October 2, 2012

FILED ELECTRONICALLY

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F St., N.E.
Washington, DC 20549-1090

Re: JOBS Act Rulemaking: File No. S7-07-12

Dear Ms. Murphy,

I am writing on behalf of Fund Democracy to comment on the Commission's proposed amendment to Rule 506 under the Securities Act to permit general solicitation and advertising ("GS&A") in connection with private offerings.[1] Section 201(a)(1) of the Jumpstart Our Business Startups Act of 2012 ("JOBS Act") requires that the Commission: (1) permit GS&A provided that all purchasers are accredited investors and (2) adopt rules requiring that "the issuer take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission." This letter incorporates by reference the comment letters listed at footnote 16.

In my view, the proposal does not comply with Section 201(a)(1) of the JOBS Act. Nor does it satisfy procedural standards for public notice and comment or the requirement that the Commission evaluate the effect of its rulemaking on investor protection, efficiency, competition and capital formation. The Commission has not complied with Congress's mandate to require issuers to take specific steps to verify the status of investors in GS&A offerings. The Commission has not evaluated alternatives to the proposed amendment, such as those suggested by commentators and SEC Commissioners. The only legally permissible step that the Commission can take is to re-propose the rule and, in doing so, consider the alternative approaches that commenters and two Commissioners have suggested, but that the proposal has ignored.

I. Failure to Consider Alternative Approaches

The Rule 506 Rulemaking does not satisfy the standards set forth in its recent staff memorandum on economic analysis in SEC rulemakings.[2] As noted in that memorandum, Section 2(b) of the Securities Act provides that:

> Whenever pursuant to [the Act] the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the

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[1] *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, Securities Act Rel. No. 33-9354 (Aug. 29, 2012) ("Proposal") *available at* http://www.sec.gov/rules/proposed/2012/33-9354.pdf.

[2] *Current Guidance on Economic Analysis in SEC Rulemakings*, Memorandum from RSFI and OGC to the Staff of the Rulewriting Divisions and Offices (Mar. 16, 2012) ("Rulewriting Memorandum") *available at* http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.

> protection of investors, whether the action will promote efficiency, competition, and capital formation.

The memorandum describes "economic analysis" as "an essential part of SEC rulemaking . . . that allows the Commission to meaningfully compare the proposed action with reasonable alternatives."[3] It states that the "Commission has long recognized that a rule's potential benefits and costs should be considered in making a reasoned determination that adopting a rule is in the public interest."[4] It acknowledges that various parties have raised questions about its rulemakings and made recommendations, including:

> (1) identifying the need for the rulemaking and explaining how the proposed rule will meet that need; (2) articulating the appropriate economic baseline against which to measure the proposed rule's likely economic impact (in terms of potential benefits and costs, including effects on efficiency, competition, and capital formation in the market(s) the rule would affect); (3) identifying and evaluating reasonable alternatives to the proposed regulatory approach; and (4) assessing the potential economic impact of the proposed rule and reasonable alternatives by seeking and considering the best available evidence of the likely quantitative and qualitative costs and benefits of each.[5]

The memorandum echoes these concerns in stating that it is:

> widely recognized that the basic elements of god regulatory economic analysis are: (1) a statement of the need for the proposed action; (2) the definition of a baseline against which to measure the likely economic consequences of the proposed regulation; (3) the identification of alternative regulatory approaches; and (4) an evaluation of the benefits and costs—both quantitative and qualitative—of the proposed action and the main alternatives identified by the analysis.[6]

The staff stated that, "[a]s a general matter, every economic analysis in SEC rulemakings should include these elements."[7]

On a more detailed level, the staff described the "baseline" as the "best assessment of how the world would look in the absence of the proposed action" that "serves as a primary point of comparison for an analysis of the proposed regulation."[8] The staff continued:

> An economic analysis of a proposed regulatory action compares the current state of the world, including the problem that the rule is designed to address, to the expected state of the world with the proposed regulation (or regulatory alternatives) in effect.[9]

[3] Rulewriting Memorandum at 1.

[4] *Id.* at 1.

[5] *Id.* at 1 - 2.

[6] *Id.* at 4.

[7] *Id.* at 4.

[8] *Id.* at 6.

Where rulemaking fulfills a statutory mandate, the comparisons described above shall "consider the overall economic impacts, including both those attributable to Congressional mandates and those that result from an exercise of the Commission's discretion."[10]

Moreover, a proposing release "should identify and discuss reasonable potential alternatives to the approach in the proposed rule," including "realistic approaches that are more or less stringent than the preferred option."[11] The release should "solicit public comment to help assess and inform the economic analysis of the alternatives."[12] A "proposing release should include a substantially complete analysis of the most likely economic consequences of the rule proposal."[13] It "should also include a discussion of any existing studies or data that bear on the proposal so that the public knows what studies or data we are relying on, can comment on it, and can provide additional data relevant to the topic."[14]

The SEC's proposal violates every one of the standards cited above. The proposal does not identify any "baseline" against which to measure its effect. The proposal does not make any "assessment of how the world would look" if alternative regulatory approaches were taken. It does not make any "comparison between the expected state of the world with the proposed regulation (or regulatory alternatives) in effect." There is no discussion of the problem that Rule 506 is intended to address, that is, the problem that Congress saw in allowing unregistered *public* offerings.

The proposal does not include any analysis of the economic impacts attributable to the Congressional mandate that the GS&A ban be removed from Rule 506 or of the economic impacts attributable to the "exercise of the Commission's discretion." The Commission does not even acknowledge the question of what discretion is has to exercise, much less what form that discretion might take.

The proposal does not identify "reasonable potential alternatives." It proposes the least stringent option that one could conceive under Section 201(a)(1), with no acknowledgment, much less any discussion, of more stringent alternatives. A previous comment letter from investor advocacy groups listed numerous alternatives, including the following:

- <u>Form D</u>. Require the filing of Form D at least 30 days before any sale in a Rule 506 offering in which there is GS&A. Expand Form D to require additional information regarding such GS&A offerings.

- <u>Pre-Filing of General Solicitations and Advertising Materials</u>. Require pre-filing of all GS&A under Rule 506 with FINRA, regardless of whether any broker-dealer involved is

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[9] *Id.*

[10] *Id.* at 8.

[11] *Id.* at 8 - 9.

[12] *Id.* at 9.

[13] *Id.* at 16.

[14] *Id*.

exempt from registration under the Exchange Act. FINRA already pre-reviews broker-dealer advertising; the same requirement should apply to GS&A in light of the significant potential for abuse. Develop content requirements for GS&A, such as explicit warnings regarding the risks of investing in unregistered securities.

- Issuer Disclosure. Require that Rule 506 issuers and their agents that engage in GS&A activities file with the Commission and deliver to all persons who contact them regarding the offering a disclosure document that sets forth basic information (*e.g.*, the disclosure document required under Rule 502(b)(2)).

- Resale Restrictions. Impose stricter requirements on the resale of Rule 506 securities with respect to which the issuer has engaged in GS&A activities.

- Integration with Crowdfunding. Substantially narrow the 6-month safe harbor for integration with crowdfunding offerings, non-GS&A Rule 506 offerings and all other offerings of unregistered securities that do not permit GS&A.

- Broker-Dealer Exemption. Identify the most significant gaps in broker-dealer regulation that the broker-dealer exemption will create and take steps to remedy this weakening in investor protection.

- Exclude Nonaccredited Investors from Rule 506. Amend Rule 506 to exclude nonaccredited investors as eligible purchasers, or narrow that category of persons to key executives of the issuer who are in a position to obtain the information necessary to make an informed investment decision. Alternatively, prohibit sales to nonaccredited investors by issuers that have made a GS&A offering.

- Bad Actor Disqualification. Amend Rule 506 to prohibit certain bad actors from relying on the rule's safe harbor, as required by Section 926 of the Dodd-Frank Act.[15]

- Recordkeeping. Create/Enhance recordkeeping requirements regarding information on, among other things, accredited investor status, content and use of GS&A, and size and qualifications of shareholder base.

- Hedge Funds. Prohibit GS&A by funds relying on the exemptions under Section 3(c)(1) and (7) of the Investment Company Act. Alternatively, apply mutual fund advertising and valuation rules to hedge funds that engage in GS&A (and, in any case, require standardized performance and fee reporting for all hedge funds), and require explicit, large-font disclaimers that hedge funds are not mutual funds and present special risks.[16]

[15] *Disqualification of Felons and Other "Bad Actors" From Rule 506 Offerings*, Securities Act Rel. No. 9211 (May 25, 2011). The Commission made a similar proposal in 2007, on which it also has not taken final action.

[16] *See* Letter From Fund Democracy, *et al*. (Aug. 16, 2012) *available at* http://www.sec.gov/comments/jobs-title-ii/jobstitleii-60.pdf. I hereby incorporate by reference this letter and other comment letters submitted by Fund Democracy: Letter from Fund Democracy, *et al.* (Aug. 28, 2012) *available at* http://www.sec.gov/comments/jobs-title-ii/jobstitleii-74.pdf; Letter from Fund Democracy, *et al*. (May. 16, 2012) *available at* http://www.sec.gov/comments/jobs-title-ii/jobstitleii-14.pdf.

The proposing release does not discuss *any* of these alternatives other than to state that the Commission had decided not to consider them.

Two Commissioners expressly agreed that the proposal should have included a discussion of alternatives. Commissioner Aguilar voted against releasing the proposal because it included “no consideration of any of the commenters’ proposals that would have decreased investor vulnerability” and “fail[ed] to consider any of the suggestions recommended by investors, investor advocates, and regulators to mitigate risk.”[17] In her statement accompanying the proposal, Commissioner Walter acknowledged commenters’ “thoughtful suggestions include[ing] requiring certain disclosures or legends to accompany general solicitation, amending the definition of accredited investor, and including additional information on Form D.”[18] She observed that, nonetheless:

> Today's proposal does not include a meaningful discussion of these suggestions. While I am voting for today's proposing release, I am disappointed that these comments were not incorporated in the proposal, either as a component of the proposed rule or as requests for further comment.[19]

I agree with Commissioners Aguilar and Walter that there is no reasonable basis for the SEC’s decision not to request comment on recommended alternatives.

The proposing release includes virtually no analysis “of the most likely economic consequences of the rule proposal,” much less a “complete analysis.” It cites no “existing studies or data that bear on the proposal,” despite the fact that much of the record that favors additional investor protection measures has been created by the Commission itself. For example, the proposal nowhere mentions the SEC’s 2007 proposal to adopt a higher accredited investor standard as a condition of relaxing of the Rule 506 GS&A ban.[20] The Commission proposed to permit limited advertising of offerings that were sold only to “large accredited investors.” Such investors who were natural persons were required to have at least $2.5 million in investments or $400,000 in annual income. If the Commission believes that such an increase would be necessary for a *limited relaxation* of the GS&A ban, then it logically must take the position that some narrowing of the accredited investor definition would be necessary for the *wholesale elimination* of the GS&A ban that the JOBS Act contemplates.

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[17] *Increasing the Vulnerability of Investors*, Statement of Commissioner Luis Aguilar (Aug. 29, 2012)(*Aguilar Statement) available at* http://sec.gov/news/speech/2012/spch082912laa.htm.

[18] *Opening Remarks Regarding the Proposal of Rules Eliminating the Prohibition against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, Statement of Commissioner Elisse Walter (Aug. 29, 2012) (*Walter Statement*) *available at* http://sec.gov/news/speech/2012/spch082912ebw.htm.

[19] *Id.*

[20] *Revisions of Limited Offering Exemptions in Regulation*, Securities Act Rel. No. 8828 at 38 (2007) *available at* http://www.sec.gov/rules/proposed/2007/33-8828.pdf. This proposal is cited only once in the proposal, and only in footnote 120 in connection with a citation to a comment letter that took issue with the proposal.

The proposing release nowhere refers to the abuses that the Commission specifically found had arisen in connection with an earlier, ill-considered weakening of the GS&A ban. In 1992, the Commission eliminated the GS&A prohibition for offerings under Rule 504, which permits offerings of up to $1 million. It subsequently found that the elimination of the GS&A ban contributed to an increase in microcap fraud. The Commission restored the GS&A prohibition, in part because it was concerned that "small businesses could be unfairly impacted by the taint that might attach to Rule 504 offerings."[21] The Commission further noted:

> If the microcap market, or offerings under Rule 504, become stigmatized as unsavory, legitimate small businesses may become less able to raise money as investors lose confidence in the market and in the integrity of those making such offerings.[22]

The proposal's failure even to acknowledge in the proposing release such directly relevant findings and concerns previously identified by the Commission itself is hard to fathom.

Along the same lines, the proposing release provides no analysis regarding the SEC's decision to extend the Rule 506 amendment to private investment companies under the Investment Company Act. The Commission states, without any analysis, that it "believe[s] the effect of Section 201(b) is to permit privately offered funds to make a general solicitation under amended Rule 506 without losing either of the exclusions under the Investment Company Act." However, Section 201(b) refers only to Rule 506; it makes no reference to the meaning of "public offering" under the Investment Company Act exemptions. The Commission notes that it has interpreted Rule 506 offerings to be private offerings under the Act, but this position was taken while the GS&A ban was in place. The proposing release includes no analysis of whether permitting GS&A by private investment companies is consistent with the protection of investors or efficient, competitive markets.

The proposal's silence on this issue is remarkable considering that the "Commission recognized over 30 years ago that hedge fund trading raises special concerns" and that hedge funds pose heightened risks for investors.[23] In its 2003 study of hedge funds, the Commission expressed concern regarding, among other things, "incentives that may cause an adviser to inaccurately value hedge fund assets," their improper use of the Internet to communicate with investors, and inadequately disclosed layering of fees in funds of hedge funds structures.[24] The

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[21] *Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption*, Securities Act Rel. No. 7541 (May 21, 1998) *available at* http://www.sec.gov/rules/proposed/33-7541.htm.

[22] *Id.*

[23] *Implications of the Growth of Hedge Funds*, U.S. Securities and Exchange Commission, at n.5 (2003) *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf.

[24] *Id. See also Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles*, Securities Act Rel. No. 8766, at 17 (2006) ("Moreover, private pools have become increasingly complex and involve risks not generally associated with many other issuers of securities. Not only do private pools often use complicated investment strategies, but there is minimal information available about them in the public domain. Accordingly, investors may not have access to the kind of information provided through our system of securities registration and therefore may find it difficult to appreciate the unique risks of these pools, including those with respect to undisclosed conflicts of interest, complex fee structures and the higher risk that may accompany such pools' anticipated

Commission has found that hedge fund enforcement actions disproportionately involve criminal charges, are notable for "the length to which the violators go to conceal their fraud," and reflect a "greater frequency of outright theft, or misappropriation, of investor funds."[25] The Commission has instituted an "Aberrational Performance Inquiry" that is specifically targeted at hedge funds' fraudulent performance claims and improper deviations from stated investment strategies,[26] and an examination program that is reviewing "whether private-equity firms are taking more profits from investments than they should under agreements with fund clients."[27] The 2003 study recommended removing the GS&A ban for hedge funds, but only for those selling exclusively to qualified purchasers, which begs the question of how the Commission can now support unconditionally permitting GS&A for sales to all accredited investors, a much larger and less sophisticated group than qualified purchasers. Even more remarkable is the fact that the proposing release has nothing to say on any of the foregoing.

The most remarkable aspect of the proposal is that it entirely ignores the significance of the pending bad actor amendment to Rule 506. The proposal to disqualify bad actors is not an "alternative" that the Commission must consider because it is not an alternative, but a nondiscretionary, statutory mandate that operates as a condition precedent to action under the JOBS Act. A prior Congress ordered the Commission to "adopt rules that disqualify securities offerings involving certain 'felons and other "bad actors"' from reliance on" Rule 506.[28] The statutory deadline for this proposal was one year after the enactment of the Dodd-Frank Act, which became law on July 21, 2010. Congress passed the JOBS Act in 2012 on the assumption that the version of Rule 506 to which the Act applied would be consistent with prior statutory mandates. The rule to which the JOBS Act applies is necessarily a rule that disqualifies bad actors; the JOBS Act does not authorize an amendment to a rule that is not in compliance with current law. There is no reasonable interpretation of law that would permit the Commission to eliminate the GS&A ban without having complied with Congress's prior, express direction to amend the very rule from which the GS&S ban is being removed.

The "Economic Analysis" section of the proposing release makes numerous, empirically unsupported claims regarding the potential benefits of the rulemaking, while merely posing questions without any analysis of the potential costs to investors. For example, the Commission finds it "likely" that efficiency would be enhanced by reduced search costs without providing any analysis. The proposal's analysis of reduced placement costs assumes that GS&A would

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returns.") *available at* http://www.sec.gov/rules/proposed/2006/33-8766.pdf.

[25] *Id.* at 74.

[26] Thomas P. Cimino and Junaid A. Zubairi, *Recent SEC Enforcement Actions Signal Shift to More Proactive Approach to Hedge Fund Regulation* (May 2012) *available at* http://www.vedderprice.com/index.cfm/fuseaction/pub.detail/object_id/b33f5c60-7b1a-4c40-9f33-f8e220a78ee1/RecentSECEnforcementActionsSignalShifttoMoreProactiveApproachtoHedgeFundRegulation.cfm. Cases cited in this firm memorandum include three enforcement actions announced on December 1, 2011: SEC v. Balboa, No. 11-CV-08731 (S.D.N.Y. 2011); *SEC v. Rooney*, No. 11-CV-08264 (N.D. Ill. 2011); and *SEC v. Kapur*, No. 11-CV-08094 (S.D.N.Y. 2011).

[27] Joshua Gallu and Christina Alesci, *SEC Said to Scrutinize Private Equity on Share of Payout*, Bloomberg.com (Sep. 21, 2012) *available at* http://www.bloomberg.com/news/2012-09-21/sec-said-to-scrutinize-private-equity-on-share-of-payout.html.

[28] Proposal at 1.

eliminate the need for intermediaries without providing any factual support. In contrast, the proposal provides no analysis of the increased fraud risk created by the rulemaking, other than to make the passing suggestion that "the public nature of [GS&A] may facilitate detection of fraudulent activity." It is true that, if bank robberies quintupled, more detection of bank robberies would likely follow. However, it is absurd to argue that greatly increasing opportunities for fraud by permitting GS&A actually benefits investors because more fraud may be detected. It is not the SEC's mission to facilitate fraud in order that it may have more fraud to detect.

The SEC's proposal stands in stark contrast to its rulemaking on conflict minerals under Section 1502(b) of the Dodd-Frank Act. The Commission adopted rules under that provision just seven days before voting on its Rule 506 proposal, but the approach taken to cost-benefit analysis in each appears to have been produced under completely different legal standards. The Commission conducted an exhaustive economic analysis of the costs attendant upon the conflict minerals rules while conducting virtually no economic analysis of the costs of the Rule 506 amendments. These rulemakings reflect the unfortunate and indefensible pro-industry bias exhibited in the SEC's cost-benefit memorandum, which appears to assume that the "costs" of rulemaking include only costs incurred by issuers and the financial services industry. The Commission seems to view "efficiency, competition, and capital formation" factors as covering only intra-industry considerations and excluding the broader economic impact of rulemaking on the health of our securities markets.

However, even under its own biased approach, the SEC's Rule 506 proposal wholly ignores its own standards. The Commission has nothing to say about whether its proposal will improve the "efficiency" of markets when it provides no practical way to investors to differentiate between the nonstandardized investment performance advertised by hedge funds and standardized investment performance advertised by mutual funds. Will it improve competition to permit such an unlevel playing field? Will competition be improved when public and "private" issuers subject to radically different disclosure requirements compete in same public securities marketing space? Will capital formation be improved by greatly facilitating fraudulent solicitations of precisely the accredited investors who were defrauded by Bernie Madoff? Will increased fraud in the securities markets make them more "efficient?" Or will the SEC's failure to consider *any* investor protection measures in proposing to permit private offerings to be, in effect, *public* offerings result in a further erosion of investor confidence in U.S. capital markets? The SEC's view that efficiency, competition, and capital formation are improved only when short-term compliance and other transaction costs of issuers and financial services firms are reduced, regardless of the broader effects on the health of our capital markets, makes a mockery of cost-benefit analysis.[29]

The proposing release effectively concedes what Commissioners Aguilar and Walter implied above: that the Commission has made no effort to satisfy legal or internal SEC standards. The Commission concedes that it is "proposing only those rule and form amendments that are, in our view, necessary to implement the mandate in Section 201(a)." The statement is followed by a terse acknowledgment of extensive public comments and an utterly stunning abdication of any responsibility to conduct a reasoned analysis of the rulemaking:

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[29] *See* Hearing before the Subcommittee on TARP, Financial Services and Bailouts of Private and Public and Private Programs, Committee on Oversight and Government Reform, U.S. House of Representatives (Apr. 17, 2012) (testimony of Mercer Bullard)(discussing cost-benefit bias in favor of quantifiable utilities) *available at* http://oversight.house.gov/hearing/the-secs-aversion-to-cost-benefit-analysis/.

> We appreciate the suggestions made by these commentators; however, at this time, we are not proposing these or any other amendments to Regulation D or to Form D.

It is not "appreciation" that the law requires, or that the Commission adopt the particular proposals recommended by commenters. Rather, it requires a good faith effort to evaluate reasonable alternatives.[30]

The SEC's failure to consider any alternatives to its proposal requires the re-proposal of the rule because it is now effectively prevented from considering alternatives in good faith. If it were to consider and adopt an alternative approach, it would have failed to provide an opportunity for public comment on that alternative. For example, if it were to require pre-filing of Form D – which all issuers must file regardless of whether they engage in GS&A – it would have failed to provide issuers and industry members an opportunity to comment. If it made any changes to resale restrictions or integration of offerings, the same objection could be made. The Commission specifically stated that it was "not proposing" any alternatives, almost as if it intended to foreclose the possibility that it could do anything other than adopt the rule as proposed.

Indeed, the statement accompanying the release that the comment period would be an absurdly short 30 days and that the Commission would act "shortly thereafter"[31] reinforces the impression that it does not intend and never intended to consider any approach other than what it has proposed. The Commission has conceded that it had originally planned to adopt an interim rule with no public notice or comment. While it claimed to have changed its mind, it ultimately issued a proposal that completely dismissed the extensive comments of groups representing tens of millions of investors. The Commission refused even to include the *questions* raised by commenters, as reflected in the list of questions that Commissioner Aguilar had to include in his dissent because they were excluded from the proposal.[32]

II. Accredited Investor Verification "Methods"

The proposal also violates Section 201(a)(1)'s requirement that GS&A issuers "take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission." This mandate is clear. It instructs the Commission to identify "methods" that constitute reasonable steps that issuers are required to take. Yet the Commission has not identified a single "method" that issuers must use to establish accredited investor status.

Rather, it has directly contradicted Section 201(a)(1)'s mandate by interpreting "reasonable steps to verify" to mean nothing more than what current Rule 506 already requires. The SEC's position that the "particular steps necessary to meet the proposed requirement to take reasonable steps to verify that purchasers are accredited investors would vary according to the

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[30] *See Motor Veh. Mfrs. Ass'n v. State Farm Ins.*, 463 U.S. 29 (1983) ("Vacating agency rescission of motor vehicle safety rules requiring passive restraints on ground that it failed to consider alternatives to complete rescission, such as mandatory nondetachable seatbelts.")

[31] Statement of SEC Chairman Mary Schapiro (Aug. 29, 2012) *available at http://www.sec.gov/news/press/2012/2012-170.htm.*

[32] *See Aguilar Statement, supra. See also Walter statement, supra.*

circumstances"[33] is indistinguishable from its longstanding position under current Rule 506 that "[w]hat constitutes reasonable belief will depend on the facts of each particular case."[34] The Commission openly "anticipate[s] that many practices currently used by issuers in connection with existing Rule 506 offerings would satisfy the verification requirement proposed for offerings pursuant to Rule 506(c)."[35]

The Commission blithely assumes that current verification practices are entirely adequate, notwithstanding that Congress specifically required to SEC to identify verification "methods" that issuers must use. The Commission states that "[w]e considered but have decided not to propose requiring issuers to use specified methods of verification."[36] In other words, this is not a proposal at all because a "decision" has already been made. The Commission explained:

> [w]e believe that, at present, proposing to require issuers to use specified methods of verification would be impractical and potentially ineffective in light of the numerous ways in which a purchaser can qualify as an accredited investor, as well as the potentially wide range of verification issues that may arise, depending on the nature of the purchaser and the facts and circumstances of a particular Rule 506(c) offering.[37]

The Commission provides no analysis as to how it formed this "belief."

III. GS&A Rule 506 Reasonable Belief Exemption

The SEC's failure to identify verification methods that issuers making GS&A offerings must use is related to its apparent view that it has the authority to create a reasonable belief exception under Section 201(a)(1). However, the JOBS Act grants no such authority. Congress specifically required that all purchasers in GS&A Rule 506 offerings be accredited investors.

Congress did not leave the requirement that all investors be accredited to the discretion of the Commission to modify, as even private counsel to issuers have recognized.[38] That all purchasers be accredited investors is a condition of engaging in GS&A activities and a basis for legislators' approval of the JOBS Act. While the Commission has the authority to determine how issuers satisfy the SEC's *own* accredited investor requirement, it does not have the authority to usurp a Congressional determination that no such exception should exist for GS&A Rule 506

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[33] Proposal at 63.

[34] *See* Alan J. Berkeley and Alissa A. Parisi, *Regulation D Offerings and Private Placements*, ST029 ALI-ABA 85, 93 (2012).

[35] Proposal at 25.

[36] *Id*.

[37] *Id.* at 25 - 26.

[38] *See, e.g.*, *The JOBS Act: What to Expect from the Not-So-Private Private Placement Regulations*, Kilpatrick Townsend (Apr. 24, 2012) ("the plain language of the statute does not seem to provide any room for error. Unfortunately, it is not clear that the SEC has the authority to implement this view, even if it were so inclined.") *available at* http://blogs.kilpatricktownsend.com/SecuritiesLaw/?p=40.

offerings.[39] The SEC's suggestion that the issue here is whether Congress intended to "repeal" the reasonable belief standard plainly argues too much. Congress created a new requirement that does not exist under Rule 506 and that the Commission does not have the authority to amend.

Where Congress has required that every purchaser in a GS&A offering be an actual accredited investor, the Commission cannot adopt a rule under which *no* purchaser in a GS&A offering is required to be an accredited investor. By analogy, Section 4(a)(5) of the Securities Act requires that securities sold in reliance on that provision be sold only to accredited investors and does not provide for a reasonable belief exception. An issuer cannot rely on that exemption if sales are made to nonaccredited investors -- *even if the issuer reasonably believes them to be accredited*.[40] The Commission is no more authorized to create a reasonable belief exception to Rule 506 GS&A offerings than to create such an exception to Rule 215 under Section 4(a)(5).

Similarly, Section 3(a)(11) of the Securities Act provides an exemption from registration that includes specific, objective requirements much like the accredited investor standard. It exempts intrastate offerings where the issuer is "a person resident and doing business within" the state and all purchasers are "resident within the state." As stated in Rule 147 under Section 3(a)(11), "[a]ll of the terms and conditions of the rule must be satisfied in order for the rule to be available." There is no reasonable belief exception.[41] Just as Section 201(a)(1) requires that all purchasers be accredited purchasers, Section 3(a)(11) requires that all purchasers be residents of the state in which the offering is made.[42] Where Congress has imposed a specific purchaser qualification, the Commission does not have the authority repeal that requirement by creating a reasonable belief exception.[43]

Congress's decision not to adopt a reasonable belief exception to the accredited purchaser requirement is reinforced by Section 201(a)(2)'s specific reference to the reasonable belief standard as applied in Rule 144A. Whereas paragraph (1) states only that GS&A offerings under Rule 506 must be limited to accredited purchasers, paragraph (2) states that GS&A offerings

[39] The SEC's argument that Rule 501 defines "accredited investor" to include persons reasonably believed to be accredited investors, and therefore the same term in the JOBS act includes such non-accredited investors, is inherently illogical. *See* Proposal at 28 – 29. The reasonable-belief defense applies (and makes sense) only where an investor is *not* an accredited investor, which renders absurd the argument that such a reasonable-belief, non-accredited investor *is* an accredited investor under the JOBS Act.

[40] *See* Jack H. Halperin, *Small and Exempt Offerings*, 616 PLI/Corp 547, 552 (1988) ("a reasonable belief in accredited investor status is a defense for a violation of Rule 505 but not to a violation of § 4(6), under which each investor must in fact be accredited."); John Cooper, *Win, Place, or Show Through Multiple Ownership of Thoroughbreds in Alabama*, 15 Cumb. L. Rev. 251, 333 – 34 (1984/1985) ("In determining who is an accredited investor for purposes of the exemption under section 4(6), however, the issuer's reasonable belief is no defense as it is under Regulation D, if an investor is actually nonaccredited.").

[41] *See*, *e.g.*, Mary E. T. Beach, *Unregistered Offerings of Corporate Securities Including Regulation D and Regulation A,* ST046 ALI-ABA 67, 70 (2012) ("Rule 147's requirements are absolute and there is no 'reasonable basis to believe' standard as in Regulation D.").

[42] *Cf.* Rule 902 (under Regulation S, sellers can rely on a reasonable belief that the buyer was outside the U.S.).

[43] *Cf. Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007) (vacating exemptive rule for fee-based brokerage accounts).

under Rule 144A must be limited to qualified institutional buyers *to include purchasers the issuer reasonably believes to be qualified.* Congress intended to use the words that appear in the JOBS Act, which reflect its decision not to create a reasonable belief exemption for GS&A Rule 506 offerings.

The Commission asserts that Congress did not really mean what it said. The Commission speculates that Congress must have misunderstood that Rule 144A already included a reasonable belief exception and that the reasonable-belief reference in Section 201(a)(2) therefore was superfluous.[44] The Commission believes that there *should* be a reasonable belief exception for GS&A offerings under Rule 506, so Congress must have *meant* to create one.

The context of the JOBS Act's Rule 506 provision demonstrates its intent not to create a reasonable belief exception. For GS&A sales under Rule 144A, Congress gave the Commission no choice but to permit purchases by ineligible investors if the issuer had a reasonable belief that they were eligible. Congress was explicit on this point. No such text appears on Section 201 with respect to Rule 506 offerings. Congress intentionally chose not to make such an exception to the mandate that Rule 506 purchasers be accredited investors.

The mandates under Rules 506 and 144A are virtually identical – each limits purchasers to eligible persons under the rule – but Congress chose to create a statutory reasonable belief exception in one case but not the other. There is no other reasonable way to construe this distinction, especially in light of the fact that *both rules* already incorporated a reasonable belief exception and Congress chose to adopt the statutory reasonable belief exception for only one of them.

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In conclusion, I note my concern that the Rule 506 proposal exhibits a worrisome lack of appreciation for the SEC's investor protection mission that may reflect the currently popular view that many defrauded investors have simply gotten "what they deserve." For example, a recent Congressional witness stated that the Rule 506 rulemaking "is not about protecting innocent little old ladies from fraudulent issuers," and that "those advocating" for additional investor protections are simply "seeking to protect those who are willing to lie to issuers."[45] The Commission seems to concur in this point of view in discussing investors who provide "false documentation" of their status and citing a series of private lawsuits in which "courts have been unsympathetic to attempts by investors who represented that they were accredited investors at the time of the sale of

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[44] *See* Proposal at 29 ("In our view, the difference in the language between Section 201(a)(1) and Section 201(a)(2) reflects only the differing manner in which the reasonable belief standard was included in the respective rules at the time they were adopted, and does not represent a Congressional intent to eliminate the existing reasonable belief standard in Rule 501(a) or for Rule 506 offerings.").

[45] Joint Hearing of Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs, Committee on Oversight and Government Reform, and Subcommittee on Capital Markets and Government Sponsored Enterprises, U.S. House of Representatives (Sep. 13, 2012) (testimony of Jeffrey J. Van Winkle, Partner, Clark Hill PLC, on behalf of the National Small Business Association) *available at* http://financialservices.house.gov/uploadedfiles/hhrg-112-ba16-wstate-jvanwinkle-20120913.pdf.

securities,"[46] as if the accredited investor standard has never been anything more than a protective device designed to serve the interests of dishonest investors.

To the contrary, the focus here should be the fraud that will result from relaxing a GS&A ban that the Commission had stood behind for decades, rather than the abusive practices of investors who lie about their accredited investor status and then seek to recover their losses. As the Commission is aware, those who are paid to sell securities have a financial incentive to obtain whatever representations are necessary to close the deal, including suborning misrepresentations about investors' net worth and income. It is stunningly naïve to suggest that the victims of securities fraud under amended Rule 506 will not include "innocent little old ladies" and other archetypal victims of Bernie Madoff's fraud.[47] There will be brokers who will create fraudulent paperwork on behalf of "innocent little old ladies" and other vulnerable investors in order to qualify them for private offerings.[48] Unfortunately, the approach to regulating GS&A activities that the Commission has proposed provides no additional measures to incentivize broker-dealers to establish compliance procedures that are reasonably designed to prevent such fraud.

I appreciate the opportunity to comment on the SEC's proposal – especially when some have opposed even complying with the notice and comment requirements of the APA – and respectfully request that the Commission re-propose its rule and give full consideration to the comments of all interested parties.

Sincerely,

Mercer Bullard
President and Founder
Fund Democracy, Inc.

cc: Honorable Mary Schapiro, Chairman
Honorable Elisse Walter, Commissioner
Honorable Luis Aguilar, Commissioner

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[46] *See* Proposal at footnote 79.

[47] *See, e.g.,* Leslie Scism, *Annuity Case Chills Insurance Agents*, WSJ.com (Mar. 18, 2012) (describing felony-theft conviction of insurance agent for fraudulent sale of indexed annuity to 83-year-old woman).

[48] *See generally Senior Financial Exploitation Study*, CFP Board of Standards (Aug. 2012) http://www.cfp.net/downloads/CFPBoard_Senior_Financial_Study_2012-08-20.pdf*; Family Members, Caregivers, Swindlers are Top Financial Exploiters of Older Americans*, Elder Investment Fraud and Financial Exploitation Prevention Program (Aug. 2012) *available at* http://www.investorprotection.org/downloads/pdf/learn/press/IPT-IPI_EIFFE_Expert_Survey_News_Release_08-15-12.pdf; *Survey: More Than 4 Out of 5 Experts Say Financial Abuse of Elderly Is Getting Worse*, Elder Investment Fraud and Financial Exploitation Prevention Program (June 2012) *available at* http://www.investorprotection.org/downloads/pdf/learn/press/IPT_Elder_Fraud_Survey_News_Release_06-13-12.pdf; Naomi Karp and Timothy Ryan Wilson, *Protecting Americans with Diminished Capacity*, AARP (Nov. 2011) *available at* http://www.aarp.org/money/investing/info-11-2011/diminished-capacity-investor-protection.html; *Senior Investor Alert: Free Lunch Seminars*, NASAA (Sep. 2007) *available at http://www.nasaa.org/1950/senior-investor-alert-free-meal-seminars/.*

Honorable Troy Paredes, Commissioner
Honorable Daniel M. Gallagher, Commissioner

Meredith Cross, Director, Division of Corporation Finance
Norm Champ, Director, Division of Investment Management
Mark Cahn, General Counsel, Office of General Counsel