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Via e-mail to **rule-comments@sec.gov**

February 1, 2012

U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090
Attention: Elizabeth M. Murphy, Secretary

Re: Securities Act Release No. 9211 (May 25, 2011); File No. S7-21-11

Ladies & Gentlemen:

Securities Act Release No. 9211 (May 25, 2011) sought comments on rule proposals designed to implement Section 926 of Dodd-Frank by extending badgirl provisions to transactions exempt under Rule 506 of Regulation D. In addition, however, the Release asked whether the bad actor provisions should be extended to Rule 504, the seed capital exemption.

Extending the bad actor provisions to Rule 504 is an appropriate reform. Nonetheless, the Commission should not merely insert the proposed bad actor provisions into the Rule. Instead, the Commission should take into account the unique attributes of Rule 504 and craft provisions that are more appropriately designed to reduce its use by recidivists.

I. Rule 504: Capital Raising v. Securities Fraud

The proposing release notes that most offerings under Regulation D rely on Rule 506.[1] While Rule 504 may not be used as often, the seed capital exemption plays a significant role in violations of Section 5 of the Securities Act, particularly those involving microcap companies.[2] This is not news. The SEC has long had concern over the role of Rule 504 in registration violations.[3]

[1] Securities Act Release No. 9211, at 4 (May 25, 2011) ("It is by far the most widely used Regulation D exemption, accounting for an estimated 90-95% of all Regulation D offerings and the overwhelming majority of capital raised in transactions under Regulation D. ").
[2] For recent enforcement actions mentioning Rule 504, *see* Appendix to this Memorandum.
[3] *See* Revisions of Limited Offering Exemptions in Regulation D, Exchange Act Release No. 8828, at 73 (Aug. 3, 2007) ("The Commission had been concerned for some time with abusive practices in Rule 504 offerings, many of

These types of violations often involve repeat players. Indeed, recidivism is a general concern under the federal securities laws. *See* Jayne W. Barnard, *Securities Fraud, Recidivism, and Deterrence*, 113 Penn St L. Rev. 189 (Summer 2008). President Obama in his State of the Union speech[4] and Chairwoman Schapiro in a recent submission to Congress[5] noted the problem of repeat offenders under the securities laws.

One way to reduce the use of Rule 504 by recidivists is to eliminate some of the attributes that make the provision appealing to bad actors. Rule 504 is the only exemption in Regulation D that permits general solicitations and freely transferable shares.[6] Eliminating one or both of these attributes might reduce the instances of microcap fraud but would also have the collateral consequence of making the Rule less attractive to legitimate companies seeking to raise seed capital.

Applying a carefully crafted bad actor provision to Rule 504 represents an alternative approach to reducing microcap fraud. It targets only recidivists and imposes minimal additional burdens on legitimate businesses.[7] At the same time, the Commission should not simply opt for uniform application of the disqualifications contained in Regulation A but should reconsider the categories of covered persons and the applicable offenses in light of the goal of reducing use by recidivists.

II. Expanding the Types of Covered Persons and Disqualifying Events

A. Covered Persons

Microcap fraud, particularly pump and dumps, generally requires an issuer, large shareholders ready to sell significant blocks of stock, and brokers that execute the trades.[8] The bad actor provisions in Rule 262 and the proposals with respect to Rule 506 for the most part

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which involved "pump and dump" schemes for securities of non-reporting companies that traded over the counter."); Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Securities Act Release No. 7644, at 1 (Feb. 25, 1999) ("Unfortunately, there have been recent disturbing developments in the secondary markets for some securities initially issued under Rule 504, and to a lesser degree, in the initial Rule 504 issuances themselves.").

[4] *See* President Barak Obama, State of the Union Address (Jan. 25, 2012 ("Some financial firms violate major anti-fraud laws because there's no real penalty for being a repeat offender. That's bad for consumers, and it's bad for the vast majority of bankers and financial service professionals who do the right thing."), *available at* http://www.nytimes.com/interactive/2012/01/24/us/politics/state-of-the-union-2012-video-transcript.html

[5] *See* Letter from Mary Schapiro, Chair, Securities and Exchange Commission to Jack Reed, Chairman, Subcommittee on Securities, Insurance and Investment, Committee on Banking, Housing and Urban Affairs, US Senate, Nov. 28, 2011 (seeking authority designed to "explicitly increase the cost of repeat offenses"), *available at* http://www.nabl.org/uploads/cms/documents/MaryShapiroLetter.pdf

[6] Companies may only do so only if the offering meets certain requirements under state law. *See* Rule 504(b)(1), 17 CFR 230.504(b)(1).

[7] Issuers would likely incur modest cost in exercising some level of due diligence designed to ensure that there were no bad actors involved in the offering.

[8] This is not to say that all of the participants violate the law. An issuer could properly place shares, with the pump and dump occurring thereafter. Similarly, brokers placing orders may have no culpability with respect to the illegal transaction.

include these persons.[9] There are, however, two additional categories that are sometimes implicated in these transactions: lawyers and transfer agents.

To effectively execute most pump and dumps, the selling shareholders must have a large inventory of what appears to be freely transferable shares. This generally means shares that purport to be free from limitations on resale and therefore do not bear restrictive legends on the certificate. Rule 504 is the only exemption in Regulation D that permits the issuance of shares without a restrictive legend. Before providing certificates in offerings under Rule 504, however, the transfer agent commonly requires an opinion of counsel[10] opining that the shares are freely transferable and the certificates need not bear a restrictive legend.[11]

The Commission has, in some cases, raised concern about problematic opinion letters from lawyers under Rule 504. *See SEC v. Gendarme Capital Corp*., 2011 SEC Lexis 211, at 15 (Jan. 6, 2011); *SEC v. Luna*, Litigation Release No. 21779, at 1 (Dec. 15, 2010); *SEC v. Alliance Transcription Services, Inc.*, Litigation Release No. 20676, at 1 (D. Ariz. Aug. 8, 2008); *In re Christison*, Securities Act Release No. 8892, at 2 (admin proc Feb. 7, 2008). Similarly, the Commission has expressed concern with "improper" removal of legends by transfer agents. *See In re Holladay Stock Transfer Inc*., Securities Act Release No. 7519 (admin proc Mar. 25, 1998).

Including lawyers and transfer agents in the category of covered persons would make the improper use of Rule 504 more difficult. Moreover, in many respects the approach would reaffirm existing practices by the Commission. The Commission has sometimes sought to bar lawyers from writing additional opinion letters. *See SEC v. Allixon International Corp*., Litigation Release No. 19987 (ND Tex. Feb. 1, 2007); *see also Complaint, SEC v. Alliance Transcription Services, Inc.*, Litigation Release No. 20676 (D. Ariz. Aug. 8, 2008).[12] The inclusion of lawyers would amount to a de facto ban on writing additional opinion letters in exempt offerings.

The concern over the role of lawyers is not alleviated by the Commission's authority under Rule 102(e). Attorneys are occasionally barred or suspended from practice before the Commission as a result of an alleged role in unregistered offerings. Not all lawyers involved in registration violations are, however, subjected to proceedings under Rule 102(e). More to the point, even those sanctioned may not be prevented from writing additional opinion letters. The opinion letters are not filed with the Commission and therefore arguably fall outside of the

[9] In addition to issuers and their affiliates, the proposed bad actor provisions would extend to "any beneficial owner of 10% or more of any class of the issuer's equity securities; any promoter connected with the issuer in any capacity at the time of such sale; any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities; or any general partner, director, officer or managing member of any such solicitor". Proposed Rule 506(c)(1).

[10] This does not mean that letters always came from lawyers. *See SEC v. Spongetech Delivery Systems, Inc.*, Litigation Release No. 21515 (ED NY May 5, 2010) (allegations that "false and misleading attorney opinion letters" were issued "in the name of a fictitious lawyer").

[11] *See In re Weeks*, Initial Decisions Release No. 199 (admin proc Feb. 4, 2002) ("It would have been difficult for an issuer to effectuate the distribution of a massive amount of unregistered securities without help from an accommodating transfer agent.").

[12] The complaint is available at http://www.sec.gov/litigation/complaints/2008/comp20676.pdf

definition of "practice before the Commission." *See* Rule 102(f) (defining practice to include the preparation of any opinion "filed with the Commission.").[13]

The inclusion of transfer agents as a covered person may have broad consequences. A transfer agent that is disqualified as a bad actor will presumably suffer a loss of business. At least some companies will likely be unwilling to remain with a transfer agent that cannot participate in exempt offerings under Rule 504. On the other hand, the possibility may well provide transfer agents with an incentive to increase their due diligence[14] when issuing stock certificates in exempt offerings.[15]

B. Expanding the Category of Disqualifying Events

The bad actor provisions also define the events that result in disqualification. These include court injunctions that prohibit the covered party from "engaging in or continuing any conduct or practice in connection with the purchase or sale of securities or involving the making of a false filing with the Commission." This presumably includes covered persons who are enjoined from violating Section 5.

Disqualifying events currently do not extend to cease and desist orders issued by the Commission. The Release has sought comment on whether cease and desist orders involving violations of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct should be included. This is an appropriate reform that should be implemented.

The proposal may, however, need to go further. It does not encompass those orders that, while free of allegations of fraud, do assert violations of Section 5. Occasionally such orders have been issued against lawyers. Consideration should be given, therefore, to including as a disqualifying event those cease and desist orders that involve opinion letters causing a violation of Section 5.[16]

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[13] This may well be a disputed point. Nonetheless, the argument is there and because the opinions are not filed, the Commission will usually be unaware of the practice. Barring a lawyer from practicing before the Commission does not, therefore, guarantee that he or she will cease writing problematic opinion letters concerning the applicability of an exemption from registration.

[14] *Compare In re World Trade Financial Corp*., Exchange Act Release no. 66114 (admin proc Jan. 6, 2012) (transfer agent that removed restrictive legends "did not consider itself responsible for conducting any due diligence on Applicants' behalf, and there was no evidence it conducted the necessary inquiry.") *with SEC v. Marshall*, Litigation Release No. 5709 (CD CA Jan. 24, 1973) ("The transfer agent has an independent duty to exercise good faith and due diligence and therefore cannot base its action or inaction upon instructions of the issuer unless upon the same facts the issuer itself could successfully defend.").

[15] *See In re Holladay Stock Transfer Inc*., Securities Act Release No. 7519 (admin proc March 25, 1998) (undertakings that required transfer agent to implement "procedures as are deemed reasonable and necessary for the issuance of stock certificates without restrictive legends and the removal of such legends from outstanding shares of stock").

[16] This would presumably include opinions involving other exemptions from registration that cause violations of Section 5, particularly Rule 144. *See* Rule 144: Selling Restricted and Control Securities ("Only a transfer agent can remove a restrictive legend. But the transfer agent won't remove the legend unless you've obtained the consent of the issuer—usually in the form of an opinion letter from the issuer's counsel—that the restricted legend can be removed."), *available at* http://www.sec.gov/investor/pubs/rule144.htm.

III. Conclusion

Application of the bad actor provisions to Rule 504 has the potential to reduce fraud without limiting the usefulness of the Rule to legitimate businesses seeking to raise seed capital. For this to be accomplished, however, the Commission should redraft the bad actor provisions to ensure that they fully limit improper use of the seed capital rule by recidivists.

/s/ J. Robert Brown, Jr.

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[redacted]

Cases over the last 10 years involving the use of Rule 504[17]

1. *SEC v. ConnectAJet.com, Inc.*, Litigation Release No. 22155, 2011 SEC LEXIS 4028 (N.D. Tex. Nov. 15, 2011)

2. *In re Bloomfield*, Initial Decision Release No. 416-A (admin. proc. Apr. 26, 2011) (pump and dump)

3. *SEC v. Gendarme Capital Corp.*, 2011 SEC Lexis 211 (Jan. 6, 2011)

4. *SEC v. Luna*, Litigation Release No. 21779 (Dec. 15, 2010)

5. *In re Briner*, Exchange Act Release No. 63371 (admin. proc. Nov. 24, 2010)

6. *In re Haque*, Securities Act Release No. 9155 (admin. proc. Nov. 1, 2010) (pump and dump)

7. *SEC v. Czarnik*, Litigation Release No. 21401 (S.D.N.Y. Feb. 2, 2010) (pump and dump)

8. *In re Newbridge Sec. Corp.*, Initial Decision Release No. 380 (admin. proc. June 9, 2009) (pump and dump)

9. *In re Stocker*, Exchange Act Release No. 60016 (admin. proc. June 1, 2009)

10. *SEC v. Alliance Transcription Services, Inc.*, Litigation Release No. 20676 (D. Ariz. Aug. 8, 2008)

11. *SEC v. Homeland Safety Int'l*, Litigation Release No. 20645 (N.D. Okla. July 15, 2008) (pump and dump)

12. *In re Allixon Int'l Corp.*, Securities Act Release No. 8925 (admin. proc. June 2, 2008)

13. *In re Alt. Energy Tech. Ctr., Inc.*, Exchange Act Release No. 57600 (admin. proc. Apr. 2, 2008)

14. *In re Christison*, Securities Act Release No. 8892 (admin. proc. Feb. 7, 2008)

15. *In re Carley*, Securities Act Release No. 8888 (admin. proc. Jan. 31, 2008)

16. *In re Disraeli & Lifeplan Associates*, Securities Act Release No. 8880 (admin. proc. Dec. 21, 2007)

[17] The listed cases are from a search of Lexis Nexis over a ten year period. These are cases that explicitly mention Rule 504. The list probably represents an undercount of cases involving the Rule. Many actions brought by the Commission that allege violations refer to Section 5 do not specify the particular exemption or safe harbor that was improperly relied upon in the offering. Some of them probably involve Rule 504.

17. *SEC v. Offill*, Litigation Release No. 20302 (N.D. Tex. Sept. 27, 2007)

18. *In re Disraeli*, Initial Decision Release No. 328 (admin. proc. Mar. 5, 2007)

19. *SEC v. Allixon Int'l*, Litigation Release No. 19987 (N.D. Tex Feb. 1, 2007); Litigation Release No. 19471 (N.D. Tex. Nov. 18, 2005)

20. *In re Temple Sec.*, Securities Act Release No. 8779 (admin, proc. Feb. 1, 2007)

21. *SEC v. Wind Farming, Inc.*, Litigation Release No. 19618 (N.D. Ill. Mar. 21, 2006); Litigation Release No. 19546 (N.D. Ill. Jan. 30, 2006)

22. *In re Harris*, Exchange Act Release No. 53122 (admin. proc. Jan. 13, 2006)

23. *SEC v. Integrated Services Grp. Inc.*, Litigation Release No. 19476 (admin. proc. Nov. 29, 2005) (pump and dump)

24. *In re Allixon Int'l Corp.*, 2005 SEC LEXIS 2973 (admin. proc. Nov. 17, 2005)

25. *In re Carley*, Initial Release No. 292 (admin. proc. July 18, 2005)

26. *SEC v. Bio-Heal Laboratories, Inc.*, Litigation Release No. 19203 (admin. proc. Apr. 27, 2005)

27. *In re Dorfman*, Securities Act Release No. 8562 (admin. proc. Mar. 31, 2005)

28. *SEC v. Custom Designed Compressor Sys. Inc.*, Litigation Release No. 19101 (admin. proc. Feb. 28, 2005)

29. *In re Nnebe*, Initial Decision No. 269 (admin. proc. Jan. 5, 2005)

30. *In re Oliver*, Exchange Act Release No. 50565 (admin. proc. Oct. 20, 2004) (pump and dump)

31. *In re Smith*, Exchange Act Release No. 50566 (admin. proc. Oct. 20, 2004) (pump and dump)

32. *In re Shapiro*, Exchange Act Release No. 47848 (admin. proc. May 14, 2003)

33. *In re Danilovich*, Exchange Act Release No. 47844 (admin. proc. May 14, 2003)

34. *In re Marvul*, Exchange Act Release No. 47846 (admin. proc. May 14, 2003)

35. *In re Montelbano*, Exchange Act Release No. 472227 (admin. proc. Jan. 22, 2003)

36. *In re Burstein*, Exchange Act Release No. 45715 & 45716 (admin. proc. Apr. 9, 2002)