*The Commonwealth of Massachusetts*
*Secretary of the Commonwealth*
*State House, Boston, Massachusetts 02133*

*William Francis Galvin*
*Secretary of the Commonwealth*

March 24, 2014

**Via Electronic Mail at rule-comments@sec.gov**

The Honorable Mary Jo White, Chairman
The Honorable Luis A. Aguilar
The Honorable Daniel M. Gallagher
The Honorable Kara M. Stein
The Honorable Michael S. Piwowar
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Proposed Rule Amendments for Small and Additional Issues Exemptions under Section 3(b) of the Securities Act
(Rel. No. 33-9497; 34-71120; 39-2493; File No. S7-11-13)

Dear Chairman White, Commissioner Aguilar, Commissioner Gallagher, Commissioner Stein, and Commissioner Piwowar:

I write in my capacity as the chief securities regulator for Massachusetts. The Office of the Secretary of the Commonwealth administers and enforces the Massachusetts Securities Act, M.G.L. c.110A, through the Massachusetts Securities Division.

This follows up the Massachusetts Securities Division's December 18, 2013 comment letter on this proposal. We ask that our prior letter be incorporated by reference into this letter. While we have comments on several elements of the proposal, our foremost objection is to provisions that preempt the ability of the states to require registration of these offerings and to review them. This proposed preemption contradicts the applicable

statutes, is bad policy, and it will put small investors unacceptably at risk in offerings under the new Section 3(b)(2) of the Securities Act (sometimes referred to as "Regulation A-Plus").

The Securities and Exchange Commission's (the "Commission" or the "SEC") proposed preemption is contrary to the plain language and the principles of the National Securities Markets Improvement Act ("NSMIA") and it contradicts the legislative history of that law. This attempt to preempt state authority under Section 3(b)(2) is also contrary to the express legislative history and policy reflected in Title IV of the JOBS Act.

The Commission has cited the burden and cost of state regulatory compliance as justifications to preempt state authority. These reasons do not support the Commission's radical steps to preempt state regulation of these offerings. As the Commission is aware, the states have developed a streamlined coordinated review system for offerings under traditional Regulation A and Section 3(b)(2). This system will greatly simplify state law compliance and reduce the costs of such compliance. Massachusetts has actively participated in developing this coordinated review, we have signed the multi-state memorandum of understanding, and we have taken a leadership role in urging all states to promptly join.

## I. The Proposal to Treat All Investors in a Section 3(b) – offering as "Qualified Purchasers" Is Directly Contrary to the Language, Principles, and Legislative History of NSMIA

Securities are covered securities and thereby exempt from state registration to the extent that they are offered or sold to "qualified purchasers," as defined.[1] Congress granted the Commission the power to define qualified purchaser under Section 18(b)(3) of the Securities Act.[2]

Under the securities laws, the term "qualified" has a set of long-established meanings; typically, that an investor or purchaser has the capacity to take on certain risks due to the investor's sophistication, size, and/or risk-bearing ability (based on high income or high net worth). This approach to investor qualification is reflected in several sections of the securities laws, including: the definition of qualified institutional buyer under SEC Rule 144A; the definition of qualified purchaser under the Investment Advisers Act; and the accredited investor definition in Regulation D. In the current proposal, which would treat all investors in Section 3(b)(2) offerings as "qualified" (without regard to investor sophistication, size, or risk-bearing ability) the Commission takes the principle of investor qualification and throws it out the window. This notable departure from logic shows that the Commission, in its attempt to preempt state authority, uses a jerry-rigged analysis to accomplish this result. We urge the Commission not to take this path.

The legislative record on the NSMIA "qualified purchaser" exemption makes it clear how the definition was intended to work, stating that, "in all cases...the definition be rooted in

[1] *See* Securities Act of 1933, § 18(b)(3), 15 U.S.C. § 77r(b)(3).
[2] *Ibid.*

the belief that 'qualified purchasers' are sophisticated investors, capable of protecting themselves in a manner that renders regulation by State authorities unnecessary."[3] Similarly, the Senate Committee on Banking, Housing, and Urban Affairs explained that "qualified purchasers" were the types of purchasers that, based on their wealth and sophistication, did not need the protection of state registration laws.[4] (emphasis added)

These are exceptionally clear statements of legislative intent. Congress deliberately used the term "qualified purchaser" to mean persons who could, based on qualifying factors such as wealth and sophistication, fend for themselves. The Commission is acting contrary to that legislative intent by making the definition applicable to all purchasers of Section 3(b)(2) securities without any regard for the characteristics of the purchasers.

We also note that the Commission's current approach is contrary to the one it took in its 2001 proposal to define "qualified purchaser." At that time, the Commission stated "Congress authorized us to define "qualified purchaser" under the Securities Act to include "sophisticated investors, capable of protecting themselves in a manner that renders regulation by State authorities unnecessary.""[5] In the 2001 proposal, the Commission indicated that both the Sec. 18(b)(3) term qualified purchaser and the accredited investor definition were based on "similar notions of the financial sophistication of investors."[6]

To state the obvious, neither NSMIA nor the JOBS Act granted to the Commission the power to preempt state authority over categories of securities, *per se*; instead, preemptive power is limited to determining that certain investors in certain transactions are qualified. The Commission's departure from the requirements of the statute is particularly unwarranted in the case of offerings under the Section 3(b)(2), which will generally be riskier offerings by unseasoned issuers. This is precisely the wrong context for the Commission to declare that all investors in such offerings meet the standard of being qualified.

Recent history teaches us about the pitfalls of using federal agency rules to override state laws designed to protect investors and consumers. In 1996, the Office of Thrift Supervision ("OTS") issued regulations governing the real estate lending activities of federal thrifts. The regulations stated that the "OTS hereby occupies the entire field of lending regulation for federal savings associations."[7] Also in 1996, the OTS issued further regulations that gave operating subsidiaries of federal thrifts the same preemptive immunity from such state laws.[8] These regulations were designed to preempt state laws that would affect the terms and conditions of real estate loans made by federal thrifts and their subsidiaries. The OTS rule release for the regulations included many references to the regulatory streamlining and cost savings that preemption was intended to achieve, but

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[3] *See* H.R. Rep. 104-622, at 31 (1996) (Conf. Rep.), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3893-94.
[4] *See* S. Rep. 104-293, at 15 (1996).
[5] SEC Rule Proposal: Defining the Term "Qualified Purchaser" under the Securities Act of 1933, 66 Fed. Reg. 66839, 66840 (Proposed Dec. 27, 2001).
[6] *Id.*
[7] OTS Regulation: Lending and Investment, 61 Fed. Reg. 50,951 (Sept. 30, 1996).
[8] OTS Regulation: Subsidiaries and Equity Investment, 61 Fed. Reg. 60,173 (Nov. 27, 1996).

there was surprisingly little discussion about the abuses that could proliferate and the harm that could result if state predatory lending laws were preempted. These preemptive regulations and the OTS's unbalanced pro-industry attitude are now widely cited as examples of regulatory capture, where the outlook and priorities of a regulatory agency became too much aligned with that of the industry it was charged with regulating.

The Commission's proposal to use the qualified purchaser definition to turn Section 3(b)(2) securities into preempted securities follows the failed logic used by OTS in preempting state lending laws. One commenter described the Commission's approach as "glib,"[9] but it is far worse than that. We urge that it is dangerous for the Commission to so grossly distort the qualified purchaser exemption by simply declaring all investors in 3(b)(2) offerings are "qualified." If the SEC guts the substance from the qualified purchaser exclusion, it is foreseeable that in the future interested parties will urge the Commission to undermine other definitions in order to remove substantive protections from the securities laws. Once the Commission starts on this path, there is no clear stopping point. The states cannot and will not passively stand by and let this happen.

## II. Congress Specifically Preserved State Authority under Title IV of the JOBS Act

Title IV of the JOBS Act began as H.R. 1070, the Small Company Capital Formation Act of 2011. In the legislative process, Congress considered, but ultimately rejected, language that would preempt state review of Regulation A-plus offerings. The North American Securities Administrators Association ("NASAA") and the states tracked the legislation and successfully urged that state authority to review these offerings should be maintained. The ultimate language of the bill was negotiated among many parties; Massachusetts and NASAA, among others, took part in the democratic process of working to shape the legislation that became Title IV.

Two pieces of legislative history demonstrate that preemption of state review was not intended by Congress and that its members explicitly stated that the bill should preserve state review because such review would be an essential feature to protect against fraud in such offerings.

First, in remarks to the House of Representatives immediately prior to passing the Bill (H.R. 1070), Representative Gary Peters stated, "[F]inally, the gentleman from Arizona has also worked with Democrats on the remaining issue of contention, and that was the preemption of state law. The gentleman from Arizona's substitute amendment to H.R. 1070 removes the exemption from State level review that was previously provided to an issuer using a broker-dealer to distribute and issue. Regulation A securities can be high-risk offerings that may also be susceptible to fraud, making protections provided by the State regulators an essential future."[10] (emphasis added)

[9] Comments of Mike Liles, Esq., Karr, Tuttle, Campbell, Seattle, Washington, on SEC Rule Proposal File No. S7-11-13, (January 17, 2014).
[10] 157 Cong. Rec. H 7229, 7231 (2011).

Second, a House Report on the JOBS Act noted, "There was one contentious issue that arose during the markup that had nothing to do with the principle of an exemption limit increase, but instead with new language preempting state law. This language preempts state securities law for Regulation A securities offered or sold by a broker or dealer, creating a class of security not subject to state level review, but which will not receive adequate attention at the Federal level. Regulation A offerings can be high risk and federal review alone may be inadequate, so states should not be preempted . . ."[11] (emphasis added)

The record demonstrates that the intent of Congress was not to preempt the states in this area because preemptive language was removed from the bill after debate. Congressional intent should not be cavalierly ignored by the Commission.

### III. Cost-Benefit Factors and the GAO Study

The cost-benefit analysis in the rule proposal does not take into account the costs that investors will incur by investing in failed or fraudulent offerings that would have been rejected or reformed in the state review process. While our purpose here is not to criticize the SEC's review of offerings, we urge that state review adds value.

The Commission has also cited the individual investment limit (no more than 10% of the investor's annual income may be invested in a particular Section 3(b)(2) offering) as a key justification for preempting state authority. We appreciate that this investment limit may protect some investors in some cases, but we note that it will still leave many small investors vulnerable. This 10% limit would still permit small investors to suffer severe losses; for a person earning $40,000, a loss of $4,000 would represent a real financial setback. We also note that the 10% limit applies only on a per-offering basis: an investor may invest up to 10% of her income or net worth in one offering, but she may then invest up to another 10% in another offering under Section 3(b)(2).

Along with the Commission, we note the GAO study's conclusion that the costs related to state review may have contributed to the non-use of the Regulation A exemption, though we also note that issuers may prefer to raise money under different regulatory rules, such as Regulation D, for a variety of other reasons. We urge that the Commission should give the GAO Report limited weight because it is based on a very thin record. For example, as the Commission is aware, in 2012 only eight Regulation A offerings were qualified by the SEC, and in the period from 2009 through 2012 only nineteen offerings were qualified. This is kind of limited record should never be the foundation for the kind of aggressive administrative preemption of state authority now proposed.

In response to the kinds of concerns raised by the GAO and by small business advocates, NASAA and the states have designed a multi-state coordinated review system for Section 3(b)(2) and Regulation A offerings. This system will directly and practically address issues of the time and cost imposed by state review. As discussed in more detail below, coordinated review will bring considerable efficiencies; issuers will receive a single

[11] Committee Reports 112th Congress, (Minority Views on H.R. 1070), H.R. Rep. 112-206 (2011)

comment letter, prepared by two examiners, issued on behalf of the states as a group and the timelines for state review, comments, and any follow-up will be short. We urge that this coordinated review system addresses key reasons that the SEC cites for preemption, namely the burdens and cost of multi-state compliance.

## IV. The States Have Developed a Coordinated Review System for Regulation A-Plus Offerings

The states, through NASAA, have developed a simple and streamlined coordinated review system for Regulation A and Sec. 3(b)(2) offerings. A majority of the NASAA members have voted to approve the coordinated review program.

Massachusetts actively participated in developing NASAA's coordinated review program. We have signed the multi-state memorandum of understanding, and we have taken a leadership role in advocating that all the states join the program.

It is important to note that NASAA began developing coordinated review long before the Commission unveiled its threat to preempt the states in the December 18, 2013 rule release. NASAA and the states clearly hear the concerns raised in the GAO study and by advocates for small business. Moreover, we understand that changes in technology and markets mean that the issuers we regulate will expect more efficient and speedy handling of their filings.

NASAA coordinated review will provide multiple benefits. Issuers will electronically file their offering materials with the program administrator state, which will in turn electronically forward the materials to the states where the issuer wants to register its securities. The state review will be conducted by two lead examiners (disclosure and merit) who will issue a single comment letter on behalf of the states as a group.[12] Timelines will be short: Initial comments are due in 21 days and responses to follow-up communications from the issuer are due in 5 days. In connection with the coordinated review, certain policies were waived or modified to accommodate the characteristics of small issuers. For example, the promoters' equity investment policy will not apply and the potential escrow period for cheap stock held by company insiders is capped at two years from the completion of the offering, with provision for the release of 50% of the escrowed shares after one year.

As we have stated before, the coordinated review system will help achieve several beneficial goals, including a simpler and faster review process and more consistent state regulatory comments. Also, coordinated review will directly benefit the states by allowing each state to more effectively use its time and resources to protect investors.

## V. This Proposal Will Force Us to Continue to Fight the Preemption Provisions

The Massachusetts Securities highly values its relationship with the SEC. The Division and the Washington and the Boston Regional Office of the Commission have cooperated

[12] If the issuer files only in disclosure states, then only a disclosure examiner will review the file.

on significant investigations and enforcement action over several years. It is a relationship that has been built on trust and mutual respect. This has created tangible benefits for investors. This cooperation of our agencies has also included enhanced investor education efforts and joint presentations at the New England Securities Conferences.

The preemption proposal is contrary to the relationship we have built between our agencies. The release proposes to preempt state authority over Regulation A-Plus offerings and it even suggests that the Commission believes that it has the power to, and is willing to, preempt state authority over traditional Regulation A offerings.

We have learned that if we do not actively fight attempts to curtail our authority, small investors end up paying a high price. A key feature of NSMIA was preemption of state authority over Rule 506 offerings. In the years after the adoption of NSMIA, problems proliferated in this area, and Rule 506 offerings have become the number one source of fraud complaints to the state securities agencies.

Massachusetts must consider all of our options to oppose this proposal. If it is adopted, it could mark the start of a larger process of preemption. We foresee that other categories of issuers and other segments of the securities market will argue that, in order to promote simplicity, efficiency and economy, state review of other categories of issuers should also be preempted.

We are prepared to continue our efforts because the Commission is forcing our hand on this issue. We would strongly prefer to work with the SEC to turn the New Section 3(b)(2) into an exemption that will work for issuers, investors, selling persons, and for the government agencies charged with overseeing these offerings. We urge the Commission to change course on this preemption proposal and to work with the states to devise ways to regulate more efficiently and effectively.

## VI. Comments on Specific Provisions Contained in the Section 3(b)(2) Exemption Proposal

### Testing the Waters Materials Should Be Filed Before First Use

We urge the Commission to require an issuer to file any testing the waters materials before they are used. While testing the waters materials would be subject to the antifraud provisions, they will not be a sufficient safeguard for the kinds of early-stage offerings that will use the exemption. Such issuers may in some cases make overly-optimistic or aggressive claims in these materials. Once such material goes into circulation, it will not be possible to un-ring the bell of inaccurate statements. This problem is compounded by the "access equals delivery" model the Commission has proposed for final offering circulars. As a result, some investors may never actually see any corrective disclosure included in the final offering circular.

### Selling Security Holders in Section 3(b)(2) Offerings

We question whether the exemption should be available for any sales by existing security holders of the issuer. It would be consistent with the logic of the exemption and the JOBS Act as a whole that funds raised in these offerings should go to the issuer in order to fund its operations (and thereby create jobs), not to enrich company insiders. Also, we note that, in some cases, it is a hallmark of a troubled company that a company's insiders are looking to sell their shares just as the public is investing in the company.

Because it will provide a measure of protection for investors and issuers, we reluctantly support the Commission's proposed 30% limit on the amount of an offering under Section 3(b)(2) that can be made by selling security holders. This standard is consistent with current Regulation A and it is better than having no restriction at all on such sales.

**Ongoing Company Reporting**

We are highly concerned about the Commission's proposal to require issuers to file reports based on a "fundamental change" as opposed to a "material" event. We foresee that the "fundamental change" standard will be an ongoing source of confusion for issuers, regulators, and the public. This standard is different from the established standard of materiality, but how it differs is not clear. In proposing this new standard for ongoing company disclosures, the Commission is opening a confusing and potentially dangerous can of worms. We urge the Commission to make reporting subject to the traditional material event standard.

The Commission has also proposed that Section 3(b)(2) companies issue reports on a half-yearly rather than on a quarterly basis. While we understand that this is intended to lighten the regulatory burdens on these issuers, this system may serve investors poorly. As the Commission has noted, it is expected that some securities issued under Section 3(b)(2) may trade in an aftermarket. If this is the case, semi-annual reports from these issuers are likely to be inadequate to inform buyers and sellers about these companies. Moreover, in the absence of accurate and timely information, opportunities for insider trading and other kinds of stock fraud will increase. In view of this, we urge the Commission to consider requiring these issuers to report on a quarterly basis.

**The Exemption Should Be Unavailable to Issuers That Fail to Meet Reporting Requirements in a Two-Year Period**

We support the Commission's proposal to disqualify issuers that have not complied with the proposed ongoing reporting requirements during the two years preceding a new filing under Section 3(b)(2). This prohibition will create a strong incentive for issuers to make the required reports. Also, an issuer that is delinquent in its ongoing reporting may present substantial risks to investors, particularly the risk of fraud.

**Prohibited Types of Issuers**

Massachusetts strongly supports the proposal to extend the existing prohibitions on the use of the exemption under Regulation A to Section 3(b)(2) offerings by investment companies, business development companies, blank check companies, special purpose acquisition vehicles, issuers of fractional undivided interests in oil and gas rights and similar interests in other mineral rights, and issuers of asset backed securities. We also ask the Commission to consider, consistent with the exclusions listed above, whether other types of investment vehicles (e.g., commodity pools and various kinds of investment funds, such as funds that invest in gold or virtual currencies) should also be prohibited from using the exemption.

**"Access Equals Delivery" for Final Offering Circulars**

Massachusetts objects to the proposed "access equals delivery" model for final offering circulars under Regulation A, under which posting on the final offering circular on the EDGAR system will constitute delivery of the offering circular to investors. Issuers should be required to actually deliver the final offering circular to investors (even though such delivery may be electronic). For the kinds of early-stage issuers that are expected to use the exemption, investors should have every opportunity to evaluate all material and up-to-date disclosure on these offerings including any disclosure that corrects statements in preliminary offering circulars or testing-the-waters notices. These offerings will often be obscure. They will not be listed on an exchange, they may not involve an underwriter, and there may be limited involvement by third party selling agents, attorneys, and accountants. Finally, because the EDGAR system can be hard to use, it is simply not reasonable to treat a posting on EDGAR as delivery of such material to the public.

**Limitation to U.S. and Canadian Issuers**

Massachusetts supports the Commission's proposed limitation on the use of the exemption to issuers organized and with their principal places of business in the United States or Canada. This is consistent with existing Regulation A, which is currently limited to issuers organized and with their principal places of business in the United States or Canada. In our view, allowing issuers from other countries to use the Section 3(b)(2) exemption would multiply the complexities of an exemption that is designed for less-established and therefore riskier issuers.

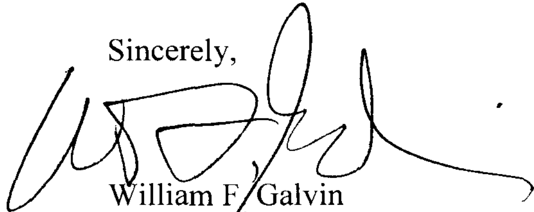
The United States has had a long tradition of shared jurisdiction between the SEC and state securities regulators. Massachusetts has been pleased to work with the Commission on a variety of investigations and initiatives. We ask the SEC to deal with the states in the same spirit of cooperation and mutual respect. The current proposal amounts to the SEC simply big-footing the traditional jurisdiction of the states. As we have stated herein, this is contrary to the language of the statutes, the Congressional record, and most importantly, it is contrary to investor protection.

The proposed preemption of state review of offerings under Regulation A-Plus will increase the risks facing investors who participate in this new segment of the securities markets. Such preemption is contrary to the documented intent of Congress and it is bad

policy, particularly with respect to small and unsophisticated investors. We urge the Commission to remove state preemption from the proposed rules in order to protect investors and the integrity of the markets.

If you have any questions about this letter or if we can assist in any way, please contact me or Bryan Lantagne, Director of the Massachusetts Securities Division, at (617) 727-3548.

Sincerely,



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