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

Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Attention: Elizabeth M. Murphy,
Secretary, Securities and Exchange Commission

Re: Comments on Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings; File No S7-21-11.

Ladies and Gentlemen:

This letter is submitted on behalf of the Committee on Securities Regulation of the New York City Bar Association in response to the Securities and Exchange Commission's proposed rule[1] that would implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, by disqualifying securities offerings including certain "felons and other 'bad actors'" from reliance on the Rule 506 safe harbor from Securities Act registration provided by Rule 506 of Regulation D.

[1] Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, File No. S7-21-11, 76 FR 31518 (June 1, 2011).

Our Committee is composed of lawyers with diverse perspectives on securities issues, including members of law firms, counsel to corporations, investment banks, investors, and government agencies.

The Committee's overall perspective on the proposed rule is as follows. The Rule 506 safe harbor is very widely used and has become an integral and enormously significant part of the capital formation process in this country. Rule 506's importance is only likely to grow over time; for example, we understand that many market participants expect to conduct their securities-based swaps business under Rule 506 going forward. It is therefore critically important that in implementing Dodd-Frank Section 926, the Commission crafts provisions that meet the statutory requirements in a thoughtful and tailored way, while seeking to minimize any resulting disruptions of or burdens on use of the Rule 506 safe harbor. Section 926 is in fact a very specific provision, and as a general matter we think it is therefore appropriate for the Commission to implement it essentially as written, without further expansions. Our principal concerns with the proposed rule relate to its proposed retroactive application, which in our view raises significant fairness as well as practical issues, and the scope of various definitional provisions, which we think in a number of respects may burden capital formation with no commensurate investor protection benefits. We also think it is very important that the new disqualification provisions be clear and simple to administer, with "bright line" provisions wherever possible.

TRANSITION ISSUES

For a number of reasons, we believe that the new rule should not be given retroactive effect. First of all, we think that fundamental fairness calls for a <u>prospective</u> application of any rules that disqualify or otherwise penalize parties based on a prior adjudication or settlement. Many disqualifications triggered by a retroactive application of the new rule will relate to settled matters in respect of which parties negotiated for other, similar waivers, but of course could not have gotten a waiver in respect of Rule 506. And we do not think that Dodd-Frank Section 926 requires retroactive application of the proposed rule; as a matter of statutory construction, retroactive effect should be given only where very clearly required, which is not the case here.

In our view the only truly fair approach would be to apply the new rule's disqualifications only to events occurring after effectiveness of the proposed rule amendment.

In addition to fairness concerns, we believe that retroactive application will create significant practical problems that risk disruption of capital formation and other offering activities currently carried out in reliance in Rule 506. As a practical matter, we expect that retroactive application of the new rule would virtually necessitate a large number of waiver requests, which we believe the Commission (for practical as well as fairness reasons) would find hard to turn down. Indeed, the practical effect of such a large number of waiver requests provides in itself another strong reason for prospective application. We believe that with the enormous workload currently facing the Commission's limited staff, the staff would find itself in the undesirable position of having either to grant all or almost all of the requests without giving them individual attention (in which case, why not take the more pragmatic approach of prospective application?) or devoting a very substantial amount of time to the individual consideration of waiver requests, to the detriment of other pressing business that the staff faces. Neither alternative is attractive; far preferable, in our view, would be simply to recognize the inherently greater fairness of applying the new provisions in a prospective manner only.

The proposing release raises several alternatives that would reduce, though not eliminate, the concerns with retroactive application. For example, an exclusion from the disqualification of orders that arose out of negotiated settlements would tend to reduce the scope of the practical problem, but doesn't really address the fairness concern. Similarly, extending waivers granted under Regulation A, Rule 505 and Regulation E to the new disqualification under Rule 506 would also (to some incomplete and not wholly predictable extent) reduce the practical problem, but would again not address the fairness issue. We therefore think the best approach would be for the new rule to apply in a wholly prospective manner. However, if the Commission instead chooses to craft an exception to disqualification based on other prior waivers, we suggest that it add to this list waivers granted in respect of the disqualification provisions of Section 27A of the Securities Act and Section 21E of the Securities Exchange Act, and Securities Act Rule 405's definition of "ineligible issuers."

The proposing release also solicits comment on the impact of the new rule on ongoing offerings. A prospective-only approach, as recommended above, would of course largely moot this issue for offerings ongoing at the effective date of the new rule. But we think that at a minimum any disqualification should apply (i) initially, only to sales made after the effective date of the new rule, and (ii) thereafter, on a sale-by-sale basis, and only to sales made after occurrence of a disqualifying event. Otherwise, it would be impossible for market participants to rely on Rule 506 going forward, given the consequent potential for retroactive loss of the Securities Act safe harbor exemption and (at least as significant) the related preemption of State securities laws.

Assuming disqualification applies to each sale in a continuous offering, we think the commission should provide guidance as to what constitutes "reasonable care", in the context of continuous offerings, in monitoring whether a disqualification has arisen. We suggest that procedures for periodic (e.g., semi-annual) updates of the factual inquiry should be sufficient, in the absence of actual knowledge to the contrary, to maintain the Rule 506 exemption notwithstanding occurrence of a disqualifying event in respect of another offering participant.

Finally, we would urge the Commission to defer the effective date of the new rule for a reasonable period of time (we suggest a minimum of 180 days), to permit broker-dealers and issuers to gear up for compliance with the new rule. Because of the wide and pervasive reliance on Rule 506, we believe this transition will pose compliance challenges to many issuers and broker-dealers, which additional time will allow them to meet more effectively. Depending on how the Commission resolves the question of retroactive application, we also think the effective date should be sufficiently delayed that persons currently operating under waivers from the existing provisions would have time to seek, and the staff would have time to consider and grant, waivers under the new provisions.

SCOPE ISSUES

Persons covered

We think the "covered person" provisions should focus the disqualification on those persons who are reasonably likely to be in a position to harm investors in future offerings. As they relate to persons associated with an issuer, the disqualification triggers should be limited to persons having specific relationships with the issuer that imply control.

We would therefore suggest that the reference in clause (c)(1) to a 10% beneficial owner of the issuer be changed to at least a 20% or 25% beneficial owner. This category should also be limited to owners of voting securities (or general partner and managing member interests), as opposed to passive interests, since only the former sorts of interests confer control. We also think this element of the rule clearly should be a bright-line percentage test, rather than a "control" test. Control determinations can be challenging and fact intensive, and distribution participants other than the issuer will often not be in a good position to assess "control", but will nonetheless be at risk of a disqualification defeating the Rule 506 exemption. (Obviously, persons who avoid being covered persons by reason of holding less than the required percentage of voting securities would still be covered by the new provisions if they came within the other elements of the "covered person" definitions—it is not likely that the suggested changes would allow many, if any, persons who are in fact integrally related to the offering to escape coverage.)

In a similar vein, we suggest that "officer" of the issuer (which includes any vice president, and the secretary) be changed to "executive officer," since the focus should be on persons who are reasonably likely to be in a position of influence. The compliance burden of expanding screening procedures to all officers could significantly outweigh any resulting benefits, and the disqualification in respect of an "officer" could often be avoided simply by changing a person's title.

We also support the inclusion of clause (c)(3), which excludes from disqualification events relating to affiliated issuers that are controlled affiliates, or affiliates under common control, that occurred before the affiliation arose. On the other hand we would recommend against adding a provision that would end a disqualification upon a change of control of the disqualified entity. It may be difficult in many cases to determine whether a change of control has occurred, and we are frankly concerned that such a provision might be susceptible of abuse. We would encourage the Commission instead to state its willingness to consider waiver requests in such situations, and to grant them freely where the change of control is clear and results in new management of the disqualified entity.

As applied to covered persons other than the issuer, we think clause (c)(1) should be revised to limit coverage to officers actually engaged in private placement activities, along with the firm's executive officers (not all officers), directors, general partners and managing members. Other employees of a distribution participant would generally not be in a position to have an adverse impact on investors in a private placement, and so should not serve to trigger a disqualification.

Disqualifying Events:

We think the proposed rule's approach to criminal convictions (clause(c)(l)(ii)) is consistent with, and largely dictated by, the requirements of Dodd-Frank Section 926. We would urge the Commission to adhere to this approach of implementing the statutory requirements but not expanding on them. In particular, we doubt there is any real practical need for longer than proposed, or lifetime, disqualifications. And we would urge the Commission not to adopt the suggestions of the North American Securities Administrators Association to broaden the range of criminal convictions that trigger disqualification. For example, the concept of "making of a false filing with a state" is much too broad and vague a standard, would therefore be quite difficult to police, and would pick up many matters having nothing to do with securities or financial fraud, or even intentional misconduct. We also suggest that the rule not be expanded to cover non-U.S. criminal convictions. Dodd-Frank Section 926 does not mention non-U.S. convictions or other proceedings. More important, there is an enormous range of legal, regulatory and procedural standards and approaches applied by other countries around the world. Adopting these, in whole cloth, as triggers for Rule 506 disqualification seems quite likely to result in random, unpredictable and often unfair disqualifications. We also think it would be difficult, if not impossible, to define an appropriate category of non-U.S. criminal convictions in a clean, "bright-line" fashion, meaning that compliance would likely be made significantly more difficult and complex if they are included.

As to court orders, injunctions and restraining orders (clause (c)(1)(ii) of the proposed rule), we agree with the proposed rule's use of a uniform five-year period. We think that a five-year disqualification represents a very substantial sanction, which should have real deterrent effect. We would also recommend against imposing different look-back periods for different types of court orders and injunctions and restraining orders; this would add considerable complexity to the rule and thus to the compliance process, for little apparent benefit. And because a five-year disqualification is a substantial sanction, we agree with the approach reflected in the proposed rule, that the disqualification ends after five years, even if the underlying order remains in effect. We would not expand the rule to include orders and injunctions of non-U.S. courts, for essentially the same reasons that we would not include non-U.S. criminal convictions.

Ideally, clause (c)(1)(ii)—or at least clause (c)(l)(ii)(C), relating to orders arising out of the conduct of any business regulated by the Commission—would be limited to situations where the order is based on a finding of fraudulent, deceptive or manipulative conduct (as opposed to, for example, record-keeping violations). We recognize that the Commission is constrained by Dodd-Frank Section 926 to adopt provisions "substantially similar" to those of Rule 262. However, the purpose of the disqualification provisions is to protect investors from "bad actors". To the extent the proposed new rule gives disqualifying effect to orders not arising out of fraudulent, deceptive or manipulative conduct, we would submit that the new provisions are not rationally related to the underlying statutory purpose. We therefore suggest that clause (c)(1)(ii) be narrowed in this manner.

As to the provision relating to orders of certain regulators (clause (c)(1)(iii) of the proposed rule), we think it is unfortunate (and inconsistent with the judgments underlying other elements of the proposed new rule) that the statute requires a 10-year disqualification period. That makes the disqualification provisions more complex, in an essentially random manner. It is therefore all the more important that disqualification under this provision apply only while the ban is actually in effect.

We think the new rule should define more clearly the term "final order." We agree that it would undercut investor protection simply to define "final" as non-appealable, but the definition should build in some basic due process elements. We suggest adding to new Rule 501(g), after "procedures," the phrase "after notice and an opportunity for hearing". We think that settled matters have to be treated as triggering events (for prospective application), just like non-settled matters, which is why we suggest "an opportunity for hearing", as opposed to some specified actual proceeding. (We would think that the rule, or at least the adopting release, should make clear that a settlement is considered for this purpose to have been made after an opportunity for hearing.) We also think that in the interest of uniform application, the disqualification trigger should be defined by the Commission's rule, as an objective test, and <u>not</u> left to the discretion of the particular regulator issuing the order.

The term "fraudulent, manipulative or deceptive conduct", as used in this clause, should also have a single, uniform definition, which should include an element of scienter and be set forth in the rule. For example, the new rule could refer to Rule 10b-5 under the Securities Exchange Act. This standard should be an objective test, <u>not</u> dependent on the authority issuing the order to decide.

As to orders of other regulators not specified in Dodd-Frank Section 926, it seems obvious to us that the Commission and the Commodity Futures Trading Commission should be included for at least some orders; the proposed standard for this category (basically, a ban from association with or engaging in a regulated business, or an order based on fraudulent, deceptive or manipulative conduct) seems appropriately focused.

Notwithstanding the question posed in the proposing release, we do not believe that cease-and-desist orders for record-keeping violations would be picked up by clause (c)(1)(iii) as proposed—and they should not be—though they could well be picked up by clause (c)(1)(ii)(C), as noted above, which is why that latter clause should be modified as we suggest.

Beyond the Commission and the CFTC, we would not add any other category of regulatory agency to clause(c)(l)(iii). In particular, we do not think that non-U.S. regulators should be included, for basically the same reasons outlined above in respect of non-U.S. criminal convictions.

OTHER POINTS

Reasonable care exception

The proposed rule includes an exception from 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 because of the presence or participation of another covered person. We think that some such exception is an appropriate and useful element of the new rule. Without it, issuers would always be in doubt as to availability of Rule 506, and use of the safe harbor would be severely inhibited.

We would also encourage the Commission to clarify (perhaps in the adopting release) what would constitute "reasonable care" for this purpose, particularly as the concept may apply to issuers. For example, we think that issuers could, as a general matter, reasonably rely on contractual representations from registered broker-dealers, or other regulated entities, as to the absence of disqualifying events. And we think that broker-dealers which adopt reasonable policies and procedures to identify disqualifications in respect of other offering participants should be presumed to satisfy the "reasonable care" test. We also think that the breadth of the proposed "covered persons" provisions, discussed above, has an important bearing on what procedures other offering participants can reasonably be expected to pursue, and that the Commission could usefully address this topic, as well, in the adopting release.

Waivers:

Experience makes clear that it is essential for the Commission to have authority to waive the new disqualification provisions. Waiver authority under analogous provisions is regularly used in the context of settled SEC proceedings.

It also seems prudent for the Commission to retain waiver authority in respect of orders of state regulators, and that this authority not be conditioned on consent of the state regulator. On the other hand, if the state regulator affirmatively determines that its order should not have a disqualifying effect, then we believe that order should not be disqualifying.

"Uniform" application of the disqualification standards to Regulations A, D and E:

While there is some considerable appeal to the idea of single uniform set of disqualification standards, in terms of simplifying regulatory compliance, we also think that there should be further detailed study, followed by the usual notice and comment process, before it is implemented.

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Members of the Committee would be pleased to answer any questions you may have concerning our comments.

Respectfully Submitted,

/s/ Robert E. Buckholz

Committee on Securities Regulation

Securities Regulation Committee

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