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NASAA

October 3, 2012

Submitted electronically to rule-comments@sec.gov

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

RE: NASAA Comments in Response to Release No. 33-9354 (File No. S7-07-12), "Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A"

Dear Ms. Murphy,

The North American Securities Administrators Association, Inc. (NASAA) submits the following comments in response to Release No. 33-9354 regarding the elimination of the prohibition against general solicitation in Rule 506 and Rule 144A. We are grateful that the Commission chose to publish the proposed rule for comment and did not adopt it as an interim final rule.

The members of NASAA are the state securities regulators who work closely with small businesses in their capital formation efforts, and we want those businesses to be successful so they can thrive and produce jobs. We recognize the need of these small businesses to reach investors – particularly accredited investors – and toward that end NASAA adopted a Model Accredited Investor Exemption ("MAIE") in 1997 to enable small businesses to solicit accredited investors through reasonable advertising.[1] Since that time, NASAA has urged the Commission to adopt a parallel federal exemption.[2] Advertising to accredited investors is clearly not a new concept to NASAA members, nor a concept that we categorically oppose.

However, NASAA members also have the duty to protect investors, and in that role we have frequent interaction with investors who have been victimized by fraudulent or unsuitable private placements. In 2011, fraudulent Rule 506 offerings were ranked as the most common product or scheme leading to enforcement actions by state securities regulators, and private

[1] The Model Accredited Investor Exemption is available at http://www.nasaa.org/wp-content/uploads/2011/07/24-Model_Accredited_Investor_Exemption.pdf. According to SEC Release No. 33-8041, forty states have either adopted the MAIE or have another provision that exempts transactions with accredited investors.
[2] See, e.g., Comment Letter from Joseph P. Borg, NASAA President and Director of the Alabama Securities Commission, in response to SEC Release No. 33-8041 (March 4, 2002), available at http://www.nasaa.org/wp-content/uploads/2011/07/93-qlfdpurchaser.37317-63930.pdf.

placements are commonly listed on our annual list of top ten investor traps.[3] We have learned that efforts to spur successful capital formation must reflect a balanced regulatory approach that minimizes unnecessary costs and burdens on small businesses while protecting investors from fraud and abuse.[4] Without adequate investor protections to safeguard the integrity of the private placement marketplace, investors should and will flee from the market, leaving small businesses without an important source of capital.

In our comment letter of July 3, 2012,[5] NASAA submitted preliminary comments to the Commission on Titles II, III, and IV of the JOBS Act. For purposes of this letter, we will not repeat every point we made with respect to Title II, but we request your consideration of our earlier comments along with the comments contained in this letter.

Overall, we are greatly disappointed in the proposed amendment to Rule 506. We recognize that there are competing interests with divergent opinions on how the Commission should move forward on this issue. However, the proposed rule does nothing more than recite what is already in the statute. It fails to give sufficient guidance to issuers, even though that type of guidance is mandated by the JOBS Act, and it fails to implement ***any*** protections for investors, even those that would be minimally burdensome to issuers. In short, the Commission has neglected its duty to both issuers and investors by proposing a rule that does nothing more than parrot statutory language.

I. Changes to Rule 506 are important to NASAA members because state securities regulators are the primary regulators of private placements.

Under Section 18 of the Securities Act of 1933, states are preempted from requiring registration of securities that are sold in compliance with Rule 506. However, states are not prohibited from investigating and bringing enforcement actions related to fraud and deceit. In reality, states have proven to be the primary regulator of offerings conducted under Rule 506 because we have demonstrated a willingness to exercise this antifraud authority.

The enforcement statistics published by the Commission do not specifically identify the number of enforcement actions involving private placements. However, under the broader category of actions involving "Securities Offerings," which presumably includes private placement offerings, the Commission reports that it took 124 enforcement actions in 2011.[6] In contrast, state regulators took more than 200 enforcement actions related specifically to Rule 506

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[3] See *Laws Provide Con Artists with Personal Economic Growth Plan: NASAA Identifies Emerging and Persistent Investor Threats* (August 21, 2012), available at http://www.nasaa.org/14679/laws-provide-con-artists-with-personal-economic-growth-plan/.

[4] In 1992, the Commission amended Rule 504 to allow general solicitation, but reversed course when investors were inundated with fraudulent offerings. See SEC Release No. 33-7644, available at http://www.sec.gov/rules/final/33-7644.txt.

[5] Available at http://www.nasaa.org/wp-content/uploads/2011/07/Initial-NASAA-Comments-to-SEC-re-JOBS-Act-Rulemaking.pdf.

[6] See http://www.sec.gov/news/newsroom/images/enfstats.pdf.

offerings. Moreover, the states pursued more than 400 investigations of Rule 506 offerings during 2011, so the number of enforcement actions may rise in 2012.[7]

As described in SEC Inspector General Report No. 459, "Regulation D Exemption Process" (March 31, 2009), the Commission conducts no substantive review of Form D filings to determine whether an issuer actually complies with Rule 506.[8] As of the date of the Report, the Commission had never brought a single action against a company for violating Rule 503 by failing to file the required Form D,[9] and we are unaware of any subsequent enforcement actions to enforce the filing requirements. However, state regulators routinely review Form D to ensure that the offerings actually qualify for an exemption under Rule 506 and to look for "red flags" that may indicate a fraudulent offering.

Even though state regulators have limited authority in the policing of these offerings and absolutely no power to amend Rule 506, states and investors understand that when it comes to policing these offerings the state regulators are the primary line of defense. *Therefore, the Commission must consider the impact on state-level enforcement efforts when it adopts changes to Rule 506.*

II. Form D should be filed prior to the use of general advertising.

We understand that the Commission must follow the mandate of the JOBS Act, even though we expect the broad public advertising of highly speculative, highly illiquid, and sometimes fraudulent investment opportunities to lead to more enforcement actions. This is an unfortunate result of a policy decision to discount the potential harm to investors. However, the Commission has the opportunity to implement the JOBS Act in a way that satisfies its mandate while minimizing the harm to investors. One simple improvement would be to require the filing of Form D prior to the use of any type of general solicitation.

Consider the practical realities that will now be faced by state enforcement personnel.[10] State blue sky laws contain a number of exemptions from the securities registration requirements, but those exemptions typically prohibit general solicitation.[11] Similarly, before the JOBS Act, none of the federal exemptions allowed the use of a general solicitation. Therefore, an investigator could be assured that any offering was required to be registered if it was publicly advertised on the internet or elsewhere. Now, under the JOBS Act, an advertised offering does not necessarily require registration. An investigator who sees an advertised offering will have no

[7] Many states do not maintain statistics for the various types of offerings that result in enforcement actions. As a result, the number of state enforcement actions and investigations related to Rule 506 offerings are likely to be significantly higher than the reported statistics.
[8] http://www.sec-oig.gov/Reports/AuditsInspections/2009/459.pdf.
[9] Id. at 10.
[10] We note that many of these challenges will also be faced by federal enforcement personnel, including Commission staff and federal law enforcement officials.
[11] One exception to this general rule is the MAIE, which requires a notice filing. See supra n. 1.

simple way of knowing whether the issuer is engaged in a compliant Rule 506 offering or is merely advertising an unregistered, non-exempt public offering.

The inability to determine the issuer's intent, along with the failure to provide the information contained in the Form D prior to advertising, will put investors at risk because state securities regulators will be unable to answer their questions. NASAA members frequently advise investors to "investigate before you invest," and we encourage investors with questions to contact state regulators. Frequently asked questions include whether the offering is registered or exempt, whether there have been any complaints against the issuer or placement agents, and whether the issuer, control persons, or placement agents have any regulatory history. Without a Form D filing requirement prior to advertising, there is no way for state securities regulators to provide this information to investors that are trying to make an informed investment decision.

The difficulty stems from the filing deadline for the Form D. If an issuer files a Form D with the Commission prior to advertising an offering, an investor or regulator could quickly find the Form D on EDGAR and conclude that the issuer is at least attempting to comply with Rule 506. However, under the current rules, Form D need not be filed until 15 days after the first *sale*, so an issuer can solicit investors without filing the form. Thus, if an offering is advertised on the internet and a Form D is not filed with the Commission, investors and regulators can no longer conclude that the offering is non-exempt. State regulators will have to contact the issuer to determine whether the offering is being conducted in compliance with Rule 506, leading to unnecessary investigatory inquiries. This may necessitate the use of subpoenas, which issuers would undoubtedly prefer to avoid, in order for regulators to obtain information that the issuer is ultimately required to provide to investors anyway.

This problem is further complicated by the Commission's failure to enforce the 15 day filing requirement. As reported by the SEC Inspector General, "there are simply no tangible consequences when a company fails to file a Form D," so the filing of a Form D is voluntary for all practical purposes.[12] *This means that a promoter who advertises an illegitimate offering with no intention of complying with Rule 506 will nonetheless be able to assert it as a defense after the fact.*

In our earlier comment letter, NASAA proposed a simple way to avoid these problems. We proposed that the Commission, while repealing the general solicitation ban as mandated by

[12] SEC Inspector General Report No. 459, "Regulation D Exemption Process" (March 31, 2009), at 10, available at http://www.sec-oig.gov/Reports/AuditsInspections/2009/459.pdf. When Rule 506 was originally adopted in 1982, it required compliance with Rules 501 through 503, including the timely filing of a Form D, in order to qualify for the exemption. 47 Fed. Reg. 11251, 11267 (Mar. 16, 1982). In 1989, Regulation D was amended to remove the requirement of compliance with Rule 503 as a condition of the Rule 506 exemption. 54 Fed. Reg. 11369, 11373 (Mar. 20, 1989). The Commission's summary of the rule change stated, "While the filing of Form D has been retained, it will no longer be a condition to any exemption under Regulation D. New Rule 507 will disqualify any issuer found to have violated the Form D filing requirement from future use of Regulation D." SEC Release No. 6,825 (Mar. 14, 1989). However, the SEC Inspector General notes that the Commission has never brought an action under Rule 507 to enjoin an issuer from future use of Regulation D. SEC Inspector General Report No. 459, "Regulation D Exemption Process" (March 31, 2009), at 10.

the JOBS Act, should also change the filing deadline so that an issuer would be required to file Form D before using any type of general solicitation or advertising. To make this requirement meaningful, the failure to file a Form D must also result in the loss of the exemption. This would give investors and regulators the ability to easily determine whether an offering purports to be made in compliance with Rule 506.

In addition to changing the filing deadline, we also proposed improvements to the Form D to provide more fulsome notice to regulators and investors. We made numerous specific recommendations in Attachment A to our earlier letter, and we commend them to you again. We also encourage the Commission to require a post-offering filing of Form D, which will allow the Commission and others to track the use of the exemption.

Unfortunately, the Commission's proposed rule not only fails to include our suggested amendments, but the proposing release does not even request comment on our suggestions. As a result, commenters are not likely to provide the Commission with a robust discussion of the advantages and possible drawbacks of these changes.[13] This is greatly disappointing to us, as it reflects an utter lack of appreciation by the Commission staff of the realities faced by state regulators in trying to assist investors who are considering Rule 506 offerings.[14]

III. The Commission should establish non-exclusive safe harbors for the verification of accredited investors.

Section 201 of the JOBS Act mandates that Rule 506 "shall require the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, *using such methods as determined by the Commission*." In its proposed amendment, the Commission has completely ignored its responsibility to determine appropriate methods for verification.

The lack of guidance in this area will lead to serious consequences – namely, litigation. Much of the burden of that litigation will be borne by NASAA members because states are not preempted from requiring registration unless an offering actually complies with Rule 506.[15] In the absence of clarity in the rules, each state regulator will have to make an independent determination whether an issuer has taken reasonable steps to verify, and those determinations will ultimately be reviewed by judges across the country. The likely result is not only costly litigation, but inconsistent interpretations. This is a poor outcome for both regulators and businesses alike, and it could easily be avoided by adopting clear rules.

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[13] We understand that issuers have been reluctant, for competitive reasons, to publicly file a Form D before investors have committed to an offering, but we fail to see any reason for such secrecy when an issuer will publicly advertise the offering.

[14] We appreciate the statement issued by Commissioner Aguilar contemporaneously with the proposing release, in which the Commissioner seeks comment on these issues. We are hopeful that many commenters will address the issues raised in his statement, which is available at http://www.sec.gov/news/speech/2012/spch082912laa.htm.

[15] See *Brown v. Earthboard Sports USA, Inc*., 481 F.3d 901, 911 (6th Cir. 2007); *Buist v. Time Domain Corp.*, 926 So. 2d 290, 295-98 (Ala. 2005).

For example, although the proposed rule contains no specific criteria for accredited investor verification, the Request for Comment includes guidance concerning what the Commission staff would consider to satisfy the standard. According to staff, "reasonable steps to verify" may be satisfied if an issuer possesses general information about the average compensation in a person's profession or workplace.[16] We strongly disagree with the staff's interpretation, and we believe many judges are likely to disagree as well.

In our earlier comment letter, NASAA proposed that the Commission adopt non-exclusive safe harbors to specify the types of things that would be considered reasonable steps to verify. In the proposing release, the Commission staff expresses concern about the practical application of safe harbors but fails to appreciate the ramifications from a lack of guidance. Accordingly, we ask the Commission to reconsider this issue and adopt specific safe harbors within the rule itself.

We also note that these types of non-exclusive safe harbors are used in many other Commission rules. Rule 506 is itself a safe harbor for Section 4(2) of the Securities Act of 1933, and Rule 144A provides a list of non-exclusive methods for determining whether a purchaser owns sufficient securities to be considered a qualified institutional buyer. We fail to see why this approach – deemed workable in so many other contexts – is considered unworkable by the staff for purposes of guiding issuers on what would be considered reasonable steps to verify whether investors are accredited.

1. Self-Certification is Inadequate

Many commenters have agreed that the Commission should create a safe harbor for investor verification, but some have suggested that "reasonable steps to verify" should be satisfied by the mere receipt of an assurance from the investor that he or she is accredited. This type of self-certification fails to satisfy the mandate of the JOBS Act.

Congresswoman Maxine Waters was the sponsor of an amendment to H.R. 2940 that created the requirement of reasonable steps to verify, and her language was ultimately included in Section 201(a)(1) of the JOBS Act. During the committee markup on H.R. 2940, Ms. Waters explained the rationale for her amendment:

> …I am concerned about the process in which accredited investors verify that they are in fact accredited. As I understand it, it is currently a self-certification process. This obviously leaves room for fraud. …If we are rolling back protections for our targeted audience of sophisticated individuals, we must take steps to ensure that those folks are in fact sophisticated.[17]

[16] 77 Fed. Reg. 54468 (Sept. 5, 2012).
[17] House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises Holds Markup on HR 1965, HR 2167, HR 2930, HR 2940 and a Draft Bill Concerning Small Companies and Regulatory Relief, 112th Cong., 1st Sess. (Congressional Hearing held Oct. 5, 2011), Congressional Quarterly Transcripts at 8-9.

The Congressional record could not be more clear. When Congress voted to mandate changes to Rule 506, they did it with the understanding that self-certification would not be sufficient verification of a person's status as an accredited investor.

We are pleased that the Request for Comment recognizes the inadequacy of self-certification. However, we believe the elevated verification requirements should be firmly established within the text of the rule instead of being mentioned in non-binding staff guidance.

2. NASAA's recommendations

NASAA again recommends that the Commission set forth clear, non-exclusive safe harbors to specify the types of actions that will be deemed "reasonable steps to verify." The verification requirements should be tailored to three types of accredited investors – natural persons who purport to satisfy the income test in Rule 501(a)(6), natural persons who purport to satisfy the net worth test in Rule 501(a)(5), and entities who purport to meet one of the other tests set forth in Rule 501(a).

a. Verification of Income

An individual's income can be verified with documents that are readily available, including tax returns, Form W-2, and Form 1099. To satisfy the safe harbor for verification, the issuer should be required to obtain copies of adequate documentary proof that the investor has satisfied the income requirements for the past two years. In addition, the investor should be required to produce a recent pay stub to demonstrate a reasonable expectation of reaching the same income level in the current year.

b. Verification of Net Worth

Verification of net worth is more challenging because an individual could provide proof of assets but not liabilities. In addition, NASAA recognizes that the verification requirements should not require the issuer to conduct a financial investigation of its investors. However, a simple fill-in-the-blank self-certification is not sufficient.

At a minimum, the Commission should require an issuer to obtain documentation that the investor has at least $1 million in assets, excluding the primary residence. Such documentation could include items like bank statements, brokerage account statements, tax assessment valuations, or appraisals. In addition, the Commission should require the issuer to obtain a list of liabilities from the investor, which would include a sworn statement that all material liabilities are disclosed.

Other simple evidence may demonstrate that an investor has $1 million in net worth. For example, if an investor makes an investment of $1 million in the issuer's securities without borrowing the money, it would be reasonable for the issuer to assume that the investor has $1

million in net worth, even though it is not necessarily a certainty. NASAA would not oppose the creation of this type of specific safe harbor, provided the factors used to demonstrate the requisite net worth are set sufficiently high.

c. Verification for Entities

The JOBS Act mandate for verification of accredited investor status is not limited to investors who are natural persons. Thus, an issuer must also verify whether an entity satisfies one of the standards for an accredited investor in Rule 501(a). For the purposes of determining whether an entity meets the definition of accredited investor, organizational documents and a simple balance sheet may be sufficient for most entities, and a quarterly statement could be used for employee benefit plans.

3. Third Party vs. Direct Verification

The JOBS Act states that the *issuer* must take reasonable steps to verify the accredited investor status of each purchaser. Moreover, the issuer is ultimately responsible for the verification because it is the issuer who will lose the benefit of the exemption if verification is inadequate. However, NASAA recommends that the Commission allow an issuer to obtain the necessary verification through registered broker-dealers, provided there are independent liability provisions for failure to adequately perform the verification. Investors will likely be more comfortable giving sensitive financial information to a registered broker-dealer, not unlike the type of information a broker-dealer currently collects to determine suitability, and the broker-dealer will be subject to rules requiring the safeguarding of private information. In addition, if broker-dealers continue to re-verify accredited status each year, the broker-dealers could develop registries of accredited investors, leading to an efficient mechanism for issuers to verify whether investors are accredited.

If an issuer conducts its own verification, the Commission should require the issuer to maintain the confidentiality of any information received for the purpose of verifying the investors' status as accredited. In addition, the Commission should require an issuer to retain records for at least five years in order to preserve the proof that its verification efforts were reasonable.

IV. The changes to Rule 506 should include disqualification provisions as mandated by the Dodd-Frank Act.

We understand the Commission's urgency to amend Rule 506 to allow general solicitation because this change was mandated by the JOBS Act. However, we cannot understand the Commission's failure to adopt disqualification provisions for bad actors who would participate in Rule 506 offerings, as mandated by Congress two years ago in the Dodd-

Frank Wall Street Reform and Consumer Protection Act.[18] We are dismayed that the Commission is implementing the JOBS Act changes to Rule 506 while ignoring an important investor-protection mandate related to the very same rule.

V. The Commission should place reasonable restrictions on the advertising that is used under Rule 506.

1. Advertising by Issuers

Entrepreneurs are optimistic by nature and often express high hopes for their businesses. These expressions may be perfectly acceptable in customary advertising, but they could easily lead to liability when done in the context of a securities offering. To minimize this risk, issuers need guidance to help them properly exercise their duty to disclose material facts to prospective investors.

To provide clarity for issuers who want to advertise offerings under Rule 506, the Commission should adopt requirements that are similar to those applicable to registered offerings. In December 2011, the Commission released "CF Disclosure Guidance: Topic No. 3,"[19] which provides guidance regarding the review of promotional and sales material. Rule 506 offerings should be required to adhere to many of those same standards, including a "balanced presentation of risks and rewards" and a requirement that statements in advertising are consistent with representations in the offering documents. If the Commission does not adopt any standards, unsophisticated issuers may find themselves liable for misrepresentations in their advertisements and unscrupulous issuers may attempt to take advantage of investors with misleading and deceptive marketing material.

2. Advertising by Private Funds

In the proposed rule, private funds subject to very little regulation will be able to compete against regulated mutual funds for investors, but the staff has proposed nothing to restrict the advertising of private funds. Because the investment strategies of private funds are typically more opaque, risky, and illiquid than those of mutual funds, private fund advertisements should be subject to restrictions that are comparable to the rules for mutual funds. At a minimum, the Commission should adopt restrictions on performance advertising that are comparable to Rule 482, and the Commission should apply the standards from Rule 156 (prohibiting misleading advertising) and Rule 206-4(8) (prohibiting deceptive or manipulative practices) explicitly to private funds.

[18] Public Law No. 111-203.
[19] See http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic3.htm.

VI. The Commission should clarify the permissible activities of platforms that facilitate the sale of securities under Rule 506.

Title II of the JOBS Act authorizes a new type of "platform," presumably internet-based, to facilitate an offer, sale, purchase, or *negotiation* involving securities. The Act prohibits transaction-based compensation and custody, and it has a bad actor disqualification, but it specifically allows the platform to conduct "ancillary services" including due diligence and the provision of standardized offering documents.

We are concerned with the intrusion of these unregulated platforms into traditional broker-dealer activities. These concerns are magnified because the platforms will not be held to traditional suitability and know-your-customer standards. To maintain a clear distinction between broker-dealers and platforms, the Commission should adopt new rules to articulate the scope of ancillary services that are permissible for unregistered platforms and establish bright lines between compensation "in connection with the purchase or sale" of a security and compensation for ancillary services. In addition, the due diligence that is performed by a platform should be no less rigorous than the reasonable investigation required of registered broker-dealers (See FINRA Notice to Members 10-22[20]).

Conclusion

The amendments to Rule 506 will have an enormous impact on market participants and regulators at the state and federal level. NASAA appreciates that the Commission took the prudent step of providing interested parties an opportunity to comment on the proposed amendments. We have vast experience dealing with fraud in the private placement marketplace, and we expect the amount of fraud and abuse to increase with the Congressional mandate to allow general solicitation in these highly risky offerings that, by their very nature, provide investors with less disclosure than registered offerings.

While we disagree with the policy choices made by Congress in much of the JOBS Act, we realize that the Commission has the responsibility of effectuating the statutory provisions. However, this does not mean that the Commission may abdicate its responsibilities in promulgating rules. The legislative history of the JOBS Act, as noted above, provides ample support for rules that would include measures to ameliorate the adverse impact of general solicitation in Rule 506 offerings. Some of our suggestions, such as the change to the Form D filing deadline, would greatly assist our efforts to police the market while being minimally burdensome to issuers. Other suggestions, such as accredited investor verification, are reasonable issuer requirements that facilitate investor trust necessary to promote investment.

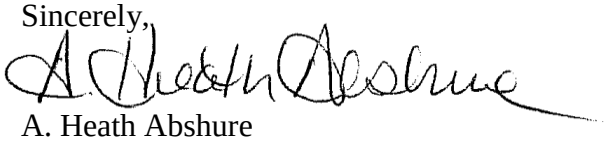
In short, the Commission's failure to propose reasonable investor protections and issuer guidance reflects poorly on its resolve to balance the needs of investors and industry. The Commission acknowledged competing viewpoints, but rather than choosing the most reasonable

[20] Available at http://www.finra.org/Industry/Regulation/Notices/2010/P121299.

and appropriate path, it did nothing. It is NASAA's deepest hope, as your partner in investor protection and as advocates for small business capital formation, that the Commission will reconsider its course and adopt rules that facilitate the proper use of Rule 506.

Please let us know if you would like further information or clarification.

Sincerely,



A. Heath Abshure
President