Consumer Federation of America

October 3, 2012

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

Re: File Number S7-07-12
Eliminating the Prohibition against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings

Dear Ms. Murphy:

I am writing on behalf of the Consumer Federation of America[1] to express our strong opposition to the Commission's proposed rule to lift the ban on general solicitation and advertising in private offerings. While we recognize that the Commission is required by the JOBS Act to lift the general solicitation ban, the Commission is not relieved of either its authority or its responsibility to ensure that investors are adequately protected and market integrity is maintained as it does so. The proposed rule fails that test. As Commissioner Luis Aguilar has stated, "it presents a framework that is not balanced and fails to address the acknowledged increased vulnerability of investors."[2]

The following are among our most serious concerns with the rule proposal put forward by the Commission:[3]

- It fails to adopt clear, enforceable standards to ensure that issuers take reasonable steps to verify the accredited investor status of those who invest in these offerings and to do so in a way that protects the interests of those investors.

- It fails to assess the adequacy of the current accredited investor definition to ensure that those who invest in private offerings have the financial sophistication to assess the risks

[1] The Consumer Federation of America (CFA) is an association of nearly 300 non-profit consumer organizations that was established in 1968 to advance the consumer interest through research, advocacy, and education.

[2] "Increasing the Vulnerability of Investors," Statement by Commissioner Luis A. Aguilar, U.S. Securities and Exchange Commission Open Meeting, August 29, 2012.

[3] In commenting on the rule proposal, we will limit our comments to those concerning Rule 506 offerings.

of these investments based on the limited information that may be available and the wealth to withstand potential losses.

- It fails to take additional steps to ensure that regulators have the tools they need to police the market, ignoring both a record of problems in this market and concrete suggestions that have been put forward that would provide those tools.

- It fails to anticipate and address problems that are certain to arise as a result of hedge fund and private equity fund advertising based on unsubstantiated, inconsistently calculated performance claims in the absence of a standard for reporting performance.

Unaccountably, the Commission only requests comment on its proposed approach to verification of accredited investor status and its proposed addition of a checkbox to Form D, dismissing without justification other issues and alternative regulatory approaches that have been brought to its attention. In fact, the only "explanation" the Commission does offer – that it is considering only those rule and form amendments necessary to implement the mandate – is patently untrue; the addition of a checkbox to Form D, while appropriate as far as it goes, is no more necessary to implement the mandate than other alternatives, including other amendments to Form D, that have been suggested.[4]

Because the Commission does not even request comment on these other alternative regulatory approaches, it would not be possible to adopt a minimally acceptable rule based on this proposing release. Moreover, the Commission's failure to consider these alternative regulatory approaches is a clear violation of both the standard imposed by the U.S. Court of Appeals for the District of Columbia Circuit in its decision on the proxy access case[5] and the Commission's own recently released guidelines for economic analysis.[6] This suggests that a rule adopted pursuant to this proposing release would be highly vulnerable to legal challenge. It also sends the disturbing message that the Commission believes rules such as this that roll back long-standing investor protections do not have to meet the same rigorous standard for economic analysis that it applies to rules to strengthen investor protections, such as those it is required to adopt under the Dodd-Frank Wall Street Reform and Consumer Protection Act.[7]

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[4] Eliminating the Prohibition against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Release No. 33-9354 (August 29, 2012). At pages 9-10, the release states: "In this release, we are proposing only those rule and form amendments that are, in our view, necessary to implement the mandate in Section 201(a). We recognize that commentators have urged us to consider and propose other amendments to Regulation D or to Form D that they believe are appropriate in connection with implementation of the rule and form amendments proposed here … 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."

[5] *Business Roundtable v. SEC*, 647 F.3d 1144, 1150 (D.C. Cir. 2011).

[6] *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) *available here*.

[7] Given that many of those rules, including all-important rules to implement the derivatives title of the Act, are more than a year past their statutory deadline for completion, the Commission cannot justify its decision to rush through this and other JOBS Act rules on the grounds that the statutory deadline for completion of rulemaking has passed.

Regardless of what one thinks of the Appeals Court decision in the proxy access case or the Commission's guidelines for economic analysis, and we have concerns about both, for the Commission to adopt such a double standard in its conduct of economic analysis is a repudiation of its investor protection mandate and a violation of the public trust. The only acceptable alternative is for the Commission to withdraw this rule proposal, to conduct a meaningful economic analysis that carefully weighs the risks to investors and alternative regulatory approaches to minimize those risks, and to issue a new proposal that incorporates and requests comments on those alternatives.

Background

As described (albeit briefly) in the proposing release, the Regulation D private offering market is large and active. An estimated $895 billion was raised through Rule 506 offerings in 2011, including both equity and debt, and an estimated $902 billion was raised in 2010. By way of comparison, $984 billion was raised in registered offerings in 2011, just under the $1.07 trillion that was raised in registered offerings in 2010. Rule 506 offerings are, as the Commission notes in the proposing release, "by far the dominant type of offering in the Regulation D market… In 2011 and 2010, the estimated amounts raised in Regulation D offerings exceeded the amounts raised in all other private offerings (Rule 144A offerings, Regulation S offerings, and other Section 4(a)(2) offerings), public debt and public equity offerings, combined. In 2009, the estimated amounts raised in Regulation D offerings were second only to the amounts raised in public debt offerings."

This market is characterized not only by the large amount of capital raised, but also by the large number of offerings. In a presentation late in 2011, Craig M. Lewis, SEC Chief Economist and Director of the Division of Risk Strategy and Financial Innovation, estimated that 37,000 such offerings had been conducted since 2009, with a median offering size of just $1 million.[8] The proposing release reports that 18,174 issuers filed an initial notice on Form D in 2011, of which 16,692 relied on the Rule 506 exemption. This almost certainly understates the total number of such offerings since, as Commissioner Elisse Walter noted in her public statement on the rule proposal, many issuers today fail to file Form D, despite the requirement to do so. The proposing release further states that at least 3,823 of those filing Form D in conjunction with Rule 506 offerings in 2011 were small issuers, and it suggests that this too understates the total number, since more than half of issuers failed to report their size. In short, whether you look at the overall amount of capital raised, the number of offerings, or the ability of small issuers to avail themselves of these offerings, there is no evidence that the ban on general solicitation and advertising is seriously constraining small company access to capital in this market and thus no justification for rushing to lift that ban without careful consideration of the consequences.

As many commenters have noted, dismantling the ban on general solicitation and advertising fundamentally alters the nature of these offerings. Exempt from the registration requirements that apply to public companies, they are sold based on far more limited information. The existing law addresses that risk in part by requiring that they be sold in a "private" offering only to investors with whom the issuer has an existing relationship. As then

[8] See Craig Lewis, "Unregistered Offerings and the Regulation D Exemption" (2011) (Powerpoint slides).

North American Securities Administration Association (NASAA) President Jack Herstein testified before the Senate Banking Committee in December 2011, "Given their knowledge of the company and its operations, these investors are in a better position than the general public to gauge the risks of the investment. They, therefore, have less need for the protections that flow from the securities registration process."[9]

By requiring the Commission to lift the ban on general solicitation and advertising, the JOBS Act strips away these protections, particularly for the individuals who qualify as accredited investors by virtue of their income or net worth. This has been called "a radical change that would dismantle important rules that govern the offering process for securities,"[10] a "profound change" that is likely to have "unintended consequences,"[11] and "a significant change in the securities framework that greatly increases the vulnerability of investors."[12] Moreover, lifting the ban on general solicitation opens the way to a variety of forms of marketing, some of which are relatively open and transparent (e.g., television, radio, and Internet ads) and others of which are not (e.g., telemarketing calls and email solicitations). Effectively policing the former will put a strain on the Commission's limited resources; effectively policing the latter will be beyond the agency's capabilities.

In their statements on this rulemaking, both Commissioner Walter and Commissioner Aguilar highlight this key point, that lifting the ban on general solicitation will make it easier for perpetrators of fraud to attract victims. NASAA pointed out in a recent letter to the Commission that there are already indications of significant abuses in the market. As evidence, they noted that "the Justice Department recently indicted two executives of Provident Royalties LLC in connection with a $485 million fraud against 7,700 investors in private placements. In 2011, states brought more than 200 enforcement actions for fraudulent Rule 506 offerings. Unfortunately, the number of frauds and the amount of damages can be expected to increase when it becomes easier to solicit victims under Rule 506."[13] But anti-fraud authority alone is not sufficient to address the problem, as Commissioner Aguilar pointed out: "Ask investors what it is like to be defrauded. In most cases, much of investors' monies are long gone by the time the fraud is identified and an action can be brought. It is the Commission's job to prevent investors

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[9] Testimony of Jack E. Herstein, President of the North American Securities Administrators Association, Inc. and Assistant Director of the Nebraska Department of Banking & Finance, Bureau of Securities, before the Senate Committee on Banking, Housing, and Urban Affairs, "Spurring Job Growth Through Capital Formation While Protecting Investors," December 1, 2011.

[10] Ibid.

[11] Opening Remarks Regarding the Proposal of Rules Eliminating the Prohibition against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Commissioner Elisse B. Walter, U.S. Securities and Exchange Commission, August 29, 2012.

[12] Statement of Commissioner Aguilar.

[13] August 15, 2012 letter from Jack Herstein, President of the North American Securities Administrators Association, to SEC Secretary Elizabeth M. Murphy urging the Commission to follow normal rulemaking procedures in lifting the ban on general solicitation because of the many complex issues it must address in the rulemaking.

from being harmed. True investor protection requires mechanisms to deter and prevent fraud before it begins."[14]

The enhanced risks associated with lifting the general solicitation ban are particularly troubling in light of apparent short-comings in the Commission's past oversight of this market. For example, the SEC Office of Inspector General noted in a March 2009 report, that, "CF [the Division of Corporation Finance] does not substantively review Form D filings, determine whether issuers appropriately use the Regulation D exemptions, and generally does not take action when CF staff learn that issuers are non-compliant with the rules of Regulation D. There are many different types of abuses and non-compliance issues involving Regulation D, including illegal securities offerings, which could be addressed by appropriate CF [Division of Corporation Finance] or Commission action."[15] We are unable to determine whether or to what degree these shortcomings have since been addressed. At least one problem identified in the Inspector General's report – that "there are simply no tangible consequences when a company fails to file a Form D" – appears to have gone unaddressed.

Long experience has taught us that, if a market becomes tarnished by fraud, legitimate companies will find it more difficult and costly to raise capital. The Commission's experience in the 1990s with regard to Rule 504 offerings is instructive in this regard. Rule 504 offers an exemption for unregistered companies seeking to raise a small amount of seed capital. In 1992, as part of an effort to promote small company capital formation, the Commission amended the rule to "eliminate all restrictions on the manner of offering and on resales under Rule 504," thus permitting general solicitation and advertising for all Rule 504 offerings.[16] Within a few years of amending the rules, however, the Commission had noticed a significant increase in fraud associated with "microcap" companies relying on the Rule 504 exemption. Having found that the elimination of the general solicitation and advertising ban had contributed to the increase in fraud, the Commission restored the ban.[17] In doing so, it cited the concern that, "Without action to hinder the use of securities issued under Rule 504 for fraudulent purposes, small businesses could be unfairly impacted by the taint that might attach to Rule 504 offerings."[18] It further noted that, "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."[19]

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[14] "Increasing the Vulnerability of Investors."

[15] U.S. Securities and Exchange Commission, Office of Inspector General, Office of Audits, "Regulation D Exemption Process," Report No. 459 (March 31, 2009).

[16] *Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption,* Release No. 33-7644, February 26, 1999, available here.

[17] Ibid.

[18] *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.

[19] Ibid.

All these factors – the size and importance of this market, past experience demonstrating that lifting the ban on general solicitation and advertising can be expected to increase the incidence of fraud, weaknesses in the Commission's oversight of this market, and evidence of abuse – argue for an approach to rulemaking in this area that incorporates extensive new investor protections to counter the widely acknowledged increased risk to investors that will result from eliminating the solicitation ban.

The Rule Proposal

Section 201 of the Jumpstart Our Business Startups Act (JOBS Act) requires the Commission to lift the ban on general solicitation and advertising in Rule 506 offerings, but it specifies that "all purchasers of the securities" must be accredited investors. In addition, it directs the SEC to adopt rules to "require the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission." To implement the statute, the SEC is proposing a new Rule 506(c), which would permit the use of general solicitation to offer and sell securities under Rule 506, provided that:

- the issuer takes (unspecified) reasonable steps to verify that the purchasers of the securities are accredited investors;

- all purchasers of securities are accredited investors, either because they come within one of the enumerated categories of persons that qualify as accredited investors or because the issuer reasonably believes that they do, at the time of the sale of the securities; and

- all terms and conditions of Rule 501 and Rules 502(a) and 502(d) are satisfied.[20]

Rather than setting specific standards for verification of accredited investor status, the Commission proposes an approach under which a determination of whether the verification steps were reasonable would be based exclusively on the particular facts and circumstances of the transaction. In addition, the Commission proposes to add a checkbox to Form D indicating whether the issuer plans to engage in general solicitation and advertising of the offering.

Proposed Approach to Verification Offers Inadequate Investor Protections

In lifting the ban on general solicitation in Rule 506 offerings, the JOBS Act specifically requires the Commission to identify "methods" issuers must adopt constituting "reasonable steps" to verify the accredited status of all investors in the offering. This is in direct contrast to the JOBS Act standard for Rule 144A offerings, which requires only that the issuer have a reasonable belief that all investors are Qualified Institutional Buyers. The Commission's proposed approach regarding verification of accredited investor status fails to satisfy the

[20] Rule 501 contains the definitions relevant to Regulation D, including the definition of accredited investor. Rule 502(a) specifies that sales within a certain time that are part of the same Regulation D offering must be "integrated," meaning they must be treated as one offering. Rule 502(d) restricts the ability to resell securities acquired through 506 offerings without registration or an exemption from registration requirements.

statutory requirement on two grounds: it fails to specify any methods for verification and it indirectly reaffirms the "reasonable belief" standard the statute intended to replace.[21]

In refusing to set clear, minimum standards for reasonable verification steps, the Commission appears to have taken its cue from commenters who have suggested that the existing system of verification is working well. However, the Commission fails to provide any evidence to support this assumption. Indeed, the Commission does not even provide a meaningful discussion of existing practices for verification necessary to allow commenters to draw their own conclusions. Nor does it acknowledge that lifting the ban on general solicitation fundamentally changes the conditions under which verification will occur, rendering any conclusion that the current system is working well invalid as a measure of how the system would work once the ban is lifted.

Instead of specifying reasonable steps that issuers must follow, the Commission proposes to rely on an after-the-fact determination of whether the steps taken were in fact reasonable. Absent clear guidelines, such an approach will be difficult to enforce. Particularly when combined with the agency's continued reliance on a reasonable belief standard, it all but guarantees a lax approach to verification by certain issuers that will result in inappropriate sales of Rule 506 offerings to non-accredited investors. This is particularly troubling given the lack of resources the Commission has traditionally devoted to oversight of this market and its record of inaction in the face of rule violations, as described in the 2009 Inspector General's report.[22]

The justification the Commission offers for its proposed approach is also completely inadequate. The Commission states the obvious, that verification steps would likely vary depending on the type of accredited investor. The obvious solution to this non-problem is to adopt different verification standards for different types of accredited investors. To the degree that the Commission is concerned about creating loopholes that could be exploited by issuers if it specifies concrete "reasonable steps," this can easily be addressed by combining a broad, principles-based requirement of the type the Commission has proposed with specific guidelines regarding what would constitute reasonable steps in different circumstances and for different types of accredited investors. If the Commission is concerned that specifying verification standards could inappropriately limit otherwise acceptable approaches, it could adopt a system for reviewing and approving any such alternative approaches issuers wish to adopt. In short, none of the arguments the Commission has put forward justify its ignoring clear congressional intent that it specify methods for complying with the "reasonable steps" requirement.

Ultimately, the steps necessary to determine whether an investor in the Rule 506 offering is accredited by virtue of being a broker-dealer, for example, will be obvious. The real issue is what the Commission proposes to require with regard to verification of income or net worth for natural persons claiming accredited investor status. This is an area of particular and heightened risk for investors, since it could require them to expose sensitive financial details in order to

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[21] The Commission does this by incorporating the reasonable belief prong of the accredited investor definition in its proposed approach.

[22] U.S. SEC OIG, "Regulation D Exemption Process."

document their income or net worth to an issuer with whom they have no previous relationship. In light of that risk, it is incumbent on the Commission to propose verification standards that balance the need to ensure that Rule 506 offerings are sold only to accredited investors with the need to ensure that investors' financial security is not put at risk. One solution that has been proposed is to encourage reliance for verification on reliable third parties, such as brokers, investment advisers, accountants, banks and attorneys. It seems reasonable to conclude that any individual who meets the income or net worth test for the accredited investor definition would have a relationship with one or more of these types of entities. Thus, it ought to be possible to develop an approach to third-party verification that simultaneously protects the privacy and security of individual investors' financial data and enables their participation in Rule 506 offerings with a minimum of regulatory burden on issuers or investors.

The Commission suggests in the proposing release that reliance on third parties for verification would be permissible if the issuer has reason to believe the third party is reliable. It offers no guidance on what constitutes reasonable belief in this context, nor does it suggest what obligations those third parties would have in fulfilling their verification responsibilities. These obligations should include, at a minimum, an obligation to maintain the accuracy of the information, to keep the information current, and to safeguard investor data. Without such standards, there is potential for pre-screened lists of the type to which the Commission refers to in the proposing release to be unreliable, insufficiently rigorous in protecting investors' information privacy and security, or both. For such a system of third-party verification to develop, therefore, and to develop on terms that benefit investors and promote market integrity, the Commission needs to adopt clear standards to permit and to define the conditions for its use. This should include standards both for the providers of third-party verifications and those who seek to rely on their services.

The Commission's proposed approach to verification fails even the minimal test of ensuring that it will not invite "liar's loan" practices into the Rule 506 market. Several commenters have suggested that such practices – e.g., self-certification through a checkbox on a questionnaire – ought to be accepted. It is logical to conclude that, without clear standards from the Commission precluding this and similar approaches, such practices are likely to be adopted, at least by some issuers. The Commission opines in the proposing release that self-certification would not be adequate where an issuer solicits new investors through "a website accessible to the general public or through a widely disseminated email or social media solicitation." It fails, however, to offer any meaningful guidance on what additional steps would be required under those circumstances. Moreover, it implies that self-certification might be acceptable in other circumstances, which would in our view be a clear violation of the statute's "reasonable steps" requirement.

Lifting the ban on general solicitation greatly increases the risks that Rule 506 offerings will be inappropriately sold to non-accredited investors. The approach to verification of accredited investor status proposed by the Commission is not adequate to protect against this risk. Nor does it do enough to ensure that verification is conducted in a manner that adequately protects investors' information privacy and security. Indeed, the proposed approach offers the worst of both worlds: inadequate protections for investors and insufficient clarity for issuers. The Commission needs to start from scratch to adopt clear standards governing verification of accredited investor status. As part of that revised approach, it must eliminate its indirect incorporation of a reasonable belief standard that is in direct conflict with the statutory mandate that all investors in offerings sold through general solicitation and advertising be accredited investors and that the Commission specify methods issuers must follow to ensure that this is the case.

Form D Checkbox Will Offer Limited Benefits Without Additional Form D Revisions

An issuer offering or selling securities in reliance on Rule 506 is required to file notice with the Commission for each new offering no later than 15 days after the first sale of securities using Form D. Because the exemption is not conditioned on the filing of Form D, however, and because the Commission apparently does not enforce the requirement, filing the form "for practical purposes is essentially voluntary," as Commissioner Aguilar explained in his public statement on the rule proposal. Commissioner Walter similarly noted that, "Notwithstanding the requirement to file Form D, many issuers fail to do so."

A number of recommendations have been suggested to make the Form D filing requirement more meaningful. These include:

- making filing of the form a condition of relying on the exemption;
- requiring the form to be filed 30 days in advance of the offering;
- requiring inclusion on the form of a brief description regarding plans for general solicitation; and
- requiring inclusion on the form of a brief description regarding plans for verification of accredited investor status.

In its rule proposal, the Commission has chosen to ignore these suggestions and has proposed only the addition of a checkbox to Form D indicating whether the issuer plans to engage in general solicitation.

In making the case for this change, the Commission suggests that addition of the checkbox would "assist our efforts to monitor the use of general solicitation in Rule 506(c) offerings and the size of this offering market" and "help us to look into the practices that would develop to satisfy the verification requirement." These are worthy goals, and it is within the Commission's power to achieve those goals through revisions to Form D. Without additional changes to Form D filing requirements, however, the SEC's proposal is unlikely to afford either of the benefits ascribed to it.

- The SEC won't gain any additional information from issuers who ignore the filing requirement. If it hopes to rely on Form D to help it monitor market developments, and we believe it should, it must take steps to ensure the forms are filed. The most logical way to achieve that is by conditioning the Reg. D exemption on the filing of Form D.

- Assuming the form is filed, a checkbox alone will not provide any meaningful information about the nature of general solicitation practices and thus will be of limited use in helping the Commission to monitor developments in this market. Because the form can be filed after general solicitation has commenced, it won't even provide regulators with a heads-up regarding offerings that may need additional scrutiny. The most logical way to address these short-comings in the Commission's proposed approach is to require the issuer to include a brief description of their plans for solicitation and advertising on the form and to require the form to be filed in advance of the first sale.

- Adding a checkbox regarding general solicitation plans will do nothing to provide the Commission with additional information regarding accredited investor verification practices. If the Commission wishes to monitor these practices, and we believe it must, it can best achieve that by requesting information on Form D regarding the issuer's verification plans. This is advisable even if the Commission follows our recommendation to set clear standards for verification, since presumably those standards will allow issuers some flexibility. It is essential if the Commission persists in its plans to adopt a facts and circumstances based approach to assessing the reasonableness of issuers' verification practices.

Monitoring the Rule 506 offering market poses significant challenges, both because of the large number of offerings and the relatively small size of many of those offerings. Opening the way to general solicitation and advertising practices will only increase the challenge. As Commissioner Walter explained, "because general solicitation is currently prohibited for almost all private offerings, today the presence of general solicitation efforts in connection with a non-registered offering is a red flag, not only of a registration violation but also potential fraud. In a world where general solicitation is permitted, fraud could be more difficult to detect and to prove. Thus, it is important that the Commission and other regulators receive notice and basic information about offerings that are occurring in order to help prevent investor harm from fraud or other unlawful offerings."

In order to improve the Commission's ability to monitor the market, and achieve the benefits the Commission ascribes to its checkbox proposal, we believe the Commission must at a minimum condition reliance of the Regulation D exemption on the filing of Form D, require the form to be filed 30 days in advance of any solicitation activities, require issuers who plan to engage in general solicitation to provide a brief description of their solicitation plans, and require issuers to also include a brief description of their plans with regard to verification of accredited investor status. Indeed, the Commission states in the proposing release that it intends to monitor developments with regard to verification practices. It is difficult to see how the Commission could fulfill that promise unless it adopts these additional changes. The Form D filing requirement could provide greater benefit to investors as well if its content was expanded to include basic information about the issuer, such as the identity of any controlling persons, the issuer's Internet address, the size of the offering, and the issuer's proposed business and use of proceeds.[23]

[23] Former SEC Commissioner Joseph Grundfest has suggested an approach that would achieve the same goal by creating a new Form GS for use by those issuers who plan to engage in general solicitation. Grundfest, who is the William A. Franke Professor of Law and Business and Senior Faculty with the Rock Center on Corporate

As Commissioner Aguilar explained, this approach offers significant advantages: "First, it would prevent any issuer that fails to file a notice from claiming that improper advertising or solicitation activities were intended as part of a legitimate Rule 506 transaction. This could reduce the amount of such activity by issuers seeking to condition the market or otherwise abuse the exemption. Second, it would provide a mechanism for potential investors to identify the source of an offer, to facilitate some degree of due diligence. Third, it would provide a mechanism for regulators to be made aware of a 'mass marketed' offering before it is launched." We agree. Indeed, we do not believe the Commission will be able to adequately monitor the market without these changes.

Others, including former SEC Commissioner and Stanford Law Professor Joseph A. Grundfest, have suggested that the Commission should go further and require Rule 506 issuers who plan to engage in general solicitation to furnish their solicitation materials to the Commission either prior to or promptly following first use.[24] Under this approach, the regulations would make clear that solicitation materials not furnished to the Commission would not qualify for the exemption. We agree with Professor Grundfest that imposing such a requirement would improve the Commission's ability to monitor market practices and identify potential instances of fraud and could even help to deter fraud. Indeed, in a previous letter, we offered a similar proposal, in our case requiring all such material to be pre-filed with FINRA, which already pre-reviews broker-dealer advertising.[25] Moreover, we believe that, properly implemented, all these changes to Form D, including the requirement that issuers furnish solicitation material to the Commission, could be adopted without adding significant costs or burdens to the capital formation process.

Governance at Stanford Law School, originated the proposal, which was included in a recommendation made by the Investor as Purchaser Subcommittee of the SEC's Investor Advisory Committee at its September 28, 2012 meeting. We are neutral with regard to whether this is accomplished through a new form or through revisions to Form D, but we agree that the pre-solicitation filing requirement included in Professor Grundfest's proposal is essential.

[24] This approach has also been developed by Professor Grundfest during deliberations of the Investor as Purchaser Subcommittee. As envisioned by Professor Grundfest, the Commission would create an online electronic "drop box" into which all general solicitation material can be deposited, together with a cover form identifying the issuer using the general solicitation material and the circumstances under which the material is to be used. The drop box would be designed to be able to accept print, audio and video forms of general solicitation.

[25] *See* Letter from Fund Democracy, Consumer Federation of America, Americans for Financial Reform, AFL-CIO, AFSCME, Public Citizen, U.S. PIRG, former SEC Chief Accountant Lynn Turner, Duke Law School Professor James D. Cox, University of Tennessee Professor Joseph V. Carcello, and Motley Fool Senior Analyst Ilan Moscovitz (Aug. 16, 2012) *available at* http://www.sec.gov/comments/jobs-title-ii/jobstitleii-60.pdf. I hereby incorporate this letter and other letters previously submitted by Consumer Federation of America: Letter from Mercer Bullard of Fund Democracy, Barbara Roper of Consumer Federation of America, and J. Robert Brown of University of Denver Sturm College of Law (Aug. 28, 2012), *available at* http://www.sec.gov/comments/jobs-title-ii/jobstitleii-74.pdf; Letter from Fund Democracy, Consumer Federation of America, Americans for Financial Reform, Consumer Action and AFL-CIO (May 24, 2012) *available at* http://www.sec.gov/comments/jobs-title-ii/jobstitleii-14.pdf.

The Proposal Ignores Other Necessary Investor Protections

A variety of other investor protections have been suggested to compensate for the increased risks that will attend the lifting of the ban on general solicitation and advertising.[26] In a clear violation of the Commission's own guidelines for economic analysis (discussed in greater detail below), the proposing release fails to give any consideration to these alternative regulatory approaches, instead adopting the least stringent regulatory approach possible.[27] We do not intend to discuss each of those proposals here. However, three stand out as deserving greater attention:

- the need to adopt the Dodd-Frank Act rulemaking disqualifying felons and other "bad actors" from relying on the Rule 506 safe harbor prior to adopting any rule to lift the ban on general solicitation and advertising;

- the need to address the potential for misleading advertising by private funds, such as hedge funds and private equity funds, either by precluding them from claiming the exemption from the general solicitation and advertising ban or, at the very least, by imposing new regulatory requirements on any such solicitation or advertising practices;

- the need to revise the definition of accredited investor to better define a population of investors with the financial sophistication to understand the risks inherent in private offerings and the wealth to withstand potential losses.

It is frankly inconceivable that the Commission has chosen to ignore these issues in its rule proposal and to do so without explanation or justification.

Bad Actor Disqualification: Before Congress enacted the JOBS Act lifting the ban on general solicitation and advertising in Rule 506 offerings, it passed the Dodd-Frank Act disqualifying felons and other "bad actors" from relying on the Rule 506 safe harbor. The Dodd-Frank Act set a one-year deadline for rulemaking to implement the requirement. Although the Commission issued a proposed rule in May 2011, it has yet to finalize that rule more than two years after the legislation was passed and more than one year past the rulemaking deadline. We do not believe the Commission can or should lift the ban on general solicitation and advertising until it has first finalized the bad actor rule. We fully concur with the argument put forward in a separate letter from Mercer Bullard of Fund Democracy in which he states that, "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."[28] That the Commission would even consider doing so reflects how far it has strayed from its investor protection mission.

[26] *See, for example* Letter from Fund Democracy et al (Aug. 16, 2012).

[27] Indeed, as discussed above, the proposed regulatory approach does not even comply with the statutory requirement to ensure that all investors are accredited or to specify reasonable steps issuers must take to verify accredited investor status.

[28] *See* Letter from Mercer Bullard, President and Founder of Fund Democracy, Inc. (Oct. 2, 2012) *available at* http://www.sec.gov/comments/s7-07-12/s70712-89.pdf.

Private Fund Advertising: When Congress was considering the JOBS Act, including the provision lifting the ban on general solicitation and advertising in Rule 506 offerings, it emphasized the act's potential to increase capital formation opportunities for small start-up companies. [29] It was only after the JOBS Act was adopted that significant attention was paid to the fact that hedge funds and private equity funds with no such claims to job creation[30] would also be able to take advantage of the relaxed solicitation and advertising constraints, absent action by the Commission to restrict their ability to claim the exemption. Indeed, according to data provided earlier this year by the Commission's Division of Risk, Strategy and Financial Innovation, private investment pools are the largest group of issuers relying on Rule 506 to conduct private offerings, representing 29.2 percent of all Regulation D offerings in 2009 and 2010, with a little over half of those (55 percent) constituting offerings by hedge funds.[31]

The potential for this rule to permit unlimited and unregulated advertising by private funds raises significant issues that deserve far greater attention than they have been given in this rule proposal. As the Investment Company Institute (ICI) noted in an earlier letter to the Commission, the existing rules for mutual fund advertising represent "the culmination of more than 60 years of practical regulatory experience with the potential for investor confusion over fund performance advertising."[32] For the Commission to ignore that experience in this rule proposal is particularly troubling given its own recognition that "hedge fund trading raises special concerns" and that hedge funds pose heightened risks for investors.[33] Among other things, the Commission has found that hedge funds have incentives to inaccurately value their assets and that they have a record of inadequately disclosing the layering of fees in funds of

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[29] *See, for example,* the statements of bill sponsor Rep. Patrick McHenry [157 Cong. Rec. H7290 (daily ed. Nov. 3, 2011)] (the bill would "allow the small business to unshackle the capital which it needs. It will allow the individual to talk to those who are accredited and it has protections to do that."); statement of Senate bill sponsor Sen. John Thune [158 Cong. Rec S183 (daily ed. Jan. 31, 2012)]("[t]his amendment would make it easier for small business to better access capital in order to expand and create jobs."); statement of Rep. Don Manzullo [157 Cong. Rec. H7293 (daily ed. Nov. 3, 2011)]("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."). This is just a small sampling of the statements emphasizing the goal of promoting small company access to capital. We have failed to identify any comparable statements highlighting its loosened regulations for hedge fund and private equity fund advertisements.

[30] Ironically, as *The Economist* recently noted, private equity firms are as likely to destroy jobs as to create them and private equity ownership "leads to significant job losses when public companies are taken over." *See* M.C.K., "Private equity: The propaganda versus the facts," *The Economist* (Sept. 21, 2012) *available at* http://www.economist.com/blogs/freeexchange/2012/09/private-equity.

[31] *See* Vlad Ivanov and Scott Bauguess, *Capital Raising in the U.S.: the Significance of Unregistered Offerings Using the Regulation D Exemption* (February, 2012), available at http://www.sec.gov/info/smallbus/acsec/acsec103111_analysis-reg-d-offering.pdf .

[32] *See* Letter from Paul Schott Stevens, President and CEO of the Investment Company Institute (May 21, 2012) *available at* http://www.sec.gov/comments/jobs-title-ii/jobstitleii-13.pdf.

[33] *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. *See, also,* Letter from Mercer Bullard (Oct. 2, 2012), with which we fully concur.

hedge fund structures.[34] Moreover, the 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." [35] And, as the Commission has previously acknowledged, private fund "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 returns."[36]

In light of these concerns, we agree with ICI that it is not enough to rely on antifraud rules to protect investors from these risks. "As the Commission's experience with performance advertising shows, an antifraud requirement alone will not stop firms from publishing unsubstantiated, misleading, and 'eye-catching' claims of performance. It is imperative that the Commission take the necessary steps to protect investors."[37] Ideally, as we have previously stated, the Commission should simply prohibit funds that rely on the exemptions under Section 3(c)(1) and (7) of the Investment Company Act from engaging in general solicitation and advertising. Such a ban would be completely consistent with the JOBS Act's focus on promoting capital formation for small start-ups. Short of an outright prohibition on general solicitation and advertising by private funds, the Commission should at the very least adopt clear standards for the reporting of performance and fees by private funds, and delay their eligibility from engaging in general solicitation and advertising until such time as those standards are in place. Finally, to reduce the potential for investor confusion, if private fund advertisements are permitted, they should be required to carry a clear, prominent warning that they are not mutual funds and carry special risks.

<u>Accredited Investor Definition</u>: In 1953, the Supreme Court rules in *SEC v. Ralston Purina* that the application of the non-public offering exemption turned on whether those to whom the securities were offered were able to fend for themselves and had access to the kind of information that would be disclosed with registration.[38] The ban on general solicitation and advertising was intended to ensure that Rule 506 offerings were only sold to investors with whom the issuer had an existing relationship. The notion was that these investors would have greater knowledge of the company and its operations and thus would be better able to assess the risks of the investment. Lifting the ban on general solicitation and advertising strips away this protection. That leaves the provision restricting sales to accredited investors as the sole justification for the private offering exemption.

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[34] Ibid.

[35] *Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles*, Securities Act Rel. No. 8766, at 74 (2006) *available at* http://www.sec.gov/rules/proposed/2006/33-8766.pdf.

[36] *Ibid.* at 17.

[37] Letter from Paul Schott Stevens (May 21, 2012).

[38] *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953).

The Commission recognized this trade-off when it proposed a partial lifting of the ban on general solicitation and advertising in 2007. In issuing its proposal, the Commission acknowledged "the potential harm of offerings by unscrupulous issuers or promoters who might take advantage of more open solicitation and advertising to lure unsophisticated investors to make investments in exempt offerings that do not provide all the benefits of Securities Act registration." It concluded that its proposal was appropriate "given the additional safeguards we have proposed."[39] Chief among them was an increase in the thresholds for the accredited investor definition. It is difficult to fathom how the Commission can now propose to eliminate the ban on general solicitation and advertising without including any such additional safeguards. As we have noted before, the fact that the Commission is required by the JOBS Act to lift the ban does not absolve it of responsibility for adopting appropriate safeguards as it does so.

Applying the test that the Supreme Court defined, the question for the Commission is whether the current definition of accredited investor reliably identifies a population of investors capable of fending for themselves without the added protections that registration would afford. There are strong reasons to conclude that it does not:

- The natural person income and net worth tests have been significantly eroded by inflation.

Using the Bureau of Labor Statistics online inflation calculator, we determined that an individual would have to have an income of just over $475,000 today to account for inflation since the $200,000 income threshold was set in 1982. The $1 million net worth test in 1982 is worth nearly $2.4 million today. While Congress recently removed the value of the home from the net worth calculation, which was something we have long advocated, that action by itself does not begin to address the effect that inflation has had on these definition thresholds. As explained in recent congressional testimony by Georgetown University Law Professor Robert B. Thompson: "[I]n 1982, an income of $200,000 or millionaire status in terms of net worth covered a relatively limited number of very well-off people, and did not affect all that many retail investors. That dollar amount hasn't changed in the three decades since even though inflation has brought more and more individuals within its definition, effectively extending its reach deeper into the cohort of those with smaller real incomes. Indeed measured as a percentage of the pool of individual taxpayers, the number of individuals whose income is above $200,000 is now 20 times larger than at the time of enactment of Regulation D."[40]

The Commission itself acknowledged this weakening of the standards in 2007, when it proposed to create a new natural persons standard under the accredited investor definition. In its proposing release, the Commission stated that "inflation, along with the sustained growth in

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[39] Revisions of Limited Offering Exemptions in Regulation, Securities Act Rel. No. 8828 at 38 (2007) ("Revisions of Limited Offering Exemption") *available at* http://www.sec.gov/rules/proposed/2007/33-8828.pdf.

[40] Statement of Professor Robert B. Thompson, Peter P. Weidenbruch Jr. Professor of Business Law, Georgetown University Law Center, at Hearings Before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs of the House Committee on Oversight and Government Reform and the Subcommittee on Capital Markets and Government Sponsored Enterprises of the House Committee on Financial Services (September 13, 2012), at pages 5-7, citations omitted, available at http://financialservices.house.gov/uploadedfiles/hhrg-112-ba16-wstate-rthompson-20120913.pdf.

wealth and income of the 1990s, has boosted a substantial number of investors past the 'accredited investor' standard. By not adjusting these dollar amount thresholds upward for inflation, we have effectively lowered the thresholds."[41] In short, a substantial increase in the income and net worth tests would be necessary to restore the thresholds the Commission set when it first adopted the accredited investor definition in 1982. Because lifting the ban on general solicitation would simultaneously increase the risks and decrease the protections available to accredited investors, an even stronger standard is warranted today.

- There is substantial evidence that wealth alone does not ensure that investors can fend for themselves without the protections that registration would provide.

It seems patently obvious that an income of $200,000 isn't a reliable marker of a financially sophisticated individual capable of fending for themselves in the private offering market. As one blogger recently wrote, "you just need to be a moderately successful dentist or interior designer."[42] Even the $1 million net worth test is an unreliable indicator. This population could, for example, include a recent recipient of a life insurance payout who has no previous investment experience or a retiree with a nest egg they must rely on for income throughout several decades and who can thus ill afford the risks associated with private offerings. Moreover, the record is replete with examples of frauds perpetrated against supposedly sophisticated accredited investors. The Madoff Ponzi scheme is just the most notorious of recent examples.

Given the increased importance of the accredited investor definition once the ban on general solicitation is lifted, the case for a strengthened definition is stronger than ever. It is worth noting that, before the accredited investor definition was adopted, Rule 146 required issuers to make a subjective judgment about the financial sophistication of each offeree or purchaser. While that approach may have had its short-comings, the concept of requiring some sort of measure of financial sophistication makes a great deal of sense, particularly in a market where the protections afforded by the ban on general solicitation have been stripped away.

Such an approach might include a threshold based on the amount of investments owned, for example. Both NASAA[43] and the Commission[44] have previously supported such an approach. Alternatively, the Commission could require some tangible proof of financial knowledge, such as is required for crowdfunding investors under Title III of the JOBS Act.

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[41] *See* SEC Release Nos. 33-8828 and IC-27922 (Aug. 3, 2007), 72 Fed. Reg. 45116 (Aug. 10, 2007), available at http://www.sec.gov/rules/proposed/2007/33-8828.pdf.

[42] *See* "New SEC Rules Practically Require Hedge Funds To Advertise On Dealbreaker," by Matt Levine *Dealbreaker.com* (Aug. 29, 2012) *available at* http://dealbreaker.com/2012/08/new-sec-rules-practically-require-hedge-funds-to-advertise-on-dealbreaker/.

[43] *See* Letter from David S. Massey, NASAA President and Deputy Securities Commissioner, North Carolina Department of the Secretary of State, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission (March 11, 2011) *available at* http://www.sec.gov/comments/s7-04-11/s7411-36.pdf.

[44] *See* Securities Act Release No. 8828 (Aug. 3, 2007) (proposing two-part standard for accredited investors to invest in certain private pooled investment vehicles that included ownership of a specified amount of "investments.")

Either approach would arguably do a far better job than the income and net worth tests of identifying a population of investors capable of fending for themselves without the protections afforded in the public market.

- The Commission clearly has the authority to act.

Some members of the SEC staff have suggested that the Commission currently lacks the authority to amend the accredited investor definition. They have suggested that Section 413 of the Dodd-Frank Act precludes any changes to the accredited investor definition until 2014, four years from the date of enactment. As we have argued in greater detail elsewhere, we respectfully disagree.[45] Nor do we believe there is any ambiguity in the statute on this point. Section 413 requires that the Commission refrain from raising the net worth threshold before 2014, but it places no other restrictions on the Commission's ability to act in this area. It in no way limits the ability of the Commission to adopt the types of changes we have suggested above. On the contrary:

> Section 413(b)(1) expressly authorizes the Commission to "undertake a review of the term 'accredited investor', as such term applies to natural persons, to determine whether the requirements of the definition, excluding the requirement relating to the net worth standard described in subsection (a), should be adjusted or modified for the protection of investors, in the public interest, and in light of the economy."
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> The statute further authorizes the Commission, "upon completion of a review" to "by notice and comment rulemaking, make such adjustments to the definition of the term 'accredited investor', excluding adjusting or modifying the requirement relating to the net worth standard described in subsection (a), as such term applies to natural persons, as the Commission may deem appropriate for the protection of investors, in the public interest, and in light of the economy."

The JOBS Act's elimination of the ban on general solicitation and advertising is precisely the type of development that would justify, indeed demand, a revision to the definition for the protection of investors. We believe it is incumbent on the Commission both to correct this misrepresentation of its authority and to avail itself of this authority as part of the general solicitation rulemaking. To do so will require a re-proposal of the rule.

The Proposal Violates the Commission's Own Guidelines for Economic Analysis

The Commission has in recent years proven to be extremely vulnerable to legal challenge based on the claim that it has not conducted an adequate economic analysis to justify its proposed regulatory approach. Most recently, the U.S. Court of Appeals for the District of Columbia Circuit issued a decision in *Business Roundtable and Chamber of Commerce of the United States of America v. Securities and Exchange Commission* that is highly critical of the economic analysis conducted as part of the Commission's proxy access rulemaking. In that

[45] Letter from Mercer Bullard of Fund Democracy, Barbara Roper of Consumer Federation of America, and J. Robert Brown of University of Denver Sturm College of Law (Aug. 28, 2012), *available at* http://www.sec.gov/comments/jobs-title-ii/jobstitleii-74.pdf.

decision, the Court criticized the Commission for: inconsistently and opportunistically framing the costs and benefits of the rule, neglecting to support its predictive judgments, and failing to respond to substantial problems raised by commenters, among other things.[46] Respected legal scholars have suggested that the court may have overstepped its regulatory review authority,[47] but the Commission declined to challenge the decision and adopted instead a set of guidelines for economic analysis responding to this and other criticism.[48]

In the staff memorandum outlining those guidelines, the staff identifies the following as "basic elements of good regulatory analysis": (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.[49] The staff states, moreover, that, "As a general matter, every economic analysis in SEC rulemakings should include these elements."[50] And it further specifies that the proposing release for a rule should "solicit public comment to help assess and inform the economic analysis of the alternatives." And yet, the so-called economic analysis accompanying this rule makes no pretense of defining a baseline against which to measure the likely economic consequences of the proposed regulation, fails to identify alternative regulatory approaches, fails to evaluate the relative benefits and costs of the proposed action and the main alternatives, and fails to request comment on those alternatives.

- The Commission fails to define a baseline against which to measure its proposal and alternative regulatory approaches.

The staff memorandum describes the "baseline" component of the economic analysis as the "best assessment of how the world would look in the absence of the proposed action" and as "a primary point of comparison for an analysis of the proposed regulation." As the memorandum explains, "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." The baseline in the proposing release doesn't remotely resemble the kind of analysis the staff guidelines call for.

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[46] *Business Roundtable v SEC*, 647 F.3d 1148 (D.C. Cir. 2011). (While we did not share the court's harsh view of the Commission's economic analysis in that rule, every weakness cited in the court decision is on full display in the discussion that passes for an economic analysis in this rule proposal.)

[47] *See, for example*, Cox, James D. and Baucom, Benjamin J. C., *The Emperor Has No Clothes: Confronting the DC Circuit's Usurpation of SEC Rulemaking Authority* (March 4, 2012). *Available at* SSRN: http://ssrn.com/abstract=2016433 or http://dx.doi.org/10.2139/ssrn.2016433

[48] *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.

[49] *Ibid.* at 4.

[50] *Ibid.* at 4.

Instead, it consists of three scant paragraphs which provide cursory information on the amount of money raised through Rule 506 and Rule 144A offerings in the last few years.

The following are just a few examples of the most glaring gaps in the rule proposal's baseline:

- It tells us nothing about the make-up of the market in terms of types of issuers (e.g., start-up companies versus private funds) or size of offerings. Without this information it is impossible to assess the likely impact of the rules on the small start-up companies the JOBS Act purports to benefit.

- It tells us nothing about the market in terms of investor characteristics (e.g., what percentage by number and dollar amount invested are natural persons, what percentage are institutions of various types, and whether that varies by type of offering). Without this information, it is impossible to assess the likely impact of any changes to either the proposed verification standards or the natural persons component of the accredited investor definition.

- It tells us nothing about current practices with regard to verification of accredited investor status or the incidence of sales to non-accredited investors. Without that information it is impossible to assess the adequacy of current practices or to identify potential approaches to better ensure that only accredited investors purchase securities sold under Rule 506.

- It tells us nothing about evidence of fraud and abuse in this market, nor does it mention the Commission's past experience when it lifted the ban on general solicitation and advertising in Rule 504 offerings. In particular, it fails to discuss concerns the Commission has previously raised with regard to risks associated with hedge funds. Without this information, it is impossible to assess the degree of risk posed by the elimination of the general solicitation ban, the nature of any such risks, or the best approaches for minimizing those risks.

- It tells us nothing about the erosion of the accredited investor definition or the ability of accredited investors to fend for themselves. Without this information, it is impossible to determine whether the current definition offers adequate protection, particularly once the general solicitation ban is lifted, or whether additional revisions to that definition are needed.

Much of this information is in the Commission's hands. It has simply chosen not to share this information with the public in the proposing release. For example, staffers in the Division of Risk, Strategy, and Financial Innovation have prepared presentations for the Commission's Advisory Committee on Small and Emerging Companies that contain significantly more information about the Regulation D market than the Commission has included in its proposing release.[51] The 2009 report from the SEC Inspector General's Office also includes valuable

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[51] *See, for example,* Craig Lewis, "Unregistered Offerings and the Regulation D Exemption" (2011) (Powerpoint slides) and Vlad Ivanov and Scott Bauguess, *Capital Raising in the U.S.: the Significance of Unregistered Offerings*

information about the market and the Commission's market oversight practices, information that is directly relevant to a consideration of regulatory approaches to strengthen the Commission's oversight ability. Previous Commission studies, such as its 2003 study on hedge fund fraud, and rule proposals, such as its 2007 proposal to revise the accredited investor definition, as well as information about the Commission's enforcement actions involving Regulation D offerings all would provide insight into issues relevant to the regulatory proposal and should have been addressed as part of the baseline for assessing that proposal. It would also be beneficial for the Commission to describe what information is not available, since that would be directly relevant to suggestions that the Commission should gather more information through Form D.

Before it can conduct an adequate economic analysis, the Commission must first define a baseline for assessing the rule proposal that incorporates all the relevant information about this market available to the Commission and that describes what information is not available and why. Only then will it have an adequate basis for assessing its proposed regulatory approach and reasonable alternatives to that approach.

- The Commission fails to identify alternative regulatory approaches.

The Commission's guidelines for economic analysis require it to analyze alternative regulatory approaches identified during the rulemaking process. The guidelines explain that alternatives analyzed should include "realistic approaches that are more or less stringent than the preferred option." As the staff guidelines explain, "where a party raises facially reasonable alternatives . . . [which the staff defines as those that are 'neither frivolous nor out of bounds'] the agency must either consider those alternatives or give some reason . . . for declining to do so." The proposing release fails to identify any alternative regulatory approaches, even though numerous alternatives have been suggested to the Commission during the JOBS Act comment process.

The following statement from the proposing release is the only "explanation" the Commission offers for this decision:

> In this release, we are proposing only those rule and form amendments that are, in our view, necessary to implement the mandate in Section 201(a). We recognize that commentators have urged us to consider and propose other amendments to Regulation D or to Form D that they believe are appropriate in connection with implementation of the rule and form amendments proposed here … 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.

The Commission offers no explanation for how it reached the conclusion that these rule proposals, and no others, are necessary to implement the mandate in Section 201(a) or why limiting itself to only necessary rules, rather than optimum rules, would be an appropriate approach. Moreover, the first sentence in this statement is patently false. As we noted above, there is simply no basis for claiming that adding a checkbox to Form D is necessary to

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Using the Regulation D Exemption (February, 2012), available at http://www.sec.gov/info/smallbus/acsec/acsec103111_analysis-reg-d-offering.pdf.

implement the statutory mandate, but making other changes to Form D is not. Nor is there any basis in our view for concluding that other enhanced investor protections are not necessary to address the increased risks that will result from removing the general solicitation ban. In particular, since lifting the ban on general solicitation strips away an important procedural protection for investors, it is incumbent on the Commission to reconsider whether the current definition of accredited investors provides adequate assurance that only investors who are capable of fending for themselves are participating in this private placement market.

The alternative regulatory approaches that have been suggested to the Commission are clearly neither frivolous nor out of bounds. Thus, it is a clear violation of the Commission's guidelines for economic analysis for the Commission to fail to give fair consideration to these alternatives.

- The Commission's discussion of the benefits and costs of the proposed rule lack both substance and balance.

In the proxy access case, the Appeals Court criticized the Commission for opportunistically framing the costs and benefits of the rule and neglecting to support its predictive judgments. While that may or may not have been a justified criticism of the economic analysis supporting the proxy access rule, it is a spot on description of what passes for an economic analysis in this case. The following are some, though certainly not all, of the most glaring examples:

- The Commission identifies as a benefit of the rule proposal that "accredited investors who previously have found it difficult to identify investment opportunities in Rule 506 offerings would be able to identify, and potentially invest in, a larger and more diverse pool of potential investment opportunities." It offers no evidence that accredited investors *have* previously found it difficult to identify investment opportunities in Rule 506 offerings or that they are clamoring for more opportunities to do so. Nor does it offer any objective data that would allow commenters to evaluate that claim. It does not appear to have given any consideration to the possibility that investors will be inundated with unwanted solicitations or solicitations for inappropriate offerings. It also fails to discuss how diverting more money into private offerings would affect the public markets. Interestingly, one of the chief arguments made for the JOBS Act was that it was designed to encourage more small companies to go public, since that is when the real jobs growth supposedly occurs. Since the SEC's own data suggests that growth in the Regulation D market has been a major factor in the reduction in small company IPOs, the potential impact of this rule on the capital available for public offerings and the incentives for companies to go public would seem to be a relevant factor to consider as part of this economic analysis.

- The Commission further suggests that eliminating the ban on general solicitation "would likely increase the flow of information about issuers to investors that may not have been publicly available previously, thereby potentially leading to more efficient pricing for the offered securities." The Commission fails to explain how efficient pricing will result from the flow of information that has not been subjected to the verification requirements that apply to public company disclosures, verification requirements that are specifically designed to promote market transparency and efficient pricing. Again, it fails to discuss what affect this change might have on the public offerings with which these private offerings will now be free to compete on unequal terms.

- With respect to privately offered funds in particular, the Commission suggests that, "eliminating the prohibition would allow accredited investors to gather information about privately offered funds at relatively lower costs and to allocate their capital more efficiently." This is a particularly cynical argument for the Commission to make, since what is being proposed is to allow private funds to advertise without being subject to the same restrictions that apply to mutual funds, with whom they will be competing for capital, and to make claims with regard to performance and fees that are not backed by any reporting standards. Elsewhere in the release the Commission acknowledges that this could in fact increase due diligence burdens on investors, which would have the opposite effect to that claimed here. Moreover, the Commission itself has in the past highlighted the risk of fraud in this market and the difficulties investors face in assessing the risks. The burden is on the Commission to show how allowing unsupported and potentially misleading performance claims will support the efficient allocation of capital.

- In a similar vein, the Commission suggests that, "Increased information about privately offered fund strategies, management fees and performance information would likely lead to greater competition among privately offered funds for investor capital." This argument might be valid if the Commission proposed to set standards for reporting of fees and performance. It knows from its past experience, however, that far from promoting competition, allowing such claims without subjecting them to appropriate standards leads to misinformation and investor confusion. Given its past expressions of concern about misleading disclosures among hedge funds, the Commission ought to at least explain on what basis it has reached the opposite conclusion here.

The rule proposal does acknowledge the heightened risks associated with lifting the ban on general solicitation. It notes, for example, that lifting the ban could: make it easier for promoters of fraudulent schemes to reach potential victims; increase the level of due diligence that investors are required to do in Rule 506 offerings (thus increasing their cost of gathering information); result in costly lawsuits by defrauded investors seeking damages; promote "pump and dump" schemes in the secondary market, especially over-the-counter markets; and undermine confidence in 506 offerings generally if, as expected, fraud increases, thus negatively affecting capital raising by legitimate issuers.

The Commission proposes to do nothing to reduce those risks. Instead, if offers the following tepid arguments to mitigate those concerns.

- The Commission suggests that “risks to investors of fraudulent offerings conducted under proposed Rule 506(c) may be mitigated to some extent by the requirement that issuers sell only to accredited investors (with reasonable steps to verify such status), who may be better able to assess their ability to take financial risks and bear the risk of loss than investors who are not accredited.” If the Commission’s main argument in defense of its lax regulatory approach is that accredited investors may be better able to assess and take financial risks, what evidence can they offer to support that claim? How have they analyzed the population of accredited investors to determine their financial sophistication or their ability to withstand financial loss? The answer, of course, is that the Commission has not conducted this analysis, or even requested comment on this crucial point.

- The Commission further notes that, “Issuers would still be subject to the antifraud provisions under the federal securities laws, and the public nature of these solicitations may facilitate detection of fraudulent activity.” Both Commissioner Walter and Commissioner Aguilar have made precisely the opposite argument: without the red flag of general solicitation activities to highlight potential frauds, the Commission’s job of detecting fraud will be more difficult, not easier. Moreover, not all general solicitation activities are “public.” Fraudulent offerings sold through telemarketing calls and email solicitations, for example, will be difficult if not impossible to detect until after significant damage has occurred. Finally, the Inspector General’s report suggests that the Commission has a poor record of policing this market and taking action against violations. At the very least, stepped up enforcement to match the increased risk of fraud would require increased resources, an increase that the Commission seems unlikely to receive in the current budget climate. Finally, it is of little comfort to investors that fraud may be detected after it has occurred. As Commissioner Aguilar has pointed out, the Commission’s responsibility is to deter fraud not just detect it. On what basis does the Commission then conclude that antifraud provisions will offer adequate protections?

- According to the Commission, the requirement for issuers “to take reasonable steps to verify that purchasers are accredited investors would likely make it more difficult for those issuers whose existing practices do not already satisfy the verification requirement to sell securities to non-accredited investors, thereby lessening the likelihood that fraudulent offerings would be completed because those who are eligible to purchase are more likely to be able to protect their interests than investors who are not accredited investors.” There are two unsupported statements here. The first is that the Commission’s proposed facts and circumstances based approach to determining whether verification steps are reasonable will require a significant change in verification practices. As discussed above, the Commission has not even provided baseline information on current verification practices necessary to assess such a claim. Moreover, the discussion in the proposing release seems to suggest just the opposite, that many current practices are likely to continue to be viewed as acceptable under the Commission’s “flexible” approach. The second unsupported claim is that accredited investors will be able to protect their interests. It is important to note that the issue isn’t whether they are better able than non-accredited investors to do so; the issue is whether accredited investors can reliably be expected to understand the risks inherent in these offerings and detect fraudulent offerings. In light of the many cases proving precisely the opposite – the most notorious case being the Madoff Ponzi scheme – how can the Commission justify this conclusion?

- Finally, the Commission notes that the flexibility offered by its proposed approach would mitigate the costs to issuers. It is not entirely clear that even this statement is true, since the proposed approach lacks the clarity with regard to their legal obligations that issuers often prefer. At the very least, however, the Commission ought also to consider whether the flexibility in its approach offers adequate assurance that verification steps will be effective and that investors will be protected.

While we are not fans of cost-benefit requirements designed to tie the agency's hands, this so-called economic analysis is shockingly inadequate. It is particularly disturbing that the Commission would ignore its obligations to analyze the potential impact of a rule that it itself acknowledges carries significant risks to investors. The lax approach to economic analysis in the JOBS Act rulemaking stands in sharp contrast to the rigorous and time-consumer process that appears to have almost completely stalled adoption of Dodd-Frank rules, many of which are now more than a year past the statutory deadline for completion. This apparent double standard sends the disturbing message that the Commission does not believe it has the same obligation to assess the potential harm to investors of rules that roll back long-standing investor protections as it does to assess the costs to business of rules that would strengthen investor protections and promote the stability and integrity of our capital markets. If that double standard is allowed to stand – if the Commission moves forward with a final rule without considering additional investor protections based on what is clearly a sham of an economic analysis – it will lose all credibility as an investor protection agency. That would be a heavy price to pay just to appease a few JOBS Act proponents who have proven time and again that they are indifferent to the law's impact on investor protection or market integrity.

Conclusion

When the Commission announced that it had abandoned its plan to proceed with an interim rule, we believed that investors had won an important victory. After all, it is only through the proposal and comment process that the Commission can fulfill its obligation to consider the full range of investor protections needed to balance the increased risk posed by the JOBS Act requirement to lift the ban on general solicitation and advertising. The Commission's failure to incorporate any such enhanced investor protections in its rule proposal (or even to meet the basic requirements of the statute), its failure to request comment on such protections, and its failure to provide any economic analysis either to justify its proposed approach or to weigh alternative regulatory approaches all suggest that this was an empty gesture designed to silence those critics who had challenged the legality of the Commission's earlier plan to lift the ban through a temporary rule.

Just as the Commission's earlier plan would have been a clear violation of the Administrative Procedures Act, adoption of a rule based on the current rule proposal would be a clear violation of both the standards set in the Appeals Court ruling in the proxy access case and the Commission's own guidelines for economic analysis. It would also be a violation of the Commission's investor protection mandate. As such, we believe the Commission has no choice but to withdraw the current proposal and issue a revised proposal that includes a meaningful economic analysis, including an analysis of the many reasonable alternative regulatory approaches that have been suggested. In our opinion, an economic analysis that fairly weighs the issues cannot help but conclude that the Commission's mission of promoting investor protection, capital formation, efficiency, and competition would benefit from incorporation of reasonable safeguards in the rule to reduce the risk of fraud and ensure that Rule 506 offerings are only sold to investors for whom they are appropriate.

In its proposing release, the Commission states that, "Preserving the integrity of the Rule 506 market and reducing the incidence of fraud would benefit investors by giving them greater assurance that they are investing in legitimate issuers. In turn, issuers would also benefit from measures that improve the integrity and reputation of the Rule 506 market because they would be able to attract more investors and capital." We agree. It is unfortunate that the Commission has chosen not to pursue a rulemaking approach that provides appropriate investor protections. As the Commission's own statement clearly indicates, the benefits of such an approach to investors and issuers alike would certainly outweigh the costs.

Respectfully submitted,

Barbara Roper

Barbara Roper
Director of Investor Protection

cc: The Honorable Mary Schapiro, Chairman
The Honorable Elisse Walter, Commissioner
The Honorable Luis Aguilar, Commissioner
The Honorable Troy Paredes, Commissioner
The Honorable Daniel M. Gallagher, Commissioner