August 16, 2012

FILED ELECTRONICALLY

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

Re: JOBS Act Rulemaking: Title II

Dear Ms. Murphy,

We are writing to comment on the Commission's pending rulemaking under Section 201(a)(1) of the Jumpstart Our Business Startups Act of 2012 ("JOBS Act"), which requires that the Commission remove the ban on general solicitation and advertising ("GS&A") for private offerings conducted pursuant to Securities Act Rule 506.

In summary, we believe that the Commission will need to make substantial additional amendments to Rule 506[1] to satisfy its obligation to ensure that the Rule is consistent with the protection of investors and integrity of our securities markets. The Commission has previously recognized significant deficiencies in current Rule 506 that for too long have been left unaddressed. The elimination of the GS&A ban, along with other JOBS Act provisions, will further weaken Rule 506. We urge the Commission to consider fully the potential harm to investors and securities markets that eliminating the GS&A ban will cause in order to ensure that the benefits of an amended Rule 506 exceed the significant costs of this radical reform.

While we recognize that the JOBS Act requires a repeal of the ban on GS&A, that leaves open a number of questions about how best that should be accomplished in order to minimize the harm to investors and market integrity. Consideration of these factors will require an extensive analysis. This is one reason that adopting an interim or temporary rule,[2] as the financial press recently reported is under consideration, would be improper. Consideration of the comments of all affected parties on any proposals that the Commission is considering is a necessary – and legally required – part of the rulemaking process. As discussed further below, we strongly oppose the adoption of any interim rule implementing Section 201(a)(1).

I. Interim Rule

We believe that the adoption of an interim rule pursuant to Section 201(a)(1) of the JOBS Act would be impracticable, inconsistent with the protection of investors, and in violation of the letter and spirit of the rules of administrative procedure, as also discussed in our letter of August 13th. An interim

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[1] As a technical matter, many of these amendments would be to other rules under Regulation D, but we refer herein only to Rule 506 for clarity.

[2] We use these terms to describe an interim rule, temporary rule, interim final rule, interim final temporary rule, and any other rulemaking that has the legal effect, even if not permanent, of amending Regulation D. *See, e.g.*, *Extension of Interim Final Temporary Rule on Retail Foreign Exchange Transactions*, Exchange Act Rel. No. 67405 (July 2012) *available at* http://www.sec.gov/rules/interim/2012/34-67405.pdf.

rule would be impracticable because considering public comments submitted *after* the Commission had already permitted GS&A activities would be, in effect, a proverbial closing of the barn door after the horses have escaped. It would be extremely difficult for the Commission to backtrack in an area where the politics of securities regulation seem to have overtaken rational policymaking. Indeed, an interim rule would appear to be an attempt merely to assuage Congressional critics while offering no redeeming social benefits.

An interim rule also would be inconsistent with the protection of investors and securities markets because the Commission has not had sufficient time, much less sufficient public input, to conduct an adequate analysis of the cost of amending Rule 506. As discussed further in this letter, existing inadequacies in Rule 506, recent market developments and other provisions of the JOBS Act present a set of major factors that must be taken into account pursuant to rulemaking – a challenge that is heightened by competition for SEC resources from pending Dodd-Frank Act rulemakings that are subject to much earlier deadlines. We question whether even *proposing* amendments on August 22 could be consistent with the SEC's obligation to complete rulemaking required by the Dodd-Frank Act with long-passed deadlines. The Commission does not have the authority to cherry-pick mandatory rulemakings based on currently prevailing political winds.

We also believe that an interim rule would violate the spirit and letter of the Administrative Procedures Act. As the Commission is aware, proposed rules must be published for thirty days to allow for public notice and comment. The Commission may adopt an interim rule without prior notice only if it "for good cause finds (and incorporates the finding and a brief statement of reasons therefor in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest."[3] We believe that there is no conceivable basis on which the Commission could show good cause to disregard notice and comment requirements. The ban on GS&A in Rule 506 offerings has been in place for decades; it would be absurd to argue that some emergency or special circumstances it must be suspended during the 30-day (or longer) pendency of the comment period.[4] If Congress had wanted to obviate compliance with the APA, it could have accomplished its goal through legislation. Instead, it chose to submit the GS&A provision to the rulemaking process, which its members undoubtedly expect to be conducted consistent with applicable law.[5] Nor do we believe that one could reasonably argue that Section 201(a)(1) constitutes adequate "notice" under the APA. As discussed below, abandoning the GS&A bank raises a myriad of issues that belie any reasonable claim that affected parties are on constructive notice as to what the resulting rule will entail.

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[3] Administrative Procedures Act Section 553(b)(3)(B). *See Mack Trucks, Inc. v. EPA*, 682 F.3d 87 (C.A.D.C. 2012) (vacating interim rule adopted to relieve company of regulatory burdens on ground that EPA did not show good cause). *See also Western Oil & Gas Ass'n v. EPA*, 633 F.2d 803, 810 - 11 (1980) (pressing statutory deadlines are not sufficient to constitute good cause).

[4] *See Riverbend Farms, Inc v Madigan*, 958 F.2d 1479, 1484 & n.2 (9th Cir 1992) ("Congress intended to let agencies depart from normal APA procedures where compliance would jeopardize their assigned missions. . . . Emergencies, though not the only situations constituting good cause, are the most common."). We believe the complexity of the issues to be addressed in this rulemaking argue for a comment period longer than the 30-day minimum. *See* Administrative Procedures Act Section 553(b)(3)(B) (requiring comment period of "not less" than 30 days).

[5] Almost all of the comment letters submitted to date have ignored this fact and assumed that the Commission has been given the authority to adopt a rule under 506 that conflicts with Section 4(2). However, Congress chose not to take that approach, preferring instead to allow GS&A within the constraints of administrative rulemaking process.

The SEC's recent record in APA challenges where affected parties *had* the benefit of notice and comment certainly counsels against adopting rules *without providing any notice period at all*.[6] Nor have so-called "temporary" rules with sunset provisions addressed the problem. For example, in 2007 the Commission adopted a "temporary" rule with a sunset provision that exempted broker-dealers from a requirement in the Investment Advisers Act.[7] The "temporary" rule was set to expire at the end 2009, but the Commission subsequently extended it until the end of 2010,[8] and then again until the end of 2012.[9] The eternally "temporary" nature of the rule has been revealed to be nothing more than a way to end-run the agency's obligation to consider and resolve issues raised during the public comment period. Ironically, the need for this "temporary" rule was triggered by another failed attempt to circumvent notice and comment procedures. In 1999, the Commission took a "temporary" no-action position when it proposed to exempt a large swath of broker-dealers from the Investment Advisers Act. It was not until five years later, and only because it was sued by an aggrieved party, that the Commission took final action on the rule – only to see it summarily vacated by a federal court.[10] These examples illustrate how "interim" and "temporary" rules often are, in effect, neither interim nor temporary and why they can be problematic.

II. The Costs of the GS&A Ban

In fact, we believe that the Commission would be hard-pressed to adopt a rule this year, much less at the end of this month. Although Congress required that Rule 506 be amended to permit GS&A, that mandate does not diminish the SEC's obligation to consider the effect of the rulemaking. Congress did not amend Section 4(2) to carve out GS&A activities. Nor did it mandate that the Commission amend Rule 506 to permit GS&A without making any other rule changes. Rather, Congress chose, by only mandating a discrete amendment to Rule 506, to delegate to the Commission the manner and scope under which GS&A activities would be permitted. Congress decided that GS&A activities did not necessarily defeat reliance on the Section 4(2)[11] private offering exemption, *and nothing more*. Congress left to the Commission the responsibility to ensure that Rule 506 *as a whole* continued to operate consistent with its statutory wellspring. The Commission therefore must evaluate fully the effects of the rulemaking and adopt a rule *only* if it is consistent with the protection of investors and the integrity of our securities

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[6] The "no action" position that was adopted while the fee-based brokerage account rule was under consideration was intended to be temporary, but it lasted for years. *See Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007) (vacating exemptive rule for fee-based brokerage accounts); *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Rel. No. 3128 (Dec. 28, 2010) (extending period of "temporary" rule to *more than five years* from its initial effective date) *available at* http://www.sec.gov/rules/final/2007/ia-2653fr.pdf.

[7] Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Investment Advisers Act Release No. (Sep. 24, 2007) available at http://sec.gov/rules/final/2007/ia-2653.pdf.

[8] Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Investment Advisers Act Release No. 2965 (Dec. 23, 2009) *available at* http://sec.gov/rules/final/2007/ia-2653.pdf.

[9] Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Investment Advisers Act Release No. 3118 (Dec. 1, 2010) available at http://sec.gov/rules/proposed/2010/ia-3118.pdf.

[10] See Financial Planning Association v. SEC, 482 F.3d 481 (D.C. Cir. 2007) (vacating exemptive rule for fee-based brokerage accounts).

[11] The correct reference is now "Section 4(a)(2)," but we have used the common terminology for clarity.

markets. The bipartisan support for the JOBS Act was assuredly premised on the SEC's fulfilling its legal obligations in promulgating amendments to Rule 506.

The SEC staff has itself recently articulated the agency's obligation to consider the full range of cost and benefits in rulemaking.[12] While we do not agree with the scope of the obligations implied by the staff's recent memorandum, and are particularly concerned that it overweights quantifiable costs to industry (*e.g.*, compliance costs) in comparison with benefits to investors and the securities markets,[13] we agree with the staff's position that Congressional policy mandates do not repeal rulemaking procedures.[14] As the staff stated:

> where a statute directs rulemaking, rulewriting staff should consider the overall economic impacts, including *both* those attributable to Congressional mandates *and* those that result from an exercise of the Commission's discretion.[15]

There is no question that the mandate in Section 201(a)(1) of the JOBS Act may have a substantial negative economic impact on investors and the securities markets. Indeed, it is for this reason that the Commission has always conditioned the Rule 506 exemption on a complete abstention from GS&A. We are not aware of any indication that the SEC's view of the costs and benefits of that judgment have changed.

There is also no question that the Commission has substantial discretion to mitigate the adverse effects of Section 201(a)(1) using the same kinds of investor protection strategies that are already reflected in Rule 506. It therefore must consider the economic impact of the exercise of such discretion. In fact, we believe any reasonable cost-benefit analysis would necessarily conclude, as discussed further below, that Section 201(a)(1) will require considerable mitigating additional amendments to Rule 506 in addition the mandatory enhancement of accreditation verification procedures.

The potential adverse effects on investors of permitting GS&A in private offerings have long been recognized by the Commission. The reason that Rule 506 is contingent on the absence of GS&A activities is that such activities substantially increase the risks of nonaccredited investors making purchases in private offerings. The Securities Act relies primarily on the regulation of offering activities by prohibiting all offers prior to the filing of a registration statement and strictly regulating all written offers once the registration statement has been filed. General solicitation and advertising activities therefore are generally permitted only if a registration statement has been filed, which provides a strong practical constraint on the ease with which fraudulent offers can mislead investors.

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[12] *Current Guidance on Economic Analysis in SEC Rulemakings*, Memorandum from RSFI and OGC to the Staff of the Rulewriting Divisions and Offices (Mar. 16, 2012) ("Rulewriting Memorandum") *available at* http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.

[13] *See The SEC's Aversion to Cost-Benefit Analysis*, Hearing before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs, Committee on Oversight and Government Reform, U.S. House of Representatives (Apr. 17, 2012) (testimony of Mercer Bullard) (discussing the problem of adopting "investor protection rules based on a reasonable belief that the unquantifiable benefits of preventing and deterring fraud and misleading sales practices exceed the often quantifiable costs of compliance with the rules") *available at* http://oversight.house.gov/wp-content/uploads/2012/04/4-17-12-Bullard-Testimony.pdf.

[14] We urge the Commission to instruct the staff to revise the memorandum to reflect a more balanced view of the full range of costs and benefits that securities regulations create.

[15] Rulewriting Memorandum at 8 (emphasis in original).

Removing the GS&A ban from Regulation D eliminates this constraint by allowing the broad dissemination of securities offers with no requirement that any information, much less a standardized registration statement, be made available to investors. Regulators will no longer be able to implement the Securities Act's approach of regulating public offers through the simple, efficient mechanism of taking immediate action with respect to any public offers of unregistered securities. Because public offering activities as to unregistered securities will no longer be an automatic, actionable red flag for regulators, that monitoring mechanism will have been eliminated. The ability of fraudsters to attract nonaccredited investors will be increased exponentially.

Nonaccredited investors are not the only beneficiaries of the ban on GS&A; it operates to protect accredited investors as well. General solicitations and advertising – without the regulating effect that a publicly available, standardized disclosure document provides – increase the risk of abusive and misleading sales practices as to accredited and nonaccredited investors alike. For this reason, the additional amendments necessary to adapt Rule 506 to the removal of the ban on GS&A must address both the accredited and nonaccredited investor markets.

III. "Reasonable Steps" Requirement

Congress has identified at least one amendment to Rule 506 that the Commission is required to make. Section 201(a)(1) of the JOBS Act requires the Commission to identify "reasonable steps" that issuers that engage in GS&A activities are required to follow to ensure that only accredited investors are purchasers. Notwithstanding industry requests that the Commission ignore this express mandate,[16] we believe that the Commission has no discretion in this respect and must comply with Congress's command to enhance the standards under which issuers confirm purchasers' accredited status. We also believe that the Commission must provide persons who are likely to be most concerned about the "reasonable steps" requirement an opportunity to comment on the many forms that it might assume. Adopting an interim rule would not allow sufficient opportunity for comment.

Section 201(a)(1) requires that rules promulgated under Rule 506 be amended to provide that the prohibition against GS&A in Rule 506 not apply to offers and sales "provided that all purchasers of the securities are accredited investors."[17] The next sentence in that provision the Act states:

> Such rules 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.

This provision unambiguously mandates rulemaking that requires that issuers take reasonable steps to confirm that purchasers of securities are accredited investors. Although the broker-dealer industry argues, as a policy matter, that it is not necessary to mandate specific "steps" in this respect, Congress decided

[16] Letter from Sean Davy, Managing Director, SIFMA, to Elizabeth Murphy, Secretary, SEC (Apr. 27, 2012) ("SIFMA Letter") *available at* http://sec.gov/comments/jobs-title-i/general/general-18.pdf. We note that the industry's letter shows its agreement that Section 201(a)(1) could not reasonably be viewed as providing adequate notice as to the substance of any rulemaking thereunder.

[17] Accredited investors generally include, among others, individuals with annual income in excess of $200,000 ($300,000 for married couples) or net worth in excess of $1 million, and a variety of institutions. *See* Rule 501(a). Purchases by up to 35 non-accredited, financially sophisticated investors are permitted as well, provided that additional written disclosure is provided. *See* Rule 506(b)(2)(i).

otherwise.[18] The industry position that the Commission need not take any action in light of this direct Congressional mandate directly contradicts the plain text of the statute.

There can be no doubt that Congress intended what it prescribed: that the Commission tighten the standards for determining whether an investor is accredited. The House Report is explicit on this question:

> H.R. 2940 requires the SEC to write rules on how an issuer would verify that the purchasers of securities are accredited investors.[19]

As the Commission is well aware, Rule 501(a) already provides that the term "accredited investor" includes persons whom the "issuer reasonably believes" come within any of the rule's enumerated categories. The rule does not identify any specific steps that issuers must take to satisfy this standard. The JOBS Act's new requirement is exactly that – a *new* requirement that the Commission is required to incorporate into Rule 506. Congress expressly required steps to "verify" accredited status, which term can only be satisfied by requiring third party evidence of an investor's income or wealth.[20]

This reading of the reasonable-steps rulemaking provision is also required by analysis of Section 201(a) as a whole. Less than 100 words after expressly requiring "reasonable steps" to ensure that Rule 506 purchasers are accredited investors, Section 201 again refers to the "reasonable belief" standard for a different offering exemption – but pointedly says nothing about any "reasonable steps" requirement. Section 201(a)(2) requires that GS&A be permitted for offerings under Rule 144A where all purchasers are eligible under that Rule, just as Section 201(a)(1) authorizes GS&A in Rule 506 offerings. Section 201(a)(2) also requires that sellers "reasonably believe" that Rule 144A purchasers are eligible investors, but it notably does *not* require that issuers or sellers take "reasonable steps" to confirm investors' status.

The purpose of this difference between otherwise parallel amendments to private offering rules could not be clearer. Congress appreciated that Rule 506 offerings create a much greater risk of participation by unsophisticated investors than Rule 144A offerings and accordingly raised the standard that applies to sales under Rule 506. Rule 144A is limited to qualified institutional buyers, which are generally institutional investors with at least $100 million in investments, whereas Rule 506 permits not only accredited investors with only $200,000 in income ($300,000 for married couples) or $1 million in net worth (minus the value of the primary residence) but also up to 35 non-accredited investors who are subject to no wealth requirements at all. Congress decided not to impose a "reasonable steps" requirement on Rule 144A offerings because sales to qualified institutional buyers simply do not raise the level of investor protection concerns that exist for Rule 506 offerings. Congress's intent that the Commission raise the "reasonable belief" standard for Rule 506 offerings in light of the removal of the GS&A ban could not be clearer.

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[18] *See supra* note 16.

[19] *Access To Capital For Job Creators Act*, House Report 112-263, 112th Cong. 1st Sess. (Oct. 31, 2012) *available at* http://www.gpo.gov/fdsys/pkg/CRPT-112hrpt263/html/CRPT-112hrpt263.htm.

[20] *See* Letter from Jack Herstein, President, North American Securities Administrators Association to Elizabeth Murphy, Secretary, SEC, at 2 (July 3, 2012). While some claim that third party verification protects only those "who are willing to lie to issuers," Letter from National Small Business Association to SEC (Aug. 2, 2012), we note that the recent prevalence of liars loans in the mortgage context was largely attributable to agents who aggressively encouraged false reporting by borrowers, which supports our view that third party verification is intended to deter the fraudulent sales practices of issuers and broker-dealers. Third-party verification is a standard practice in the lending industry.

In contrast, the broker-dealer industry perceives no difference between Rule 506 and Rule 144A offerings and offers no explanation for the different positions in Section 201(a)(1) and (2).[21] Rather, it argues that it is "generally accepted that certification by an offeree as to its status as an accredited investor or a qualified institutional buyer provides a basis for a reasonable belief and believe that such certification should constitute reasonable steps for purposes of Section 201(a) of the JOBS Act."[22] The conflation of the standards that should apply under Rules 506 and 144A is flatly inconsistent with the current provisions of those rules, the express distinction made in the text of Section 201(a), and any semblance of rational public policy. Nor is it clear to us how a *purchaser's* having taken steps in the form of providing a certification could satisfy a requirement for the *issuer* to take steps, as Section 201(a)(1) specifically requires.

The necessity of raising the "reasonable belief" standard for Rule 506 offerings is as much a matter of good public policy as it is nondiscretionary compliance with an express Congressional mandate. Permitting GS&A activities in connection with private offerings will substantially increase the likelihood that unsophisticated investors will be lured into fraudulent or unsuitable investments. It therefore is necessary to adopt stronger measures to ensure that only accredited investors make purchases.

Indeed, Congress had good reason to lack confidence in the current legal standards regarding investors' accredited status. In a 2007 release, the Commission stated that its "experience indicates that some issuers may not have taken appropriate measures to satisfy their obligation under Rule 501(a) to form a reasonable belief that a prospective purchaser satisfied the definition of accredited investor."[23] Thus, Congress was rightfully concerned that such noncompliance with the "reasonable belief" standard warranted stronger measures in light of the JOBS Act's elimination of the GS&A ban. We may comment on specific "reasonable steps" that the Commission should consider once notice of a proposal has been issued.

IV. Context of Rulemaking: The Need for Additional Investor Protections

The removal of the ban on GS&A must be accompanied by other changes to Rule 506 designed to ensure that investors are adequately protected. The Commission has already taken positions on the inadequacy of Rule 506 as currently drafted that must be considered in light of any GS&A amendment. In other words, even with the current GS&A ban there are recognized deficiencies in Rule 506 that must be corrected before the Commission can even reach the question of what additional reforms are necessitated by the ban's elimination. We believe that these existing problems, all of which have previously been acknowledged by the Commission, must be fully addressed for any rulemaking under Section 201(a)(1) to proceed consistent with the rules of administrative procedure.

A. Accreditation Standard

The Commission has recognized that, even under the current GS&A ban, the accredited investor net worth and income tests are inadequate to ensure that investors are financially sophisticated or have sufficient wealth to bear large losses. In 2007, the Commission proposed increasing the accredited investor net worth/income minimums from $1 million/$200,000 to $2.5 million, noting that the current

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[21] *See* SIFMA letter, *supra* note 16.

[22] *Id.* at 6 – 7.

[23] *Revisions of Limited Offering Exemptions in Regulation*, Securities Act Rel. No. 8828 at 38 (2007) ("Revisions of Limited Offering Exemption") *available at* http://www.sec.gov/rules/proposed/2007/33-8828.pdf.

standards, if adjusted for inflation, were dramatically lower than the amounts considered appropriate when they were initially adopted.[24]

Moreover, in 2007 the Commission went on record as viewing a higher accredited investor standard as a condition of relaxing of the Rule 506 GS&A ban.[25] The Commission proposed to permit limited advertising of offerings that were sold only to "large accredited investors." Such investors who were natural persons were required to have at least $2.5 million in investments or $400,000 in annual income. If the Commission believes that such an increase would be necessary for a *limited relaxation* of the GS&A ban, then it logically must take the position that an increase of at least that scale would be necessary for the *wholesale elimination* of the GS&A ban that the JOBS Act contemplates.

Furthermore, net worth and income limits elsewhere in the JOBS act strongly support an increase in the accredited investor standard. While the crowdfunding exemption would permit an investor with $1 million in investments to invest only $100,000 in all crowdfunding offerings combined, accredited investors can invest *100% of their net worth* in a single private offering. To impose more stringent limits on crowdfunding offerings where GS&A is *not* permitted than are imposed on private offerings where GS&A *is* permitted defies reason. Such an inconsistency between the crowdfunding requirements and Rule 506 could not be consistent with Congressional intent as expressed in the JOBS Act.

At a minimum, the Commission cannot reconcile its longstanding positions on the inadequacy of accredited investor minimums and the relationship between those limits and the scope of permitted GS&A activities, as discussed above, with Rule 506 amendments that do not include increases in the natural person accredited investor minimums. The Commission has found that the current minimums are inadequate – especially in the context of a relaxed GS&A ban. It cannot now find that the minimums are adequate where the GS&A has been entirely eliminated consistent with maintaining that Rule 506 as whole continues to be a rational interpretation of Section 4(2)'s public offering prohibition. To reconcile this inconsistency and to ensure adequate protection for investors, the accredited investor income/net worth minimums should be increased at least to $400,000/$2.5 million and these minimums should be automatically adjusted to reflect inflation.

B. Financial Complexity

Another factor that the Commission has recognized as having heightened risks for investors and markets is the increasing complexity of financial products and financial planning. Financial products sold to retail investors have grown increasingly complex, often resulting in abusive sales practices and large investor losses, especially in the context of hedge funds (to include private equity funds). The replacement of defined benefit plans with defined contribution plans, along with the shift of retirement assets from employer-supervised employee-benefit plans to broker-advised Individual Retirement Accounts, has required investors to assume greater responsibility for their financial security in retirement. Permitting GS&A activities under Rule 506 will undoubtedly prompt aggressive marketing campaigns encouraging workers to rollover large 401(k) balances into unregulated hedge funds in IRAs, and many will be retirees who are inappropriately treated as accredited investors not because they are either financially sophisticated or wealthy, but because they have accumulated a considerable nest egg that they

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[24] *See id.*; *Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles*, Securities Act Rel. No. 8766 (Dec. 27, 2006) (noting that 1982 accredited investor standards have made investors eligible today who would not have previously been eligible and the increasing complexity of investments) *available at* http://www.sec.gov/rules/proposed/2006/33-8766.pdf.

[25] Revisions of Limited Offering Exemption, *supra*.

must rely on for income throughout the remainder of their lives. The increased complexity of financial products and financial planning argues for strengthening Rule 506 – regardless of whether GS&A activities are permitted.

C. Internet and Social Media

At the same time that the Commission must authorize some degree of GS&A activities in private offerings, the Internet continues to expand the potential for such activities to facilitate fraud in the securities markets. In restoring the Rule 504 GS&A prohibition (see below), the Commission specifically noted that "market innovations and technological changes – most notably, the Internet – have created the possibility of nationwide markets for these exempt securities that were once thought to be sold only locally."[26] Since the Commission expressed this view, the Internet – and its power to disseminate false information – has grown many times over. The evolution of social media has increased the likelihood of affinity fraud in cyberspace, where the potential reach and thus the potential harm is multiplied exponentially.

D. Private Markets

The development of markets in unregistered securities has exploded, with the very public trading of millions of shares of Facebook prior to its IPO making a mockery of the concept of "private" markets.[27] These markets may permit participation based on only the thinnest of representations by investors. More than 20,000 investors have "certified themselves as accredited investors" on SecondMarket's platform with no apparent third-party verification. The increased publicity surrounding and popularity of private markets heightens investor protection concerns and create a natural magnet for nonaccredited investors. The financial incentives of issuers significantly expand the risk that, absent appropriate safeguards, "liar's loan" practices will be introduced into the private offering market.

E. Hedge Funds

Hedge funds (to include private equity funds) make up a disproportionate percentage of Rule 506 offerings. They also represent, as demonstrated by the extensive and detailed regulation of mutual funds, the kind of structure that poses special risks for investors. To the extent that GS&A involves investment performance figures, there is good reason to believe that fraudulent hedge fund advertising will be the single greatest source of abuse under amended Rule 506. Hedge fund compensation structures promote risk-taking, and these funds, unlike mutual funds, can hold unlimited amounts of illiquid securities, with respect to which valuation fraud has been rampant. We believe that, while Section 4(2) cannot be deemed to be unavailable solely on the basis of GS&A, the Section 3(c)(1) and (7) exemptions in the Investment Company Act can and should be deemed to be unavailable on the basis of GS&A because of the special concerns attendant upon investment pools.

Alternatively, the Commission should consider restrictions on hedge fund offerings that address the special investor protection concerns that these investments raise. For example, the Commission should consider applying mutual fund advertising and valuation rules to hedge funds that engage in GS&A (and,

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[26] *Id.*

[27] That problem is made significantly worse by the JOBS Act provision increasing the shareholder threshold for becoming a publicly reporting company from 500 to 2,000 shareholders. *See generally* Mercer Bullard, *Facebook Fiasco Reveals Flaws in Private Offerings*, Morningstar.com (Jan. 10, 2011) (discussing active trading of Facebook shares in private market) *available at* http://news.morningstar.com/articlenet/article.aspx?id=369342.

in any case, require standardized performance and fee reporting for all hedge funds), and require explicit, large-font disclaimers that hedge funds are not mutual funds and present special risks.

The worsening obsolescence of the accredited investor standard; the growth of the Internet; the increasing complexity of financial products and financial planning, and the development of private trading markets are all factors that support substantially strengthening Rule 506 *regardless of any JOBS Act mandate*. The regulatory risks created by hedge funds warrant adopting a GS&A ban under the Investment Company Act. The GS&A mandate will only make an unacceptable situation worse if the Commission does not take steps to ensure that Rule 506 continues to be consistent with investor protection and efficient capital markets.

V. Context of Rulemaking: Experience with GS&A under Rule 504

Not only has the Commission previously recognized existing deficiencies in current Rule 506; it also has specifically recognized the harmful effects of permitting GS&A in the context of unregistered offerings. The SEC's experience with Rule 504 amendments in the 1990s illustrates the potential for increased fraud that eliminating the GS&A ban will create. [28] In 1992, the Commission eliminated the GS&A prohibition for offerings under Rule 504, which permits offerings of up to $1 million. It subsequently found that the elimination of the GS&A ban contributed to an increase in microcap fraud. The Commission restored the GS&A prohibition, in part because it was concerned that "small businesses could be unfairly impacted by the taint that might attach to Rule 504 offerings."[29] Like the inadequacies of Rule 506 previously identified by the Commission, the agency's experience with Rule 504 must be fully vetted as part of any Rule 506 amendment that would similarly liberalize GS&A activities. This experience reflects the adverse effects on both investor protection *and* access to capital for small businesses.

VI. Context of Rulemaking: New Concerns Created by the JOBS Act

Amendments to Rule 506 cannot be considered in isolation. In many respects, there are new concerns created by the JOBS Act that also must be addressed in any Rule 506 rulemaking. Some have been created by the elimination of the GS&A ban. Others would be concerns requiring amendments to Rule 506 even without the ban's elimination. All of the following problems must be considered as part of the context of Rule 506 rulemaking under Section 201(a)(1).

- <u>Number of Shareholders Triggering Public Company Status</u>. The JOBS Act increased the number of shareholders that a company can have before being subject to reporting under the Exchange Act. This provision will allow more companies to avoid public company status and thereby increase the number that can raise capital under Rule 506 without disclosure of basic information about their business and finances or compliance with other public company regulations. At the same time, permitting GS&A activities will exponentially increase the dissemination and availability of unregulated information. Rule 506 amendments therefore must address the new problem – which exists even without the exacerbating effect of permitting GS&A – of an entirely

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[28] *Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption*, Securities Act Rel. No. 7541 (May 21, 1998) ("If the microcap market, or offerings under Rule 504, become stigmatized as unsavory, legitimate small businesses may become less able to raise money as investors lose confidence in the market and in the integrity of those making such offerings.") *available at* http://www.sec.gov/rules/proposed/33-7541.htm.

[29] *Id.*

new category of larger companies with significantly larger shareholder bases operating in the shadows of the private markets.

- Crossover with Crowdfunding. Crowdfunding will create a parallel market where GS&A is not permitted but securities can be sold to anyone. This creates the risk that GS&A activities will be made under cover of Rule 506 that are actually intended to condition the market for crowdfunding offerings. Rule 506 amendments therefore must address the problem of GS&A under Rule 506 where GS&A is being used to engage in illegal marketing of crowdfunding offerings.

- Stimulated Resale Markets. The GS&A activities that accompany a private offering will create substantially greater interest in the securities in the resale market. However, current resale restrictions assume that securities issued in private offerings have *not* been subject to such broad, market-conditioning activities. Current resale rules must be revisited because they are inadequate to address the increased resale activity that GS&A will promote.

- Nonaccredited Investors. Rule 506 currently permits sales to nonaccredited investors. It will become substantially more difficult to determine whether sales to such investors were permissible, because this determination will require tracing each sale to a nonaccredited investor back to *all* of the relevant sales activities to determine whether they included GS&A. Rule 506 does not require integration across separate Rule 506 offerings; the rule should, at a minimum, prohibit *all* Rule 506 sales to nonaccredited investors by issuers that have made GS&A under Rule 506. The Commission must also consider whether sales to nonaccredited investors under Rule 506 continue to be viable under any circumstances.[30]

- Broker-Dealer Exemption. Section 201(c) of the JOBS Act exempts broker-dealers that provide a platform used for Rule 506 offers and sales from registration under the Exchange Act. This exemption dramatically alters the context for private offering regulation by removing intermediary regulation that is crucial for the protection of investors and the integrity of markets. This change alone would militate for substantial revisions to Rule 506 even without the GS&A mandate. The GS&A mandate now requires an even more thorough effort to ensure that the important investor and market protections under broker-dealer regulation that are lost as a result of this exemption are replaced in an amended Rule 506.

These are only some of the considerations that must attend any changes to Rule 506. We urge the Commission to conduct a ground-up review of the full regulatory context in which private offerings occur to ensure that amendments to Rule 506 fully reflect the impact that removing the ban on GS&A will have on investors and the securities markets.

VII. Potential Reforms

As a general matter, we will reserve any detailed comments on amendments to Rule 506 pending notice of the SEC's proposed rulemaking. However, we consider two specific amendments to be nondiscretionary, in addition to the requirement that the GS&A ban be removed. First, the Commission

[30] Eliminating non-accredited investors from Rule 506 eligibility also might reduce issuers' net compliance costs. Issuers and intermediaries may prefer not to have the option of selling to non-accredited investors (*e.g.*, friends and family of accredited investors) because of the increased compliance risk and costs [*e.g.*, the Rule 502(b) disclosure document] that such sales pose. Many issuers and intermediaries therefore might prefer to have their hands tied in this respect.

must enhance verification procedures for accredited investor status for GS&A offerings, as expressly required by Section 201(a)(1). Second, the Commission must raise the standards for natural persons to qualify as accredited investors, standards that the Commission has acknowledged are grossly inadequate.

In addition, we believe that the Commission must take additional steps to address the substantial risk of investor harm and damaged market confidence that allowing GS&A in unregistered offerings will create. While we do not propose a particular mix of reforms at this time, we do believe that the Commission must consider, among other options, the following reforms and explain why, if they are not adopted, why they are not necessary or appropriate in light of the SEC's longstanding view, reflected in the current Rule 506, that GS&A create significant potential for abuse.

- Form D. Require the filing of Form D at least 30 days before any sale in a Rule 506 offering in which there is GS&A. Expand Form D to require additional information regarding such GS&A offerings.

- Pre-Filing of General Solicitations and Advertising Materials. Require pre-filing of all GS&A under Rule 506 with FINRA, regardless of whether any broker-dealer involved is exempt from registration under the Exchange Act. FINRA already pre-reviews broker-dealer advertising; the same requirement should apply to GS&A in light of the significant potential for abuse. Develop content requirements for GS&A, such as explicit warnings regarding the risks of investing in unregistered securities.

- Issuer Disclosure. Require that Rule 506 issuers and their agents that engage in GS&A activities file with the Commission and deliver to all persons who contact them regarding the offering a disclosure document that sets forth basic information (*e.g.*, the disclosure document required under Rule 502(b)(2)).

- Resale Restrictions. Impose stricter requirements on the resale of Rule 506 securities with respect to which the issuer has engaged in GS&A activities.

- Integration with Crowdfunding. Substantially narrow the 6-month safe harbor for integration with crowdfunding offerings, non-GS&A Rule 506 offerings and all other offerings of unregistered securities that do not permit GS&A.

- Broker-Dealer Exemption. Identify the most significant gaps in broker-dealer regulation that the broker-dealer exemption will create and take steps to remedy this weakening in investor protection.

- Exclude Nonaccredited Investors from Rule 506. Amend Rule 506 to exclude nonaccredited investors as eligible purchasers, or narrow that category of persons to key executives of the issuer who are in a position to obtain the information necessary to make an informed investment decision. Alternatively, prohibit sales to nonaccredited investors by issuers that have made a GS&A offering.

- Bad Actor Disqualification. The Commission has proposed to amend Rule 506 to prohibit certain bad actors from relying on the rule's safe harbor, as required by Section 926 of the Dodd-Frank Act.[31] The one-year deadline imposed under Section 926 has long since passed. We urge the

[31] *Disqualification of Felons and Other "Bad Actors" From Rule 506 Offerings*, Securities Act Rel. No. 9211 (May 25, 2011). The Commission made a similar proposal in 2007, on which it also has not taken final action.

Commission to adopt final amendments no later than the elimination of the GS&A ban under Section 201(a)(1).

- Recordkeeping. Create/Enhance recordkeeping requirements regarding information on, among other things, accredited investor status, content and use of GS&A, and size and qualifications of shareholder base.

- Hedge Funds. Prohibit GS&A by funds relying on the exemptions under Section 3(c)(1) and (7) of the Investment Company Act. Alternatively, apply mutual fund advertising and valuation rules to hedge funds that engage in GS&A (and, in any case, require standardized performance and fee reporting for all hedge funds), and require explicit, large-font disclaimers that hedge funds are not mutual funds and present special risks.

In summary, for decades the Commission has imposed a ban on GS&A under Rule 506 for good reason: general solicitation and advertising activities create special risks for investors and the integrity of markets. Congress recognized this concern by delegating to the Commission the authority to find a way to permit GS&A consistent with the SEC's exercise of authority under Section 4(2). We believe that it is only possible to accommodate GS&A under Rule 506 offerings if extensive reforms such as those set forth above are adopted to address the abuses that GS&A will unleash.

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In conclusion, we appreciate this opportunity to comment on rulemaking under Section 201(a)(1) of the JOBS Act. We hope that the Commission will recognize that an interim or temporary rule under this provision would be inappropriate and improper, especially in light of the considerable revisions to Rule 506 that eliminating the GS&A ban will necessitate. The Commission must consider pre-existing deficiencies in Rule 506 as well as new problems that Section 201(a)(1) and other JOBS Act provisions have created. It is important to note that, while Congress has instructed the Commission to craft a rule under Section 4(2) that permits GS&A, it did not limit in any way the SEC's obligation to ensure that Rule 506 as a whole is consistent with the Section 4(2) exemption's requirement – its only requirement – that the exempted transactions be "nonpublic."[32]

We look forward to providing further comments once notice of a proposed rule has been issued. Thank you for your consideration of our comments.

Sincerely,

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Fund Democracy, Inc.

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[32] Section 4(2) states as follows: "The provisions of section 5 shall not apply to – . . . (2) transactions by an issuer not involving any public offering." Section 201(a)(1) of the JOBS Act provides that Rule 506 shall not be unavailable solely "as a result of general advertising or general solicitation."

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