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NASAA

July 25, 2011

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-1090

Subject: Disqualification of Felons and Other "Bad Actors" From Rule 506 Offerings, Release No. 33-9211, File No. S7-21-11

Dear Ms. Murphy:

The North American Securities Administrators Association, Inc. ("NASAA")[1] is pleased to provide comments on recently proposed amendments to the Securities and Exchange Commission's ("Commission") rules to disqualify certain felons and other bad actors from offering securities in reliance on the safe harbor from securities registration in Rule 506 of Regulation D. The adoption of disqualification provisions for securities offerings under Rule 506 has long been advocated by NASAA and was finally mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act last year.[2] We commend the Commission for proposing disqualification provisions that are consistent with a number of advance comments submitted by NASAA and encourage further consideration of potential refinements raised in the Commission's requests for comments. In the interest of investor protection and the fulfillment of the mandate of the Dodd-Frank Act, we further encourage the Commission to resist calls for the watering down of its proposal.[3]

1. **NASAA strongly urges the Commission to resist calls to weaken its proposals through the grandfathering of disqualifying events or by delaying implementation of the proposed disqualification provisions.**

The Commission requests comment on whether it should "provide for grandfathering of pre-existing disqualifying events or other phase-in procedures for the new disqualification provisions." NASAA agrees strongly with the Commission's analysis of this issue under the

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators, Inc. was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.
[2] Public Law No. 111-203 [hereinafter Dodd-Frank Act].
[3] *See, e.g.*, Letter from Kenneth E. Bentson, Jr., Executive Vice President, Public Policy and Advocacy, Securities Industry and Financial Markets Association, to Elizabeth Murphy, Secretary, Securities and Exchange Commission (Jul. 14, 2011), *available at* http://www.sec.gov/comments/s7-21-11/s72111-19.pdf [hereinafter SIFMA Comment Letter]. In its 29-page comment letter, SIFMA calls for numerous and wide-ranging revisions to the disqualifications provisions proposed by the SEC that are so substantially different from current Rule 262 and Section 926 of Dodd-Frank that were the SEC to adopt them, the rule may be deemed ultra vires.

Dodd-Frank Act and existing case law and urges the Commission to reject suggestions to grandfather any disqualifying events or otherwise delay the implementation of the disqualifications mandated by the Act.[4] We note that while some have characterized the rule as having potentially retroactive effect, that is not the case as the rule will only disqualify offers and sales of securities under Rule 506 that occur after the rule takes effect. Grandfathering disqualifying events, delaying the implementation of the disqualification provisions proposed, or otherwise granting special treatment would be clearly contrary to the mandate of the Dodd-Frank Act to implement the specified disqualification provisions by the first anniversary of the Act's enactment and would only serve to further delay meaningful investor protection in this area.

In addition, we strongly support the Commission's proposal to apply the disqualification provisions to each sale of securities after the amendments become effective. We urge the Commission to resist any suggestions to move the date for determining whether an offering is disqualified to the date of first sale or first offering. Doing so would allow bad actors to continue offering and selling securities in exempt offerings after a disqualifying event and would be detrimental to investor protection. We note that many securities sold in exempt offerings are sold on the same date or within a relatively short period of time and that any disqualifying events that occur after the date of first sale are likely to come to the attention of an issuer or broker-dealer conducting the offering in a natural and expeditious manner.

2. NASAA continues to advocate for the adoption of uniform disqualification provisions.

In the proposing release, the Commission requests comments on whether the proposed disqualification provisions should apply uniformly to all exempt offerings under Regulation A, Regulation D, and Regulation E. The Commission noted that NASAA has previously expressed its support for the adoption of uniform disqualification provisions for all exempt offerings conducted under Regulation D.[5] In its own Regulation D rulemaking release from 2007,[6] the Commission proposed disqualification provisions that would have applied to all offerings made under Regulation D, not just those under Rule 506.

We agree with the Commission that the existence of different disqualification standards will create confusion and increase compliance costs. The adoption of different disqualification standards simply would not make any sense. Not only would it be burdensome and thus more costly for issuers and their counsel to apply different disqualification standards, but investors would not understand the differences. Further, as we commented in our Advance Comment

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[4] *Id*.

[5] *See* Letter from David S. Massey, NASAA President and Deputy Securities Commissioner of the North Carolina Department of the Secretary of State, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (Nov. 4, 2010), *available at* http://www.sec.gov/comments/df-title-ix/regulation-d-disqualification/regulationddisqualification-1.pdf [hereinafter Advance Comment Letter]; Letter from Karen Tyler, NASAA President and Commissioner of the North Dakota Securities Department, to Nancy M. Morris, Secretary, Securities and Exchange Commission (Oct. 26, 2007), *available at* http://www.sec.gov/comments/S7-18-07/s71807-57.pdf [hereinafter 2007 Comment Letter].

[6] Revisions of Limited Offering Exemptions in Regulation D, Release No. 33-8828, 72 Fed. Reg. 45,116 (Aug. 10, 2007), *available at* http://www.sec.gov/rules/proposed/2007/33-8828fr.pdf [hereinafter 2007 Reg. D Release].

Letter, inconsistent disqualification provisions will encourage issuers conducting offerings involving recidivists to rely on exemptions with the least protective disqualification provisions, especially Rule 504 which is not currently subject to any disqualification provisions. As the Commission notes, this could negatively affect the market for offerings conducted under exemptions with less protective disqualification provisions. In the interest of consistent investor protection and decreased compliance costs through uniformity, NASAA strongly encourages the Commission to adopt disqualification provisions that apply uniformly to all exempt offerings under Regulation A, Regulation D, and Regulation E.

3. NASAA strongly supports the adoption of disqualification provisions that apply uniformly to all members of the class of covered persons.

NASAA commends the Commission for proposing disqualification provisions that will apply uniformly to each member of the class of covered persons. In our Advance Comment Letter,[7] we advocated for the adoption of a rule that would disqualify an offering under Rule 506 if a disqualifying event applied to any person relevant to the offering, rather than adopting a rule that specified different disqualifying events for different classes of persons. We noted that the adoption of disqualification provisions applicable to all relevant persons would not only be consistent with the Commission's own Regulation D rulemaking release from 2007,[8] but would also foster greater uniformity with similar disqualification provisions contained in model rules promulgated by NASAA[9] that have been adopted by numerous states.

We continue to believe that offerings that involve any persons who have a history of misconduct relevant to a securities offering should be subject to registration. If an issuer chose to allow a covered person who is the subject of a disqualifying event to continue to be involved with an offering, the offering would be subject to registration which would allow regulators the opportunity to evaluate the adequacy of disclosure provided in the offering documents or, in the alternative, whether an order denying registration is appropriate. In the interest of investor protection and greater uniformity between state and federal law, NASAA strongly supports the Commission's proposal to apply all disqualifying events to all members of the class of covered persons.

4. NASAA commends the Commission for including in the class of covered persons those that may currently subject an offering to disqualification and strongly encourages the Commission to broaden the class of covered persons.

In both our 2007 Comment Letter and our Advance Comment Letter, NASAA urged the Commission to adopt disqualification provisions that would include all relevant persons in the class of persons that may subject an offering to disqualification. NASAA urged the Commission to follow Rule 262 and adopt disqualification provisions that include 10% beneficial owners and officers of the issuer. These persons are presumed to hold a degree of control over an issuer such

[7] Advance Comment Letter, *supra* note 5.
[8] 2007 Reg. D Release, *supra* note 6.
[9] UNIFORM LIMITED OFFERING EXEMPTION; MODEL ACCREDITED INVESTOR EXEMPTION, adopted Apr. 27, 1997, *available at* http://www.nasaa.org/content/Files/Model_Accredited_Investor_Exemption.pdf.

that their prior bad acts should disqualify an issuer from conducting an exempt offering and instead afford prospective investors the protections of the registration process. In addition, NASAA urged the adoption of disqualification provisions that would be triggered by prior disqualifying events of underwriters as they play a critical role in securities offerings and issuers rely on them to sell their securities. NASAA is pleased that the disqualification provisions proposed by the Commission include in the class of covered persons 10% beneficial owners, officers of the issuer, and "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," among others. The inclusion of such persons is critical to ensure that offerings that involve bad actors whose involvement is material may not be conducted in reliance on exemptions from registration and are instead subject to registration and the protections it affords investors.

We also support the Commission's proposal to include general partners and managing members of an issuer in the class of covered persons that may trigger disqualification. The rights and responsibilities of general partners is so significant in a partnership that an offering that involves general partners who are the subject of a disqualifying event should be subject to regulatory oversight through the registration process in the interest of investor protection. While the general partner of an issuer is included to some degree in current Rule 262, that rule does not include managing members who are equally relevant for disqualification purposes. Relevant prior bad acts of either should trigger disqualification and we commend the Commission for including this in its proposal.

In the proposing release, the Commission requests comment on whether the class of covered persons should also include investment advisers of issuers, or the directors, officers, general partners, or managing members of such investment advisers. As the Commission notes, a significant percentage of Rule 506 offerings are for pooled investment funds and frequently the advisers and individuals that control the adviser are in control of the fund. The states have also observed these realities. Further, many of these advisers are not subject to registration or licensing as an investment adviser under state law pursuant to the national de minimis standard,[10] thereby preventing the states from protecting investors by requiring registration of either the offering or the adviser. For these reasons, we strongly agree with the Commission's position that it is appropriate to include investment advisers and their directors, officers, general partners and managing members in the class of covered persons that may trigger disqualification.[11]

5. **NASAA strongly encourages the Commission to expand the list of disqualifying events to include all relevant events and circumstances that should trigger disqualification in the interest of investor protection and greater uniformity with state laws.**

In NASAA's Advance Comment Letter, we made several comments suggesting the inclusion of events and circumstances that should trigger disqualification that were not specifically included

[11] Consistent with these comments and those in comment 8 below, NASAA urges the Commission to require disclosure of the investment adviser to a pooled investment fund in the "Related Persons" section of the Form D.

in Section 926 of the Dodd-Frank Act or in current Rule 262.[12] These suggestions were made in the interest of improved investor protection and uniformity with model state laws. For example, the Advance Comment Letter urged the Commission to include in the list of disqualifying events criminal convictions involving fraud or deceit, as well as administrative orders entered under state or federal franchise, commodities, investment, or finance laws. At a minimum, all cease and desist orders of the Commission ought to constitute a disqualifying event. The inclusion of Commission cease and desist orders as disqualifying events is necessary for a basic level of investor protection, especially in light of the fact that many securities law violations are addressed by the Commission through cease and desist orders. Their omission from Rule 262 is an accident of history as pointed out in the Commission's release[13] and should not be carried forward in a new rule intended to protect the public from private offerings by recidivists. NASAA continues to urge the Commission to broaden the list of disqualifying events to include these and the other relevant events and circumstances discussed in our Advance Comment Letter.[14]

6. While NASAA generally supports the incorporation of a reasonable care exception from disqualification, such an exception must be conditioned upon making a reasonable "factual inquiry."

The Commission has proposed that an offering will not be disqualified where an offering would otherwise be disqualified if the issuer "establishes that it did not know, and in the exercise of reasonable care could not have known, that a disqualification existed." The Commission has included an instruction in the text of the proposed rule that an exception cannot be established "unless [the issuer] made a factual inquiry into whether any disqualifications exist" and that "[t]he nature and scope of the requisite inquiry will vary based on the circumstances of the issuer and the other offering participants."

While NASAA generally supports the incorporation of a reasonable care exception, and recognizes that doing so would be consistent with the Model Accredited Investor Exemption (MAIE) it has promulgated, the exception must be conditioned upon the issuer having made a reasonable "factual inquiry." Further, NASAA disagrees with the suggestions that inquiry solely of the covered persons or the use of questionnaires similar to those used for establishing whether an investor is "accredited" could reasonably suffice as a "factual inquiry."[15] A "factual inquiry" requires, at a minimum, that the issuer investigate the free records available to the public pursuant to state open records provisions, online through FINRA's BrokerCheck,[16] and the

[12] See comments 5-9 of NASAA's Advance Comment Letter, *supra* note 5.
[13] At the time Rule 262 was adopted, the Commission did not have authority to enter cease and desist orders and the rule has not been amended since the Commission gained that authority.
[14] We encourage the Commission to clarify in its adopting release that although an event may not be sufficient to trigger disqualification, the nature and existence of the event may be material nonetheless and therefore necessary to disclose to prospective investors in the interest of full disclosure.
[15] Letter from Carol Bavousett Mattick, Carol Bavousett Mattick, P.C., to Nancy M. Morris, Secretary, Securities and Exchange Commission (Oct. 9, 2007), *available at* http://www.sec.gov/comments/s7-18-07/s71807-36.pdf.
[16] Available at http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/.

Investment Adviser Public Disclosure (IAPD) system[17] for state and SEC registered investment advisers and may, as the Commission observes, require additional investigation. It is unreasonable to suggest that an issuer could establish that it exercised reasonable care in making a factual inquiry as to whether any disqualifications exist where a simple search of publicly available and widely publicized records available online through FINRA, the SEC, and the Internet in general would have revealed the existence of a disqualification.

7. **NASAA urges the Commission to condition any waiver of disqualification on a finding by the Commission that a waiver will not be prejudicial to an action by a state or other regulator.**

As indicated in our previous comments on the 2007 Regulation D Release and in our Advance Comment Letter, any waivers of disqualification granted by the Commission should be conditioned on a finding that a waiver would not prejudice an action by a state or other securities regulator in the interest of regulatory cooperation and the protection of investors. In the alternative, affected state regulators should be provided notice of a request for waiver and an opportunity to object. We urge the Commission to revise the proposed rules accordingly.

8. **NASAA encourages the Commission to require the reporting of each member of the class of covered persons in the "Related Persons" section of the Form D and to conform the signature block consistent with the proposed disqualification provisions.**

NASAA supports the Commission's proposal to conform the signature section of the Form D to require a certification that the offering is not disqualified under the proposed rules.

In addition, NASAA urges the Commission to further revise the Form D to require the reporting of each member of the class of covered persons in the "Related Persons" section. The inclusion of covered persons on the form is appropriate and will allow the staff of the SEC and the states to conduct their own inquiry as to whether an offering is subject to disqualification based on the prior bad acts of any covered persons. Without this information, the states that currently conduct this type of inquiry, even in the absence of disqualification provisions, will be unable to ascertain whether an offering conducted in their state is disqualified and should have been registered for the benefit of investors in their states.

9. **Should the Commission determine to adopt a uniform "look-back" period for disqualifying events that specify a look-back period, the Commission should apply a uniform "look-back" period of no less than ten years.**

The Commission requests comment on whether it should adopt a uniform look-back period for all disqualifying events that specify a look-back period. In light of the egregious nature of many of the events that would trigger disqualification, including criminal convictions, if the

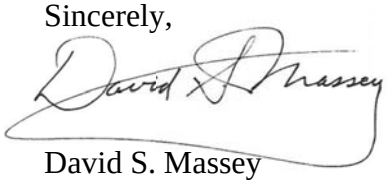
[17] Available at http://www.adviserinfo.sec.gov/(S(32hkfjfl3j4ow2gvkd0jevz1))/IAPD/Content/IAPDMain/iapd_SiteMap.aspx.

Commission determines to adopt a uniform "look-back" period, that period should be no less than ten years.

We note that SIFMA has advocated for a one-year look back period, asserting that a ten year look back period is "fundamentally too long" and "will unduly punish an issuer."[18] SIFMA does not indicate how it is in the interest of the investing public to allow an issuer to avoid registration and the protections it affords investors after a period of just twelve months has passed since the occurrence of a disqualifying event. It is unreasonable to expect that a bad actor has reformed its ways, such that a year after a disqualifying event, which may include a criminal conviction for securities fraud or a final order based on a violation of state law prohibiting fraudulent, manipulative or deceptive conduct, should be allowed to be involved in a private offering to potentially unsophisticated, non-accredited investors with no regulatory oversight. Further, if the circumstances demonstrate that the fact that a covered person is the subject of a disqualifying event should not require registration, then the issuer may apply for a waiver from the disqualification. As a general rule, however, offerings involving covered persons who are the subject of a disqualifying event in the prior ten years should be subject to registration and the protections it affords investors.

Should you have any questions regarding the comments in this letter, please contact the undersigned; Joseph Brady, General Counsel for NASAA, at jb@nasaa.org or (202) 737-0900 x.117; or Heath Abshure, Securities Administrator for the State of Arkansas and Chair of NASAA's Corporation Finance Section at habshure@securities.arkansas.gov or (501) 324-9260.

Sincerely,



David S. Massey
NASAA President and
Deputy Securities Commissioner, North Carolina Department of the Secretary of State

[18] SIFMA Comment Letter, *supra* note 3.