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July 14, 2011

BY ELECTRONIC MAIL

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

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

Dear Ms. Murphy:

We are submitting this letter in response to the request of the Securities and Exchange Commission (the "Commission") for comments regarding the Commission's proposal (the "Release") to amend Rule 506 of Regulation D ("Rule 506") under the Securities Act of 1933, as amended (the "Securities Act").[1] We appreciate the opportunity to comment on the matters discussed in the Release.

Rule 506 provides a widely used safe harbor from the registration requirements of the Securities Act,[2] and permits, subject to compliance with the various provisions of the rule, the unregistered sale of an unlimited amount of securities to accredited investors and a small number of non-accredited investors. We commend the Commission for its efforts to implement

1 SEC Release No. 33-9211 (May 25, 2011), 76 Fed. Reg. 31518 (June 1, 2011).

2 The Release notes that between 90% and 95% of all Regulation D offerings are made pursuant to Rule 506, and that more than 16,000 filings for Rule 506 offerings were received in the 12 months ended September 30, 2010.

the legislative mandate of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") and to adopt rules disqualifying securities offering involving certain "felons and other 'bad actors'" from reliance on the safe harbor from Securities Act registration provided by Rule 506, while at the same time taking steps to avoid significantly increasing costs to issuers or others who may assist them in conducting Rule 506 offerings.

We believe the proposed rule-making addresses an area of legitimate concern, as under current regulations, there are neither federal nor state-level bad actor disqualification rules applicable to Rule 506 offerings. In addition, the Dodd-Frank Act requires the adopted rules to be "substantially similar" to the disqualification provisions of Rule 262 of Regulation A under the Securities Act ("Rule 262"), and they must also cover certain additional matters enumerated in Section 926 of the Dodd-Frank Act. The Release does, however, raise a number of questions and concerns, and the Commission has included specific comment requests with respect to the proposed amendments. We address some of these points below.

I. More Narrowly Focus the Proposed Rule's on Appropriate "Covered Persons"

The proposed amendments will prohibit several groups of people from participating in Rule 506 exempt securities offerings if they have been convicted of certain crimes, are subject to certain court-administered sanctions or have violated certain other laws or regulations. Proposed Rule 506(c)(1) lists various "covered persons" who, if they have engaged in "bad actor" conduct set out in the rule and were involved in the offering, would preclude an issuer from relying on the Rule 506 safe harbor. As noted in the Release, the list generally corresponds to the persons covered by Rule 262, with appropriate adaptations (for example, to address the fact that Rule 506 offerings are private placements rather than registered offerings). We believe, however, that to avoid unduly hampering the widely used Rule 506 safe harbor, the Commission should apply the provisions of Section 926 of the Dodd-Frank Act to a more limited subset of covered persons, particularly with respect to "officers," than the list set out in Rule 262.

A. *"Executive Officers" As Opposed To "Officers"*

We believe imposing Rule 506 bad actor disqualifications on any "officer" (as defined in Rule 405 under the Securities Act) will prove particularly problematic, and urge the Commission to instead reserve disqualification for bad acts to "executive officers" (as defined therein). The term "officer" potentially encompasses any person having a "vice president" title (including, *inter alia*, executive vice presidents, senior vice presidents, vice presidents, and assistant vice presidents) as opposed to the term "executive officer" (which would include only vice presidents who are "in charge of a principal business unit, division or function", or who serve another senior policy-making function). Large financial institutions may have as few as 10 or 15 executive officers, but (as suggested in the Release) literally hundreds of vice presidents.

As a result, the number of individuals who must be evaluated for bad acts in connection with any particular transaction would vary dramatically based on this distinction. It may not even be possible for an issuer to identify which persons should be evaluated absent significant disclosure from any compensated solicitor participating in the Rule 506 offering.

By categorizing such a large potential group as potential covered persons, the proposed amendments create three issues:

- First, using the term "officer" potentially encompasses many more people than necessary to protect investors. While acknowledging it is likely appropriate to protect investors from involvement by a senior policy-making employee who has previously engaged in bad acts by precluding an issuer from reliance on the Rule 506 safe harbor, it is unlikely to be relevant, either to investors or to the integrity of the offering process, if a lower-level employee – who may titularly be a vice president but is neither in a position of significant authority nor directly involved in any particular transaction – is employed either by the issuer or a compensated solicitor and would fall within one of the Rule 506 bad actor categories.

- Second, including such a large number of people in the potential bad actor pool is likely to create unnecessary compliance problems, both for compensated solicitors and for issuers. Ensuring there are no individuals at or above the vice president level who have committed any bad acts would require establishing a robust and ongoing real-time compliance program, pursuant to which any individual engaged in any bad-actor conduct would need to immediately and voluntarily self-report that conduct. Even if such programs could be established, issuers and solicitors would still be required at least in part to rely on self-reporting by those bad actors, with a potential consequence of a failure to report being a violation of Section 5 of the Securities Act.

- Third, the proposed rule would potentially impose significant obligations on compensated solicitors to disclose the identities of their employees to issuers. Proposed Rule 506(c)(2)(ii) provides that an issuer will not be disqualified from using the Rule 506 safe harbor if it "did not know, and in the exercise of reasonable care could not have known," of a bad act disqualification. While the Release makes clear the scope of the factual inquiry necessary to establish that reasonable care taken in making that determination will vary, the Release suggests that at least some sort of inquiry might be necessary with respect to all covered persons at a compensated solicitor.[3] If the scope of that inquiry must cover all "officers" of the compensated solicitor, it may be difficult or indeed impossible for an issuer to determine who those persons are absent cooperation from, and effectively reliance on, the compensated solicitor itself. This differs from executive officers, at least for publicly traded financial

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[3] The Release states "[f]inancial institutions that are acting as placement agents may have large numbers of employees that would come within this definition, many of whom would not have any involvement with any particular offering, but all of whom would be covered persons for purposes of disqualification. Issuers could potentially devote substantial amounts of time and incur significant costs in making factual inquiries." The Release goes on to note in a footnote that "[w]hile some types of disqualifying events are readily ascertainable from public records, others are not."

institutions that must identify those persons in their periodic filings with the Commission. Accordingly, absent the implementation of other mechanisms to clarify the availability of the safe harbor, solicitors could be required to disclose the identities of a large number of their employees to issuers (which some might be reluctant to do, thereby limiting market participation in Rule 506 transactions).

In addition, in order to help address investor protection concerns, it might well (as the Commission itself suggests in the Release) be appropriate to impose bad actor disqualifications on the "officers" at a compensated solicitor who are "actually involved" in a particular Rule 506 offering. If the Commission determines that investor protection requires inclusion of such "officers" in the disqualification provisions, however, we ask that the Commission (either in the adopting release or in the rule itself) clarify what "actual involvement" would entail. For example, one approach might be to specify that any employee of the compensated solicitor who participates directly with the issuer or potential investors who purchase securities in the offering is "actually involved" in that transaction. As with "officers" more generally, however, it may be difficult or impossible for an issuer to establish the identities and disqualification status of even those persons who have actual involvement in any given transaction absent disclosure and other assistance by, and reliance on, the compensated solicitor (particularly insofar as their involvement is with potential investors rather than the issuer).[4]

B. *Increase Size Of "Significant" Shareholders*

In the Release, the Commission proposes including 10% shareholders as covered persons for purposes of the bad actor disqualification, but requested comment as to whether that was an appropriate threshold. We concur that a bright-line threshold test is appropriate compared to, for example, an "actual control" test (which would, we believe, potentially create a new standard requiring additional explanation). We believe, however, that a 10% threshold is too low for at least two reasons:

- First, most companies have little ability to prevent third parties from acquiring blocks of their stock. Accordingly, any bright-line test creates a possibility that truly unscrupulous actors could acquire a company's stock (and even hedge the economic exposure) simply to prevent them from conducting Rule 506 offerings (with the expectation, for example, that a company might agree to repurchase its own stock from such an investor in order to then raise capital via a Rule 506 transaction). While this problem is not entirely addressed by raising the threshold, a higher threshold would make any such activity more difficult. Since many of the issuers who use Rule 506 offerings to raise capital are smaller companies, this may be an even greater problem for them given their relative size.

[4] The provision of such information by the solicitor should also be taken into account in determining whether an issuer can rely on the "reasonable care" exception, as discussed further in Section III.A below.

- Second, a 20% threshold would align this bright-line test with the one used in Regulation 13D/G to determine whether a "passive" investor is required to make filings on Schedule 13D. When it adopted the amendments to Rule Rule 13d-1(c) and the rest of Regulation 13D-G permitting such investors to continue to file on Schedule 13G until reaching a 20% shareholding level, the Commission noted that the then-existing reporting scheme "imposed unnecessary disclosure obligations on persons whose acquisitions do not affect the control of issuers."[5] We believe, similarly, that issuers should not be precluded from taking advantage of the Rule 506 safe harbor in cases where a shareholder is unlikely to control the issuer.

While these considerations are we think particularly appropriate in situations where the company in question is a public issuer, we think a 20% threshold is equally appropriate in the case of a privately held issuer. In such situations, where a person holds 20% or less of a company but is neither a director nor an executive officer, that person is still unlikely to be in a position where they can exercise significant control over the company.

C. *Enhance Protections Against Promoters*

Another area where the Commission may want to consider further expanding the group of covered persons relates to promoters. The proposed rule does not extend to directors, executive officers, general partners or managing members of promoters, but only to promoters themselves. Accordingly, if a promoter has been sanctioned in connection with a prior transaction, it is potentially possible to separate that particular entity from future transactions while reconstituting and involving new promoter entities substantially the same as (and controlled by the same persons as) the sanctioned entity.

To help address this potential concern, we suggest including in the list of covered persons the "directors, executive officers, general partners and managing members" of promoters involved in any particular transaction, thereby treating promoters in the same way as issuers and compensated solicitors. This would help to protect investors from bad-actor promoters and their controlling persons by making it more difficult for them to actively participate in the Rule 506 offerings, and would also encourage companies to better diligence the promoters being used in connection with any particular offering.

II. Modify the Proposed Disqualifying Events to Enhance Certainty of Application

A. *Combine All Regulatory Orders And Similar Events*

Understanding the events and circumstances that give rise to disqualification is, as the Release notes, a critical element of understanding proposed Rule 506(c). As drafted, the proposed rule separately incorporates the events specified in Rule 262 and additional events listed in Section 926(2) of the Dodd-Frank Act. While understanding the Commission's desire to clearly demonstrate compliance with the mandate set out by Dodd-Frank, we believe this

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5 SEC Release No. 34-39538 (Jan. 12, 1998), 63 Fed. Reg. 2854 (Jan. 16, 1998).

approach may lead to unnecessary complexity. Accordingly, we suggest combining the various regulatory agency-related provisions contained in the Dodd-Frank Act, Rule 262 and otherwise suggested by the Commission into a single disqualifying event.

This approach would have a two-fold benefit. First, it would help generally to simplify the rule, making it easier for issuers and other offering participants to apply. Second, this change would harmonize certain aspects of the rule that are currently in our view either under-inclusive or over-inclusive. For example, we believe the proposed rule could be seen as under-inclusive because it currently does not explicitly address all final orders issued by the Commission addressing fraudulent, manipulative or deceptive conduct, but could be viewed as over-inclusive because it includes technical orders issued by the Commission applicable to broker-dealers for more ministerial matters such as books-and-records violations.

In addition, as an element of harmonizing the treatment of regulatory entities, we also propose including both the Commodity Futures Trading Commission (the "CFTC") and the Commission as specified regulators. Although as the Release notes there is some risk that including CFTC and Commission orders could impair capital formation, we believe the benefits of doing so outweigh these risks because adding the CFTC and the Commission will more effectively work to screen out bad actors and improve internal consistency of the rules.

B. *Include "Scienter" Requirements*

The Commission has requested comment both on whether it should provide guidance on what constitutes "fraudulent, manipulative or deceptive conduct" for purposes of bad actor disqualification, and whether scienter should be required in determining whether such conduct has taken place. While it may not be necessary for the Commission to provide specific guidance on what sort of conduct might be viewed as fraudulent, manipulative or deceptive, the amended Rule should (in most cases, at least) require scienter when determining whether a disqualifying bad act has occurred.

Any scienter requirement should generally apply equally to orders of the Commission as well as other regulators. So, for example, Commission cease-and-desist orders should include an element of scienter before creating a disqualification under Rule 506. One exception to that rule would apply to orders related to violations of Section 5 of the Securities Act. Since Section 5 imposes strict liability (meaning that intent will not necessarily have been determined by an adjudicator to find fault), but is a cornerstone of the U.S. securities law regime, we believe for purposes of future disqualifications any violation of Section 5 should be considered a "bad act," and persons who are determined by the Commission or a court to have violated Section 5 should lose the benefit of exemptive relief for at least five years thereafter.

C. Time Limits On Expiring Orders And Injunctions

In the Release, the Commission solicits comment as to whether it should establish different look-back periods for different events. We believe that, rather than attempting to harmonize look-back periods, the Commission should simply retain the existing distinctions set forth in Rule 262 and the Dodd-Frank Act. With regard to injunctions or orders that have a specific duration of less than five or ten years, however, we believe it is appropriate for those to cease to be disqualifying at expiration of the injunction or order, as the case may be.

D. Do Not Extend Disqualification to Actions by Foreign Courts or Regulators

In the Release, the Commission solicits comment as to whether it should extend disqualification to injunctions or orders by foreign courts, securities regulators or securities exchanges on the same basis as those issued by their U.S. counterparts. We believe the Commission should not extend the proposed Rule 506 disqualification provisions in that manner. We note neither the Dodd-Frank Act nor Rule 262 would require those entities to be included in the disqualification provisions. In addition, we note analogous statutory provisions and Commission rules and regulations do not provide for disqualification on the basis of judgments, orders or regulatory actions outside the United States, including most notably the Private Securities Litigation Reform Act of 1995 ("PSLRA") and Securities Offering Reform ("SOR").[6] Under SOR, for example, an issuer will be an "ineligible issuer" if within the past three years it has violated U.S. federal securities laws, has entered into a settlement with any U.S. government agency involving allegations of violations of U.S. federal securities laws, has been made the subject of a judicial or administrative decree or order prohibiting certain conduct or activities regarding the U.S. federal securities laws, or is or has been the subject of certain Commission orders.[7] Disqualification does not, however, extend to decrees or orders by, or settlements with, non-U.S. courts or regulators. Similarly, Section 27A of the Securities Act and Section 21E of the Securities Exchange Act, as added by the PSLRA, provide that the exclusion for issuers from the safe harbor for forward-looking statements provided for therein only results from violations of the U.S. securities laws and does not extend to foreign laws.

III. Establish Bright-Line Safe Harbors for the "Reasonable Care" Exception

We applaud the inclusion of the "reasonable care" exception, which (as the Release notes) should help to alleviate issuers' new burden of inquiry. We are concerned, however, that the Commission's approach to the exception will not fully alleviate these new burdens and may make it more difficult than the Commission foresees to conduct Rule 506 offerings once the amendments are adopted. We believe the "reasonable care" exception would benefit from a greater degree of certainty and should relate only to what is actually known to the issuer, so that issuers will be able to ascertain whether they have complied with the requirements using measureable, bright-line standards.

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6 Pub. L. 104-67, 109 Stat. 737 (Dec. 22, 1995); SEC Release No. 33-8591; 34-52056; IC-26993 (July 19, 2005), 70 Fed. Reg. 44722 (Aug. 3, 2005).

7 See clauses (1)(v)-(viii) of the definition of "*Ineligible Issuer*" set forth in Rule 405 under the Securities Act.

A. Greater Certainty As To What Constitutes Due Inquiry

The Commission has, in other contexts, created bright-line standards for inquiries necessary to permit reliance on safe harbors from registration. For example, in ascertaining whether a prospective purchaser of Rule 144A securities is a qualified institutional buyer ("QIB"), sellers can rely on, among other things, a written certification by the chief financial officer or another executive officer of that prospective purchaser as to the amount of securities owned or invested by that purchaser.[8] In the Rule 144A adopting release,[9] the Commission simply noted that, whether or not other public information was available, the seller and any person acting on its behalf could rely on such a certificate (although such persons cannot rely on certifications they know to be, or were reckless in not knowing are, false). The Commission specifically noted that "[u]nless circumstances exist giving a seller reason to question the veracity of the certification, the seller would not have a duty of inquiry to verify the certification."

While the Commission did not provide a significant discussion of why the certification prong was created in the Rule 144A adopting release, one can assume the concern related to whether sufficient information would be publicly available to enable sellers to determine whether potential purchasers were in fact QIBs, particularly for privately held companies that publish little if any financial information. These same concerns exist to a possibly even greater extent with respect to the bad actor inquiries potentially necessary under proposed Rule 506. It may simply not be possible for an issuer or others involved in a Rule 506 offering to gather the information necessary to determine which persons should be the subject of inquiry (particularly for a third-party solicitor or promoter), much less conducting actual investigations of those persons. Accordingly, we believe, at least in the absence of actual knowledge to the contrary, issuers should be permitted to rely on certifications in determining whether third parties such as solicitors or promoters are "bad actors" for purposes of Rule 506.

B. Cut-Off Timing for Determination of Bad Actor Involvement

In addition, greater certainty is needed in determining the point in time at which the existence of a "bad actor" must be determined. Since the current rule is silent as to when this determination should be made, the test for whether there has been a disqualifying event must effectively be done on a real-time basis at the time of every sale of securities pursuant to Rule 506. This is potentially problematic (particularly if one takes into account the broad definition of "officer", as discussed above), since companies may not have systems in place that would permit even persons associated with a specific Rule 506 offering to know if a disqualification event exists across the organization as a whole at any particular time.

In order for the reasonable care exception to work as a practical matter, we believe the Commission should include a cut-off concept in determining when a person involved in a Rule 506 offering is a bad actor. In the Rule 144A context, for example, the officer

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8 Rule 144A(d)(1)(iv).

9 SEC Release No. 33-6862; 34-27928; IC-17452 (Apr. 23, 1990), 55 Fed. Reg. 17933 (Apr. 30, 1990).

certification to establish QIB status can be dated "as of a specific date on or since the close of the purchaser's most recent fiscal year."[10] While a fiscal-year cut-off might be excessive for Rule 506 offerings, we believe an appropriate cut-off date that is within a reasonable period of time before commencement of the offering (for example, 15 days prior to the offering date) would be appropriate. Similarly, for continuous offerings, we propose that such offerings could continue without daily monitoring provided that an appropriate certification was delivered at the commencement of sales, but that there would be a duty to update those certifications, for example on a monthly basis, if the offering period continued for more than 30 days.

IV. Ensure Transition Issues are Appropriately Addressed

In the Release, the Commission indicates both that it believes past disqualifying events should be taken into account under amended Rule 506, and that it does not propose to exempt, "grandfather" or otherwise make special provision for events that occurred before enactment of the Dodd-Frank Act or the effective date of the proposed amendments. The Commission's analysis of the framework for the first determination is clearly set out in the Release.[11] We generally do not believe the position set out in the Release is correct, and that it is more likely that Congress did not intend for the amended provisions of Rule 506 to apply retroactively. We understand, however, that the Commission's view is to the contrary, and accordingly recognize there is a significant likelihood that Rule 506, when adopted, will apply to pre-enactment events.

We do, however, believe that actors who voluntarily engaged in actions that at the time did not disqualify them from reliance on Rule 506 but that will now constitute disqualifying events should either not be picked up by the amended rule or should be granted a waiver with respect to those prior voluntary actions. In particular, some entities, such as broker-dealers, that previously entered into consent settlements or decrees and will now be disqualified from conducting Rule 506 offerings might have structured those decrees differently (or not entered into them in the first place) had they known such an amendment would be applied retroactively.

As discussed in the Release, this is similar to the situation that arose when the Commission enacted SOR.[12] The proposing release for the SOR amendments provided for an issuer to be "ineligible" if it was found either to have violated, or to have settled allegations that it had violated, any federal securities law within the three years preceding the testing date.[13] At that time, various commenters suggested retroactive application was inappropriate as issuers did not know they would be required to negotiate a waiver or exemption at the time of their original settlements. In the amendments as adopted, the rules were revised to provide that ineligibility

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[10] Rule 144A(d)(1)(iv).

[11] In particular, we note the Commission's analysis of *Landgraf v. USI Film Products*, 511 U.S. 244 (1994) contained in footnote 92 and the accompanying discussion in the text of the Release.

[12] SEC Release No. 33-8591; 34-52056; IC-26993 (July 19, 2005), 70 Fed. Reg. 44722 (Aug. 3, 2005).

[13] SEC Release No. 33-8501; 34-50624; IC-26649 (Nov. 3, 2004), 69 Fed. Reg. 67392 (Nov. 17, 2004).

based on settlements would apply only to those decrees or orders entered into after the effective date of the amendments (*i.e.*, December 1, 2005).[14]

We believe the situation is similar with respect to the amendments to Rule 506. At the very least, the Commission should exclude from bad act disqualification decrees, consents and other voluntary actions taken prior to the effective date of the proposed amendments.

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We very much appreciate this opportunity to provide you with our thoughts on the Proposing Release. Please do not hesitate to contact Leslie N. Silverman, Alan L. Beller or James D. Small (212-225-2000) if you would like to discuss these matters further.

Very truly yours,

CLEARY GOTTLIEB STEEN & HAMILTON LLP

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[14] See clause (1)(vi) of the definition of "*Ineligible Issuer*" set forth in Rule 405 under the Securities Act.