. Barron, Counsel for Citigroup Global Markets, Inc. (May 31, 2006).

30 78 Fed. Reg. 44,828.

31 78 Fed. Reg. 44,828.

This exclusion represents an almost certain gaping loophole, which threatens to subvert the informational purposes of the rule. To avoid submitting certain statements to the SEC, and to keep the SEC in the dark as to the true nature of the solicitations made to investors, issuers could (and the unscrupulous ones will) simply limit the bulk of their solicitation materials to oral communications. To prevent this evasion, the SEC should require issuers to keep a record of their oral comments made during general solicitations and to submit that record along with any written materials that are used to the SEC.

Second, Proposed Rule 510T is a temporary provision, which would only last for two years after its effective date. This is an unwarranted limitation on the SEC's oversight authority, requiring the SEC to later take further action if it wishes to continue to adequately monitor the 506(c) marketplace. Instead, the SEC should make this proposal permanent. If the SEC later determines that the general solicitation materials it gathers from issuers do not merit regulatory scrutiny, it could at that time repeal the rule and rely on its investigative authority to obtain this information on an ad hoc basis.

## IV. The SEC must act now to redefine and strengthen the definition of "accredited investor."

The definition of accredited investor is the cornerstone of the entire Rule 506 offering regime. Rule 506 was designed to provide an exemption from the full-scale registration requirement for offerings between small businesses and sophisticated investors who could fend for themselves and withstand any potential losses. These offerings to "accredited investors" were deemed non-public offerings, for which the full protections of the securities laws were unnecessary. As the Supreme Court has stated, "[s]ince exempt transactions are those as to which there is no practical need for [the Securities Acts'] application, the applicability of [the exemption] should turn on whether the particular class of persons affected needs the protection of the Act."[32]

However, the current definition of accredited investor remains woefully inadequate. For example, the financial thresholds for natural persons have not been updated since their adoption in 1982, **31 years ago**.[33] According to the definition in Rule 501, an accredited investor includes "a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of the purchase, excluding the value of the primary residence of such person;" **or** "a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year." Taking inflation into account, these thresholds should have been more than doubled, as they now represent $2.4 million in net worth and approximately $485,000 in individual income or approximately $727,000 in joint income.[34]

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32 *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953) (internal quotations omitted).

33 78 Fed. Reg. 44,808.

34 BUREAU OF LABOR STATISTICS, CPI INFLATION CALCULATOR, http://www.bls.gov/data/inflation_calculator.htm.

Put another way, $1 million in today's dollars is worth only $413,000 in 1982 dollars, and $200,000 and $300,000 in income today is worth only $83,000 and $124,000 in 1982 dollars. According to the SEC, "at least 8.7 million U.S. households, or 7.4% of all U.S. households, qualified as accredited investors in 2010, based on the net worth standard in the definition of 'accredited investor.'"[35] In 1982, when the thresholds were adopted, only 1.87 percent of all U.S. households could qualify as accredited investors.[36] These metrics, applied in today's world, hardly reflect the level of financial sophistication that the accredited investor definition was intended to capture.

The Release seeks to minimize the significance of these figures by claiming that "only a small percentage of these households are likely to participate in securities offerings, especially exempt offerings."[37] However, lifting the ban on general solicitation is virtually certain to change that assumption, since issuers now may broadly advertise and solicit investors, thus capturing many more accredited investors than were previously inaccessible to issuers.

Moreover, as stated above, fraud and abuse has been a persistent problem in Rule 506 offerings, illustrating that even those who qualify as accredited investors and participate in those offerings may not be as sophisticated as the exemption suggests. As the SEC points out, non-accredited investors "only participated in 11% of the Rule 506 offerings conducted between 2009 and 2012."[38] Thus, the fact that the vast majority of Rule 506 offerings were limited to accredited investors and yet fraud and abuse have nevertheless been prevalent should inform the SEC rulemaking as it seeks to fulfill its duty to protect investors, whether they are called "sophisticated" or not.

Rather than address this problem, the SEC declined to propose an amendment in the Release,[39] citing its future review contemplated by the Dodd-Frank Act and the GAO report that was completed in July 2013.[40] This is unacceptable. The SEC should act without further delay to update and improve the accreditor investor definition. This should include (1) any increases in quantitative measures that are possible within the parameters set forth in the Dodd-Frank Act, and (2) creating new alternative measures that can serve as a far more accurate test of financial knowledge, experience, and sophistication than income and assets.

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35 78 Fed. Reg. 44,838.

36 Revisions of Limited Offering Exemptions in Regulation D; Proposed Rule, 72 Fed. Reg. 45,119 n. 51 (Aug. 10, 2007).

37 78 Fed. Reg. 44,839.

38 78 Fed. Reg. 44,837.

39 78 Fed. Reg. 44,829-30.

40 GAO, REPORT TO CONGRESSIONAL COMMITTEES, SEC, ALTERNATIVE CRITERIA FOR QUALIFYING AS AN ACCREDITED INVESTOR SHOULD BE CONSIDERED, GAO-13-640 (July 2013), *available at* http://www.gao.gov/assets/660/655963.pdf

## V. As it finalizes all of its rules, the SEC should adhere to a number of core principles governing the economic analysis actually required under the securities laws.

A critically important aspect of the SEC's rulemaking process is the way in which it approaches economic analysis. This issue is fundamentally important because the SEC's approach to economic analysis affects **all** of the proposed rules, regardless of their specific substantive focus.

In reality, and as discussed in detail below, the SEC's statutory duty is narrow: it need not conduct a cost-benefit analysis for any of its rules, and its first priority in the rulemaking process is to protect investors and serve the public interest, not compromise the strength of its regulations to accommodate industry's often baseless cost concerns or speculative and hypothetical competitive issues, no matter how often claimed.

Nevertheless, even when the SEC has clearly fulfilled its limited statutory duty to consider the economic impact of its rules, representatives from industry have challenged proposed rules claiming—without merit—that the SEC failed to appropriately conduct what the industry calls "cost-benefit analysis." These attacks rest on a series of fundamentally flawed claims. For example, in challenging rules promulgated by the Commission, the industry has:

(1) greatly exaggerated the actual duty imposed on the Commission by its governing statutes, Section 2(b) of the Securities Act and Sections 3(f) and 23(a)(2) of the Exchange Act, in effect seeking to transform that limited duty into what they call "cost-benefit analysis," but which is in reality an "industry cost-only analysis;" and

(2) entirely disregarded the paramount statutorily required role of the public interest in the rulemaking process.

Accordingly, as the Commission finalizes the Proposed Rules, it is imperative that it adhere to a series of core principles governing the actual contours of its duty to consider the economic impact of its rules.[41]

### A. Under the securities laws, the Commission has no statutory duty to conduct cost-benefit analysis; its far more narrow obligation is simply to consider certain enumerated factors.

Section 2(b) of the Securities Act and Sections 3(f) and 23(a)(2) of the Exchange Act (collectively, "Applicable Statutes") set forth the Commission's statutory requirement

[41] We regularly advocate that the SEC should observe a third core principal in its economic analysis, which requires the SEC to take into account the overarching goals of the Dodd-Frank Act and the benefits of avoiding another devastating financial crisis. However, the Proposed Rules are being promulgated under the securities laws generally, and not under the Dodd-Frank Act. Their primary focus is less on preventing systemic risk and future crises than it is on the extremely important goal of investor protection. Therefore, the SEC's focus in implementing the Proposed Rules should be the overarching goal of the securities laws: protecting investors and the public.

to "consider" a rule's impact on several specifically listed economic factors.[42] Specifically, the Commission is required, after considering "the public interest" and the "protection of investors," "to consider . . . whether the action will promote efficiency, competition, and capital formation."[43] Additionally, the Commission must "consider among other matters the impact any such rule or regulation would have on competition," and to refrain from adopting the rule if it "would impose a burden on competition not necessary or appropriate in furtherance of the purposes of [the statute]."[44] The Applicable Statutes contains no language requiring a cost-benefit analysis and there is no basis for imposing any such requirement.

When Congress intends cost-benefit analysis to apply, it explicitly refers to "costs" and "benefits" and specifies the nature of the analysis.[45] And, when Congress wants agencies to be free from those constraints, it imposes a less burdensome requirement, thus giving overriding importance to particular statutory objectives.[46]

Recently, the Court of Appeals for the District of Columbia confirmed these principles.[47] The Court addressed the CFTC's economic analysis duty under Section 15(a) of the Commodity Exchange Act ("CEA"), which is similarly framed in terms of a duty to "consider" certain factors. Even though the CEA actually references "costs" and "benefits," the Court made clear that the duty simply to "consider" such factors is a limited one and does not require a cost-benefit analysis:

> The appellants further complain that CFTC failed to put a precise number on the benefit of data collection in preventing future financial crises. But the law does not require agencies to measure the immeasurable. CFTC's discussion of unquantifiable benefits fulfills its statutory obligation to consider and evaluate potential costs and benefits . . . . Where Congress has required "rigorous, quantitative

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42 15 U.S.C. §§ 77b(b), 78c(f), 78w(a)(2).

43 15 U.S.C. §§ 77b(b), 78c(f).

44 15 U.S.C. §78w(a)(2). Better Markets has set forth a comprehensive analysis regarding the scope of the Commission's duties under the securities laws in BETTER MARKETS, SETTING THE RECORD STRAIGHT ON COST-BENEFIT ANALYSIS AND FINANCIAL REFORM AT THE SEC, at 39-44 (July 30, 2012), *available at* http://bettermarkets.com/sites/default/files/CBA%20Report.pdf. In addition, Better Markets filed an *amicus curiae* brief in support of the Commission on the agency's statutory duties in *American Petroleum Inst. v. SEC*, No. 12-1398 (D.C. Cir. Oct. 10, 2012). Both the report and *amicus* brief are incorporated by reference as if fully set forth herein.

45 *See American Textile Mfrs. Inst., Inc. v. Donovan*, 452 U.S. 490, 510-512 & n. 30 (1981) (stating that "Congress uses specific language when intending that an agency engage in cost-benefit analysis" and citing numerous statutory examples).

46 *See Whitman v. American Trucking Ass'ns., Inc.*, 531 U.S. 457, 471 (2001) (holding that a statute "unambiguously bars cost considerations"); *see also Nat'l Ass'n of Home Builders v. EPA*, 682 F.3d 1032, 1039 (D.C. Cir. 2012) (statutes in which agencies must "consider" the "economic" impact or "costs" do not require cost-benefit analysis); *Cent. Ariz. Water Conservation Dist. v. EPA*, 990 F.2d 1531, 1542 n.10 (9th Cir. 1993) (language in 42 U.S.C. § 7491(g)(1) requiring "consideration" does not require a cost-benefit analysis).

47 *Inv. Co. Inst. v. CFTC*, No. 1:12-cv-00612 (D.C. Cir. June 25, 2013).

economic analysis," it has made that requirement clear in the agency's statute, but it imposed no such requirement here.[48]

Like the CFTC's obligation under the CEA, the Commission's duty under the securities laws stands in sharp contrast to the statutory provisions in which Congress explicitly mandates a netting or specific balancing of costs and benefits, let alone mentions "costs" and "benefits."

Moreover, Congress's careful choice of words in the Applicable Statutes and the case law construing similar provisions, make clear that the Commission has broad discretion in discharging its duty. The Supreme Court has long recognized that when statutorily mandated **considerations** are not "mechanical or self-defining standards," they "imply wide areas of judgment and therefore of discretion" as an agency fulfills its statutory duty.[49]

The plain fact is that the Commission has no statutory or other obligation[50] to quantify costs or benefits,[51] weigh them against each other,[52] or find that a rule will confer a net benefit before promulgating it. The rationale for this flexible obligation in the law is clear: Requiring the Commission to conduct a resource intensive, time consuming, and inevitably imprecise cost-benefit analysis as a precondition to rulemaking would significantly impair the agency's ability to implement Congress's regulatory objectives.

The industry's desire to have its costs prioritized over all other costs (what they falsely refer to as "cost-benefit analysis") does not change the law, the rationale for the law, or the underlying policy.

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48 *Id.* at 14-15 (cited authorities omitted).

49 *Sec'y of Agric. v. Cent. Roig Ref. Co.,* 338 U.S. 604, 611 (1950).

50 Indeed, there is no other law which would subject the Commission to a cost-benefit duty. The APA does not require such an analysis, *Vill. of Barrington v. Surface Transp. Bd.,* 636 F.3d 650, 670-671 (D.C. Cir. 2011), and the Executive Orders on cost-benefit analysis exclude the Commission and other independent agencies, Executive Order 13,579, 76 Fed. Reg. 41,587 (July 14, 2011); Executive Order No. 13,563, 76 Fed. Reg. 3,821, § 7 (Jan. 21, 2011); Executive Order 12,866, 58 Fed. Reg. 51,735, § 3(b) (Oct. 4, 1993).

51 *Cf.* 42 U.S.C. § 300g-1(b)(3) (imposing a duty on the Environmental Protection Agency to use analysis of specific factors including the "[q]uantifiable and nonquantifiable health risk reduction benefits," the "[q]uantifiable and nonquantifiable costs," and "[t]he incremental costs and benefits associated with each alternative."). Courts have repeatedly held that an agency need not quantify the costs and benefits of a rule when a statute does not require it. *See, e.g., FMC Corp. v. Train,* 539 F.2d 973, 978-979 (4th Cir. 1976) (finding that 33 U.S.C. §§ 1314(b)(1)(B), (b)(2)(B) and § 1316 do not require quantification of the benefits in monetary terms). In fact, the D.C. Circuit has explicitly recognized that even in a cost-benefit analysis an agency's "predictions or conclusions" do not necessarily need to be "based on a rigorous, quantitative economic analysis." *Am. Fin. Services Ass'n. v. FTC,* 767 F.2d 957, 986 (D.C. Cir. 1985); *see also Pennsylvania Funeral Directors Ass'n v. FTC,* 41 F.3d 81, 91 (3d Cir. 1994) (recognizing that "much of a cost-benefit analysis requires predictions and speculation, in any context," and holding that the "absence of quantitative data is not fatal").

52 Even when a statute refers to "costs" and "benefits," Courts refuse to impose a duty to conduct cost-benefit analysis absent language of comparison in the statute. *See Weyerhaeuser Co. v. Costle,* 590 F.2d 1011, 1045 (D.C. Cir. 1978); *see also Am. Petroleum Inst. v. EPA,* 858 F.2d 261, 265 & n.5 (5th Cir. 1988); *Reynolds Metal Co. v. EPA,* 760 F.2d 549, 565 (4th Cir. 1985).

B. The Commission must be guided first and foremost by the public interest and the protection of investors as it considers the economic impact of its rules, not by concerns over the costs of regulation imposed on industry.

The SEC's preeminent duty when promulgating rules is to protect investors and the public interest. The agency was established for the purpose of implementing the securities laws, and therefore its primary duty is to achieve the legislative objectives of those laws, which are first and foremost to protect investors and the public interest from fraud, abuse, and manipulation in the securities markets. As is evident from the securities laws themselves, their legislative history, and the specific delegations of rulemaking authority, the public interest and protection of investors is a key consideration in the SEC's rulemaking process. Indeed, Section 2(b) of the Securities Act and Section 3(f) of the Exchange Act explicitly refer to "the protection of investors" and "the public interest," but do not mention any industry-focused concerns, such as compliance costs or the feasibility of conforming to rule requirements.[53]

The Commission's duty to protect investors and the public interest has renewed importance in light of the 2008 financial crisis. The financial crisis is a powerful reminder of the need to remain focused on the core purposes of securities regulation and the Commission's overriding duty to protect the public, investors, and the integrity of the markets. The Supreme Court's admonition about the importance of raising standards of conduct to the highest possible level following the Great Depression applies with equal force today:

> It requires but little appreciation . . . of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail in every facet of the securities industry.[54]

If these goals are subordinated to industry concerns over the costs of regulation in the rulemaking process, then proposed regulations will have little chance of protecting investors, as intended by the securities laws. Thus, in promulgating the Proposed Rules, the Commission must be guided by the preeminent concerns of the public interest and the protection of investors, not the burdens of regulation on industry.

## VI. The Release shows that the SEC complied with its duty under the Applicable Statutes but could do much more to clarify and streamline its economic analysis.

The Release shows that the SEC has considered the economic impact of the Proposed Rules under Section 2(b) of the Securities Act and Sections 3(f) and 23(a)(2) of

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[53] *Cf.* 42 U.S.C. § 300g-1(b)(3)(C) (requiring analysis of certain costs of safe drinking water regulations including costs that "are likely to occur solely as a result of compliance with the maximum contaminant level, including monitoring, treatment, and other costs"); 42 U.S.C. § 6295(d) (1976 ed., Supp. II) (requiring a weighing of the economic impact on manufacturers and the savings in operating costs as "compared to any increase in the price of, or in the initial charges for, or maintenance expenses of, the covered products which are likely to result").

[54] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186-87 (1963) (quoted authorities omitted).

the Exchange Act.[55] However, the SEC can still enhance its discussion of economic analysis in several respects. First, it should be more limited in its approach, adhering more closely to the statutory requirement and expressly disavowing any obligation to conduct cost-benefit analysis. To the extent the SEC believes it is desirable to consider specific costs and benefits, it should clearly tie those costs and benefits to the three statutory factors (efficiency, competition, and capital formation) to avoid any possible misunderstanding. Finally, the SEC should more clearly highlight the primary and overriding purpose of the securities laws—to protect investors—and the role of the Proposed Rules in accomplishing that purpose.

A. <u>The SEC complied with the Applicable Statutes.</u>

The SEC set forth its statutory duty[56] and appropriately considered and explained how various aspects of the rule would affect efficiency, competition, and capital formation.[57] This is what the securities laws require, and by considering the specified factors, the SEC has fulfilled its duty with respect to economic analysis.

B. <u>The SEC must ensure that its economic consideration is limited to its narrow duty under the Applicable Statutes.</u>

The SEC should carefully avoid undertaking a general cost-benefit analysis, or any similar approach in which agencies determine and quantify costs and benefits, net them against one another, and adopt the least costly rule. This type of analysis is not required by the Applicable Statutes, it poses a threat to the implementation of Congress's policy goals, and it wastes agencies' resources without producing accurate or useful results. In fact, consideration of costs and benefits beyond those specifically tied to the relevant securities law provisions tends to mislead the public and the Commission by overemphasizing easily quantifiable costs to the detriment of important, albeit unquantifiable, benefits.

At a minimum, the SEC should emphasize its statutory duty under the Applicable Statutes, and it should explicitly assert that it is not required to perform a cost-benefit analysis, quantify or compare costs and benefits, or perform any analysis that exceeds the requirements in the Applicable Statutes. Moreover, as mentioned above, there is no need for the agency to quantify or "determine" the Proposed Rules' costs and benefits.

Throughout the Release, the SEC discusses specific costs and benefits associated with the Proposed Rules. Assuming that particular costs and benefits are at all relevant to the SEC's required economic consideration, the agency should more clearly set forth how those costs and benefits are directly related to protecting investors or the public or to efficiency, competition, or capital formation.

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55 78 Fed. Reg. 44,848-49.

56 78 Fed. Reg. 44,833 n. 171.

57 *See, e.g.,* 78 Fed. Reg. 44,849 ("The inclusion of legends and additional disclosures would inform investors about the differences between Rule 506(c) offerings and registered offerings, allowing for greater transparency and better understanding of the differences in the underlying risks of the two types of offerings. This would improve investor decision-making and thereby, the allocative efficiency of capital in the Rule 506 market.").

**CONCLUSION**

Unregistered securities offerings under Rule 506 can be an important capital raising tool, but they also pose heightened risks to investors, since they lack many of the important regulatory protections that normally apply in the securities markets. The Proposed Rules, with the changes outlined above, will be an effective tool for enhancing SEC regulation and safeguarding investors.

Sincerely,

Dennis M. Kelleher
President & CEO

Stephen W. Hall
Securities Specialist

Katelynn Bradley
Attorney

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
(202) 618-6464

dkelleher@bettermarkets.com
shall@bettermarkets.com
kbradley@bettermarkets.com

www.bettermarkets.com