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To: SEC Advisory Committee on Smaller Public Companies

From: Professor Stuart R. Cohn

Re: Response to Preliminary Recommendations of Capital Formation Subcommittee

Date: February 9, 2006

I write in response to the Preliminary Recommendations Proposed by the Capital Formation Subcommittee of the SEC Advisory Committee on Smaller Public Companies, dated December 7, 2005.

The capital-raising problems faced by smaller companies under our current securities laws and regulations have long been a particular concern of mine. I enclose a copy of my vitae that includes a list of law review articles I have written, some of which are critical of the SEC for its failure to address adequately the capital formation needs of small businesses. The Subcommittee's Proposals offer the promise of progress, although, as my comments will note, I believe that some of the recommendations are too narrow and at least one is too broad. My particular comments are as follows:

1. Proposal One: A New Private Offering Exemption

I strongly favor this proposal. The Subcommittee has correctly noted that current prohibitions against general advertising and solicitation may unreasonably restrict the opportunities for smaller

businesses to attract investors. I would have preferred it if the Subcommittee had applied its concern to all of the current exemptions that restrict solicitation and advertising, rather than create a single new, somewhat limited exemption. Nevertheless, the Proposal is a step in the right direction.

However, I am concerned that the proposed exemption may be too narrowly defined to be of substantial value to small businesses. I refer here to the proposal's definition of "Eligible Purchasers." In particular:

1. Net Worth: My experience, both in the practice of law and as an observer for many years of small enterprises, is that small companies do not usually have access to the types of "Eligible Purchasers" described in the proposal. Small businesses must often rely on a great many friends, acquaintances, friends of friends, and more remote potential investors. In most cases, these potential investors will not have a \$1 million net worth, let alone \$2 million as proposed. I would suggest that a preferable standard applicable to small businesses would be a much lower minimum net worth if the investment was a small percentage of the purchaser's net worth, a concept employed in some state exemptions.
2. Investment Sophistication: An alternative class of "Eligible Purchasers" is based upon "investment sophistication." This concept might be of benefit to small businesses depending upon how it is defined. The definition of "investment sophistication" in Footnote 2 refers to "the ability...to understand the merits and risk of making a particular investment." I favor such a definition over the "sophistication" standard in Rule 506, which is based on "knowledge and experience in financial and business matters," because the Proposal's definition may be interpreted to encompass people of ordinary intelligence without including the litmus test of prior financial or investment activity. However, it is readily foreseeable that the "ability" standard will be narrowly interpreted, in much the

same way that the phrase “fend for oneself” has been interpreted by the courts and the SEC. If that is so, we could end up with a case such as Andrews v. Blue, 489 F. 2d 367 (10th Cir. 1973), in which an admittedly sophisticated real estate investor was deemed by the court to be a “babe in the woods” when it came to stocks. Therefore, I would recommend that Footnote 2 be expanded, indeed be made part of the text, to make it clear that “investment sophistication” can be satisfied by persons of ordinary intelligence without prior financial or investment experience, and that prior investment experience in private or public offerings is a factor but not a condition in considering whether a person meets that standard. Indeed, it would be preferable if the term “investment sophistication” were amended to use a phrase other than “sophistication,” a term that carries baggage of numerous years and interpretations.

2. Private Placement Exemption Adjustments

The two recommendations under this heading regarding (a) relaxing the prohibition against general solicitation and advertising and (c) shortening the integration safe harbor period both appear to be related solely to Rule 506 offerings. Excluded from these recommendations are offerings under Section 4(2), Section 4(6), Rule 504, Rule 505, and Section 3(a)(11).

While I favor each of those two Proposals, I would urge the Subcommittee to consider similar provisions for all exemptions. The problem caused by the prohibition against general solicitation and advertising is already well recognized. The integration doctrine also creates an enormous problem for many small companies that need to raise capital on a near-term and sporadic basis. An ABA Task Force came to that conclusion years ago, and provided a comprehensive set of alternative guides, but the SEC has not made any significant changes to the integration doctrine.

3. Qualified Purchasers

Proposal 3.d. recommends that the SEC define “qualified purchasers” so that the NSMIA federal preemption for “covered securities” can be applied. Although the recommendation may somewhat enlarge capital-raising opportunities for small businesses by freeing them from state registration provisions, I have serious concerns that the Proposal’s costs outweigh its benefits. .

I am a frequent expert witness in criminal proceedings brought by the State of Florida against persons who engage in fraudulent securities promotions. The Committee is no doubt aware that numerous promotions ranging from pay telephones to currency trading to animal breeding are constantly being offered throughout the country by persons who prey on the naive and innocent. Unfortunately, many of the naive and innocent are also wealthy. If the Subcommittee’s proposal is adopted, and “qualified purchasers” become exempt from state registration requirements, that will bring to an end a fundamental component in state enforcement against such schemes, namely a registration violation. The proposed exemption will also create problems regarding enforcement against unlicensed dealers. Violations of registration and licensing provisions involve strict liability and therefore are a much more effective enforcement measure than proving elements of fraud. If an exempt open hunting season was declared for “qualified purchasers,” there is no doubt in my mind that state enforcement against the myriad of fraudulent promotional schemes will be substantially hindered, which in turn will generate further efforts by fraudulent promoters to comb the woods for suitable targets.

Of course, Rule 506's preemption of state registration has much the same effect. But at least Rule 506 has numerous regulatory provisions within Regulation D that must be followed in order to preempt state law. If the only criterion for state preemption was that someone meet the “qualified purchaser” definition, it will be extremely easy for the unwholesome to ensnare the unwary without fear of regulatory violation. The Subcommittee’s proposed increase in the “accredited investor” criteria reduces

the potential class of targets (if similar criteria are used for “qualified purchasers”), but in this age of highly inflated real estate values, meeting a \$2 million net worth figure is not difficult for many retirees and others.

As a practical matter, Rule 506 and Proposal 1 of the Subcommittee will combine to create an enlarged class of potential investors. The recommendation to create an additional exemption for “qualified purchasers” will not significantly enhance the opportunities for small businesses, but as a stand-alone exemption there is a strong likelihood that it will open the door to enormous problems of securities fraud. For that reason, I would not recommend adoption of this aspect of the Subcommittee’s proposal.

Thank you for allowing me to submit these comments.

Sincerely,

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