July 14, 2011

Via E-Mail: rule-comments@sec.gov

Ms. Elizabeth Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Release No. 33-9211; File No. S7-21-11;
Proposed Rule 506(c) under Regulation D of the Securities Act of 1933 to Implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act

Dear Ms. Murphy:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on the Securities and Exchange Commission's (the "SEC" or "Commission") proposed amendments to certain rules under the Securities Act of 1933 (the "Securities Act") to implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

Section 926 of the Dodd-Frank Act requires the SEC to issue rules establishing certain disqualification events that would render an offering of securities ineligible to be conducted pursuant to Rule 506 of Regulation D under the Securities Act.[2] Specifically, the SEC is required to issue rules that (i) are "substantially similar" to the disqualification provisions set forth in Rule 262 of Regulation A under the Securities Act, (ii) arise from certain "final orders" of certain States authorities, including any State securities commission, (iii) arise from certain "final orders" of certain federal banking authorities, and (iv) arise from a conviction for any

[1] SIFMA brings together the shared interests of more than 600 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

[2] Rule 506 of Regulation D establishes a non-exclusive safe harbor exemption from registration under the Securities Act pursuant to Section 4(2) thereof. Section 4(2) of the Securities Act provides an exemption from registration in respect of an offering by an issuer not involving any public offering. Rule 506 also establishes a so-called "covered securities" offering pursuant to Section 18(b)(4)(D) of the Securities Act that results in the federal preemption of the securities registration, disclosure, and merit review requirements under the various States' so-called "Blue Sky" or securities laws.

felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the SEC.[3]

The SEC's proposed amendments include adding a new subsection (c) to Rule 506 ("Proposed Rule 506(c)") and amending Rule 501 of Regulation D, as well as revising Form D.[4]

I. Introduction and Executive Summary

SIFMA supports the policy underlying Section 926 of the Dodd-Frank Act, namely, to protect investors from unscrupulous sellers who repeatedly engage in securities fraud, without stifling capital formation.[5] However, SIFMA believes that Proposed Rule 506(c) is overly broad and, if adopted, would lead to the disqualification of many broker-dealers, particularly larger full-service firms, from being able to participate as selling or placement agents in Rule 506 offerings, and would also make it more difficult and costly for asset managers who advise investment funds to discharge their fiduciary duties. The result will be a less efficient, and more costly, capital raising process for issuers who likely will not have ready access to other traditional sources of financing/capital, such as bank loans.

As the Commission notes in the Proposing Release, Rule 506 is the most widely used Regulation D exemption, with approximately 90-95% of all Regulation D offerings claiming a Rule 506 exemption, and accounts for a vast majority of the capital raised in transactions under Regulation D. SIFMA is concerned that if Proposed Rule 506(c) is implemented in its current proposed form, it will not only preclude many broker-dealers and asset managers from participating in Rule 506 offerings, but will also effectively eliminate the ability for many issuers to raise capital in the U.S. other than by means of a public offering, which likely will not be a viable or cost-effective alternative for many private issuers.

SIFMA is also concerned that Proposed Rule 506(c) could have a chilling effect on the ability of issuers – from traditional brick-and-mortar companies to technology start-ups – to raise essential capital necessary to sustain and grow their businesses, which could contribute to, if not exacerbate, a substantial drag on the growth of the U.S. economy by impeding the ability of issuers to invest in their businesses and create needed jobs for the economy.

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3 *See* Securities Act Release No. 9211 (May 25, 2011), 76 Fed. Reg. 31518 (Jun. 1, 2011), *available at* http://sec.gov/rules/proposed/2011/33-9211.pdf (the "Proposing Release").

4 Pursuant to Rule 503 of Regulation D under the Securities Act, Form D is filed with the SEC in connection with the conduct of an offering pursuant to, among other things, Rule 506. Form D is also the basis for notification under applicable States' Blue Sky laws in respect of the conduct of a covered securities offering pursuant to Section 18(b)(4)(D) of the Securities Act.

5 *See* Statement of Senator Christopher Dodd, CR S3813 (May 17, 2010).

In this regard, and as noted above, because offerings that are currently conducted pursuant to Rule 506 constitute covered securities offerings under Section 18(b)(4)(D) of the Securities Act, the ineligibility to rely on Rule 506, by reason of the adoption of Proposed Rule 506(c), will also result in the ineligibility of the issuer to conduct a covered securities offering under Section 18(b)(4)(D) of the Securities Act. This would result in an issuer, and its private offering, now being subject to, and having to comply with, the general securities registration requirements of potentially multiple States under the various States' Blue Sky laws (in each State where the offering is conducted/made). The potential applicability of multiple, and potentially conflicting, State requirements could impact the business or economic terms of an offering and could result in undermining capital formation by substantially increasing the cost of raising capital to an issuer. In fact, it is possible that one or more States would not permit an offering to be conducted in such States because an issuer may not be willing, or able, to comply with certain State disclosure or merit requirements, thereby, inefficiently eliminating sources of capital and potentially driving up capital costs to the issuer.

Because the implementation of Proposed Rule 506(c) could substantially increase the cost to issuers to raise capital in the U.S. private market, U.S. issuers may be unfairly, and competitively, disadvantaged vis-à-vis foreign issuers who could look, instead, to raise capital outside of the U.S. That unfair disadvantage may also result in a two-tiered market for private capital in the U.S., as larger issuers may be driven offshore to raise capital via Regulation S under the Securities Act, but which foreign access may not be available to smaller U.S. issuers. Thus, at a time when the U.S. economy most needs U.S. companies to grow and create jobs, Proposed Rule 506(c) could, unfortunately, act as a two-fisted drag on many U.S. issuers who seek to raise capital in the only available capital market – the U.S. private market.

In light of the vast amount of private capital raised in the U.S. in reliance on the Rule 506 safe harbor, and the widespread and potentially severe impact of Proposed Rule 506(c) on the source of capital, SIFMA believes that the SEC should consider scaling back the scope of the application of Proposed Rule 506(c), and has directed its comments in this letter towards this end.

Based on the foregoing, and as explained in greater detail below, SIFMA's views on the proposed amendments can be summarized as follows:

<u>Covered Persons</u>

- A disqualification event involving an affiliated issuer should only result in a disqualification of the issuer if the issuer and the affiliated issuer have overlapping day-to-day management on a senior management or executive officer basis.
- Predecessor issuers should be treated like affiliated issuers under Proposed Rule 506(c)(3); that is, an event that arose while the predecessor issuer was controlled by another entity or group should not be the basis for disqualification of the

successor issuer. Also, if the predecessor issuer is a "fundamentally different" entity, as defined herein, from the successor entity, the successor entity should not be subject to the predecessor's disqualification event.

- The term "officer" should be defined to mean an "executive officer," as defined in Rule 501(f) of Regulation D under the Securities Act.
- General partners of limited partnerships or managing members of limited liability companies should not be covered persons. The focus should be on the executive officers or directors of a general partner or a managing member – consistent with the establishment of covered persons in respect of executive officers and/or directors "of the issuer."
- A promoter that is subject to a disqualification event should only render an offering ineligible under Rule 506 if involved in the day-to-day management of the issuer or paid remuneration for solicitation of purchasers.
- The definition of "beneficial owner" as set forth in Rule 13d-3 of the Securities Exchange Act of 1934 ("Exchange Act") should be incorporated and applied to Proposed Rule 506(c), and the threshold beneficial ownership percentage should be raised from 10% to 50%, but should exclude both synthetic participation in the economic gains/losses of the issuer through a swap agreement not entered into by the issuer or an entity that controls the issuer, and certain passive investors, direct or indirect, who do not have the ability to participate in the day-to-day management of the issuer.
- The SEC should allow issuers to rely on an affirmative representation obtained within the past twelve months from investors concerning their beneficial ownership percentage, and thereafter on an annual confirmation via a negative consent letter, consistent with the Financial Industry Regulatory Authority, Inc. ("FINRA") Rules 5130 and 5131.
- An investment adviser to a hedge fund or private equity fund, where the fund/issuer has an independent board of directors, managing member or general partner, should not be a person covered under Proposed Rule 506(c).
- Because investment advisers are subject to a fiduciary duty with respect to their advisory clients and, under the Dodd-Frank Act, would generally be subject to federal and State regulation, investment advisers should not be a separate category of covered persons.
- Disqualification at the master fund or trading fund level should not render a feeder fund or fund-of-funds ineligible to rely on Rule 506 in connection with the private offering of interests in such upper-tier funds, where the master/trading fund is not under common management/control with the feeder fund or fund-of-funds. Similarly, a disqualification event of such a feeder fund or fund-of-funds should not render such master/trading fund ineligible to rely on Rule 506 in connection with the private offering of interests in such lower-tier fund.
- Broker-dealers who do not receive remuneration from the issuer for soliciting prospective investors in connection with a private offering should not be covered

persons, even if the broker-dealer internally compensates its sales/marketing personnel. Remuneration should be defined to be compensation for actual selling, and not for providing financial advisory or consulting services, or structuring advice. Remuneration received by affiliates of a broker-dealer, separate from the broker-dealer's solicitation activities on behalf of the issuer, should not be included as remuneration paid to the broker-dealer for these purposes.

- To establish a disqualification event, orders, judgments or decrees entered with, or involving, a broker-dealer should relate to a broker-dealer's activities of offering securities.
- Foreign broker-dealers who are not subject to SEC regulation and who solicit foreign investors located outside the U.S. and introduce those foreign investors to a U.S. issuer or who solicit appropriate U.S. institutional investors in accordance with the chaperoning provisions of Rule 15a-6(a)(3) under the Exchange Act should not be subject to disqualification.
- Certain excepted categories of offerings for certain sophisticated investors should be adopted – consistent with FINRA Rule 5122.
- Private offerings conducted by issuers registered as investment companies under the Investment Company Act of 1940 ("1940 Act") should be exempt from Proposed Rule 506(c).

Disqualification Events

- Bars should establish a disqualification event only for so long as the bar has continuing effect, and permanent bars should have an ultimate cut-off after a specified period of time after the entry of the bar.
- Long look-back periods to establish disqualification events serve only to unduly punish issuers; the SEC should adopt not greater than a one-year look-back period to the extent that it has flexibility to determine appropriate look-back periods.
- "Bad actors" who are no longer employed by, connected to or otherwise involved with the issuer or any controlling affiliate of the issuer should not subject the issuer to disqualification.
- Issuers should not be disqualified if the senior management or executive officers who controlled or oversaw the issuer when a disqualification arose are no longer employed by the issuer or a controlling affiliate of the issuer in a senior management or executive role, or the issuer has implemented policies and/or procedures designed to prevent from arising in the future the activities to which the disqualification relates, and such policies and/or procedures have been approved by either a regulator or court whose action results in a disqualification for the issuer, or an outside third party who has been authorized by such regulator or court to approve the policies and/or procedures.
- Criminal convictions should only be disqualifying if they relate to securities offerings, in the manner currently prescribed in Proposed Rule 506(c).

- Court injunctions, judgments and restraining orders should only be disqualifying if entered within, and only during, the relevant look-back period, and look-back periods should be uniform and measured as of the date of the entry of the injunction, judgment or order.
- SIFMA generally supports the SEC's definitions of "bar" and "final order," with minor variations.
- The SEC should establish what constitutes "fraudulent, manipulative or deceptive" conduct by requiring a scienter-based standard in conformity with Section 17(a) of the Securities Act and Section 10(b) and Rule 10b-5 under the Exchange Act in order to avoid disqualification events arising by reason of technical violations.
- SIFMA believes that the SEC should adopt a definition of "order" based upon Form BD.
- A cease and desist order should not create a disqualification unless it imposes a limitation or restriction on conduct.
- Final orders of the Commodity Futures Trading Commission ("CFTC") or other regulators not specifically identified in Section 926 of the Dodd-Frank Act should not establish a disqualification event under Proposed Rule 506(c).
- Corresponding orders or events arising in foreign jurisdictions should not establish a disqualification event under Proposed Rule 506(c).

<u>Reasonable Care Exception</u>

- SIFMA supports the reasonable care exception, and recommends that an issuer be permitted to establish the exception solely through an initial, written/affirmative representation about the potential applicability of disqualification events, followed by subsequent annual negative consent letters relating to any changes to such written/affirmative representation – consistent with FINRA Rules 5130 and 5131.

<u>Waivers</u>

- The SEC should exercise waiver authority with respect to all categories of disqualification events arising under Proposed Rule 506(c).
- The SEC should provide for automatic waivers, similar to the Model Accredited Investor Exemption and the Uniform Limited Offering Exemption, in each case, promulgated by the North American Securities Administrators Association, Inc. ("NASAA"), where a disqualification event is based upon an order in which the applicable regulator determines that an offering should not be ineligible by reason of Proposed Rule 506(c).

Transition Issues

- A disqualification event should only arise with respect to orders, judgments, decrees or injunctions that are entered after the adoption of Proposed Rule 506(c).
- Negotiated and other settlements that predate the adoption of Proposed Rule 506(c) should not establish a basis for a disqualification.
- A disqualification event should only be applicable to a sale that occurs after the disqualification event, and should not disqualify any sales prior to the event.
- Because of the substantial preparation necessary to implement Proposed Rule 506(c), the SEC should provide for a one-year implementation period for Proposed Rule 506(c).

We address these and other points in further detail below and provide our views on the possible positive and negative consequences of the proposed amendments, along with our opinion as to whether the proposed amendments would foster the stated policy goals of Congress in enacting Section 926 of protecting investors while encouraging capital formation. In addition, we also address below certain questions raised by the Commission in the Proposing Release.

II. "Covered Persons"

Under Proposed Rule 506(c), the disqualification provisions arise if any one or more of the following persons ("covered persons") is, or becomes subject to, a disqualification event set forth in Proposed Rule 506(c): (i) the issuer and any predecessor of the issuer or an affiliated issuer; (ii) any director, officer, general partner or managing member of the issuer; (iii) any beneficial owner of 10% or more of any class of the issuer's equity securities; (iv) any promoter connected with the issuer in any capacity at the time of the sale; (v) any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with the sales of securities in the offering in question (such as, a placement agent or finder); and (vi) any director, officer, general partner, or managing member of any such compensated solicitor.

A. *"Affiliated Issuer"*

As noted above, "the issuer and any predecessor of the issuer or an *affiliated issuer*" would be considered covered persons for purposes of Proposed Rule 506(c). (italics supplied.) The term "affiliated issuer" is not defined in Regulation A under the Securities Act, Rule 405 under the Securities Act or Rule 501 of Regulation D under the Securities Act. The term, however, appears to contemplate any "affiliated entity" that, based on the definitions of "affiliate" and "control" set forth in Rule 405,[6] would be any entity directly or indirectly

[6] As set forth in the Proposing Release, the SEC proposes to incorporate the applicable definitions in Rule 405 under the Securities Act, with which SIFMA generally agrees. However, with respect to the determination of "control," SIFMA believes that the threshold ownership for control should be established at a 50% ownership level in conformity with FINRA Rule 5122 (relating to private placements of securities issued by FINRA members or their affiliates), as approved by the SEC. At an ownership level of less than

controlling, controlled by or under common control with the issuer.[7] SIFMA seeks clarification from the Commission as to the scope of "affiliated issuer."

Further, SIFMA believes that even though an affiliate of an issuer may be subject to a disqualification event, such affiliate relationship should not, in and of itself, give rise to a disqualification of the issuer under Proposed Rule 506(c). Rather, SIFMA believes that a disqualification event involving an affiliated issuer should only result in a disqualification of the issuer if the issuer and the affiliated issuer have overlapping day-to-day management on a senior management or executive officer basis. This approach is consistent with Proposed Rule 506(c)(3), where a disqualification event involving an affiliated issuer will not result in a disqualification of the issuer if the disqualification arose before the affiliation and the affiliated issuer is not in control of the issuer. Otherwise, there is a substantial risk that in a large holding company ownership/structure, a relatively minor affiliate of the issuer, which could be involved in a completely unrelated business to the issuer, could cause, or result in, the disqualification of the issuer under Proposed Rule 506(c).

B. *"Predecessor Issuer"*

As noted above, "the issuer and any *predecessor of the issuer* or an affiliated issuer" would be considered covered persons for purposes of Proposed Rule 506(c). (italics supplied.) SIFMA believes that predecessor issuers should be treated like affiliated issuers under Proposed Rule 506(c)(3), *i.e.*, if a disqualification arose while the "predecessor" issuer was controlled by another entity or group, then the disqualification should not result in a disqualification to the "successor" issuer (where, for example, the senior management of the successor issuer is different from that of the predecessor issuer).

Additionally, SIFMA believes that if the predecessor issuer is a fundamentally different entity than the successor entity, the successor entity should not be subject to the predecessor's disqualification. A fundamentally different entity for the purposes of Proposed Rule 506(c) should include the following: (i) an issuer that sells a division or unit that was the cause of a disqualification; (ii) an issuer that acquires a division or unit that was the subject of a disqualification, which division or unit represents less than 50% of the issuer's total assets and

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50%, remote investors who do not possess the ability to direct the day-to-day management of an issuer could nonetheless result in a disqualification of the issuer. SIFMA does not believe that the latter appropriately serves the intent of Section 926 of the Dodd-Frank Act, which is to disqualify issuers with substantial involvement by or with certain bad actors.

7 Pursuant to Proposed Rule 506(c)(3) (which provides an exception for certain "affiliated issuers" from triggering a disqualification where an affiliated issuer is subject to a disqualification and the disqualification arose prior to the establishment of an affiliation between the issuer and the other entity), the SEC appears to equate an "affiliated entity" with an "affiliated issuer" and does not appear to mean an affiliated entity that is also an issuer of securities to third parties, but SIFMA seeks clarification on this point.

revenues; or (iii) a merger of "equals" where the surviving entity was not subject to a disqualification.

C. *"Officer"*

As noted above, "any director, officer, general partner or managing member of the issuer" would be considered covered persons for purposes of Proposed Rule 506(c). In response to the Commission's request for comment, SIFMA believes that the term "officer" should be defined to mean an "executive officer," as defined in Rule 501(f) of Regulation D under the Securities Act. SIFMA agrees with the Commission that, in many organizations, certain officers (*e.g.*, vice presidents) may not be involved in policy-making or executive decisions, and believes it would be more appropriate to limit coverage to individuals who play a senior/executive or policy-making role with, or on behalf of, the issuer.

D. *"General Partner or Managing Member of the Issuer"*

A covered person would include a general partner and a managing member of the issuer (where the issuer is a limited partnership and a limited liability company, respectively). However, a covered person would not include any director or officer of a general partner or managing member of an issuer.[8]

SIFMA believes that including a general partner or managing member of the issuer as a covered person is not the correct approach; rather, the focus should be on the executive officers or directors of the general partner or managing manager – the more direct analog to the executive officers or directors "of the issuer." In this regard, the general partner or managing member of an issuer, which is a limited partnership or limited liability company, as applicable, may be engaged in substantial other activities, via other divisions or business units, that are unrelated to the management of the issuer or the offering of securities, which other activities conducted through such other divisions/units might become the basis, albeit an incidental basis, of a disqualification event. Because the intent of Section 926 of the Dodd-Frank Act is to disqualify certain bad actors from continuing to take advantage of the Rule 506 private placement process, the proper focus for determining covered persons based on the management of the issuer should be on those executive officers or directors of the general partner or managing member who are engaged in the day-to-day management of the issuer.

Proposed Rule 506(c) would include a "promoter" as a covered person, as such term is defined in Rule 405 under the Securities Act.[9] For the same reasons as set forth above, unless a

8 Proposed Rule 506(c) specifically includes as covered persons any director, officer, general partner, or managing member of the issuer or of any compensated solicitor, but not any director or officer of a general partner or managing member of an issuer.

9 Pursuant to Rule 405 under the Securities Act, the term "promoter" means:

promoter is involved in the day-to-day management of the issuer or will be paid remuneration for solicitation of purchasers, SIFMA does not believe that a person who is a promoter, and the subject of a disqualification event, should result in the ineligibility of the offering to be conducted pursuant to Rule 506.

E. *"Beneficial Owner of 10% or More of Any Class of the Issuer's Equity Securities"*

As noted above, "any beneficial owner of 10% or more of any class of the issuer's equity securities" ("10% Beneficial Owners") would be considered a covered person for purposes of Proposed Rule 506(c). The term "beneficial owner" is not defined in the Proposing Release, and SIFMA suggests that the definition of "beneficial owner," as set forth in Rule 13d-3 of the Exchange Act, should be incorporated and applied to Proposed Rule 506(c).[10]

SIFMA also believes that the following should not establish beneficial ownership for these purposes: (i) synthetic participation in the economic gains and losses of the issuer through a swap agreement that is not entered into by the issuer or an entity that controls the issuer; and (ii) passive investments no matter what the level of ownership, such as investments in a hedge fund or private equity fund, in which the investor, directly or indirectly, has no right to

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> (i) Any person who, acting alone or in conjunction with one or more other persons, directly or indirectly takes initiative in founding and organizing the business or enterprise of an issuer; or (ii) Any person who, in connection with the founding and organizing of the business or enterprise of an issuer, directly or indirectly receives in consideration of services or property, or both services and property, 10 percent or more of any class of securities of the issuer or 10 percent or more of the proceeds from the sale of any class of such securities. However, a person who receives such securities or proceeds either solely as underwriting commissions or solely in consideration of property shall not be deemed a promoter within the meaning of this paragraph if such person does not otherwise take part in founding and organizing the enterprise.

10 *See* 17 C.F.R. § 240.13d-3. Pursuant to Rule 13d-3(a), a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares (1) voting power, which includes the power to vote, or to direct the voting of, such security, and/or (2) investment power, which includes the power to dispose, or to direct the disposition of, such security. Pursuant to Rule 13d-3(d), a person shall also be deemed to beneficially own any securities that he or she has the right to acquire beneficial ownership of within 60 days. Further, pursuant to Rule 13d-3(b), any person who, directly or indirectly, creates or uses a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement, or device with the purpose of effect of divesting such person of beneficial ownership of a security or preventing the vesting of such beneficial ownership as part of a plan or scheme to evade the reporting requirements of Sections 13(d) or (g) of the Exchange Act shall be deemed for purposes of such sections to be the beneficial owner of such security. Additionally, pursuant to Rule 13d-3(c), all securities of the same class beneficially owned by a person, regardless of the form which such beneficial ownership takes, shall be aggregated in calculating the number of shares beneficially owned by such person.

participate in the day-to-day management of the issuer.[11] This latter exclusion is supported by footnote 20 of the Proposing Release, which provides that the Commission "see[s] no policy basis for imposing disqualification on a partnership based on violations of law by its limited partners, and accordingly propose[s] to clarify that only general partners would be covered."

Additionally, and subject to the discussion above regarding passive investment, SIFMA believes that the threshold beneficial ownership percentage should be raised from 10% to 50%. As noted above, using 50% as the threshold for ownership would eliminate the risk that an issuer could become disqualified under Proposed Rule 506(c) as a result of the actions of a remote, or incidental, investor who does not have the ability to participate in the day-to-day management of the issuer. The latter would be consistent with the definition of "control" set forth in FINRA Rule 5122.[12] At the very least, however, the SEC should set a floor beneficial ownership of 25%, which would be consistent with the Commission's definition of "control" as set forth in the Form BD[13] and under Section 2(a)(9) of the 1940 Act.[14]

Finally, SIFMA is concerned with the potential monitoring problem that could arise by including 10% Beneficial Owners as covered persons, especially in the context of ongoing

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11 Consistent with applicable State law, statutory voting rights that, for example, require limited partners or non-managing members be afforded the right to vote, as a class, to approve certain changes to constituent documents or to approve the sale or disposition of substantially all the assets of an issuer should not be deemed to constitute participation in the day-to-day management of the issuer.

12 FINRA Rule 5122 defines "control" as "beneficial interest . . . of more than 50 percent of the outstanding voting securities of a corporation, or the right to more than 50 percent of the distributable profits or losses of a partnership or other non-corporate legal entity."

13 The term "control" is defined in Form BD as follows:

> [T]he power, directly or indirectly, to direct the management or policies of a company, whether through ownership of securities, by contract, or otherwise. Any person that (i) is a director, general partner or officer exercising executive responsibility (or having similar status or functions); (ii) directly or indirectly has the right to vote 25% or more of a class of a voting security or has the power to sell or direct the sale of 25% or more of a class of voting securities; or (iii) in the case of a partnership, has the right to receive upon dissolution, or has contributed, 25% or more of the capital, is presumed to control that company.

See "Explanation of Terms" applicable to FINRA Form BD (*available at* http://www.finra.org/web/groups/industry/@ip/@comp/@regis/documents/appsupportdocs/p116979.pdf.)

14 The term "control" is defined in Section 2(a)(9) of the 1940 Act to mean "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company," with a presumption of control by any person who beneficially owns, directly or indirectly, more than 25% of the voting securities of a company (and with a presumption of an absence of control if a person does not own more than 25% of the voting securities of a company).

offerings, such as those by a hedge fund. Specifically, the applicability of the disqualification events to any 10% Beneficial Owner would require ongoing, and careful, monitoring, and could be read to require an issuer to obtain information on a flow-through basis with respect to multiple layers of indirect owners. For example, if a continuously-offered hedge fund has other third-party managed funds investing therein (which in turn could have other funds investing in them), it could be impossible to determine the covered person status of all of the beneficial owners, especially if the level of beneficial ownership necessary to trigger a disqualification is set too low, such as at 10% ownership.[15] As such, SIFMA recommends that the Commission adopt a provision in Proposed Rule 506(c) that is similar to provisions in FINRA Rules 5130 and 5131,[16] which rules were approved by the SEC, relating to the allocation by FINRA member firms of new issues, or initial public offerings of equity securities. These rules permit a FINRA member, in good faith, to rely on an affirmative written representation from a person for one year that such person is not ineligible to receive new issues under such rules and, annually thereafter, to rely on a negative consent letter that is sent to such purchaser requesting that the purchaser advise the member whether or not any changes to such initial affirmative representation have occurred, and if the member does not receive any update from the purchaser, the member can assume that no changes have occurred thereto (providing that the member relies thereon in good faith). SIFMA believes that a similar practice, namely, good faith reliance on a written representation and annual confirmation thereafter, should be allowed under Proposed Rule 506(c) in order to help alleviate the potentially heavy burden of monitoring beneficial ownership.

F. *Investment Advisers to Hedge Funds and Private Equity Funds*

In the Proposing Release, the SEC indicates that investment advisers of issuers are not covered persons, but requests comment on whether including investment advisers as covered persons would be appropriate. As set forth above, SIFMA believes that the focus of the covered person categories with respect to the management or operation of a non-corporate issuer should be based on those individuals who are the equivalent of executive officers or directors of the issuer, and not upon an entity serving as the general partner or managing member of the issuer who employs such individuals. Similarly, SIFMA believes that an investment adviser which is hired or appointed, for example, by a hedge fund or a private equity fund that has a board of directors, managing member or general partner which are/is independent of the investment adviser should not be a covered person under Proposed Rule 506(c).

In addition, because investment advisers are subject to a fiduciary duty with respect to their advisory clients and, under the Dodd-Frank Act, would, generally, be subject to registration

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15 However, to the extent that such investors would be passive, without any ability to manage the underlying fund, they should not be deemed to have beneficial ownership over the fund for these purposes, as discussed above.

16 *See* FINRA Rule 5130(b) and FINRA Rule 5131.02.

and substantial regulation under State securities laws or the Investment Advisers Act of 1940, as the case may be, including separate disqualification provisions, SIFMA believes there is no need to create a separate covered person category for investment advisers under Proposed Rule 506(c).

G. *Offerings Involving Master/Feeder Funds and Fund-of-Funds*

Suppose that a feeder fund or fund-of-funds invests in an underlying master or trading fund, and such master/trading fund is managed by persons who are not affiliated with the manager of the feeder fund or fund-of-funds. Suppose further that the manager of the master/trading fund is a covered person (subject to a disqualification event under Proposed Rule 506(c)), but that no disqualification event arises at the feeder fund or fund-of-funds level. SIFMA seeks confirmation from the SEC that, in connection with the private offering of interests by the feeder fund or fund-of-funds, the ineligibility of the master/trading fund to conduct a private offering in accordance with Rule 506 would not render ineligible the feeder fund or fund-of-funds from relying on Rule 506 in connection with the private offering of interests in such upper-tier funds.[17] Similarly, SIFMA seeks confirmation from the SEC that a disqualification event of such feeder fund or fund-of-funds should not render such master/trading fund to be ineligible to rely on Rule 506 in connection with the private offering of interests in such lower-tier fund.

H. *Persons Who Receive Remuneration for Solicitation of Purchasers*

Pursuant to Proposed Rule 506(c), one of the categories of covered persons is "any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities."

Remuneration should be defined to mean that the recipient thereof (assumed for these purposes to be an Exchange Act-registered broker-dealer) is receiving payment for actually soliciting prospective purchasers in connection with an issuer's private offering – engaging in selling activities – and not for activities that are unrelated to the actual solicitation of prospective investors, for example, for providing financial advisory or consulting services or structuring advice to an issuer or an affiliate of the issuer, or for providing, or arranging, a loan or credit facility to the issuer (by or from an affiliate of the broker-dealer or other person). Conversely, broker-dealers who do not receive remuneration from the issuer for soliciting prospective investors in connection with a private offering should not be covered persons in respect of such

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17 Pursuant to Rule 140 under the Securities Act, a person, the chief part of whose business consists of the purchase of the securities of one issuer, or of two or more affiliated issuers, and the sale of its own securities is deemed to be engaged in the "distribution" of the securities of such issuer or affiliated issuers within the meaning of the definition of "underwriter" in Section 2(a)(11) of the Securities Act. In the conduct of a private offering conducted pursuant to Section 4(2) of the Securities Act and Rule 506 thereunder, however, there is no distribution being conducted and, thus, no person could be deemed to be an "underwriter."

offering, even if the broker-dealer internally compensates its sales/marketing personnel in connection with such offering.

In order to establish a disqualification event under Proposed Rule 506(c), orders, judgments, decrees or injunctions that are entered into with a broker-dealer should relate to a broker-dealer's activities of offering securities as a placement or selling agent or underwriter. For example, an order entered into with a broker-dealer that relates to retail trading should not establish a disqualification event for the broker-dealer under Proposed Rule 506(c). In this regard, the purpose of Section 926 of the Dodd-Frank Act is to "disqualify felons and other 'bad actors' who have violated Federal and State securities laws from *continuing to take advantage of the rule 506 private placement process*" and "reduce the danger of fraud in private placements."[18] (italics supplied). The latter indicates that the intent of Section 926 is to disqualify persons "from continuing" to engage in private placements via Rule 506 where those persons have demonstrated that they are "bad actors" in connection with the offering of securities and, thus, should be subject to restrictions in the conduct of *future* private placements. Unless the person in question is a bad actor by reason of prior activities involving the offer and/or sale of securities, there is no clear link between a person's prior acts and such person's propensity to engage in "fraud in private placements,"[19] as contemplated by Section 926.

In addition, because, as noted above, Section 926 of the Dodd-Frank Act focuses on "felons and other 'bad actors' who have violated Federal and State securities laws" in connection with the private offering of securities, SIFMA believes that the Commission should exclude foreign broker-dealers who are not subject to regulation under the Exchange Act and who solicit foreign investors, located outside of the U.S., and introduce those foreign investors to a U.S. issuer.[20] In addition, SIFMA believes that the Commission should exclude foreign broker-dealers who solicit appropriate U.S. institutional investors in accordance with the chaperoning requirements of Rule 15a-6(a)(3) under the Exchange Act, which rule imposes its own disqualification requirements.[21]

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18 Statement of Senator Christopher Dodd, *supra* note 5.

19 See, for example, the disqualification provisions set forth in Section D(a), (b), (c), and (d) of NASAA's Model Accredited Investor Exemption. All of the disqualification events arising thereunder, with the exception of certain criminal convictions, are limited to activities involving the offer, purchase or sale of a security.

20 These exemptions may not be necessary if the Commission limits the scope of disqualification events under Proposed Rule 506(c) to U.S. federal and State regulatory or legal actions, as SIFMA recommends below.

21 See Rule 15a-6(a)(3)(ii) under the Exchange Act. Such an exception may be unnecessary in light of our suggestion of establishing certain excepted categories of offerings, as set forth below.

In construing the applicability of a disqualification event to a broker-dealer, the SEC should be mindful that with respect to larger, full-service broker-dealers, which operate multiple business lines, there is a significant risk under Proposed Rule 506(c) that some relatively minor portion of the broker-dealer's overall business could cause, or result in, the entire broker-dealer becoming disqualified from being able to participate in, or conduct, a private offering pursuant to Rule 506.

I. *Excepted Categories of Offerings*

SIFMA believes that the Commission should except out, or exempt, from disqualification certain categories of offerings to certain sophisticated investors who possess sufficient knowledge and experience to be able to evaluate the merits and risks of the prospective offering on their own. Specifically, SIFMA believes that offerings sold solely to (i) "qualified purchasers," as defined in Section 2(a)(51)(A) of the 1940 Act, (ii) "knowledgeable employees," as defined in Rule 3c-5 under the 1940 Act, (iii) "qualified institutional buyers," as defined in Rule 144A under the Securities Act, (iv) "qualified purchasers," as such term may be defined by the SEC pursuant to Section 18(b)(3) of the Securities Act, and/or (v) any other institutional account as set forth in Rule 3110(c)(4)[22] of the former National Association of Securities Dealers, Inc. ("NASD") should be excepted or exempt from disqualification under Proposed Rule 506(c).

SIFMA believes such an exception would be consistent with FINRA Rule 5122 related to private offerings by member firms, as approved by the SEC, which exempts from the disclosure, filing and use-of-proceeds requirements set forth in the rule private offerings sold solely to, among others, "qualified purchasers," as defined in Section 2(a)(51)(A) of the 1940 Act, "knowledgeable employees," as defined in Rule 3c-5 under the 1940 Act, "qualified institutional buyers," as defined in Rule 144A under the Securities Act, and a person who qualifies as an "institutional account," as defined in NASD Rule 3110(c)(4).[23] If such an exception or

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[22] NASD Rule 3110(c)(4) defines the term "institutional account" to mean "the account of: (A) a bank, savings and loan association, insurance company, or registered investment company; (B) an investment adviser registered either with the Securities and Exchange Commission under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or (C) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million."

[23] Of note, FINRA recently proposed to amend Rule 5122 to expand the scope of the rule to cover all private placements in which a FINRA member firm participates, not just those in which the member firm or a control entity is the issuer, but would nonetheless maintain each of the aforesaid exemptions that are set forth in current FINRA Rule 5122(c) (although "knowledgeable employees" is not a specified category under FINRA Rule 5122 or the proposed amendment thereto, FINRA Rule 5122(c) does provide an exemption for offerings to employees and affiliates of the issuer or its control entities). *See* FINRA Regulatory Notice 11-04, "Private Placements of Securities," *available at* http://www.finra.org/Industry/Regulation/Notices/2011/P122788.

exemption were adopted, issuers could still be obligated to disclose in the relevant private placement memorandum, term sheet or similar offering documents, any of the excepted or exempted parties involved in the offering who are subject to any of the disqualification events set forth in Proposed Rule 506(c), if applicable.

SIFMA further believes that providing these limited categories of excepted purchasers, as described above, is consistent with the legislative intent underlying Section 926 of the Dodd-Frank Act and would not involve the type of investors "who fall victim to sellers who repeatedly engage in securities fraud."[24]

In addition, SIFMA believes that the SEC should establish an exception or exemption in respect of private offerings that are conducted by issuers which are registered as investment companies under the 1940 Act and, thus, which are subject to regulation thereunder, including the ineligibility provisions of Section 9(a) of the 1940 Act.[25]

III. Disqualification Events

Proposed Rule 506(c) would render the Rule 506 safe harbor unavailable to an issuer if any covered persons were subject to any of the following disqualification events: (i) certain criminal convictions; (ii) certain court injunctions and restraining orders; (iii) certain final orders of certain State regulators (such as State securities, banking and insurance regulators) and federal regulators; (iv) certain SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers, and investment companies and their associated persons; (v) suspension or expulsion from membership in, or suspension or bar from associating with a member of, a securities self-regulatory organization; (vi) SEC stop orders and orders suspending a Regulation A exemption; and (vii) U.S. Postal Service false representation orders. Some of these disqualification events are subject to a five- or ten-year look-back period.

A. *Look-Back Periods*

1. Bars

SIFMA agrees with the SEC's proposal that a bar should establish a disqualification event only for so long as the bar has continuing effect. The Commission requests comment on whether it would be appropriate to have a cut-off date for permanent bars, after which point the bar would no longer be a disqualifying event. The Commission notes that under the current

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[24] Statement of Senator Christopher Dodd, *supra* at note 5.

[25] Section 9(a) of the 1940 Act makes it unlawful for certain disqualified persons to serve or act in the capacity of employee, officer, director, member of an advisory board, investment adviser, or depositor of any registered investment company, or principal underwriter for any registered open-end company, registered unit investment trust, or registered face amount certificate company.

interpretations of Rule 262, permanent bars are permanently disqualifying. SIFMA believes, however, that a permanent bar should operate like a continuing court order or injunction and should not have a continuing effect because of fundamental fairness, but rather should have an ultimate cut-off after a specified period of time after the entry of the bar, as proposed under Proposed Rule 506(c) and as further discussed below.

2. Length of Look-Back Periods

Proposed Rule 506(c) applies ten-year look-back periods for criminal convictions and final orders of certain State and federal regulators related to fraudulent, manipulative or deceptive conduct. SIFMA believes that these decade-long look-back periods are fundamentally too long. SIFMA fears that such lengthy look-back periods will unduly punish an issuer and, absent the legal certainty of the safe harbor afforded by Rule 506 of Regulation D, could adversely affect or restrict an enterprise's access to capital markets for business development and growth. This is especially problematic if the "bad actors" are no longer employed by the issuer or a controlling affiliate in a senior management or executive officer role, or if the issuer has implemented policies and/or procedures designed to prevent similar disqualifying events from occurring in the future.

For enterprises seeking to raise capital, even one year is a long time to be restricted from accessing certain parts of the capital markets. Accordingly, to the extent that the SEC has flexibility to determine appropriate look-back periods, SIFMA recommends a uniform one-year look-back period. A one-year look-back period should at least apply if (i) the senior management or executive officers who controlled or oversaw the issuer when the disqualification arose are no longer employed by the issuer or a controlling affiliate of the issuer in a senior management or executive role, or (ii) the issuer has implemented policies and/or procedures designed to prevent from arising in the future the activities to which the disqualification relates, and such policies and/or procedures have been approved by either a regulator or court whose action results in a disqualification for the issuer, or an outside third party who has been authorized by such regulator or court to approve the policies and/or procedures.

B. *Former Employees and Approved Policies and/or Procedures*

SIFMA is also seeking clarification from the Commission regarding the impact on the issuer when persons responsible for either causing the disqualification event, or overseeing the issuer when the disqualification event arose, are no longer employed by the issuer or a controlling affiliate of the issuer. Specifically, SIFMA is concerned that continuing a disqualification of the issuer in such situations would be unwarranted and unfair to the issuer. It is SIFMA's understanding that the policy reasons behind Section 926 are to protect investors by preventing "unscrupulous persons" from continuing to engage in private placements and to reduce the danger of fraud in private placements.[26] Proposed Rule 506(c) implements these

[26] *See* Statement of Senator Christopher Dodd, *supra* note 5.

policy concerns by preventing so-called "bad actors," who were directly involved in causing a disqualification event, from conducting or continuing Rule 506 offerings. For example, if an issuer hires a third party placement agent who subsequently becomes subject to a disqualification event, the issuer's offering would cease to be ineligible to be conducted under Rule 506 if the issuer terminates its relationship with such placement agent. Similarly, SIFMA believes it follows that, once those "bad actors" are no longer employed by, connected to or otherwise involved with the issuer or any controlling affiliate of the issuer, there is no need to maintain the issuer's disqualification from a Rule 506 offering, and no policy served by continuing to penalize the issuer by rendering unavailable the safe harbor in Rule 506 of Regulation D.

Further, SIFMA believes that disqualification of an issuer should arise only if the senior management or executive officers who controlled or oversaw the issuer when the disqualification arose are still employed by the issuer or a controlling affiliate of the issuer in a senior management or executive role. Additionally, even if the senior management or executive officers who controlled or oversaw the issuer when the disqualification arose are still employed by the issuer or a controlling affiliate of the issuer in a senior management or executive role, a disqualification should not arise, or continue to arise, if (i) the issuer has implemented policies and/or procedures designed to prevent from arising in the future the activities to which the disqualification relates, and (ii) such policies and/or procedures have been approved by either a regulator or court whose action results in a disqualification for the issuer, or an outside third party who has been authorized by such regulator or court to approve the policies and/or procedures. Alternatively, as discussed above, there should be at maximum a one-year look-back period in such situations.

C. *Criminal Convictions*

As noted above, Proposed Rule 506(c) includes certain criminal convictions as a disqualification event. Specifically, Proposed Rule 506(c)(1)(i) provides that the Rule 506 safe harbor is unavailable for an offering of securities if any covered person:

> Has been convicted, within ten years before such sale (or five years, in the case of issuers, their predecessors and affiliated issuers), of any felony or misdemeanor: (A) In connection with the purchase or sale of any security; (B) Involving the making of any false filing with the Commission; or (C) Arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities.

In 2007, the SEC proposed Rule 502(e) ("2007 Proposal"), a rule similar to Proposed Rule 506(c), that would have implemented disqualification events applicable to all Regulation D offerings. Although the 2007 Proposal was never adopted, the SEC did receive comments to the 2007 Proposal to which the SEC refers in the Proposing Release. The SEC also received several comment letters regarding Proposed Rule 506(c) in advance of the publication of the Proposing Release. NASAA submitted comment letters in response to the 2007 Proposal and in advance of

Proposed Rule 506(c). In both letters, NASAA urged the SEC to broaden the scope of the criminal convictions disqualification event, to encompass "any criminal conviction involving fraud or deceit," not just convictions related to securities offerings. The SEC requests comment on the appropriateness of this expansion in the Proposing Release.

SIFMA believes that expanding the scope of the disqualification event in respect of criminal convictions as suggested by NASAA will create legal uncertainty and confusion, particularly because the scope of what constitutes a "felony" and a "misdemeanor," and "fraud" and "deceit," can vary greatly among jurisdictions. As discussed below, for example, with respect to disqualification events arising from State orders that are based on fraudulent, manipulative or deceptive conduct, many States interpret those terms to encompass violative conduct that can be merely technical in nature, such as a late notice filing. Thus SIFMA is concerned that conduct based upon these events, but without a uniform (federal) standard for the determination of when such conduct is deemed to arise, will result in inconsistent and vague approaches, thereby, subjecting the determination of whether or not a disqualification event arises to variation in interpretation among many jurisdictions. In contrast, the current categories of criminal convictions in Rule 262 of Regulation A are narrowly-focused to offerings of securities – and thus are simpler to monitor and apply. Considering that Section 926 of the Dodd-Frank Act directs the SEC to adopt rules that are "substantially similar" to Rule 262, it should follow that the categories of criminal convictions in Proposed Rule 506(c) should correspond with those in Rule 262. However, if the SEC does adopt NASAA's suggestion and expands the scope of the criminal conviction disqualification event to include any conviction involving fraud or deceit, SIFMA believes the SEC should define the terms "felony" and "misdemeanor" in Proposed Rule 506(c) by taking the definitions directly from the Form BD,[27] as well as should propose definitions of the terms "fraud" and "deceit" to ensure the application of uniform standards across different jurisdictions and to simplify the monitoring for such disqualification events.[28]

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27 "Felony" is defined in Form BD as "an offense punishable by a sentence of at least one year imprisonment and/or a fine of at least $1,000. The term also includes a general court martial." "Misdemeanor" is defined in Form BD as "an offense punishable by a sentence of less than one year imprisonment and/or a fine of less than $1,000. The term also includes a special court martial." *See* "Explanation of Terms" applicable to FINRA Form BD (*available at* http://www.finra.org/web/groups/industry/@ip/@comp/@regis/documents/appsupportdocs/p116979.pdf.) The Commission should adopt these definitions, generally, for the purposes of Proposed Rule 506(c).

28 SIFMA believes that the SEC should define "fraud" or "fraudulent," "deceit" or "deceptive," and "manipulative" to be scienter-based and interpreted in a manner that is in conformity with Section 17(a) of the Securities Act and Section 10(b) and Rule 10b-5 under the Exchange Act.

D. *Court Injunctions and Restraining Orders*

As noted above, Proposed Rule 506(c) includes certain court injunctions and restraining orders as disqualifying events. Specifically, Proposed Rule 506(c)(1)(ii) includes as a disqualification event certain court injunctions and restraining orders entered within five years prior to the offering and that, at the time of the offering, "restrains or enjoins such person from engaging or continuing to engage in any conduct or practice" involving the three situations prescribed in Rule 506(c)(1)(i), related to criminal convictions, as noted above.

To clarify the look-back period in this provision, the Commission states in footnote 45 to the Proposing Release that "disqualification no longer arises from an injunction or restraining order after the requisite amount of time [*i.e.*, five years] has passed, even though the injunction or order is still in effect." However, the Commission then requests comment on whether such disqualification should instead continue for as long as the injunction or order continues in effect.

As noted above in the discussion of bars, SIFMA supports the provision as proposed that court injunctions and restraining orders be disqualifying only if entered within the five-year look-back period.[29] SIFMA believes that, even if the court injunction or restraining order is continuing, an order, judgment or decree that establishes a disqualification event and that was entered or issued more than five years prior to the relevant sale should cease to be a disqualification event because a longer disqualification period is fundamentally too long and unduly punishes (and burdens) an issuer. This is especially true if the senior management or executive officers who controlled or oversaw the issuer when the disqualification arose are no longer employed by the issuer or a controlling affiliate of the issuer in a senior management or executive role, or if the issuer has implemented policies and/or procedures designed to prevent from arising in the future the activities to which the disqualification relates, and such policies and/or procedures have been approved by either a regulator or court whose action results in a disqualification for the issuer, or an outside third party who has been authorized by such regulator or court to approve the policies and/or procedures.

E. *Disqualification Events Should Arise Only Upon the Entry of an Order, Judgment, Decree or Injunction*

The Proposing Release states that the measurement of the look-back period related to final orders of certain State and federal regulators will be "from the date of the order and not the date of the underlying conduct," although the SEC seeks comment as to whether or not the measurement should be based on the underlying conduct thereof. Because the underlying conduct does not establish a disqualification event until the entry of an order, and because it may be difficult to determine when the underlying event/conduct actually occurred, SIFMA believes

[29] As discussed above in Section III.A.2, SIFMA proposes that the SEC adopt a short one-year look-back period.

that it will provide for easier compliance with and monitoring of Proposed Rule 506(c) to use the date of entry. Moreover, under Rule 262 of Regulation A, as incorporated into Section 926(1) of the Dodd-Frank Act, disqualification events related to orders, judgments or decrees arise only upon the entering, or issuance, of the order, judgment or decree by the applicable court or regulator. Because, as noted earlier, Section 962(1) of the Dodd-Frank Act directs the SEC to adopt disqualification rules that are "substantially similar" to Rule 262, SIFMA believes that this approach should apply consistently to the Proposed Rule 506(c) provisions related to orders, judgments or decrees.

Finally, in the Proposing Release, the SEC requests comment on whether different look-back periods should be established for different types of court injunctions and restraining orders. SIFMA encourages the SEC to keep the look-back periods in Proposed Rule 506(c) uniform. As discussed above in Section III.A.2, SIFMA believes that there should not be different look-back periods among court orders or injunctions, or based upon the severity of the underlying conduct, as there does not appear to be any statutory basis for such distinctions in Section 962, and the SEC has not recognized such distinctions under Rule 262. Further, as discussed above, SIFMA considers ten years a fundamentally long time for any disqualification and recommends a much shorter (one-year) look-back period where possible.

F. *Final Orders of States and Certain Other Regulatory Authorities*

As noted above, Proposed Rule 506(c) includes final orders of certain State and federal regulators as disqualifying events. This includes orders that bar a person from certain stipulated activities, including association with a regulated entity or engaging in securities, insurance or banking business or savings association or credit union activities, as well as orders entered within the past ten years that are based on a violation of a law or regulation that prohibits fraudulent, manipulative or deceptive conduct.

1. <u>Bars</u>

In the Proposing Release, the Commission requests comment on whether it should clarify what constitutes a bar. SIFMA believes that the term "bar" should mean "prohibiting a person from engaging in a particular activity," including the prohibition of a person from being associated with a particular entity. Further, SIFMA recommends that the term "bar" should not include an order that merely requires that the person engage in some specified activity or conduct.

2. <u>Final Order</u>

The Commission is also proposing to adopt a definition of "final order" to Rule 501 of Regulation D. SIFMA supports having a standard, uniform definition of "final order," as it should minimize the potential that a person be subject to inconsistent interpretations that might be governed by multiple States' Blue Sky laws.

Specifically, the definition of "final order," as set forth in the proposed amendments, would mean "the final steps taken by a regulator." The proposed definition of "final order" is based on FINRA's definition of "final order" as set forth in Forms U4, U5 and U6.[30] SIFMA supports this basis, as the FINRA definition of "final order" has worked well, and regulators have experience with such term as so defined, including State regulators. As such, SIFMA believes this would minimize the risk of confusion over multiple definitions in different regulatory contexts. However, SIFMA recommends that the SEC add to the definition that, in order to constitute a "final order," the applicable regulator must have made a finding of fact and set forth conclusions of law on a record, and that a "final order" cannot be subject to appeal – in order to clearly establish true finality. SIFMA believes that defining a "final order" in this way would avoid potential inconsistencies and discrepancies among States and the different laws and regulations that may be applicable.

3. Fraudulent, Manipulative and Deceptive Conduct

As noted above, a final order would be disqualifying if the final order is based on a violation of a law or regulation that prohibits fraudulent, manipulative or deceptive conduct. In the Proposing Release, the Commission seeks comment on what and who should determine whether conduct is "fraudulent, manipulative or deceptive." Consistent with our comments above, SIFMA believes there should be a common standard for "fraudulent, manipulative and deceptive" conduct that is determined by the SEC. SIFMA fears that, if such determination was instead left to individual States (or other regulators), this would almost certainly result in an inconsistent approach. Also, SIFMA believes a common standard would avoid creating a disqualification in many States by reason of a "technical" violation, such as a late filing of a Form D or a Form U-4 registration for an associated person of a broker-dealer, that could be based upon a statutory provision involving fraudulent, manipulative and deceptive conduct.[31] Finally, SIFMA believes that the scope of fraudulent, manipulative and deceptive conduct should be limited to activities involving past securities offerings, in order to be a bar against future securities offerings, and should be scienter-based and interpreted in a manner that is in conformity with Section 17(a) of the Securities Act and Section 10(b) and Rule 10b-5 under the

[30] FINRA defines a "final order" in Forms U4, U5 and U6 as "a written directive or declaratory statement issued by an appropriate federal or State agency . . . pursuant to applicable statutory authority and procedures, that constitutes a final disposition or action by that federal or state agency." *See* "Explanation of Terms" applicable to FINRA Forms U4, U5, U6 (*available at* http://www.finra.org/web/groups/industry/@ip/@comp/@regis/documents/appsupportdocs/p116979.pdf).

[31] As another example, the Proposing Release, in footnote 59, cites the Advance Comment Letter of Investment Program Ass'n (Mar. 2, 2011) (*available at* http://www.sec.gov/comments/df-title-ix/regulation-d-disqualification/regulationddisqualification-3.pdf), which describes how all violations of the New York General Business Law are "fraudulent practices," including, by example, a placement agent's failure to file a "Further State Notice" for an unrelated offering.

Exchange Act. Prior non-securities conduct should not be the basis for a disqualification event, as described above, and can be more properly handled through disclosure.

In addition, SIFMA believes that the SEC should adopt the definition of "order" from Form BD, meaning a "written directive issued pursuant to statutory authority and procedures, including orders of denial, suspension, or revocation; but does not include special stipulations, undertakings or agreements relating to payments, limitations on activity or other restrictions unless they are included in an order," as this is a definition that has existed for many years and with which regulators are very familiar.

Further, SIFMA believes that a censure or an order mandating that a party must comply with the law and/or a rule or regulation in the future or must engage in some future conduct (as opposed to not engaging in certain conduct) should not create a disqualification event when the applicable party has not otherwise engaged in past conduct that is determined to be objectionable (and/or is not prohibited from engaging in certain conduct). Additionally, an order to merely pay money, such as a civil money penalty, but which does not otherwise restrict or limit the conduct of the subject person, should not constitute a disqualification. Considering that the policy behind Proposed Rule 506(c) is to regulate offerings by or involving "bad actors," SIFMA does not believe that a regulator should be able to use a threat of disqualification to encourage persons to pay fines or should otherwise be able to establish a disqualification merely because a regulator requires a person to do something in the future when, in each case, the person in question is not otherwise a "bad actor" under Proposed Rule 506(c) and as contemplated in Section 926 of the Dodd-Frank Act.

G. *Cease-and-Desist Orders*

Although orders in stand-alone SEC cease-and-desist proceedings are not disqualifying under Rule 262 or Proposed Rule 506(c), the SEC requests comment in the Proposing Release on whether cease-and-desist orders should be an appropriate basis for disqualification. SIFMA believes that cease-and-desist orders should not create a disqualification unless the cease-and-desist order otherwise imposes a limitation or restriction on conduct, such as a bar. In contrast, a cease-and-desist order that only requires the subject person to engage in future activity, or to not violate a specific law or rule in the future, should not be a disqualifying event, as the express language of Section 962 of the Dodd-Frank Act is intended to disqualify persons who, through *past* conduct, have demonstrated themselves to be "bad actors." This interpretation should apply not only to SEC cease-and-desist orders, but also to State cease-and-desist orders. As such, because bars and limitations on activities ordered by a prescribed State or federal authority, including the SEC, are already covered by the provisions in Proposed Rule 506(c), SIFMA does not believe an explicit reference to cease-and-desist orders is necessary.

H. *Orders of Other Regulators*

In the Proposing Release, the SEC solicits comment on whether final orders of the CFTC, or possibly other regulators, should have the same effect for disqualification purposes as those of the State and federal regulators explicitly prescribed in Proposed Rule 506(c). The language in Section 926 of the Dodd-Frank Act, however, already establishes that Congress did not intend the disqualification events to go beyond the orders issued by specified parties: the SEC, certain prescribed State regulators, certain federal banking regulators, or the National Credit Union Administration. Regarding CFTC final orders, specifically, the futures commodities markets are fundamentally different from the securities markets, and "bad actor" conduct may not translate from one market to the other. Similar arguments apply with respect to other non-securities regulators. As such, SIFMA believes that final orders of the CFTC, or other regulators, should not be a basis of disqualification for a securities offering under Proposed Rule 506(c) (or Rule 262 of Regulation A) and is not supported by Section 926 of the Dodd-Frank Act.

I. *Foreign Jurisdictions*

In the Proposing Release, the Commission seeks comment on whether Proposed Rule 506(c) should be triggered by corresponding disqualification events in foreign jurisdictions. Specifically, the Commission requests comment on whether disqualification based on criminal convictions, court injunctions and restraining orders, final orders of certain State and federal regulators, suspension or expulsion from membership in or association with a member of a self-regulatory organization, and Commission stop orders and orders suspending a Regulation A exemption, should include corresponding events related to foreign courts, regulators and securities exchanges.

Section 926 of the Dodd-Frank Act does not specifically reference disqualifications arising from foreign convictions, foreign regulatory or court orders or judgments or suspension or expulsion from foreign securities exchanges, but rather, is limited to events arising under U.S. or State law. As such, it does not appear that Congress intended or contemplated that a disqualification could arise under foreign law or regulations. Further, there is no reference to foreign jurisdictions among the disqualification events set forth in Rule 262 of Regulation A. In this regard, SIFMA believes that disqualification events arising in a foreign jurisdiction would not necessarily be "substantially similar" to the disqualification events under Rule 262. As such, because Rule 262 does not reference foreign jurisdictions, and Congress did not explicitly reference foreign jurisdictions when it referenced the other disqualification events in Section 926 of the Dodd-Frank Act, it is SIFMA's view that foreign convictions, foreign regulatory or court orders or judgments and suspension or expulsion from foreign securities exchanges should not be included among the disqualification events in Proposed Rule 506(c). Moreover, it may be difficult, and costly, to determine, or attempt to determine, if a foreign regulatory or court action, or criminal action, constitutes a basis for disqualification under Proposed Rule 506(c), as an issuer and/or other covered persons will likely need to separately secure appropriate foreign/local counsel, at potentially great expense. These foreign/local counsel may not be conversant with

SEC standards and requirements, and may interpret the same conduct differently that may result in conflicting conclusions. Also, the determination of whether a foreign order or action is comparable to an SEC or State order or action which gives rise to a disqualification event may be difficult, and in many cases may result in substantial uncertainty and at great economic cost.

Similarly, foreign criminal convictions may not be based upon the same or similar standards afforded to convictions under U.S. or State laws. There is no assurance that foreign convictions even constitute crimes which are equivalent to a misdemeanor or felony under applicable U.S. or State laws. Further, there is also no assurance that foreign criminal proceedings that resulted in a conviction afforded the respondent with due process rights akin to such rights under applicable U.S. and State laws, including adequate notice and the opportunity to be heard, to appear and to defend himself/herself, together with written findings of fact and conclusions of laws.

Furthermore, SIFMA believes that the text of Proposed Rule 506(c) should explicitly provide for its inapplicability to foreign convictions, foreign regulatory or court orders or judgments and suspension or expulsion from foreign securities exchanges.

IV. Reasonable Care Exception

Proposed Rule 506(c)(2) sets forth an exception to disqualification for offerings where the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known, that a disqualification existed at the time of the sale. SIFMA supports the inclusion of a reasonable care exception and believes it would not be fair to disqualify an issuer from an important source of capital when the issuer did not reasonably know, or could not have reasonably known, about a disqualification at the time of a sale. For example, in the case of a continuous offering, if an issuer has employed a financial intermediary, such as a major broker-dealer, as a placement agent, the broker-dealer could be an ongoing source of disqualification based upon regulatory actions to which the issuer would not generally be privy.

In the Proposing Release, the SEC provides examples of the exercise of reasonable care, such as making a factual inquiry directly to the covered person through a written questionnaire and investigating publicly available databases. SIFMA believes that reliance on a written representation and annual confirmation, consistent with the provisions in FINRA Rules 5130 and 5131, discussed above in Section II.E, should be a sufficient exercise of reasonable care, at least for covered persons who are unaffiliated parties, such as investors and third-party placement agents. Specifically, issuers should be permitted to rely upon, for one year, a written, affirmative representation from an unaffiliated party who is a covered person, indicating such person is not subject to any disqualification events, and then annual confirmations thereafter of no change in such person's disqualification status via a negative consent letter. SIFMA believes that such representations and annual confirmations should be sufficient exercise of reasonable care, and that any further factual inquiry by the issuer, such as direct inquiry or database searches, should not be necessary. This is currently the practice, and has worked very well, for determining eligibility of persons to receive new issues by FINRA member firms under FINRA Rules 5130 and 5131 (that is, determining whether an investor is a "restricted" person), and SIFMA believes it would work well in this context.

V. Waivers

The SEC currently exercises authority to grant waivers from disqualification with respect to Rule 262 of Regulation A. Additionally, Section 962(1) of the Dodd-Frank Act directs the SEC to adopt rules relating to disqualification that are "substantially similar" to Rule 262. As such, because the SEC already exercises authority to provide waivers of disqualification events under Rule 262, SIFMA agrees with the SEC that the exercise of such authority under Proposed Rule 506(c) should be construed as being "substantially similar" to the waiver authority with respect to Rule 262. In addition, Section 962(2) of the Dodd-Frank Act requires the SEC to adopt rules relating to disqualification events arising from certain final orders of certain State authorities, federal banking authorities and the National Credit Union Administration. SIFMA believes that, because Section 962 of the Dodd-Frank Act requires the SEC, and not any State or other regulator, to promulgate rules to implement these disqualification events, and because the SEC has historically exercised waiver authority in connection with rules providing for disqualifications from securities offerings, such as Rule 505 and Regulation E, in addition to Rule 262 of Regulation A, the SEC should be able to exercise waiver authority with respect to all categories of disqualification events under Proposed Rule 506(c).

Further, in response to the SEC's request for comment, SIFMA recommends that, similar to the Model Accredited Investor Exemption, promulgated by the NASAA,[32] as well as NASAA's Uniform Limited Offering Exemption,[33] a disqualification should be deemed to be automatically waived with respect to a final order of an applicable regulator which creates a disqualification event under Proposed Rule 506(c), if such regulator determines as part of the order that an offering should not be ineligible to be conducted pursuant to Rule 506 by reason of Proposed Rule 506(c).

VI. Transition Issues

A. *Disqualifying Events that Pre-Date the Rule*

According to the Proposing Release, sales of securities made under Rule 506 after the effective date of Proposed Rule 506(c), including sales that are part of an ongoing offering that commenced prior to said effective date, would be subject to disqualification for all disqualifying events that occurred during the relevant look-back period, even if these events occurred before

[32] *See* NASAA, Model Accredited Investor Exemption, NASAA Reports (CCH) ¶¶ 361 – 362.

[33] *See* NASAA, Uniform Limited Offering Exemption, NASAA Reports (CCH) ¶ 6201.

Proposed Rule 506(c), or even the Dodd-Frank Act, was effective. The SEC recognizes in the Proposing Release the potential unfairness of this provision, but states that the statutory language of Section 926 of the Dodd-Frank Act supports it. SIFMA respectfully disagrees and believes that in order to avoid fundamental unfairness to parties who may have entered into orders without reasonably knowing, or expecting, that such orders would, at some point in the future, result in their disqualification to conduct a private offering pursuant to Rule 506, then only those disqualification events that arise *after* the effective date of Proposed Rule 506(c) should establish the basis for a disqualification under Proposed Rule 506(c).[34]

Without applying Proposed Rule 506(c) only prospectively, continuous offerings that were structured to comply with Rule 506 could be subject to substantial disruption that could undermine an issuer's capital raising initiative, and could result in substantial additional legal and regulatory costs of compliance to the issuer.

Further, a covered person might have agreed to enter into an order or conviction without contesting the allegation, believing, reasonably, that doing so would be less expensive than contesting, and that there would not be any adverse consequence to being able to rely on Rule 506. Similarly, with respect to orders "arising out of negotiated settlements agreed to before enactment of the Dodd-Frank Act, or before the rules were proposed, adopted or became effective," SIFMA agrees with the SEC that these orders, too, should not be the basis for the establishment of a disqualification event under Proposed Rule 506(c). SIFMA agrees with the SEC that, for these types of negotiated and other settlements, there is a "possibility that the party would not have agreed to the relevant order if it had known that a collateral consequence of the agreement would be disqualification from all Rule 506 offerings." As such, because the parties may not have settled on the same terms, or at all, if Proposed Rule 506(c) had been effective at the time of the settlement, and the parties could not have been given a chance to negotiate a waiver, SIFMA believes that negotiated and other settlements that predate the adoption of Proposed Rule 506(c) should, similarly, not establish a basis for a disqualification event thereunder.[35]

SIFMA believes that, because Congress delegated to the SEC the duty to adopt rules to implement Section 926 of the Dodd-Frank Act, the SEC should have the authority to implement

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[34] However, the SEC might consider requiring disclosure of any disqualification event that arose prior to the adoption of Proposed Rule 506(c).

[35] We note that SEC Commissioner Troy A. Paredes dissented from the proposed amendments implementing Section 926 of the Dodd-Frank Act on the basis of their retroactive effect, stating that, if Proposed Rule 506(c) were adopted, "it would be impermissibly retroactive insofar as it changes the legal consequences of conduct that occurred before Dodd-Frank was enacted." *See* Troy A. Paredes, SEC Commissioner, Statement at Open Meeting to Proposed Rules Regarding Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings (May 25, 2011), *available at* http://www.sec.gov/news/speech/2011/spch052511tap-item1.htm.

the rules in a fair and orderly fashion that would have the least disruptive effect to the capital raising process.

Further, SIFMA agrees with the SEC that a disqualification event should only be applicable to a sale that occurred after the establishment of such disqualification event, and should not be a basis to disqualify any sales in the same offering that occurred prior to the establishment of such disqualification event. Otherwise, the uncertainty that would be created would likely vitiate the ability of any issuer to elect to rely on Rule 506 for a private offering. For example, from a Securities Act perspective, although the issuer could always recharacterize its offering under Section 4(2) in the absence of the Rule 506 safe harbor, such a recharacterization would have a major impact under most States' Blue Sky or securities laws. Because a disqualification event would result in the inability of an issuer to rely on Rule 506 for some period of time, the issuer's offering would cease to qualify as a covered securities offering under Section 18(b)(4)(D) of the Securities Act. As such, the issuer's offering would become subject to the securities registration requirements of the various States' Blue Sky laws wherein the offering is made, subject to an exemption, if any, under such laws. The retroactive loss of Rule 506 for all sales in an offering could result in prior sales (which occurred prior to the disqualification event) being deemed to have been made in violation of applicable States' Blue Sky laws and could result in civil and criminal penalties, including claims for rescission and damages. SIFMA believes this would not be a fair result.

B. *Timing of Implementation*

Finally, the SEC indicated in the Proposing Release that there is no phase-in period or delay contemplated before issuers would be required to comply with Proposed Rule 506(c). However, because of the need for issuers to (i) determine whether or not one or more disqualification events may be applicable to their offerings, (ii) seek waivers as may be appropriate, or possibly change service providers, to the extent a disqualifying event is identified, (iii) implement procedures to obtain representations, on an ongoing basis as may be necessary, from investors and participants in the offering as to the applicability of any disqualification event(s) under Proposed Rule 506(c), (iv) implement procedures to establish the reasonable care exception under Proposed Rule 506(c), (v) amend Form D filings with the SEC and the various States as may be necessary in connection with ongoing offerings, and/or (vi) comply, as may be necessary, with applicable States' Blue Sky laws in the event that Rule 506 becomes ineligible to the offering, SIFMA believes the SEC should establish a one-year implementation period for Proposed Rule 506(c). SIFMA believes that a one-year implementation period is justified because it can be anticipated that the SEC and possible State regulators will be subject to a substantial number of waiver requests from issuers and other parties, as well as requests to resolve interpretive issues of many new terms and procedures that will likely arise under the new rule, and such regulators will need adequate time to resolve those requests. In addition, issuers will need time to consider, adopt and implement a whole new set of procedures that have not heretofore been required in private offerings.

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VII. Conclusion

SIFMA appreciates the opportunity to comment on the Commission's proposed amendments to certain rules under the Securities Act to implement Section 926 of the Dodd-Frank Act. We support the efforts by the Commission to improve investor protection while encouraging capital protection in relation to private placements but urge the Commission to consider the suggestions and recommendations set forth in this letter, and to make modifications and clarifications as appropriate, before adopting a final version of the proposed amendments.

If you have any questions or require additional information, please do not hesitate to contact the undersigned at (202) 962-7400 or via email at kbentsen@sifma.org, or David M. Katz at Sidley Austin LLP at (212) 839-7386 or via email at dkatz@sidley.com. Thank you for your attention to this request.

Very truly yours,

Kenneth E. Bentsen, Jr.
Executive Vice President, Public Policy and Advocacy

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