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July 30, 2011

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

Re: Release No. 33-9211, File No. S7-21-11 – Disqualification of Felons and other "Bad Actors" from Rule 506 Offerings.

Dear Ms. Murphy:

This letter is submitted in response to the request for comments by the Securities and Exchange Commission ("SEC") in Release No. 33-9211, File No. S7-21-11 (the "Rule Proposal"). In the Rule Proposal, SEC has proposed to revise SEC Rule 506 in response to Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The undersigned are members of the Securities Committee (the "Committee") of the Business Law Section (the "Section") of the State Bar of Texas. Mr. Fahy is Committee vice-chair. Each advises securities issuers, brokers and dealers. In addition, Mr. Waller serves as the Chairman of the Securities Law Committee of the American Association of Attorney-Certified Public Accountants, and is also the Chairman of its Dallas chapter. Please note that the comments expressed in this letter represent the views of the undersigned only and do not represent the views of their colleagues, clients or law firms or the official position of the Committee, the Section, the State Bar of Texas or of the American Association of Attorney-Certified Public Accountants. None of the undersigned are being compensated, directly or indirectly, for our work on this comment submission.

Definition of "Covered Persons" – Unaffiliated Registered Broker-Dealers and their Associated Persons

Questions Nos. 1 and 2 of the Rule Proposal ask if additional persons included in the definition of "Covered Persons" should be included or excluded from the definition. We believe that persons which are (a) unaffiliated with any securities issuer (as the term "affiliation" is defined by the SEC) and (b) which are properly licensed to offer and sell securities on behalf of such issuers, should be excluded from the definition. Rule 506 is an issuer exemption safe harbor, not a broker-dealer exemption. Consequently, persons who manage or control the business entity that will be receiving the net proceeds of investor funds are clearly more relevant to the policy concerns inherent in Section 926 than the distribution channel. The SEC should exempt from the definition of "Covered Persons" those persons who are not affiliated with the issuer of the securities but who are duly registered as securities brokers or, in the case of an intrastate securities broker, registered with the relevant state. This assumes that a person who is suspended is not duly-registered for the term of the suspension.

The policy reasons for our view are manifold.

1) Registered broker-dealers and associated persons are subject to net capital requirements, testing standards, background checks, fingerprinting, compliance protocols and examination and administrative discipline by securities regulators. This comprehensive regulatory regime does not apply to issuers, issuer management and unregistered brokers.

2) Registered broker-dealers and their associated persons who are duly licensed and in good standing have been permitted by securities regulators to be in the securities industry and to engage in the relevant sales activity. If a regulator has found cause that a broker-dealer or associated person should not engage in certain securities activities, it can impose limitations on that broker-dealer or associated person. For example, FINRA controls permitted business lines for broker-dealers through its member agreements.

3) The proposed order, as drafted, broadly applies to a variety of non-fraud offenses, including non-fraud offenses that could have nothing to do with Rule 506 private placements. For example, it applies to court orders generally "arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser," administrative orders from the SEC that "place limitations on the activities, functions or operations of such person" and SRO orders for violations of "just and equitable principles of trade." While we understand that the SRO order disqualification requires an active suspension or bar remedy, the SEC should be made aware that FINRA routinely deems the commonly-used principal license suspensions to be a "statutory disqualification" and a full suspension from being an associated person for the term of the suspension, even while the persons technically remains an associated person of the registered broker-dealer.

4) The rule, as drafted, would cause an issuer to lose its safe harbor based upon the history of an unaffiliated registered securities broker which directly or indirectly

> receives remuneration for the solicitation of securities. Typically Rule 506 issuers who use unaffiliated broker-dealers sign a selling agreement directly with one or more of them. Those broker-dealers are not the issuer. Consequently, should such a broker receive a suspension under a state administrative order or a FINRA order during the term of an offering for an act "inconsistent with just and equitable principles of trade," the issuer would unknowingly lose its safe harbor under Rule 506. While we anticipate that securities counsel will alter their selling agreements to include representations and warranties about current and continued compliance with the Rule 506 "bad boy" provisions, in reality the unaffiliated issuer will have insufficient control over the sales process to exclude registered representatives of unaffiliated broker-dealers which sell a private placement.

Ten Percent Shareholder

As to question No. 4 regarding coverage of 10% shareholders, we think that the proposed rule should be revised to parallel the affiliate standard in Rule 144 rather than using the "10% or more of any class of the issuer's equity securities" standard. This class of equity securities standard is borrowed from the disclosure requirements of Sections 13(d) and 16(a) of the Securities Exchange Act relating to disclosures of corporate control matters to public shareholders. But, in considering securities registration safe harbors, a standard similar to the affiliate standard to Rule 144 is more appropriate.

The Sections 13(d) and 16(a) derive from the Williams Act's concerns with secretive takeovers that provide lower values to passive shareholders and the ability of the owner of a large bloc of a particular equity class to unfairly control the trading in that class. It applies only to classes of stock actually registered with the SEC and thus subject to trading and free purchase and sale. Thus the policy concerns behind this standard are completely different from the policy concerns related to a securities registration safe harbor exemption.

Instead, the SEC should look to another securities registration safe harbor exemption – Rule 144. That rule provides more limited safe harbor relief to affiliates than non-affiliates. And the definition of affiliate is well-settled through references to the definition of control under SEC Rules 405 and 12b-2. (17 C.F.R. §§230.405 and 240.12b-2). Those rules define shareholder control to be determined by ownership of voting securities, not ownership of a class of equity securities. This is the more appropriate standard for private issuers because the votes control the issuer. The equity securities are generally illiquid and there is less likelihood of secret acquisitions of controlling positions and no risk of domination of a trading market. Consequently, we urge the Commission to adopt a standard that parallels the well-understood affiliate standard from Rule 144 as evidenced by the definitions of control in SEC Rules 405 and 12b-2.

Question 5 states that the proposed rule intends to incorporate the terms used in Rule 405, including the definition of "control." But, that definition is actually inconsistent with the Rule Proposal because the Rule 405 definition uses "voting securities" and the Rule Proposal uses "class of equity securities." If the SEC intends to incorporate the definitions used in Rule 405, it should use the voting securities standard, not the class of equity securities standard, to define who is a covered person.

If the SEC is concerned about the use of Rule 506 in private equity sales by public companies, it could adopt specific provisions applicable to reporting companies or rely on the disclosure obligations already extant in Sections 13(d) and 16(a) of the Securities Exchange Act.

As to whether a ten percent voting securities threshold should be deemed to be sufficient to be a covered person under Rule 506, we urge that the standard be moved up to at least twenty-five percent or skipped when there is a controlling shareholder or shareholder group. If there is a controlling shareholder or shareholder group, an unaffiliated minority shareholder who does not otherwise serve as director, officer, general partner, managing member or promoter will not really have any indicia of any control. Their vote is functionally irrelevant. While they can examine books and records under state corporate law and make claims for breaches of fiduciary duty, they do not control the business entity. Private issuers who have controlling shareholders should not be barred from using Rule 506 due to the transgressions of a powerless minority shareholder. This is especially true when the minority shareholder interest is illiquid. In that case the Rule 506 disqualification cannot be easily cured by that shareholder's sale of its interest in a secondary transaction.

Disqualifying Events Before Affiliation

Question 6 asks about providing an exception for disqualifying events involving affiliates if the event occurred before the affiliation with a reference to Rule 262(a)(5). We believe that this would be appropriate. We also suggest that the SEC provide guidance in the Rule Proposal or otherwise that it will consider a change of control as a consideration in a showing of good cause for an application under Proposed Rule 506(c)(2)(i). Alternatively, as suggested by Question 12, we suggest that entities that have undergone a change of control be permanently cured of the bad boy disqualification once an application is filed.

As to how to define change of control, we suggest that it involve a 50% or more change of beneficial ownership. And the changes of ownership should be real changes of ownership, so transactions that do not substantively change beneficial ownership, such as a trust distribution to beneficiaries or changes of owning business entity due to tax planning, would not be deemed to be a change of ownership.

"Executive Officers" and "Officers"

Question 7 asks about using the term "executive officers" instead of "officers" for the definition of covered person. We believe that it would be appropriate to use the term "executive officers." This would be more consistent with the intent expressed in also referring to directors, general partners, managing members and large beneficial owners. The disqualifying event should be tied to someone with some indicia of control, not just someone with a title and no real authority to control the enterprise or direct its policies. Many officer titles, especially in financial institutions, are honorifics tied to sales levels and are used for marketing purposes.

Officers of Covered Persons other than the Issuer

Question 8 asks about limiting coverage of the Rule Proposal to those, other than the issuer, who actually devote time to the relevant offering or to some other specified group of officers along with the executive officers. We believe that this is appropriate because it ties in with the reasonable care standard in Proposed Rule 506(c)(2)(ii). Since the distribution channel will often include non-affiliates and the issuer may not have any direct control over or even know the identity of a person "directly or indirectly" receiving "remuneration for solicitation of purchasers in connection with such sale of securities" after the offering commences, it would be beneficial to be able to identify a finite group of people to verify disqualifying backgrounds at the commencement of the offering. This would help provide a standard for issuers to meet the reasonable care standard under Proposed Rule 506(c)(2)(ii).

We are not suggesting that this should be the sole basis for meeting the reasonable care standard. We anticipate that representations and warranties relating to Proposed Role 506(c) will soon become standard in most selling agreements.

Investment Advisers and their directors, officers, general partners and managing members

Previously we suggested that Covered Persons should not include duly registered broker-dealers and their associated persons due to their operation under a comprehensive regulatory regime subject to background checks, examination, recordkeeping and compelled production to regulators. The same policy considerations apply to investment advisers and their senior personnel in the SEC's consideration of Question no. 9. If the SEC or the relevant state permits these business entities and persons to be licensed advisers and associated persons, there should be no limitation on their activities derived from disqualifying events under Proposed Rule 506(c).

We understand that the SEC does not license associated persons of advisers; but almost all states do. So, such carveout from the list of Covered Persons could require that the associated persons be licensed with the appropriate states. Also, as with broker-dealers we would view suspended associated persons to not be duly-licensed for the term of the suspension.

Finally, as a matter of clarification, we seek to understand whether being paid a portion of advisory fees, such as a solicitor, could be deemed to be "directly or indirectly" receiving "remuneration for solicitation of purchasers in connection with such sale of securities."

Orders from Foreign Courts and Regulators

Questions 14, 19, 40 and 49 ask about foreign convictions, civil court orders and administrative orders as well as orders from foreign stock and commodities exchanges. Using foreign court convictions, civil court orders or judgments, administrative orders and foreign exchange orders as disqualifying events is problematic. First, the standards of conduct, proof and evidence are likely to be vastly different than they are in the U.S. and the SEC should be concerned about the ability to determine what would be an equivalent order or sanction. Second, as pointed out in the comments from Sullivan Worcester dated July 1, 2011, there is no easy way for an issuer to conduct a comprehensive check of foreign courts, regulators and exchanges to meet the reasonable care standard under Proposed Rule 506(c)(2)(ii).

Disqualifying Court Injunctions and Restraining Orders

Question 17 asks for comments on the disqualification term for injunctive relief, especially permanent injunctive relief. We believe that it is appropriate to have a reasonable termination for the disqualification period, even for permanent injunctions. Proposed Rule 506 provides for disqualification based on court orders relating to non-*scienter* offenses. A non-fraudulent or negligent act should not result in a permanent disqualification where there is no recidivism.

Disqualifying Regulatory Orders

Question 18 requests comments on disqualifying events for final orders of state regulatory agencies and federal banking regulators barring a person from the regulated activity or constituting a "final order based on any violation of law that prohibits fraudulent, manipulative or deceptive conduct within the ten-year period ending on the date of the filing or the sale." See Dodd Frank Section 926. Many states, such as Texas, have statutory schemes with anti-fraud provisions that do not require any culpable mental state. A negligent omission about an unrelated third party could, in some cases, be sufficient for liability. But Congress appears to be contemplating requiring a culpable mental state by is use of "manipulative" and "deceptive." Consequently, we suggest that the SEC consider applying the disqualification only to findings of *scienter*-based violations of the State's anti-fraud provisions or willful violations of anti-fraud provisions that carry no specific *scienter* requirement. This may help allay the disparity which may impose a ten year disqualification for a non-scienter state administrative order and a five year disqualification for a SEC-obtained court injunction for a scienter-based violation.

Definition of Bar in State Orders

Question 19 asks whether the SEC should define "bar" for the purposes of State orders. We suggest that the SEC make clear that a prohibition on one activity, such as being a securities principal, not be treated as a bar if the State allows the relevant person to be a registered associated person of a broker-dealer or investment adviser. However, a bar from association with a broker-dealer or investment adviser should be treated as a bar.

Meaning of Fraudulent, Manipulative or Deceptive Conduct

Questions 29 and 30 asks whether the SEC should provide guidance by rule or otherwise what "fraudulent, manipulative or deceptive conduct" means and whether *scienter* should be required. We suggest that it such guidance would be beneficial because of the ten year disqualification for state administrative orders for fraudulent, manipulative or deceptive conduct. We also think that the guidance should be by rule to have the impact of law. As stated above, state anti-fraud statutes may not require a culpable mental state. For example, the Texas Securities Act does not require a culpable mental state for violations to support fraud findings in orders issued under Sections 14, 23, and 23-2 of the Texas Securities Act. We request that the SEC consider imposing a requirement that when there is no intent element for a state order involving the state's anti-fraud statute, that the disqualifying order be required to contain a finding of willful or knowing violations of the anti-fraud provisions. We do not think that is appropriate to impose a ten-year disqualification for acts that constitute mere negligence.

The SEC is a national regulator and it strives to have a uniform consistency across the U.S. But, question 32 asks whether the determination of the standard for what is "fraudulent, manipulative or deceptive conduct" should be left to each state. Unfortunately, our experience is that, despite NASAA's efforts at uniformity, all of the States have different statutes, standards and practices. The Uniform Securities Act has a 1956 version, a 1985 version, a 1988 amendment, and a 2002 version. Only 12 states and the U.S. Virgin Islands have adopted the 2002 version of the Uniform Securities Act. And several states, including populous states such as California, Texas and New York, have never adopted any version of the Uniform Securities Act. Consequently, we request that the SEC impose a uniform standard as to what is deemed to be "fraudulent, manipulative or deceptive conduct." This will also have the help of mitigating compliance costs because securities counsel will need to need to educate themselves on only one standard as opposed to up to 50 different standards – clearly an impediment to capital formation.

As question 33 states, another way of mitigating compliance costs by providing certainty is for the SEC to maintain a list of state agencies who can issue disqualifying orders. That would allow legal and compliance personnel to more quickly determine whether a state administrative order is a disqualifying order.

Questions 34 and 35 asks about whether SEC cease and desist orders should be disqualifying events and for what period. We believe that like the state orders, disqualifying SEC cease and desist orders should include findings of violations made with *scienter*. The SEC can issue cease and desist order for violations of a variety of non-fraud provisions, and safe harbor disqualification is a harsh remedy for, for example, a books and records violation or a good faith accounting treatment that turns out to be incorrect. Further, rather than list the provisions that do not lead to disqualification, it may be more appropriate to list the violations that do lead to disqualifications. Alternatively, the SEC should consider borrowing the willful violation approach from the statutory disqualifications in Section 15(b)(4)(D) and (E) of the Securities Exchange Act. Further, if the SEC determines to also incorporate CFTC orders, it should also require willful violations before any disqualification occurs.

Reasonable Care Standard

Questions 54 through 58 concern the proposed reasonable care standard. Securities registration violations are strict liability violations without culpable mental states. Consequently, good faith attempts to honor the safe harbor should not lead to a loss of the safe harbor. Indeed, this is the policy rationale behind the "good faith" and "reasonable attempt" standard in SEC Rule 508 adopted in 1989. Consequently, the reasonable care exemption is consistent with Regulation D as it currently reads. Further, having a reasonable care exemption will facilitate the provision of legal opinions as to safe harbor compliance. Indeed, the more specific the SEC is about what constitutes reasonable care, the more certain an issuer and its opinion counsel will have as to compliance. While this guidance may not necessarily need to be in the rule itself, the guidance should be adopted as an official position of the SEC. Finally, as to what steps that should be taken:

1) The selling agreement should contain representations and warranties about not having disqualifying events in relevant personnel;
2) Questionnaires can be required from the issuer, issuer control persons and relevant persons in the distribution channel;
3) Routine inquiries can be made to state regulators; and
4) Routine background checks can be run.

We see no reason to require professional background search companies as recommended by the comment letter from Sullivan Worcester. That may impose an unnecessary level of expense on small offerings. Further, online background databases may be thorough.

One concern that we have is not having a central database of all state orders for all relevant state agencies. NASAA maintains "NASAASID" as a database for internal use, but there is no public access to the public information there. The reasonable care standard would be enhanced by having a central database of public orders for state securities, insurance and banking regulators.

Waiver Authority

Questions 59 through 62 relate to SEC and state agency waiver authority. We believe that the SEC should have the ability to grant reviews and waivers. If the SEC did not have that authority, there is a risk of judges imposing such waivers in final judgments which may lead to a lack of uniform standards. Likewise, the uniformity and the quality of the waiver applications would be enhanced by the SEC providing guidance as to factors it will consider in granting such waivers. Further, state agencies already have the authority to grant a disqualifying event waiver in other contexts. It would be appropriate for a state agency to make its own determination as to whether it deems its own order as an appropriate disqualifying event. Indeed, we anticipate that most such waivers will relate to settled consent orders. If state agencies did not have the authority to issue such waivers, it could hamper their ability to craft appropriate settlements and would lead to a flood of applications to the SEC seeking waivers. Some of those applications may even include a letter from state securities administrator recommending such a waiver – a piece of evidence that the SEC should view as persuasive. Given the SEC's limited resources, it makes little sense to process a large number of waiver requests that are unopposed or recommended by the state agency that issued the order.

Grandfathered Orders

As stated in Proposing Release's discussion around question 63, we believe that most existing state and federal administrative and court orders that are disqualifying events were the result of good faith negotiated settlements. The settlement decision was often premised on it <u>not</u> being a disqualifying event under existing Rule 506. Indeed, had the parties known that it would be a disqualifying event under Rule 506, the parties could have discussed a possible waiver or waiver recommendation, or in some cases, gone to hearing. As for the effective date of the grandfathering, it should be the effective date of the Rule 506 amendment, unless the SEC anticipates a lengthy phase-in period. That would be the date that the legal certainty of the nature and scope of the Covered Persons and disqualifying events would be evident to all parties negotiating settlements in court and relevant state and federal agencies.

As to previous Regulation D and E waivers that have been granted, those should be extended to Rule 506 offerings as well. Many of those waivers were parts of negotiated settlement offers and it would disturb the equities of the settlements to have a disqualifying event come back in on a post facto basis.

We also believe that the disqualifying events should only apply to offerings commenced after the effective date of the rule amendment. Issuers should not be subject to changes in safe harbors in the middle of the capital formation process.

Some offerings, particularly hedge funds, may continue for years with ongoing efforts to update information. We have concerns that this should not be used to avoid the application of the Rule 506 amendments for years down the road. Consequently, it would be reasonable for offerings commenced a year or more before the effective date of the Rule 506 amendment to be subject to the disqualifying event standards. Plus, Form D provides information to regulators as to whether the offering is anticipated to be for more than one year or whether the Form D is being amended due to the lengthy offering period. So, it should be a relatively mild burden for the SEC and state securities agencies to determine which offerings are subject to disqualifying events based on the information in the Form D.

Timing of Disqualifying Event

We anticipate that issuers will generally conduct the searches necessary to meet the reasonable basis standard before commencing the offering. A date certain would be required to provide the issuer with confidence that it has met the reasonable basis conduct. So, as to issuer disqualifying events we believe that the date of the commencement of the offering is appropriate. Sometimes well after the commencement of the offering a new broker-dealer may be added to a selling group. If that happens, it may be appropriate to use the date the broker-dealer enters into the selling agreement as the specific date for the broker-dealer personnel subject to the reasonable basis review under SEC guidelines.

Conforming Regulation A and E

We believe that the SEC should not have multiple disqualifying event standards depending on the type of the offering and we encourage conforming Regulation A and E disqualifying event standard to Rule 506. This will lessen the complexity of settlement negotiations and compliance protocols, thus providing savings to the expense of securities offerings in general and regulatory litigation. This conformity should include conforming the compliance determination date.

Respectfully Submitted,

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