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July 14, 2011

Via E-mail; Rule-comments@sec.gov

Ms. Elizabeth M. Murphy,
Secretary,
Securities and Exchange Commission,
100 F Street, N.E.,
Washington, DC 20549.

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

Ladies and Gentlemen:

We appreciate the opportunity to comment on the proposed rules disqualifying felons and other "bad actors" from Rule 506 offerings as mandated by Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Please be advised that these comments are ours and are not made on behalf of any client of the Firm.

As set forth in Section 926 of the Dodd-Frank Act, the Securities and Exchange Commission is required to promulgate rules that disqualify felons and other "bad actors" from relying upon the safe harbor from registration provided by Rule 506 of Regulation D under the Securities Act of 1933. These rules are required to be "substantially similar" to the disqualification provisions of Rule 262 under the Securities Act, which apply to offerings under the safe harbors from registration provided by Regulation E and Rule 505 of Regulation D, and to expand the list of disqualifying events to include certain state regulatory and other actions mandated by Section 926.

We recognize that the Commission is obligated to issue rules that implement the requirements of Section 926. However, we believe that some aspects of the proposed rules, which are not mandated by Section 926, will make the scope of the disqualifications unnecessarily broad and make it difficult for issuers and market participants to comply with the disqualification provisions. As suggested by the statistical data provided in the proposing release,[1] we believe the Rule 506 safe harbor is substantially more important to the private capital-raising process than the Rule 505 and other safe harbors that are subject to the existing disqualification provisions of Rule 262, and we believe it is particularly important that the issues we describe below be resolved in ways that do not impair the usefulness of Rule 506.

COVERED PERSONS

In our view, the categories of persons covered by the proposed disqualification provisions raise three significant issues. First, the term "officer" as defined in Rule 405 under the Securities Act is far too broad for purposes of determining who is a covered person as applied, both to personnel of the issuer and to personnel of paid solicitors. As the Commission rightly notes in the proposing release, large financial institutions that serve as private placement agents can have large numbers of vice presidents and other personnel who might be deemed to be "officers" as defined under Rule 405, even though many of them may not play a significant policy-making role for the institution generally and may not participate in any particular offering conducted under Rule 506. In addition, issuers have widely varying practices in terms of which personnel are given "officer" titles. Such a broad category of covered persons is likely to result in numerous disqualifications of offerings for reasons having no connection to the offering activities of the issuers or placement agents. Equally important, this broad category will make it difficult for issuers and market participants to identify all potential disqualifications on an ongoing basis, thus making it particularly difficult to comply with the "reasonable inquiry" requirement discussed below. And "officer" status frequently turns on a title, rather than the substance of a person's job, making it an inherently less meaningful yardstick. We believe the term "officer" should be narrowed to cover those personnel who play a significant leadership role in the relevant entity, not only to ensure that compliance with the proposed rules can be effectively managed but also to align the scope of the rules with the underlying policy goals more effectively. Thus, we urge the Commission to modify the proposed rules to replace references to the term "officer" as defined in Rule 405 with references to the term "executive officer" as defined in that rule (and in Rule 501(f) of Regulation D) – in general, limiting this category of covered persons to officers who play a policy-making function.[2]

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1 Footnote 8 of the proposing release indicates that, during the twelve months ended September 30, 2010, over 90% of the Form D filings made with the Commission claimed a Rule 506 exemption.

2 As an alternative, narrowing the term "officer" to include only officers who are "actually involved with or devoting time to the relevant offering," as suggested in the proposing release, would be preferable to the current proposal but would create practical compliance problems by making it harder to determine which

Second, we are concerned about including "any beneficial owner of 10% or more of any class of the issuer's equity securities" as a covered person. We believe the 10% threshold for beneficial ownership is too low in this context and could capture a number of persons that do not in fact have a control relationship with the issuer or other entities participating in the offering, making it difficult for the offering participants to monitor compliance with the disqualification provisions. We think the ownership threshold should be raised from 10% to 25%, which is consistent with the Commission's definition of "control" presumption used in Form BD.[3] In light of the compliance obligations that arise from the ownership threshold under the proposed rules, we think the 25% standard applicable to Form BD, which involves similar compliance considerations, is the more appropriate standard. And whatever level is chosen, the test should be a "bright line," numerical test, not simply a "control" test; a "control" test requiring constant judgments would impose a very substantial compliance burden.

Third, we believe the term "promoter" is unclear and should be defined so as to include only persons who are involved in the offering and have a material financial interest in the outcome of the offering. We question whether this concept is necessary given that covered persons already include all persons paid to solicit purchasers in the offering as well as various related persons, but if this concept is retained, the Commission should provide guidance as to its parameters. At the very least, the rules should make clear that an investment adviser to a fund is not a "promoter" of a fund for this purpose.

GRANDFATHERING PRIOR EVENTS

We believe the disqualification provisions should apply only to events occurring after the effective date of the proposed rules, and we strongly urge the Commission to "grandfather" disqualifying events occurring before that date for reasons of fairness and to avoid costly efforts to address retroactive disqualification. We do not believe that Section 926 of the Dodd-Frank Act mandates retroactive application of the bad actor provisions, and in the absence of a specific mandate we think the Commission should implement these provisions in a manner that reflects basic fairness and practical considerations. As noted in the proposing release, retroactive application would be unfair to persons who entered into negotiated settlements with various regulators in the past and, as conditions to those settlements, obtained waivers of various disqualification provisions

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personnel actually fall within the scope of the term. Identifying officers who are "involved with" or "devoting time" to a particular offering will be difficult to do with precision and may result in a continuously shifting pool of covered persons that changes from one offering to another.

3 A 25% control presumption also is used in Section 2(a)(9) of the Investment Company Act of 1940.

under the federal securities laws, including those of Rule 262, but did not do so and could not have done so with regard to the proposed Rule 506 provisions. Given the relatively greater importance of the Rule 506 safe harbor, it is fair to assume that such persons would have negotiated for waivers under Rule 506 with at least as much interest as they did for waivers under Rule 262, had they known that their settlements would result in disqualifications under Rule 506 pursuant to future rules.[4]

At the very least, we believe that waivers granted under Rule 262 with regard to events occurring prior to the effective date of the proposed rules should automatically be extended by the Commission to apply under Rule 506 with regard to those events. However, while this step would help to mitigate the adverse consequences of retroactive application, it would not eliminate them for two reasons. First, settling parties may not have sought waivers under Rule 262 given the relatively limited scope of the related safe harbors (Regulation E and Rule 505), whereas they may well have done so had they known the resulting disqualifications would implicate Rule 506, a much broader and more important safe harbor for issuers seeking to raise capital in unregistered offerings.[5] For these parties, extending prior waivers under Rule 262 to apply to Rule 506 would do no good. Second, the scope of the disqualifying events under Rule 262 (at least as in effect in the past) is narrower than the scope of the disqualifying events under Rule 506 as currently proposed. As a result, prior settlements may have involved events that did not trigger a disqualification under Rule 262, and thus did not prompt the parties to seek waivers under that rule, but could do so under Rule 506 if adopted in its current form. Thus, as in the situation described above, extending prior waivers under Rule 262 in this situation would not do these parties any good.

We urge the Commission to provide that the proposed disqualification provisions relating to Rule 506 will not be triggered by events occurring before the effective date of those provisions.[6] If the Commission concludes that a narrower

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4 Giving retroactive effect to these rules may create a troublesome precedent for future settlement negotiations, in which the settling parties may feel compelled to seek prospective application of waivers so as to encompass any disqualification rules that may be adopted in the future. This could complicate the regulatory settlement process, as well as Staff efforts to respond to waiver requests, going forward.

5 This particular problem could be partially addressed by providing for automatic extension not only of prior waivers granted under Rule 262 but also of those granted under more significant provisions, such as the definition of "ineligible issue" in Rule 405.

6 Using the earlier effective date of the Dodd-Frank Act for this purpose would not be fair to prior settling parties, as they have not been in a position to seek waivers

grandfathering is appropriate, then we urge the Commission to provide that all disqualification waivers previously granted by it or the Staff with regard to events that were the subject of a negotiated settlement be automatically extended to apply to Rule 506, whether or not the prior waivers were granted under Rule 262. As discussed above, limiting automatic extension to waivers granted under Rule 262 could operate unfairly upon parties to prior settlements, and we see no reason why automatic extension should not apply with regard to all waivers granted under the statutes and rules administered by the Commission and the Staff.[7]

Absent relief with regard to prior events, we expect many issuers and market participants that have entered into regulatory settlements relating to prior events will feel compelled to seek waivers with regard to those events and Rule 506 as soon as the proposed rules are adopted. This could trigger a substantial number of waiver applications for prior events, and we question whether such efforts would really serve the public interest, especially in light of the potential impact on Commission and Staff resources.

We note that, while disqualification under Rule 506 would not preclude issuers from conducting private placements in reliance on Section 4(2) of the Securities Act, reliance on Section 4(2) could have collateral consequences under state securities laws. Whereas state securities laws are generally pre-empted under Section 18 of the Securities Act with regard to offerings made pursuant to Regulation D, they are not pre-empted with regard to offerings made solely in reliance on Section 4(2) unless the issuer has securities listed on a national securities exchange (or the offering otherwise qualifies for pre-emption). Thus, for many issuers, particularly small businesses and other entities that are not public companies, disqualification under Rule 506 will generally mean that their private capital-raising efforts will be subject to the securities laws of various states. Yet numerous states do not provide exemptions for private offerings that are comparable to the exemption provided by Section 4(2). For instance, while some states allow up to 15 or 25 unregistered sales in their jurisdiction in a twelve month period (excluding sales

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from the Section 926 disqualifications at any time prior to the adoption of the Commission's implementing rules (which will establish the right to request a waiver).

7 Automatic extension should apply, for example, to prior waivers relating to the safe harbors for forward-looking statements under Section 27A of the Securities Act and Section 21E of the Securities Exchange Act of 1934; to prior waivers and exemptive orders relating to the Investment Company Act of 1940, the Investment Advisers Act of 1940 and the rules thereunder; and to prior waivers relating to eligibility for "well known seasoned issuer" status under Rule 405 and the disqualification provisions of Rule 262.

to institutional investors as defined), other states' statutes are much more limiting or have additional requirements.

DISQUALIFYING EVENTS

Section 926 of the Dodd-Frank Act mandates that the proposed rules include a range of specified disqualifying events, and we think that the proposed rules should adhere closely to the statutory requirements. For example, we do not believe that the disqualifying events should include making a false filing with a state, as suggested by the North American Securities Administration Association. This concept is very broad and vague and could be construed, for example, to include the late filing of a Form D or sales report. In our view, inaccurate or incomplete filings of this kind are unlikely to fall within the scope of fraudulent, manipulative or deceptive conduct, which under Section 926 is the relevant predicate for disqualification due to state law violations.

Likewise, expanding the disqualifying events to include non-US criminal convictions, as suggested in the proposing release, would not be fair in light of the differing legal systems and standards of justice that might give rise to those convictions. The same rationale holds true for orders and injunctions of non-US courts.

As noted above, Section 926 requires disqualification for final orders of certain state authorities based on violations of laws that prohibit "fraudulent, manipulative, or deceptive conduct." Because the states have varying definitions of such conduct, we believe this term should be defined by reference to federal law standards in order to avoid unintended and unfair results across the different jurisdictions. The term "fraudulent, manipulative, or deceptive conduct" as used in the proposed rules should be defined to include an element of scienter, for instance by referring to Rule 10b-5 under the Exchange Act. Violations that do not involve intentional or reckless misconduct, such as many books and records violations, should not give rise to disqualification.

FACTUAL INQUIRIES

The proposed rules include an exception from disqualification if the issuer can show that "it did not know, and in the exercise of reasonable care could not have known, that a disqualification existed." The proposal goes on to state that the issuer will not be able to show that it has exercised reasonable care unless it has made "a factual inquiry into whether any disqualifications exist" and that "the nature and scope of the requisite inquiry will vary based on the circumstances of the issuer and the other offering participants."

We are concerned that, unless the Commission provides clear guidance on how to comply with the "reasonable care" standard, the disqualification provisions will have a chilling effect on issuers' use of Rule 506. In particular, we are concerned that this standard could be interpreted to require continuous, real-time monitoring for potential disqualifications with regard to all covered persons throughout the conduct of a Rule 506 offering. For such offerings made on a continuous or delayed basis, this could be especially onerous. Moreover, the use of broad concepts (such as "officers" as described above) to define the scope of covered persons could make this process unworkable for many offering participants.

We urge the Commission to make it clear, either in an instruction to the proposed rules or in the adopting release, that issuers and other offering participants may rely on written representations obtained from covered persons on a periodic basis, provided that the persons obtaining the representations have no reason to believe that the representations are false. We think procedures similar to those permitted under FINRA Rules 5130 and 5131, which allow reliance on written representations for up to twelve months and updating confirmation via the use of negative consents annually thereafter, should be specifically authorized by the Commission on a non-exclusive basis. Procedures of this kind have functioned well in other compliance contexts, and it is critical that offering participants be able to comply with the factual inquiry requirement on a reasonably periodic rather than continuous basis. Otherwise, we think this requirement may prove to be unworkable.[8]

We would be pleased to discuss these matters if you wish. Please feel free to contact David Harms at 212-558-3882, Robert Buckholz at 212-558-3876 or Mark Lab at 212-558-7383.

Very truly yours,

/s/ Sullivan & Cromwell LLP

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8 Given the interplay between federal pre-emption under Section 18 of the Exchange Act and the availability of the Rule 506 safe harbor, we are also concerned that compliance uncertainty with regard to the factual inquiry requirement could result in violations of state securities laws and thus de facto state regulation of the proposed disqualification rules.