CARL LEVIN
MICHIGAN

United States Senate

WASHINGTON, DC 20510–2202

December 5, 2013

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

RE: Proposed Amendments to Regulation D, Form D and Rule 156 under The Securities Act, File Number S7-06-13[1]

Dear Secretary Murphy:

I am writing to express my concerns with, and offer suggestions to strengthen, the Commission's proposed amendments to Regulation D, Form D and Rule 156 under the Securities Act of 1933 (the "Proposed Amendments").[2] As stated in your public notice of proposed action to adopt these amendments, they are intended to enhance the Commission's ability to evaluate the development of market practices in Rule 506 offerings and to address concerns that may arise in connection with permitting issuers to engage in general solicitation and general advertising under new paragraph (c) of Rule 506 in connection with implementing Title II, Section 201of the Jumpstart Our Business Startups Act (the "JOBS Act").[3]

The Commission's efforts in the Proposed Amendments to protect investors from fraudulent offerings would be an improvement from the soon-to-be "Wild West"[4] that now exists under the final Rule 506[5] adopted by the Commission earlier this year. Unfortunately, the improvements in the Proposed Amendments do not go far enough. The Commission should further enhance the Proposed Amendments as outlined in this letter, including taking additional steps to ensure that investors in Rule 506(c) offerings are provided with full and complete disclosure information and that such investors are actually "accredited investors" as required by Congress.

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[1] This comment letter supplements my letter co-signed by Senators Heinrich, Harkin, Pryor, Merkley and King to Mary L. Schapiro, Chairman, Sec. and Exch. Comm'n (June 28, 2013) available at http://www.sec.gov/comments/s7-07-12/s70712-267.pdf

[2] Amendments to Regulation D, Form D and Rule 156 under the Securities Act, Securities Act Rel. No. 33-9416, Rel. No. 34-69960 and Rel. No. IC-30595 (July 24, 2013).

[3] Jumpstart Our Business Startups Act, Pub. L. 112-106, 126 Stat. 306 (2012).

[4] Letter from William F. Galvin, Secretary of the Commonwealth, Commonwealth of Massachusetts to Elizabeth Murphy, Secretary, Sec. and Exch. Comm'n (July 2, 2012) at page 3. Available at http://www.sec.gov/comments/s7-06-13/s70613-394.pdf

[5] Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Rel. No. 33-9415, 78 Fed. Reg. 44,771 (July 24, 2013).

While Section 201 of the JOBS Act removes the long-standing ban on general solicitation and advertising in private offerings to accredited investors, the Commission is still required, under the JOBS Act, to issue rules regarding how such marketing and solicitation can be conducted. Rule 506(c), as amended by the Proposed Amendments, would still lack the necessary minimum safeguards for investor protection and would have negative consequences for vulnerable sectors of the general public such as the elderly and the financially unsophisticated.

I would like to address all seven of the amendments being proposed and offer some suggestions that I urge the Commission to adopt to significantly strengthen the protections in Rule 506 as finally amended by the Commission.

BACKGROUND ON THE PROHIBITION AGAINST GENERAL SOLICITATION

Our nation's longstanding ban on general solicitation and advertising of private offerings dates to the catastrophic stock market collapse of 1929 (the "Crash of 1929") and ensuing Great Depression. Newspaper readers in the years leading up to the Crash of 1929 were inundated with advertisements for offerings of securities in various types of companies, many of which advertisements were intended, according to leading brokers of the time, to "excite public interest in the stock so that when it was listed on a public exchange the individuals on the preferred list would be in a position to realize a substantial profit."[6]

In 1932 and 1933, in the midst of the Great Depression, the Senate Committee on Banking and Currency, popularly known as the Pecora Commission,[7] held hearings into the causes of the Crash of 1929 that exposed significant fraud and conflicts of interest at the highest levels of a number of brokerage houses.[8]

Senator Duncan Fletcher of Florida, a member of the Pecora Commission, explained in 1933 that

> People have been persuaded to invest their money in securities without any information respecting them, except the advertisements put forth by the agents or representatives of those issuing the securities, and such advertisements have not given full information to the public. The result was that we had a saturnalia of speculation throughout the country...People were persuaded to put their money into these investments sometimes because they were attracted by the high rates of interest and often because they were told

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[6] S. Rep. No. 1455, 73rd Cong. 2d Sess. 107 (1934).

[7] See, e.g. *Stock Market Practices: Hearing Pursuant to S. Res. 84 and S. Res. 239 Before a Subcommittee of the Senate Committee on Banking and Currency*, 72nd Cong. (1933).

[8] For example, National City Bank and National City Company, the largest stock distributors of the era, sold bonds backed by the Peruvian government to uninformed investors. National City never disclosed its awareness of "Peru's history of difficulties in collecting taxes, paying government salary arrearages, honoring contractual obligations, balancing its budget or weak economic conditions in real estate, the cotton industry and the securities market." Further it failed to disclose to investors that its own bankers refused to make further loans to Peru. S. Rep. No. 1455, *op. cit.* at pages 126-31. Also, Chase National Bank misrepresented the quality of Cuban debt it underwrote. The offering materials suggested that Cuba's revenues exceeded its expenditures by over $22.5 million. In attempting to list the securities on the New York Stock Exchange two years later, Chase admitted that expenditures were actually $4 million more than revenues. Investors faced substantial losses. Rep. No. 1455, *op. cit.* at page 135.

that the price of the securities would go up and they would make money easily and rapidly by investing in them.

Some persons, under some circumstances, have been persuaded to dispose of perfectly good securities and invest in worthless securities that were offered to them by agents all over the country. There are instances which were brought out by the testimony before the committee where widows who owned Liberty bonds, having invested the accumulations of a lifetime in such bonds, were persuaded by some of these agents to sell their bonds and invest their all in valueless securities by all sorts of misrepresentations, such as that they were bound to increase in value, that returns would be considerable, and all that sort of thing. There are instances where persons who had savings deposits were inveigled into withdrawing those deposits and investing in worthless securities. It is estimated that something like $90,000,000,000 in the hands of people have during recent years been invested in such securities, most of which have become practically worthless."[9]

To rectify the problem of fraudulent securities offerings to the public, Congress passed the Securities Act of 1933 (the "Securities Act") embodying a disclosure-based regime that distinguished between public and private offerings of securities, required registration of all public offerings with the Securities and Exchange Commission (the "Commission") and banned general solicitation and advertising of private offerings.[10] At the time of passage, Congress viewed private offerings - those not subject to registration requirements - as those with fewer than 25 offerees, each of whom could reasonably be expected to have the bargaining power needed to obtain information necessary to make an informed investment decision.[11] Under guidance provided by the Commission in 1935, the "manner of offering"[12] was a key consideration in determining whether an offering would qualify as "public" and thus be subject to registration requirements.

In the years since, the courts,[13] the Commission and Congress have significantly altered their views on the nature of public offerings. In 1974, the Commission adopted Rule 146 that focused significantly on the number of purchasers of a security to determine whether a "public" offering had occurred.[14] This approach was expanded further by the Commission in 1982 when it

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[9] 77 Cong. Rec. 2983 (May 8, 1933) (statement of Mr. Fletcher).

[10] Initially registration was required with the Federal Trade Commission, but one year later this responsibility was shifted to the newly-formed Commission. See Securities Exchange Act of 1934, Pub. L. 73-291, 44 Stat. 881 (1934).

[11] Letter of the General Counsel of the Commission discussing the factors to be considered in determining the availability of the exemption from registration provided by the second clause of Section 4(1) of the Securities Act. See Securities Act Rel. No. 33-285 (1935), 1935 WL 27785.

[12] *Id.*

[13] In 1953, the Supreme Court threw out the 1935 Commission guidance, finding it overly restrictive. But the Court ruled narrowly, and did not throw out the Commission's determination that general solicitation and advertising should be considered in whether an offering constituted a "public" offering: "the applicability...should turn on whether the particular 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.'" *SEC v. Ralston Purina Co.*, 346 U.S 119 at page 125 (1953).

[14] Transaction By an Issuer Deemed Not To Involve Any Public Offering, 4 S.E.C. Docket 154 (1974), 1974 WL 161966.

adopted Regulation D.[15] None of these changes, however, removed the longstanding ban on general solicitation and advertising in private offerings.

Then in 1992, the Commission took action to lift the general solicitation ban for a small class of private offerings.[16] Very shortly thereafter, significant problems with fraud on investors began to arise just as they had 60 years prior in the Crash of 1929. After just seven years and frequent investor frauds, the Commission realized their error and reinstated the general solicitation ban, noting that:

> "Recent market innovations and technological changes, most notably, the Internet, have created the possibility of nation-wide Rule 504 offerings for securities of non-reporting companies that were once thought to be sold locally...
>
> In some cases, Rule 504 has been used in fraudulent schemes... As a part of this arrangement, these securities are then placed with broker-dealers who use cold-calling techniques to sell the securities at ever increasing prices to unknowing investors. When their inventory of shares is exhausted, these firms permit the artificial market demand created to collapse, and investors lose much, if not all, of their investment. This scheme is sometimes colloquially referred to as 'pump and dump'."[17]

However, this experience did not stop further attempts to weaken investor protections and disclosure requirements. Just eight years after the Commission ended its ill-advised experiment allowing general solicitations in private placements, the Commission's Advisory Committee on Small Public Companies recommended that the Commission again adopt rules that would allow for general solicitation in unregistered offerings by some small issuers.[18] This time the Commission appropriately declined to adopt this recommendation.

This checkered history brings us to the recently passed JOBS Act. Despite the warnings of many experts,[19] Congress passed the JOBS Act to allow the use of general solicitations and advertising

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[15] Revision of Certain Exemption from Registration for Transaction Involving Limited Offers and Sales, Securities Act Rel. No. 33-6389, 47 Fed. Reg. 11,251 (Mar. 8, 1982), 1982 WL 35662. This rule set forth the modern framework for exemptions of offerings from registration based on the presumed financial sophistication of potential investors whose net worth exceeds $1 million or whose annual income exceeds $200,000, including the initial version of Rule 506.

[16] This effort resulted from the Commission's Small Business Initiatives program, which had recommended the Commission take action to help small businesses raise capital using arguments similar to those used by advocates of the JOBS Act and for weak rules implementing that Act. Small Business Initiatives, Securities Act Rel. No. 33-6949; Securities Exchange Act Rel. No. 34-30968; Trust Indenture Act Rel. No. 39-2287 1992 WL 188930 (July 30, 1992).

[17] Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Securities Act Rel. No. 33-7644, 64 Fed. Reg. 11,090 (Feb. 25, 1999).

[18] Advisory Cmte On Smaller Public Companies, Final Report of the Advisory Cmte on Smaller Companies to the U.S. Sec. and Exch. Comm'n at page 8 (2006) available at http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf

[19] For example, Professor John C. Coffee, a securities law expert at Columbia Law School, noted that "upper-middle-class Americans who qualify as accredited investors will soon begin receiving streams of unsolicited offers from brokers they do not know for unregistered offerings. ... From a consumer protection standpoint, this combination of little sophistication and even less disclosure seems troubling." Paul Sullivan, *Deciding Who's Rich*

in Rule 506 offerings and reduce the costs to small businesses of raising capital.[20] In doing so, Congress adopted measures requiring both issuers and the Commission to put in place systems to ensure that only accredited investors purchase Rule 506(c) general solicitation offerings.[21]

As discussed above, past experiences with general solicitations have not been satisfactory. Based on those experiences and the explicit direction of Congress, the Commission should be very cautious in its approach to securities offerings employing general solicitation.[22] I encourage the Commission to be especially mindful of investor protection concerns as it considers and implements rules governing Rule 506(c) offerings using general solicitation and advertising.

PROPOSED AMENDMENTS ARE IMPROVEMENTS, BUT NOT ENOUGH

The Proposed Amendments address some of the concerns raised by commenters, including me,[23] in response to the previous Proposed Rule by including a few improvements in the Proposed Amendments. However, they should be further improved to strengthen investor protections. I will address each improvement and my concerns and suggestions in turn.

1. Requirement to file Form D in Rule 506(c) offerings before the issuer engages in a general solicitation.

Currently, a Form D is not required to be filed until 15 days after a Rule 506(c) offering has commenced. I support the Commission's proposal[24] to require filing an Advance Form D *before* a general solicitation offering commences, as other commenters have suggested.[25] However, rather than allowing potential issuers to file an Advance Form D that contains limited information, I believe a full, complete Form D should be required to be filed at least 15 days before a general solicitation begins.

(or Smart) Enough for High-Risk Investments, N.Y. Times, Jan. 13, 2012 at B5 (statement of John. C. Coffee, Jr., Adolph A. Berle Professor of Law, Columbia Law School). Also, "the removal of the 'general solicitation' prohibition contemplated by [the JOBS Act] would represent a radical change that would dismantle important rules that govern the offering process for securities." *Spurring Job Growth Through Capital Formation While Protecting Investors: Hearing on S.1965, S.1933, H.R.3606, S.1824, S. 1544 and S.1970 Before the Senate Comm. on Banking, Housing and Urban Development*, 112th Cong. Rec. 9 (2011) (statement of Jack E. Herstein, President, North American Sec. Administrators Assoc., Inc.).

[20] Jumpstart Our Business Startups Act, *op. cit.* at Sect. 201.

[21] *Id.*

[22] Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, *op. cit.* See also, *e.g.*, Letter from A. Heath Abshure, *op. cit.* at page 2.

[23] Letter from Senator Carl Levin to Elizabeth Murphy, Secretary, Sec. and Exch. Comm'n (October 5, 2012) available at http://www.sec.gov/comments/s7-07-12/s70712-155.pdf

[24] Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, *op. cit.* at page 13.

[25] *See, e.g.* Letter from William F. Galvin, *op. cit.* at 5: "The Commission should also require the issuer to file the Form D prior to the first use of general advertising or general solicitation, and prior to the first offer of securities. These requirements will notify federal and state regulators that these offerings are in the marketplace, and they will give potential investors an opportunity to obtain basic information about the issuer and the offering."

Some commenters[26] have inaccurately suggested that a 15-day pre-solicitation filing requirement may violate the JOBS Act. An examination of the statute and accompanying legislative history clearly rebuts such a suggestion.

The JOBS Act states that "the prohibition against general solicitation or general advertising…shall not apply to offers and sales of securities made pursuant to section 506, provided that all purchasers of the securities are accredited investors."[27] Nothing in that language or elsewhere in the JOBS Act impairs the Commission's discretion to set qualifications for the Rule 506 exemption, such as the timing requirements for filing an Advance Form D. Rather than imposing a 15-day ban on general solicitation[28] as two commenters suggest, the desired result can be achieved by simply adopting a 15-day pre-filing requirement for offerings to qualify pursuant to the Rule 506 exemption.

As other commenters note:

> "Congress chose, by only mandating a discrete amendment to Rule 506, to delegate to the Commission the manner and scope under which GS&A activities [general solicitation and advertising] would be permitted. Congress decided that GS&A activities did not necessarily defeat reliance on the Section 4(2) private offering exemption, *and nothing more*. Congress left to the Commission the responsibility to ensure that Rule 506 *as a whole* continued to operate consistent with its statutory wellspring."[29]

That a 15-day pre-solicitation filing requirement does not violate the JOBS Act is clear from the legislative history of the JOBS Act. Pre-filing requirements are common for offerings, and nothing in the JOBS Act or the legislative history suggests that this legislation limits the Commission's authority to amend filing requirements as it sees fit for Rule 506 offerings.

The Commission should consider whether 15 days[30] is an adequate amount of time for its staff and state securities regulators to analyze filings for compliance and that banned "bad actors" are not participating in new issuances.

Whatever the time period becomes, I am concerned that the Commission staff will not review each Advance Form D promptly after it has been filed.[31] The Commission's failure to review and effectively monitor Form D filings has been a problem for some time. In 2009, the Inspector General reported that Commission staff "does not substantively review the more than 20,000

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[26] Letter from Rep. Patrick McHenry and Rep. Scott Garrett to The Honorable Mary Jo White, Chairman, U.S. Sec. and Exch. Comm'n (July 22, 2013) available at http://www.sec.gov/comments/s7-06-13/s70613-72.pdf

[27] *Id.* at Sect. 201(a).

[28] Letter from Rep. Patrick McHenry and Rep. Scott Garrett to The Honorable Mary Jo White, *op. cit.* at page 1.

[29] Letter from Mercer Bullard, Barbara Roper, Lisa Donner , and Lynn Turner, et al. to Elizabeth Murphy, Secretary, Sec. and Exch. Comm'n (August 16, 2012) at page 3. Italics in original.

[30] Investor advocates suggest 30 days. *See e.g.* Letter from Mercer Bullard *op. cit.*) at page 12. Available at http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2012/08/JOBS-Act-Rule-506-ltr-8-16-12-FINAL.pdf.

[31] Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, *op. cit.* at page 22.

Form D filings that it receives annually"[32] and, further, that the Commission "does not generally take action when [Corporate Finance] staff learn that issuers have not complied with the requirements of the Regulation D exemptions."[33]

One other point on this improvement in the Proposed Amendments needs to be made. If the Commission fails to review Advance Form D filings or take action against those found to be deficient, the beneficial changes put in place by this amendment will be largely lost.[34] Therefore, in addition to considering whether 15 days is an appropriate amount of time for pre-filing, the Commission should take steps to ensure that all Advance Form D filings are reviewed by Commission staff prior to the commencement of solicitation and full Form D filings are reviewed promptly after being filed.

2. Requirement to file a closing amendment to Form D after the termination of any Rule 506 offering.

The Commission notes that the current registration requirements do not require a closing filing and, thus, do not give the Commission a complete picture of which offerings are currently active.[35] The requirement in the Proposed Amendments that a closing filing be made is an improvement over current practice and should be adopted and enforced.

The Commission should also extend the closing amendment requirement to all Rule 506 offerings, not just those filing for the Rule 506(c) exemption, given the substantial benefits and limited costs of such filings as suggested by the Commission.[36] An Advance Form D should expire automatically 30 days after filing unless the relevant issuer files a notice of renewal between the 25th day and the 31st day after the filing date or files a final Form D for such offering before the Advance Form D expires. The extension filing requirement to extend the life of an Advance Form D will discourage issuers from filing several Advance Form Ds with no specific offering planned and from filing perpetual Advance Form Ds.

3. Requirement that written general solicitation materials used in Rule 506(c) offerings include certain legends and other disclosures.

The Proposed Amendments requiring legends and disclosures (the "fine print" often included in advertisements) are well intended but opaque and lacking in detail. The Commission should adopt and require the use of model disclosures to ensure that the legends and disclosures are

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[32] The Inspector General's report further stated "...that the [Form D] filings are only intended to be notice filings. [The Division of Corporation Finance] officials said that the Commission only reviews Form D filings or makes substantive use of the information on a selective basis, in connection with investigations conducted by the Division of Enforcement (Enforcement), program monitoring and rulemaking." U.S. SEC and Exch. Comm'n Office of Inspector General, Regulation D Exemption Process, Rep. No. 459 (2009) at page 8.

[33] *Id.*

[34] State securities regulators suggest that, under current enforcement practices, "the filing of a Form D is voluntary for all practical purposes." Letter from A. Heath Abshure, *op. cit.* at page 4.

[35] Amendments to Regulation D, Form D and Rule 156 under the Securities Act, *op. cit.* at page 28.

[36] *Id.* at page 134. "Requiring a closing Form D amendment for Rule 506 offerings would likely come at a nominal cost to issuers in terms of filing another notice, particularly because the filing would be substantially similar to the initial Form D filing or prior Form D amendments for the offering."

specific and provided in plain language that is understandable to investors.[37] Although investors are required to be "accredited," not all will possess the level of financial sophistication necessary to understand fully offering material generally drafted in legalese. And even financially sophisticated investors would benefit from the clarity and convenience of having risk factors set forth in plain and standardized language.

The Commission should consult with consumer protection experts, state regulators, FINRA and other federal regulators, including the Consumer Financial Protection Bureau, to develop a set of model, required, plain language disclosures that are clear, concise and informative.[38]

At a minimum, the legends and disclosures for all general solicitation offerings for private investment funds (particularly hedge funds and private equity funds) should be at least as rigorous as those required for mutual funds.[39] In dealing with these offerings, the Commission should draw experience from required mutual fund disclosures that have been developed over many years. These requirements provide a readily available starting point for disclosures needed in advertising and general solicitation materials for investments in private investment funds with their own particular risks.[40]

However, private investment funds, especially hedge funds and private equity funds, generally provide less transparency and oversight for investors and present substantially greater risks than mutual funds and should be marketed with clear warnings of their additional risks. Private investment funds are much less regulated, and in many cases are not required to have boards of directors[41] to advocate on behalf of their investors, are not required to have strict limits on their

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[37] One suggestion, from the Investment Company Institute, suggests that hedge funds and private investment funds should be required to note in the advertisements that "This fund is a [hedge/private] fund. It is not registered with the Securities and Exchange Commission and not available to the public. It may be sold solely to 'accredited investors' as defined in the Securities Act of 1933." Letter from Karrie McMillan, General Counsel, Investment Company Institute to Elizabeth Murphy, Secretary, Sec. and Exch. Comm'n (October 5, 2012) at page 5.

[38] For example, the Commission may wish to consult studies conducted by the Federal Reserve regarding consumer responses to potential amendments to the "Schumer Box" required to be included on credit card solicitations and advertisements. Truth in Lending, 74 Fed. Reg. 5244 (Jan. 29, 2009). Further, the Commission may wish to review its consideration of similar rules for advertising of mutual funds. *See* Presentation of Explanatory Information in Final Rule: Amendments to Investment Company Advertising Rules. Release Nos. 33-8294, 34-48558 and IC-26195, 68 FR 57,760 (Oct. 6, 2003).

[39] Vladimir Ivanov and Scott Bauguess, Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009-2012, July 2013, Division of Economic and Risk Analysis (DERA), U.S. Sec. and Exch. Comm'n, page 9-10. *Available at* http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf "The largest issuers in the Regulation D by amount sold market are pooled investment funds, classified in the Form D filings as hedge funds, venture capital funds, private equity funds, and other pooled investment funds. The predominant entities among other pooled investment funds are registered investment companies and commodity pools. Since the inception of the electronic Form D filings, beginning in 2009, pooled investment funds have accounted for $2.8 trillion of new capital raised through Regulation D offerings and reported on Form D, compared to $623 billion raised by non-funds. Hedge funds are the largest fund issuer, accounting for $1.26 trillion of new capital, of which $386 billion was raised in 2012."

[40] Final Rule: Amendments to Investment Company Advertising Rules, *op. cit.*

[41] In contrast, the Commission requires mutual funds to have a board that consists of at least three-quarters independent advisors, an independent director as chairman of the board, annual board performance reviews,

investments in certain products[42] and, as the Commission knows far too well following the recent financial crisis, private investment funds can lose significant value[43] and saddle their investors with substantial or total losses. For comparison, an investor's investment in a mutual fund, while certainly not immune from risk, is unlikely to result in a total loss of capital.[44] The Commission should view the requirements for warnings in mutual fund advertisements as a minimum basis for the regulation of private investment fund advertisements.

Further, most investors, even accredited investors, are relatively inexperienced in evaluating private investment funds given their being unavailable to most investors heretofore. By comparison, nearly all of the public has seen advertisements for mutual funds and, as private investment funds begin advertising, it will be important that investors have a clear understanding of the differences between mutual funds and private investment funds so that investors do not assume that any advertised private offering has the same investor protections in place as a mutual fund.

Therefore, the Commission should require private investment funds, in addition to the requirements in the Proposed Amendments, to further specify in plain-language[45] that:

(1) private investment funds are not mutual funds,
(2) private investment funds are not required to invest assets in a diversified portfolio, and
(3) private investment funds are not subject to the same investor protection regulations as mutual funds.

The Commission should pay particular attention to the calculation and marketing of private investment fund performance. The Commission itself has expressed concern about the proper use of performance data in the context of highly regulated mutual fund advertising,[46] and should

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mandatory board meetings, and the authorization for independent directors to obtain expertise needed to conduct their duties. Investment Company Governance, Release No. IC-26520, 69 Fed. Reg. 46,378.

[42] Section 5(b) of Investment Company Act of 1940, Pub. L. 76-768, §5(a), 54 Stat. 800 (1940).

[43] *See, e.g.* Steve Eder and Josh Barbanel, *Hedge Fund Files for Bankruptcy*, Wall Street Journal, July 4, 2012. *See further*, Press Release, U.S. Sec. and Exch. Comm'n, Commission Charges Connecticut-Based Hedge Fund Managers with Fraud (Feb. 26, 2013).

[44] *See, e.g.* Penelope Wang, *Could Your Fund Go Bankrupt? Why you don't have to worry*, CNN MONEY, Dec. 1, 2003.

[45] Preferably, plain language that is developed specifically by the Commission as noted above. *See, e.g.* Letter from Karrie McMillan, *op. cit.* page 4.

[46] Final Rule: Amendments to Investment Company Advertising Rules, *op. cit.* "Advertising that focused on extraordinary fund performance during 1999-2000 led to increasing concerns that some funds, when advertising their performance, may resort to techniques that create unrealistic investor expectations or may mislead potential investors. These concerns have arisen again with the recent improvement in market performance, as commentators have noted an increase in advertisements highlighting favorable short-term performance. To address these concerns, we are adopting...changes to the narrative disclosure that is required to accompany performance advertisements. These changes are intended to help investors understand the limitations of past performance data and enhance their ability to obtain updated performance information. In particular, these amendments will require funds to include the following information in [mutual fund] advertisements that contain performance data: (i) a statement that past performance does not guarantee future results; (ii) a statement that current performance may be lower or higher than the performance data quoted; and (iii) a toll-free or collect telephone number or a website where an investor may

look even more closely at the advertising of private investment funds, which are governed much more loosely than mutual funds.

The Commission rightly acknowledges the potential for abuse of performance statistics, and attempts to put in place rules to protect investors by including in the Proposed Rule requirements, similar to those for mutual funds, that private investment fund advertisement legends note that "past performance does not guarantee future results" and that data used in advertisements "must be as of the most recent practicable date."[47] However, instead of setting forth specific standards for reporting performance data of private investment funds, like the Commission (with FINRA) has done for mutual fund advertisements, the Commission's proposed requirements largely rely on a blanket legend disclosing that "the private [investment] fund is not required by law to follow any standard methodology when calculating and representing performance data."[48] The Commission, instead of simply washing its hands of the potential for performance data manipulation by requiring this legend, should put in place a specific set of requirements for the disclosure of performance data, such as standardizing performance metrics, ensuring charts are reasonably scaled, and requiring material be printed in a readable font, to name just a few issues that the Commission should consider.

The Commission need not reinvent these standards, just adopt more of the standards it put in place for mutual funds in similar circumstances in 1996 when Congress passed legislation requiring the Commission to update its rules to allow for increased mutual fund advertising. In that instance, the Commission included substantial investor protection requirements that it further strengthened in later years.[49] Although the Commission's required discloses under the current Proposed Amendments seem to mirror the legends required under the 2003 amendments to those mutual fund rules, the Commission does not include in the Proposed Amendments any similar attempt to mirror the existing mutual fund requirements for performance data[50] despite evidence that those currently existing rules offer relatively strong investor protections.[51]

To better protect investors, the Commission should require private investment funds to calculate returns based on a standardized methodology, disclose fees and their impact on performance, disclose the impact of taxes on yield figures presented and present one, five and ten year returns.[52] Further, the Commission should provide far more specific guidance on acceptable advertising terms, with training and guidance available to industry participants. FINRA, for example, generally prohibits mutual fund advertisements that use promissory terms like "ideal

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obtain performance data current to the most recent month-end, unless the advertisement includes total return quotations current to the most recent month ended seven business days prior to the date of use."

[47] Amendments to Regulation D, Form D and Rule 156 under the Securities Act, *op. cit.* at page 171.

[48] *Id.*

[49] *See,* Final Rule: Amendments to Investment Company Advertising Rules, *op. cit.*

[50] *Id.*

[51] In 2011, the GAO found that "Although…regulators had received over 50,000 complaints or inquiries during this 17-month period, they identified just 25 complaints or inquiries as possibly relating to misleading mutual fund or ETF advertisements during the period we reviewed, and after discussing the details of these complaints or inquiries with regulators, we determined that only 3 complaints appeared to involve misleading fund advertisements." U.S. Gov't Accountability Office GAO-11-697, *op. cit.* at page 18.

[52] These requirements were all put in place by the Commission for mutual funds in 2003. Final Rule: Amendments to Investment Company Advertising Rules, *op. cit.*

investment," "maximize return and minimize loss" and "prepare your portfolio for success" as well as prohibiting potentially misleading practices such as "third party studies taken out of context" and "charts and graphs that distort data."[53] Similar guidance should be provided for private investment funds, which will be advertising directly alongside mutual funds in many cases.

4. Temporary requirement to submit written general solicitation materials used in Rule 506(c) offerings.

Requiring a review of advertising material used in offerings of securities of private investment funds is especially important.[54] As the legislative history of the JOBS Act makes clear, Congress intended to help small businesses raise capital by lifting the ban on general solicitation.[55] Congress did not even consider, let alone intend, for hedge funds, private equity funds and other private investment funds to use the Rule 506(c) exemption to attract investors. As I discussed previously, mutual funds face very close scrutiny of their advertisements and are already subject to submission and review requirements for their advertising materials.[56] While I believe all general solicitation and advertising materials should be submitted for review, at the very least all such materials for offerings of private investment funds should be submitted and reviewed for compliance with applicable requirements in a manner at least as rigorous as that for the much more regulated mutual funds.

Requiring the submission of advertising material would be consistent with existing requirements for public offerings.[57] Under current rules, mutual funds are required to submit their advertising material for review by FINRA.[58] Similar reviews, either by the Commission or by another third party such as FINRA, should be required for advertising material for private offerings under the

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[53] *See* Mutual Funds – A Roadmap to Compliant Communications, FINRA Advertising Regulation Conference, October 25, 2012. *Available at* http://www.finra.org/web/groups/industry/@ip/@edu/@mat/documents/education/p124626.pdf

[54] Letter from Karrie McMillan, *op. cit.* at page 2.

[55] S*ee, e.g.*, 157 Cong. Rec. H7292 (daily ed. Nov. 3, 2011) (statement of Rep. Robert Dold) ("this bill removes the ban on small companies from soliciting equity financing from accredited investors."); 157 Cong. Rec. H7293 (daily ed. Nov. 3, 2011) (statement of Rep. Don Manzullo) ("I hear complaints from our small business constituents back home about the difficulty in raising capital. Today, we have an opportunity to fix one aspect of this problem so that our Nation's small businesses can obtain the funds that they need to hire workers."); 157 Cong. Rec. H7293 (daily ed. Nov. 3, 2011) (statement of Rep. Mike Kelly) ("[This legislation] is as basic as blood is to the body, the access to capital for small businesses, the ability to raise capital in hard times."); 157 Cong. Rec. E1991 (daily ed. Nov. 3, 2011) (statement of Rep. Phil Gingrey) ("I rise today as a proud supporter of H.R.2940, the Access to Capital for Job Creators Act ... which seek[s] to help entrepreneurs and small business owners access the capital they need to start or expand their business."); 157 Cong. Rec. E2003 (daily ed. Nov. 3, 2011) (statement of Rep. Chris Van Hollen) ("[T]he Access to Capital for Job Creators Act will allow small companies to raise capital more easily by removing restrictions against general solicitation and advertising to potential investors.").

[56] U.S. Gov't Accountability Office GAO-11-697, *op. cit.*

[57] Letter from Andrea L. Seidt, *op. cit.* at page 7, "such a filing requirement is consistent with the requirements of the Commission, FINRA, and the states where issuers in registered public offerings file advertising and solicitation materials prior to use, and will further level the playing field between registered public offerings and exempt public offerings."

[58] U.S. Gov't Accountability Office GAO-11-697, *op. cit.*

Rule 506(c) exemption. All solicitation materials should be subject to such a review regardless of whether they are prepared and used by the issuer or a broker-dealer (or other party).[59]

Also, the submission of general solicitation materials will allow the Commission to better understand "the market practices in the Rule 506 market"[60] and their ongoing submission will allow the Commission to follow developments in market practices for Rule 506 offerings.[61] As the markets evolve over time, the Commission should continue to collect and monitor these materials for developing risks. Accordingly, the requirement to submit solicitation materials should be made permanent.

The Commission notes that it expects most advertising to take place by print or media,[62] but phone solicitation has long proven to be an area ripe for fraud[63] and can target some of the most vulnerable segments of the population. Therefore, any scripts or guidance material developed for phone solicitations should be submitted to, and reviewed by, the Commission in addition to the print and media advertising that would be collected under the Proposed Amendments.

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[59] Letter from Andrea L. Seidt, *op. cit.* at page 3, "In the absence of Commission-developed content standards, advertising and solicitation in exempt public offerings will be subject to different requirements depending on whether the transaction is sold by broker-dealers or by issuers directly. Advertising used in broker-dealer sold offerings is subject to FINRA content stand[ard]s under NASD Rule 2210, as well as review by FINRA's Advertising Regulation Department."

[60] Amendments to Regulation D, Form D and Rule 156 under the Securities Act, *op. cit.* at page 89.

[61] Letter from Andrea L. Seidt, Commissioner, Ohio Division of Securities letter to Elizabeth Murphy, Secretary, Sec. and Exch. Comm'n (July 3, 2012) "The Division's experience is that fraudulent statements and material omissions are often prevalent in advertising to investors. For example, the Division frequently observes attempts to entice investors through advertising promising 'guaranteed returns' and fraudulent projections or forecasts of performance... These risks will be amplified by Title II of the JOBS Act. Accredited investors present prime, well-funded targets to scam artists who will not hesitate to take advantage of the new general solicitation and general advertising freedoms to troll for victims. The damage will not be limited to accredited investors, as Title II opens such advertising to all audiences."

[62] "We expect that many issuers will prefer to use written general solicitation materials due to the potentially greater reach and lower costs of such solicitation methods." Amendments to Regulation D, Form D and Rule 156 under the Securities Act, *op. cit.* at page 89.

[63] In reinstating investor protections removed in 1992, the Commission explained: "Securities are...placed with broker-dealers who use cold-calling techniques to sell the securities at ever-increasing prices to unknowing investors. When their inventory of shares is exhausted, those firms permit the artificial demand created to collapse, and investors lose much, if not all, of their investment. This scheme is sometimes colloquially referred to as 'pump and dump.'" Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, *op. cit.* See also, *Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation: Hearing Before the H. Subcomm. on Capital Markets and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 112th Cong. 58 (2012) (prepared testimony of Heath Abshure, Arkansas Securities Commissioner and Chairman of the Corporation Finance Section Committee, North American Securities Administrators Association, Inc. ("In 2005, the 55-year-old owner of a North Carolina cleaning service was surfing the internet when a "pop-up" window appeared on his screen requesting personal information. What soon followed was a variety of investment opportunities ranging from oil to gas ventures to real estate deals and body scanning. A phone call followed with a sales pitch soliciting a $15,000 investment in Lifeline Imaging, a California medical diagnostic business. The deal sounded good and the investor, together with his wife, borrowed money from their retirement savings and followed the salesman's instructions to transfer their funds to a designated account. After months without word of the investment's status, the investor checked his investment account. It was empty....In Alabama, a 72-year-old man living on disability checks became the target of a series of cold calls pitching a variety of limited offerings, including Lifeline Imaging. His $25,000 investment in the business has vanished.).

Finally, the Commission should change the Proposed Amendments to make submitted advertising material available publicly either through the Commission's EDGAR system or otherwise. Solicitation materials used in offerings registered with the Commission are made public and there is no reason not to make public the solicitation materials used in these unregistered but quasi-public offerings also.

5. Disqualification of an issuer from relying on Rule 506 for future offerings during a one-year period if the issuer, or any predecessor or affiliate of the issuer, did not comply, within the last five years, with Form D filing requirements in a Rule 506 offering.

This proposed amendment is long overdue, and I applaud the Commission for putting it forward. For years, bad actors have repeatedly victimized investors through fraudulent Regulation D offerings.[64] Because "the disqualification provision of Rule 507 has rarely been invoked since its adoption,"[65] the proposed amendment is sorely needed. It will provide more meaningful consequences for those who do not file Form D and added deterrence of such failures.

Congress took action to rid the industry of such bad actors during consideration of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[66] That law directs the Commission to take steps to bar any issuer, or its predecessors and affiliates, who violates the requirements for Form D filings from participating in any additional Regulation D offerings for a one-year period commencing when all required filings have been made. I support the Commission's effort to keep bad actors out of the industry, and I encourage the Commission to approve a strong final amendment.

6. Proposed Amendments to Form D to require an issuer to include additional information about offerings conducted in reliance on Regulation D.

The Commission's proposal to require additional information is an improvement from current practice and will be helpful in monitoring developing practices in the new Rule 506(c) marketplace. Where applicable, it will also be helpful for improving the consistency of Form D submissions for Rule 504 and Rule 505 offerings. However, the following additional information should also be required to be included in Form D:

1. whether a platform[67] is being used to solicit accredited investors and, if so, the name of the platform being used;

2. given the unique nature and significant additional risks posed by securities of private investment funds, whether the issuer is a private investment fund; [68]

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[64] According to the North American Securities Administrators Association, "fraudulent private placement offerings were ranked as the most common product or scheme leading to investigations and enforcement actions." Press Release, NASAA Top Investor Threats, North American Securities Administrators Association (2013)
[65] Amendments to Regulation D, Form D and Rule 156 under the Securities Act, *op. cit.* at page 48.
[66] Dodd-Frank Wall Street Reform and Consumer Protection Act. Pub. L. 111-203 §926, 124 Stat. 1376 (2010).
[67] Jumpstart our Business Startups Act, *op. cit. See also* Letter from William F. Galvin, *op. cit.* at page 5.
[68] Letter from A. Heath Abshure, *op. cit.* at page 8.

3. the names of the entities and individuals who are acting as their advisors because the issuer's return is largely dependent on the quality of its management - the Commission rightly included these required disclosures in its Proposed Amendments;

4. the names and appropriate identifying information for those tasked with verifying whether the investors are, in fact, accredited investors to allow the Commission or state regulators to monitor whether certain parties are common in problematic offerings; and

5. the specific plan of solicitation and a list of any outside firms contracted to solicit on behalf of the issuer.

7. Proposed Amendments to Rule 156 to extend the antifraud guidance contained in that rule to the sales literature of private investment funds.

The Proposed Amendments would rightly extend the legends and disclosure requirements in Rule 156 to advertisements for private investment funds. But as I suggest above, those legend and disclosure requirements should be strengthened as well for private investment fund offerings under Rule 506(c).

8. Additional improvements needed to ensure that investors are in fact "accredited investors"

In addition to commenting on the specific issues on which the Commission requested comment, I wish to offer the suggestion that the Commission take further steps to protect investors and comply with the intent of Congress by significantly strengthening the verification requirements to ensure that investors in Rule 506(c) offerings are in fact accredited investors. The legislative history of the JOBS Act makes clear that Congress closely considered and intended for the lifting of the general solicitation ban to be coupled with the requirement that only accredited investors participate in these offerings.[69] Further, Section 201 of the JOBS Act directs the Commission to detail the specific "methods" necessary to demonstrate that the issuer has taken reasonable steps to ensure that such investors are accredited.[70] Unfortunately, the Final Rule approved by the Commission did not include many of the helpful suggestions of previous commenters on this issue.[71]

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[69] Rep. Waters offered the language, which was included in the final bill, requiring "specific steps." She noted "it would be difficult to limit the sale of these securities to only accredited investors when issuers advertise to everyone, particularly since accredited investors were able to self-certify their status." 157 Cong. Rec. H7290 (daily ed. Nov. 3, 2011) (Statement of Rep. Maxine Waters). *See also Access to Capital for Job Creators Act, Markup on H.R.2940 Before the House Subcommittee on Capital Markets and Government Sponsored Enterprises, House Financial Services Committee*, 112th Cong. (2011) (Statement of Rep. Maxine Waters) "I am concerned about the process in which accredited investors verify that they are in fact accredited...if we are rolling back protections for our targeted audience of sophisticated individuals, we must take steps to ensure that those folks are in fact sophisticated."

[70] Jumpstart our Business Startups Act, *op. cit.*, Sec. 201.

[71] *E.g.* Letter from A. Heath Abshure, *op. cit.*, Letter from Mercer Bullard, *op. cit.* at pages 5-7 and Letter from Andrea L. Seidt, *op. cit.* at page 6.

The Commission should strengthen the "reasonable steps" and "reasonable belief" safe-harbor standards for an issuer to deem a potential investor to be an "accredited investor". For example, the safe harbor standards for the verification of investor income and net worth that the Commission has adopted unfortunately are far too wide and should be strengthened by requiring additional documentation and verification.

Some commenters have argued that such documentation requirements would result in "many [investors] refusing to participate in this type of investing."[72] Yet, in nearly all common financial transactions, including applications for loans and margin accounts, parties are expected to share financial information far more detailed that that required by the Proposed Amendments. Also, under the terms of the Final Rule approved by the Commission, any registered broker-dealer, investment advisor, licensed attorney or certified public accountant[73] could make a representation, on behalf of the investor, that the investor is indeed an accredited investor. Thus, beyond the investor's accredited status, an issuer would not receive any additional information whatsoever about the investor's net worth. The benefits of requiring the collection of simple, common documentation seem to vastly outweigh any burdens associated with such a requirement.

The safe harbors should be exclusive. If they are not exclusive, then the Commission leaves wide open the opportunity for issuers to adopt investor verification regimes that meet the Commission's very low "reasonable steps" and "reasonable belief" standards for verification and allow considerable leeway for non-accredited investors to be sold unregistered securities. Thus, the Commission is undermining the fundamental principle of the JOBS Act, which is that only accredited investors can participate in Rule 504(c) unregistered offerings. In addition, by relying on a "facts and circumstances" analysis, the Commission faces a difficult enforcement environment in which each fraudulent case that occurs under the general solicitation exemption will require the Commission to litigate the "facts and circumstances".

The Commission should require that documentation used by or on behalf of the issuer to verify an investor's qualification as an accredited investor be maintained by the verifying party for a reasonable time and be made available to the Commission for inspection on request. As the Commission acknowledges in its rulemaking,[74] it does not expect to review each Form D as it is filed and, based on that assertion, it seems highly unlikely that the Commission will take contemporaneous steps to verify the veracity of claimed accredited investor representations in each offering. Thus, the only time an issuer's "reasonable steps" will be questioned will be after complaints about an offering are raised and, at that time, it will likely be far too late to verify whether an issuer actually took "reasonable steps" unless the documentation used in that process has been retained for later review. As the Commission expects to examine the "facts and

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[72] Press Release, Angel Capital Association, New SEC Rules Could Kill Angel Investing, Hurt Startups, and Hinder Job Growth (July 15, 2013) available at http://www.angelcapitalassociation.org/data/File/pdf/Release-New_SEC_Rules_Could_Kill_Angel_Investing_Final.pdf

[73] Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, *op. cit.* at page 114-115.

[74] *See,* Amendments to Regulation D, Form D and Rule 156 under the Securities Act, *op. cit.* at page 22, "Commission does not anticipate that its staff will review each Advance Form D filing as it is being made."

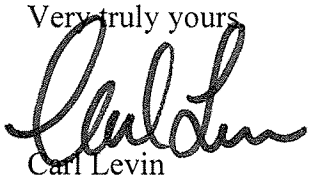
circumstances"[75] of an issuer's efforts to determine the legitimacy of an investor's accredited status, preservation of these documents will be essential in litigating, or avoiding litigating, these time-consuming and resource-intensive determinations.[76]

CONCLUSION

The Proposed Amendments are improvements from the Commission's previously proposed rules, but the Proposed Amendments continue to have significant flaws that will imperil investors and will likely result in a substantial and unnecessary increase in securities-related fraud. I strongly urge the Commission to improve and strengthen the Proposed Amendments for implementing Section 201 of the JOBS Act.

Thank you for your consideration of my concerns and suggestions.

Very truly yours,



Carl Levin

[75] Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Id. at page 27, "whether the steps taken are "reasonable" will be an objective determination by the issuer (or those acting on its behalf), in the context of the particular facts and circumstances of each purchaser and transaction."

[76] Practitioners agree in their comments. *See, e.g.* Letter from Andrea L. Seidt, *op. cit.* at page 6: "The issuers should review and confirm (*and maintain appropriate records of*) the accredited investor's level of sophistication." Italics added.