March 21, 2014

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

Via email to rule-comments@sec.gov

Re: File No. S7-11-13, "Proposed Rule Amendments for Small and Additional Issues Exemptions under Section 3(b) of the Securities Act"

Dear Ms. Murphy:

I am pleased to provide these comments on the proposed rule amending Regulation A.[1]

Summary

The most important of my comments may be summarized as follows.

1. The Commission's regulation of small business capital formation and entrepreneurship is of macroeconomic significance;
2. Overregulation by state regulators and the Commission has destroyed the usefulness of Regulation A (as well as Regulation D Rules 504 and 505);
3. The proposed rule is a modest step in the right direction, of potential value to firms making Tier II offerings between $5 million and $50 million but for various reasons will be of much less value than the Commission appears to believe unless the proposed rule is revised;
4. The Commission should broaden the scope of its qualified purchaser definition, otherwise Tier I will be an illusion and remain just as unhelpful to small business capital formation as Regulation A is currently;
5. The Commission needs to resist calls by state regulators to narrow the scope of its qualified purchaser definition and to otherwise over regulate small business capital formation and entrepreneurship;
6. The Commission needs to reduce the regulatory burden on Tier II issuers. Given the fact that the proposed Tier II compliance burdens are similar, although less, to the burdens imposed on small public companies, it is likely to be the case that many issuers will find the proposed rule to be of little value and continue either to use Rule 506 or become a registered company;
7. The Commission should reject the proposed investor limitations as inconsistent with the disclosure and fraud prevention principles of federal securities law, as having no statutory basis and being inconsistent with Congressional intent. The Commission should not get

[1] "Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act," *Federal Register*, Vol. 79, No. 15, January 23, 2014, p. 3926. Release Nos. 33-9497, 34-71120 and 39-2493; File No. S7-11-13 [hereinafter "Proposed Rule"].

into the business of providing investment advice, it should not mandate that people maintain a particular portfolio and it should not mandate the level of risk that they may choose to undertake;

8. The Securities Exchange Act section 12(g)(1) thresholds must be relaxed for Regulation A offerings; if they are not then Tier II will be of very limited utility except for small offerings substantially below the $50 million cap because per investor sales amounts will have to be extremely high if the current section 12(g) limits are maintained. The interaction of the section 12(g)(1) thresholds and the investor limitations are likely to make offerings anywhere near the $50 million cap simply infeasible. The presumption of Commission staff that broker-dealers will typically hold Regulation A securities in street name, thus reducing the number of holder of record substantially, is entirely unwarranted; and
9. It currently takes 8 months, on average, to qualify a Regulation A offering. For a start-up business, this is an eternity. If the Commission wants Regulation A to work, then it must, as a management matter, dramatically reduce both the length of time it takes to navigate the qualification process and its complexity.

The Commission is to be commended for recognizing the problem with the existing Regulation A, taking Congressional concerns about the small issue exemption seriously and making a concrete proposal to rectify the problem. However, unless the proposed rule is modified in substantial ways, it will be of only limited value to issuers seeking to raise capital.

Introduction

The original 1933 Securities Act contained the small issue exemption that is the basis for Regulation A. Congress has increased the dollar amount of the exemption over the years.[2] Overly burdensome and sometimes inconsistent regulation by state regulators and the Commission combined with the opportunity for issuers to avoid burdensome blue sky laws via Rule 506 of Regulation D has rendered the current Regulation A a dead letter that is virtually never used.[3] In 2011, only one Regulation A offering was completed.[4] Data from the "Introduction and Background" section of the proposed rule shows that Regulation A between 2009 and 2012 was used to raise only 0.3 percent ($73 million) of the comparably-sized offerings[5] under Regulation D ($25 billion) and 8.7 percent of comparably-sized public offerings ($840 million).[6] Thus, over that three year period, Regulation A accounted for less than 3/10ths of one percent of the capital raised for small firms raising $5 million or less.[7]

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[2] Securities Act of 1933 §3(b); 15 USC 77c(b). It was originally $100,000 and was increased to $300,000 in 1945, to $500,000 in 1970, to $2 million in 1978 and to $5 million in 1980. The JOBS Act in 2012 created section 3(b)(2) which allows certain Regulation A offerings to raise as much as $50,000. This is so-called Regulation A+.

[3] See, e.g., Rutheford B Campbell, Jr., "Regulation A: Small Businesses' Search for a Moderate Capital," 31 Del. J. Corp. L. 77 (2006); Stuart R. Cohn and Gregory C. Yadley, "Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns," 4 N.Y.U. J. L. & Bus. 1, (Fall 2007); "Factors That May Affect Trends in Regulation A Offerings," United States Government Accountability Office, July 2012 (GAO-12-839) [hereinafter" GAO Study"].

[4] See GAO Study, p. 9.

[5] Namely, those under $5 million.

[6] Proposed Rule, p. 3928.

[7] $73 million out of $25,840 million. If section 4(a)(2) private offerings made without use of the Regulation D safe harbor were considered, the percentage would be substantially lower still.

Title IV of the JOBS Act[8] demonstrates a clear, bi-partisan consensus that this is unacceptable and that the section 3(b) small issue exemption needs to be rethought to promote small business capital formation and, therefore, economic growth and job creation.

The proposed rule represents a historic opportunity to breathe life back into Regulation A and restore it as an important means for small firms to raise capital. The Commission is to be commended for recognizing the problem with the existing Regulation A, taking Congressional concerns about the small issue exemption seriously and making a concrete proposal to rectify the problem. A reformed Regulation A could play an important role in promoting entrepreneurship, economic dynamism and robust job creation.

The proposed rule, however, will not accomplish this objective unless the Commission both broadens the preemption of state blue sky laws for Regulation A, revises the proposed rule to reduce the regulatory burden that the revised rule would impose on Tier II offerings if adopted in its current form and limits the application of section 12(g) of the Securities Exchange Act to Regulation A offerings.

Economic Importance of Small Business Capital Formation

Entrepreneurship fosters discovery, innovation and competition. It also enables the creative destruction of existing technologies, economic institutions, business production processes or management techniques.[9] Both are central to the dynamism, creativity and flexibility that enables market economies to grow and adapt successfully to changing circumstances. Securities regulation can, and currently does, impede entrepreneurship and risk-taking. Compliance costs have a disproportionate adverse impact on small and start-up firms.

Commission policies regarding Regulation A and Regulation D are macroeconomically important, regulating hundreds of billions raised annually by entrepreneurs and, conversely, impeding a substantial fraction of that amount each year.[10] Economic research has increasingly demonstrated that most of the job creation in the economy comes from young, dynamic companies. These companies need equity investment to launch and to grow. Some call these

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[8] The Jumpstart Our Business Startups Act, Public Law 112–106, Apr. 5, 2012.

[9] See, e.g., Nobel Laureate Edmund Phelps, "Economic Justice and the Spirit of Innovation," First Things, October, 2009 http://www.edmundphelps.com/home/recent-papers/recent-papers-attachments/FirstThings.pdf?attredirects=0; Israel M. Kirzner, "Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach," Journal of Economic Literature, Vol. 35, No. 1 (1997), pp. 60–85; Julian L. Simon. *The Ultimate Resource II: People, Materials, and Environment* (1998) http://www.juliansimon.org/writings/Ultimate_Resource/; Joseph Schumpeter, Capitalism, Socialism, and Democracy (1942), pp. 82-85; W. Michael Cox and Richard Alm, "Creative Destruction," Concise Encyclopedia of Economics (2010) http://www.econlib.org/library/Enc/CreativeDestruction.html.

[10] See, e.g., David R. Burton, "Don't Crush the Ability of Entrepreneurs and Small Businesses to Raise Capital," Heritage Foundation Backgrounder #2874 February 5, 2014 at http://www.heritage.org/research/reports/2014/02/dont-crush-the-ability-of-entrepreneurs-and-small-businesses-to-raise-capital.

companies Gazelles. A recent survey of the economics literature on the subject reached the conclusion that Gazelles "create all or a large share of net new jobs."[11]

Adopting policies that impede these dynamic firms' access to capital will exacerbate unemployment and hold down real wage improvements. Such policies will harm millions of Americans who will not be able to secure good, well-paying jobs because the firms that create those jobs will not exist or will not be able to grow. They will also harm consumer choice and increase consumer prices. Conversely, adopting policies that improve the ability of these firms to raise capital will have a pronounced positive impact on innovation, productivity growth, real wages, economic growth, job creation and consumers.

Qualified Purchaser Definition

By far the most constructive aspect of the proposed rule is the proposed definition of qualified purchaser that would effectively preempt the application of state blue sky laws to Tier II Regulation A offerings.[12] However, the failure to apply this preemption to Tier I offerings means that Tier I is unlikely to be used.

Under the proposed rule, Tier I would mean offerings under $5 million that do not comply with the relatively burdensome Tier II offering circular and continuing disclosure rules. Tier I is, in effect, the "old" Regulation A with its attendant uneconomic compliance costs (including but not limited to blue sky compliance). There is every reason to believe that Tier I will remain as unattractive and unused as the existing Regulation A. It is almost universally understood that "Reg A offerings are today low, slow, costly, and burdensome — a toxic stew of impediments," as Commissioner Gallagher put it.[13]

The Commission must, at the very least, retain the preemption of blue sky laws for Tier II offerings if its initiative is to have a meaningful positive effect. It must reject the self-serving objections of state regulators.[14] If it does not, the rule-making will be a Potemkin village, creating the appearance of constructive action regarding small business capital formation when in fact there will be none.

It is important to note, as the state regulator comment letters fail to mention, that states still will still have the authority under the law to police fraud or other unlawful conduct by an issuer or

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[11] Magnus Henrekson and Dan Johansson, "Gazelles as Job Creators: A Survey and Interpretation of the Evidence," Small Business Economics, Vol. 35, pp. 227-244 (2010).

[12] Proposed 17 CFR §230.256.

[13] Commissioner Daniel M. Gallagher, "Statement at an Open Meeting of the Commission to Consider a Proposal for Amendments to Regulation A to Implement Section 401 of the Jumpstart Our Business Startups Act," Dec. 18, 2013 http://www.sec.gov/servlet/Satellite/News/Speech/Detail/Speech/1370540520816.

[14] See. e.g., North American Securities Administrators Association letter dated February 19, 2014 signed by 18 state regulators http://www.sec.gov/comments/s7-11-13/s71113-12.pdf; William F. Galvin, Secretary of the Commonwealth of Massachusetts dated December 18, 2013; http://www.sec.gov/comments/s7-11-13/s71113-1.pdf; letter of A. Heath Abshure, Arkansas Securities Commissioner dated February 20, 2014 http://www.sec.gov/comments/s7-11-13/s71113-14.pdf; see also, "Issue Brief: Regulation A," North American Securities Administrators Association http://www.nasaa.org/issues-and-advocacy/issue-brief-regulation-a/.

broker-dealer.[15] They will still retain the authority to compel issuers to make notice filings and the power to collect filing fees.[16] What they will lose is their ability to impose large regulatory costs on small businesses and to engage in merit review where state regulators substitute their investment judgment for that of investors.

The National Securities Markets Improvement Act (NSMIA) of 1996 amended section 18 of the Securities Act[17] to exempt from state securities regulation any covered security. 15 USC 77r(b)(4)(E) provides that "[a] security is a covered security with respect to a transaction that is exempt from registration under this subchapter pursuant to … commission rules or regulations issued under section 77d(2) of this title, except that this subparagraph does not prohibit a State from imposing notice filing requirements that are substantially similar to those required by rule or regulation under section 77d(2) of this title that are in effect on September 1, 1996. Section 77d(2) is a reference to section 4(2) of the Securities Act (now section 4(a)(2)), to wit, transactions by an issuer not involving any public offering. Only Rule 506 *explicitly* invokes section 4(2) private offering exemption. For that reason, Rule 504 and Rule 505 offerings have not been treated as covered securities by the SEC or the state regulators.[18]

This means that issuers relying on Rule 504 and Rule 505 must comply with state blue sky laws but those using Rule 506, originally meant for larger issuers, do not.[19] Even though Rule 504 and Rule 505 contain fewer federal requirements, they are little used because Rule 506 enables an issuer to avoid costly state regulatory requirements. Rule 506 accounts for about 94 percent of Regulation D offerings and over 99 percent of the capital raised via Regulation D.[20] The withering of Rule 504, Rule 505 and Regulation A because these offerings are subject to blue sky laws demonstrates the tremendous adverse impact that state blue sky laws have on small business compliance costs and their cost of capital. This is why the Commission should not consider reversing its proposal to preempt blue sky laws for Tier II offerings.

The SEC clearly has the authority to define qualified purchaser as it has in the proposed rule and is to be commended for doing so. NSMIA states that "qualified purchaser" shall be defined "consistent with the public interest and the protection of investors."[21] As concerns the definition of "public interest", NSMIA also states that when the Commission considers whether a regulation is "in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation."[22] Clearly, the proposed definition of qualified investor would "promote efficiency, competition and capital formation."

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[15] 15 USC 77r(c)(1).
[16] 15 USC 77r(c)(2).
[17] 15 USC 77r(a).
[18] Of course, were it so inclined, the SEC could cure this problem by issuing a revised Rule 504 and Rule 505 explicitly promulgated under section 4(a)(2). The Commission should do so.
[19] For a good discussion of this issue, see Rutheford B Campbell, Jr., "The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions," The Business Lawyer, Vol. 66, August, 2011.
[20] Vladimir Ivanov and Scott Bauguess, "Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009-2012," Division of Economic and Risk Analysis, U.S. Securities and Exchange Commission, July, 2013, pp. 8-9, http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf. Campbell, "The Wreck of Regulation D," op. cit., developed similar figures.
[21] 15 USC 77r(b)(3).
[22] 15 USC 77b(b).

Tier I Offerings and Blue Sky

It should be clear that the proposed Tier I will be no more used than existing Regulation A. It is, in effect, existing Regulation A.[23]

It is neither in the public interest nor consistent with Congressional intent for small companies seeking to raise $5 million or less to be effectively barred from raising capital except via Rule 506. Yet that will be the effect to retaining the current regulatory environment for those firms. Rule 506 will remain the only economically feasible alternative.

It is not realistic to think that firms offering $5 million or less are going to find it cost-effective to comply with the Tier II requirements which are markedly similar to those of a registered offering. And Rule 504 and Rule 505 will remain as unattractive as ever because of the high cost of blue sky compliance.

The Commission can take a genuinely meaningful step towards addressing small business capital formation needs and promoting entrepreneurship and job creation by broadening its proposed qualified purchaser definition to include Tier I offerings (i.e. all Regulation A offerings). Such a step could transform the ability of small, dynamic companies to access the capital that they need to grow, to innovate and to create jobs.

This will not have an adverse impact on investor protection because current Regulation A offerings (the new Tier I) are not, by any reasonably measure, lightly regulated. Even the federal aspects of existing Regulation A are generally regarded as burdensome. The disclosure required is more than sufficient given the scope of the risk and substantially more than what is required under Regulation D (the alternative that will be used).

Investment Limitation

The proposed rule would limit sales to investors by an issuer to no more than 10 percent of the greater of the purchaser's annual income or net worth.[24]

First, if this limitation is retained, it is critical to also retain the provision in the rule allowing the issuer to rely on the representations of the purchaser as to their income or net worth. Otherwise, the costs of compliance will be substantial which in turn will make it much less likely that the

[23] Commissioner Stein was right when she stated:

> I am concerned that the rule we are proposing today will not work for issuers seeking to raise smaller amounts of capital … and will not ultimately achieve the goals of the drafters. … The Proposed Rule also fails to make any real attempt to make the old Regulation A, which is for offerings up to $5 million, work. I think we could and should have included in the text of the rule a clear proposal as to how to make the old Regulation A exemption work.

Commissioner Kara M. Stein, "Statement on Proposed Rules to Amend Regulation A," Dec. 18, 2013 http://www.sec.gov/servlet/Satellite/News/Speech/Detail/Speech/1370540516481 .

[24] See Proposed Rule 251(d)(2)(i)(C) and discussion at pp. 3937-38.

Commission's initiative in this area will have a meaningful positive impact. Moreover, investors will be reluctant to provide tax return or bank statement information to issuers or intermediaries, especially in connection with relatively small investments. The Commission should emphatically not adopt the burdensome verification rules applicable to general solicitation offerings under Rule 506.[25]

Second, this limitation is unwarranted. I freely grant that were the Commission staff, or I, to provide investment advice to the purchasers, we would probably suggest that diversification in a portfolio is a sound policy. But the Commission is not, and should not be, in the business of giving investment advice or substituting its investment judgment for that of individuals in the marketplace.

Moreover, there is absolutely no statutory basis for such a provision. There is absolutely no reason to believe that Congress intended such a rule when it enacted Title IV of the JOBS Act. Moreover, federal securities law does not countenance this sort of creeping federal merit review. The principles underlying federal securities law are fraud prevention and full disclosure. Full stop.

The Commission should not get into the business of providing investment advice. It should not mandate that people maintain a particular portfolio. It should not mandate the level of risk that investors may choose to undertake.

Importantly, as discussed below, the interaction of the section 12(g)(1) thresholds and the investment limitations are likely to make the proposed rule of limited value for issuers seeking to make offerings anywhere near the $50 million cap.

Should the Commission decide to retain some investment limitation, then it should not be applicable to any accredited investor. Moreover, it should not be applicable to any current or former investor, employee or officer of the issuer. These later persons have better knowledge of the issuer and its potential than do others. They have less need of protection and, in many cases, it would be unfair for the Commission to prevent them from participating in the success of the company.

Section 12(g) Triggers

Section 12(g)(1) of the Securities Exchange Act requires a company to register its securities if it has assets of $10 million or more and more than 2,000 holders of record or 500 holders of record who are not accredited investors.[26]

Some simple arithmetic illustrates why the section 12(g)(1) threshold poses a serious limit on the efficacy on Regulation A+. Let us assume that a company makes an offering of $50 million under tier II of the new Regulation A and further assume (utterly unrealistically) that is has no other shareholders. To avoid having to register (i.e. become a public company) under section

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[25] Final Rule, "Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings," *Federal Register*, Vol. 78, No. 142, July 24, 2013 pp. 44771-44805; 17 CFR 230.506(c).
[26] 15 USC 78l(g)(1).

12(g), it would need to make sales of at least, on average, of $100,000 to each non-accredited investor or $25,000 to each accredited investor. This is because $50 million divided by the section 12(g) limit of 500 is $100,000 and $50 million divided by the section 12(g) limit of 2,000 is $25,000.

A key goal of most companies making a Regulation A offering is the ability to sell to non-accredited investors (i.e. to the public). Yet companies making a Regulation A offering will be required by section 12(g) to limit their sales to fewer than 500 investors. Even a relatively small offering of $10 million, will be forced to require that non-accredited investors buy at least $20,000 in securities on average. This is more than many non-accredited investors will wish to invest. And this arithmetic assumes, unrealistically, that there are no previous investors and that the company will make no further offerings. Thus, the effective requirement will in practice substantially exceed $20,000.

But this does not fully capture the problem. One of the key advantages of purchasing securities sold via Regulation A is that they are not restricted securities. Thus, the securities can be sold in the secondary market relatively easily. An issuer that makes initial sales of securities bringing it close to the section 12(g) limit may find itself having more than 500 holders of record because of secondary market sales by those that bought the securities from the issuer. There is, after all, a high likelihood that an original purchaser will sell to more than one buyer in the secondary market or sell only part of their holdings (thus also increasing the number of holders).

The cost of becoming a public company too early in a company's life cycle could be catastrophic. According to the Commission, the cost of registration is $2.5 million, on average, and the cost of continuing compliance averages $1.5 million.[27] A well advised issuer will be aware of this risk and limit the number of non-accredited investors accordingly. This, of course, thwarts one of the primary purposes of using Regulation A rather than Regulation D, particularly for issuers seeking more than the $5million Tier I cap. The proposed rule discussion acknowledges this issue[28] but then incorrectly brushes it off.

The Commission staff presumes, incorrectly, that broker-dealers will routinely hold Regulation A securities in street name, thereby reducing the number of holders of record substantially. The proposed rule discussion states:

> Because of the manner in which shareholders of record are tabulated, the likelihood of a Regulation A issuer triggering the 12(g) threshold is low if not triggered at the time of offering. In particular, beneficial owners of Regulation A issuers who hold their shares at a broker are not counted as a record holder. Their shares, held in ''street name,'' are counted at the broker level, so that each brokerage at which there is a least one beneficial owner would constitute one shareholder of record. Because of this treatment, the number of shareholders of record is often significantly less than the number of beneficial owners.[29]

[27] Proposed Rules, "Crowdfunding," *Federal Register*, Vol. 78, No. 214, November 5, 2013, p. 66509.
[28] Proposed Rule at p. 3985.
[29] Ibid.

There are at least five strong reasons to believe that this is not the case.

First, securities held in street name must be utterly fungible. This is the case with registered securities. It will not be the case with Regulation A securities if the investment limitations are retained.[30] Securities sold in violation of this provision would presumably be subject to rescission. Broker-Dealers are likely to feel compelled out of fear of Commission or FINRA[31] enforcement action to conduct due diligence to ensure that sales were not made in violation of the rule. Sales by selling security holders raise similar issues of non-fungibility.[32] In short, there is every reason for broker-dealers to hold the securities separately in each customer's account and not to hold them in street name.

Second, the number of securities holders in any Regulation A issuer will usually be relatively small. The number of holders of any particular Regulation A security doing business with any particular broker-dealer is likely to be small. Thus, the economies to be had from holding the security in street name are correspondingly small.

Third, lack of active secondary market in a Regulation A security is likely to raise issues as to the proper valuation of the security on brokerage statements. It may also be difficult to know valuation of a security for purposes of determining whether rules that apply to "penny stocks" are applicable.[33] These issues are likely to also make broker-dealers reluctant to hold the security in street name.

Fourth, and perhaps most importantly, broker-dealers will be reluctant to hold Regulation A securities in street name because there is little or no profit in it. Those broker-dealers who were not underwriters will have made no money in connection with the security. Most probably, few, if any, broker-dealers will make a market in the security (at best one or two). They may, as a favor to a substantial customer, allow the security to be held in the account as they might for securities purchased via Regulation D, but they are not likely to hold the security in street name.

Fifth, as discussed above, holders of Regulation A securities are likely to sell them over time and likely to sell them to multiple follow-on holders.

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[30] Proposed Rule 251(d)(2)(i)(C) and discussion at pp. 3937-38.

[31] FINRA Rule 5123 being one of many potential concerns to broker-dealers. That rule provides that:

> Each member that sells a security in a non-public offering in reliance on an available exemption from registration under the Securities Act ("private placement") must: (i) submit to FINRA, or have submitted on its behalf by a designated member, a copy of any private placement memorandum, term sheet or other offering document, including any materially amended versions thereof, used in connection with such sale within 15 calendar days of the date of first sale; or (ii) indicate to FINRA that no such offering documents were used.

It does not appear to this commentator that any of the exemptions afforded by the rule apply. Nowhere is the small issue exemption or Regulation A mentioned. The qualified purchaser definition is that found in section 3 of the Investment Company Act and would not be applicable to many purchasers of Regulation A securities. Sales to accredited investors are exempt. FINRA could, of course, clarify this concern and others but FINRA action is a necessary predicate to ameliorating these concerns.

[32] See Proposed Rule discussion at p. 3936.

[33] See, e.g., Securities Exchange Act §15(h) and 17 CFR 240.3a51-1 Definition of "Penny Stock."

There are probably other issues that have not occurred to this commentator. The Commission should seriously investigate whether broker-dealers are likely to hold Regulation A securities in street name. Informal, off-the-record discussions with broker-dealers by members of the Securities Regulation Working Group indicate, with one exception, that they will not.

Section 36 of the Securities Exchange Act provides authority to the Commission to relax the section 12(g)(1) thresholds for Regulation A securities. It provides, in relevant part, that:

> SEC. 36. GENERAL EXEMPTIVE AUTHORITY.
> (a) AUTHORITY. —
> (1) IN GENERAL.—Except as provided in subsection (b), but notwithstanding any other provision of this title, the Commission, by rule, regulation, or order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

At the very least, the Commission should allow a Regulation A company to have 2,000 holders of record (whether accredited or not) without being subject to the requirement to register, although even this would limit the value of Regulation A considerably. A much better approach would be to adopt the Crowdfunding rule by exempting Tier II Regulation A purchasers from the section 12(g) limit counts altogether. This is entirely appropriate since the Tier II disclosure requirements approach those in public offerings.

Content of the Offering Circular and Continuing Disclosure Requirements

The proposed rule Tier II is meant to increase investor protection by, among other things, imposing greater disclosure requirements, requiring companies to include audited financial statements in their offering circulars, requiring that Commission staff approve (qualify) the offering circular before it becomes effective and by requiring Tier II companies to file enhanced continuing disclosure reports if there are at least 300 holders of record.

As the Commission staff has effectively acknowledged, the offering circular and continuing disclosure rules proposed for Tier II companies are nearly as burdensome as those imposed on smaller reporting companies.[34] They are dramatically more complex and burdensome than the rules imposed on Rule 506 offerings. The question becomes then whether it will make sense for many issuers to use the proposed Tier II Regulation A. If they want to access the public market, then, given the relatively small incremental cost, they are likely to choose becoming a smaller reporting company with all of the attendant benefits of being a true public company. If the issuer is resource constrained, then Rule 506 will be a better option due to its dramatically lower compliance costs.

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[34] "We expect that Regulation A offering statements would continue to receive the same level of Commission staff review as registration statements," Proposed Rule at p. 3991.

The Commission needs to reduce the contemplated regulatory burden on Tier II offerings if Regulation A+ is to have a meaningful place in entrepreneurial capital formation.

The Commission is seeking comment about whether it should exempt some issuers from ongoing reporting requirements on the basis of criteria other than offering size, such as issuer size or whether the issuer has taken steps to foster a secondary market for their securities. In principle, the answer is yes. Both the risk to investors and the burden on the company relative to its ability to bear that burden is not a function of offering size. The size of the company (its revenues, its profits, its shareholder's equity and its liquid assets) determines its ability to bear additional costs. The amount of securities outstanding held by non-insider investors (particularly unaccredited investors) -- not just the securities being currently offered -- is the best measure of the risk to investors.

The Commission is seeking comment about whether it should permit issuers to suspend their reporting obligations in a Tier 2 offering under Regulation A, as proposed, when they take on Exchange Act reporting obligations. The answer to this question is undoubtedly yes. A reporting company has greater disclosure obligations than a Regulation A company (although they are very similar). Requiring both forms of disclosure is duplicative and adds costs that are quite literally a waste in the sense they do not increase investor protection at all.

The Commission is seeking comment about whether it should allow issuers to terminate ongoing reporting under Regulation A if, for example, immediately upon completion of the offering they have less than 300 holders of record? This would be entirely appropriate given the small number of investors at risk and the likelihood that the company will be small. A much more relaxed reporting requirement may be appropriate. For example, the Commission could require only financial statements and a management letter regarding operations and results.

Qualification

Between 2002 and 2012 the amount of time that typically elapsed between the initial filing of the Form 1-A and qualification was eight months **on average**.[35] If the Commission continues to handle Regulation A offerings at such a dilatory pace, this will become widely known and few entrepreneurs will be willing to undertake Regulation A offerings. Eight months is an eternity for start-up businesses. They will continue to use Regulation D.

This problem is not so much a regulatory issue as a management issue. Nevertheless, if the Commission is serious about Regulation A actually becoming a meaningful avenue for small firms to raise capital, the time between filing and qualification must be reduced by at least two-thirds.

Coordinated Review System

Mr. William Galvin, Secretary of the Commonwealth of Massachusetts, in his letter to the SEC, wrote:

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[35] Proposed Rule at p. 3956 and p. 3975.

> The states, through NASAA, have been working actively to develop a simple and streamlined coordinated review system for these offerings.[36]

The prospect of this process having a meaningful positive impact on compliance costs should not be taken seriously. As Mr. Galvin well knows, NASAA has an existing coordinated review process. The coordinated review protocol for offerings exempt from federal registration under either Regulation A or Rule 504 of Regulation D is known as CR-SCOR.[37] As discussed above and demonstrated by the Commission's own data, it is under this "simple and streamlined" system that state regulators effectively killed Rule 504 and Regulation A. Virtually all small business offerings are conducted under Rule 506 (or section 4(a)(2) without relying on the Regulation D safe harbor) precisely to avoid the burdens of CR-SCOR and the delays and costs of the state regulatory process.

There is absolutely no good reason to believe that the revised coordinated review system for Regulation A+ that eventually emerges from the NASAA process will be any better than the existing CR-SCOR coordinated review process that effectively killed Regulation A and Rule 504. In fact, there is every reason to anticipate that the revised review process will not be a material improvement. The current version of Regulation A was adopted by the SEC in 1992.[38] Regulation A substantially in its current form has existed since 1953. Yet the state regulators have not taken action to solve the problem. How many more decades are the entrepreneurs of this country to wait until state regulators get this right?

Fraud and Small Issuers

Most of those who wish to impose burdensome rules on Regulation A offerings argue that it is necessary for "investor protection." They argue that small issuers are more likely to engage in fraud than the likes of Enron, WorldCom, Tyco International or HealthSouth (all large public companies). The problem with this theory is that there is absolutely no evidence to support it.

Moreover, penny stocks are often registered companies. The SEC regards penny stocks as posing greater risk of fraud, primarily due to the risk of market manipulation.[39] The fundamental point is that the registration process by no means prevents fraud and there is no factual basis to believe that the public market has less fraud than the Regulation A marketplace or, for that matter, the Regulation D marketplace.[40] In the context of a discussion of Regulation D, the SEC staff has acknowledged this:

[36] Letter of December 18, 2013, http://www.sec.gov/comments/s7-11-13/s71113-1.pdf.
[37] "Coordinated Review," North American Securities Administrators Association http://www.coordinatedreview.org/index.html.
[38] "Small Business Initiatives," 57 *Federal Register* 36442, August 13, 1992 [Release Nos. 33-6949, 34-30968, 39-2287; FR-39].
[39] See, e.g., "Important Information on Penny Stocks," http://www.sec.gov/investor/schedule15g.htm, "Microcap Stock: A Guide for Investors," http://www.sec.gov/investor/pubs/microcapstock.htm and "Penny Stock Rules," http://www.sec.gov/answers/penny.htm.
[40] The Commission should collect and publish data on the sources and causes of fraud so that the public debate is better informed and so the Commission can better allocate its enforcement resources. The IRS, for example, does this regularly and the GAO conducts detailed analyses of the tax gap.

> Because data on the incidence of fraud in private securities offerings is extremely limited, we are unable to estimate the extent of fraud in the existing market for privately offered securities.[41]

Venture Exchanges

The Commission should encourage the development of ‘‘venture exchanges’’ or other trading venues that focus on facilitating secondary market trading in the securities of Regulation A issuers by reducing the regulatory risk and regulatory burden for both issuers, broker-dealers and potential exchanges involved with Regulation A securities.

Insignificant or Immaterial Violations

Insignificant or immaterial violations should not result in the loss of the issuer's exemption. By definition, these violations are not significant or material and consequently investor protection is not meaningfully harmed by the violation. In contrast, loss of the exemption would have a catastrophic impact on the issuer. Thus, the punishment for the violation would be wholly disproportionate to the seriousness of the violation and therefore unjust. Notice should be given with time provided to cure the violation. Lesser sanctions (such as fines) should be imposed if the violation is not cured.

Valuation

The Commission is seeking comment on whether it should consider adding a disclosure requirement in Part II of Form I-A that would require issuers to disclose the value of the issuer prior to the contemplated Regulation A offering and how the price to the public was determined.

The Commission should not impose such a requirement and were it to do so it would almost certainly prove to be unworkable. Valuation, particularly for small and start-up companies, is notoriously difficult. Different analysts will undoubtedly come up with radically different valuations depending on their assessment of the technology or business plan of the issuer, its market potential, its competition, the strength of its management team and other factors.

There is, quite simply, no objective manner to value a start-up or young company with little or no operating history. The uncertainty regarding the company's future prospects is too high. Any valuation provided by an issuer will inevitably be exploited by the plaintiff's bar if the company is unsuccessful. Obviously, many start-ups will be unsuccessful. Every investor knows this. But some investors will attempt to recoup their investment through litigation based on an "inaccurate" valuation. More importantly, issuers will come to understand this risk and Regulation A will become an unattractive option due to Commission-created regulatory risk.

The fact that investors are willing to invest, assuming full disclosure of all material facts, means that the investors attached a value to the securities being issued that was higher than the issuing price.

[41] Proposed Rules, "Amendments to Regulation D, Form D and Rule 156," *Federal Register*, Vol. 78, No. 142, July 24, 2013, p. 44840.

Securities valuation is not an objective science. It involves making judgments about an uncertain future. For example, different valuations are inherent in any secondary market transaction. The seller typically believes there are better investment opportunities available. That is why he or she is selling. The buyer typically believes the security represents the best opportunity available among all of the competing possibilities. That is why he or she is buying this particular security rather than the thousands of other possibilities. One will be right and one will be wrong.

Testing the Waters Confidentiality

The Commission should allow issuers to maintain the confidentiality of all required filings and disclaimers in connection with the testing the waters process or during the qualification phase so that the issuer's competitors do not prematurely have access to vital information. If the Commission does not do this, the attractiveness of Regulation A will be substantially diminished.

Conclusion

The Commission is to be commended for recognizing the problem with the existing Regulation A, taking Congressional concerns about the small issue exemption seriously and making a concrete proposal to rectify the problem. However, unless the proposed rule is modified in substantial ways, it will be of only limited value to issuers seeking to raise capital.

Sincerely,

David R. Burton
Senior Fellow in Economic Policy
The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
202-608-6229 (direct dial)
David.Burton@heritage.org