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NASAA

May 6, 2014

The Honorable Jeb Hensarling	The Honorable Maxine Waters
Chairman	Ranking Member
House Committee on Financial Services	House Committee on Financial Services
2129 Rayburn House Office Building	B301 Cannon House Office Building
Washington DC, 20515	Washington DC, 20515

Re: Legislation to be considered by the House Financial Services Committee on May 7, 2014

Dear Chairman Hensarling and Ranking Member Waters:

On behalf of the North American Securities Administrators Association ("NASAA"),[1] I am writing to express my concern regarding legislation that the House Financial Services Committee will be considering this week. State securities administrators support efforts at the state and federal level to expand opportunities for small businesses to access investment capital, however, the legislative provisions discussed below would shift policies in the wrong direction, weakening oversight of our capital markets and placing ordinary investors needlessly at risk. It has been our experience that weakening investor protections can result in a loss of confidence by investors in the very markets and businesses we all want to see grow and prosper.

(1) The Startup Capital Modernization Act of 2014 (Discussion Draft - Rep. McHenry)

The proposed Startup Modernization Act would raise the offering limit of "traditional" Regulation A from $5 million to $10 million and expand the scope of possible state preemption. Given the inherently risky nature of investing in the startups and small businesses that will likely use Regulation A to make offerings to investors, and the primacy of the states' role in policing small offerings, state oversight is critically important for investor protection and responsible capital formation.

Regulation A has the potential to be an exciting tool for small and emerging businesses to access investment capital without incurring the costs associated with a full-scale public offering. Unlike other federal exemptions that restrict sales to wealthier investors, Regulation A permits companies to sell directly to ordinary "mom and pop" investors. At the same time, however, the factors that make Regulation A attractive to issuers – namely, substantially relaxed disclosure and reporting requirements relative to publically listed securities – also have the potential to make these offerings high-risk

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc. (NASAA) 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.

investments for ordinary investors. It is therefore vital that Congress not undertake any action that could remove the ability of state securities regulators to review securities offered under Regulation A.

State regulators additionally provide a level of accessibility to local small business issuers and local investors that is unavailable from the U.S. Securities and Exchange Commission ("SEC" or "Commission"). In addition to responding to inquiries from local investors questioning the legitimacy of offerings, state securities regulators regularly field inquiries from entrepreneurs, small business owners, and local counsel regarding options for raising capital.

At the same time, state securities regulators also appreciate that dealing with multiple states may be burdensome for some small companies. Over the past year, state securities regulators, working through NASAA, have undertaken unprecedented steps to improve and better streamline the processes we use to review Regulation A offerings. The culmination of this effort is the NASAA Coordinated Review Protocol ("Protocol") – a modernized and efficient system for Regulation A review.

NASAA membership approved the new Regulation A Protocol on March 7, 2014, and, as of today, 49 of 53 U.S. jurisdictions have implemented it by signing a Memorandum of Understanding.[2] Under the new Protocol, filings are made with one program coordinator and distributed to other states. Only lead examiners communicate with the applicant. This process is complete 21 business days after the initial filing, assuming no deficiencies in the application, and any delay in clearing an application is directly tied to the issuer's response time. Once the lead examiners clear the application of all deficiencies, the decision is binding on the other states.

Notwithstanding the serious and substantial effort undertaken by states to develop and implement the Protocol, the Startup Capital Modernization Act could preempt state authority to review Regulation A offerings. Given the inherently risky nature of the offerings, and the primacy of the states' role in policing small securities offerings, state oversight is critically important for investor protection, and the states should not be preempted in this area.

In addition, Section 5 of the Startup Capital Modernization Act would add a new transactional exemption in Section 4 of the 1933 Act ("Securities Act") for secondary market sales by any person other than an issuer, underwriter, or dealer. While state securities regulators are sensitive to the desire for increased liquidity for holders of unlisted securities, NASAA is concerned that investor protection could be significantly compromised by such an exemption.

Exempt transactions are subject to the antifraud provisions of the Securities Act, which generally make it unlawful to offer or sell a security without fully disclosing all material facts. With respect to nonpublic companies, it will be very difficult for a selling security holder to obtain and provide to a purchaser the information required to fulfill this requirement, as sources of information such as 10-K and 10-Q reports will be unavailable, and since the disclosures that the selling security holder received when he or she acquired the security likely will be significantly out-of-date. Moreover, the issuer may not have, or may not be willing to reveal, material information about the company to a purchaser with which it is not familiar.

Finally, allowing ordinary investors to generally solicit to prospective purchasers, as the discussion draft proposes, could invite fraud and other unlawful conduct. The changes to Rule 506 of Regulation D only permit issuers to generally solicit so long as the ultimate purchasers are accredited. NASAA is concerned about the consequence of allowing individual investors to resell their shares

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[2] Information about the NASAA Coordinated Review Protocol is available on the NASAA Website. http://www.nasaa.org/issues-and-advocacy/issue-brief-regulation-a/

through generally soliciting the public when investors are not subject to the protective rules governing broker-dealers. This would be particularly troublesome when an investor seeks to unload their investment without providing the purchaser with current, material information. Moreover, because the bill discussion draft deems these transactions as a "covered security" and thus preempts state review, NASAA is very concerned about the potential repercussions for investors who are subject to fraud or other unethical conduct. As with Rule 506 offerings, state securities regulators will only be able to take action after the fraud has occurred, and in many instances the investor's funds will be unrecoverable.

NASAA strongly urges you to <u>oppose</u> the Startup Capital Modernization Act, or other legislation that could weaken investor protection through the preemption of state authority to review Regulation A offerings.

(2) The Private Placement Improvement Act of 2014 (Discussion Draft – Rep. Garrett)

The discussion draft legislation entitled "The Private Placement Improvement Act," would prohibit the SEC from adopting proposed rules to implement common-sense investor reforms for Regulation D, Rule 506 offerings. NASAA supports the SEC's proposal and believes that these modest reforms will result in substantial benefits to investors with minimal costs to issuers.

Title II of the Jumpstart Our Business Startups ("JOBS") Act repealed a long-established prohibition on general solicitation and advertising of securities under Rule 506. When the SEC adopted rules to implement Title II, on July 10, 2013, it also voted to propose rules that could mitigate the risk to ordinary investors from 506 offerings, including by requiring a pre-filing of "Form D" when issuers intend to advertise Rule 506 securities to the general public, and by imposing meaningful penalties on issuers who fail to file a Form D.[3] The Private Placement Improvement Act would effectively prohibit the Commission from adopting these rules.

Prohibiting the SEC from taking sensible steps to protect investors would be a grave mistake. State securities regulators, pursuant to our antifraud authority, are the primary regulators of offerings conducted under Regulation D, Rule 506. Frauds involving Rule 506 offerings are routinely among the most frequently reported by state securities regulators.[4] In 2012, for example, state regulators pursued more than 200 investigations and took 130 enforcement actions related specifically to Rule 506 offerings. State securities regulators consider swift adoption of the SEC's proposed rules essential to ameliorating problems with these offerings.

NASAA appreciates that the sponsor has removed from the legislation a prohibition proposed in an earlier draft of the bill that would have prevented the SEC from adopting rules requiring filing of the Form D prior to the first sale of a Rule 506 offering; however, to ensure adequate protection of investors, rules requiring the filing of Form D <u>before the use of general solicitation</u> are necessary.

The information contained in a Form D is crucial to state securities regulators who regularly encourage investors to "investigate before you invest." When investors contact their local state regulators (particularly after hearing about the offering through an advertisement or solicitation), a Form D notifies the state that the issuer is conducting the offering in compliance with a lawful exemption. The Form D is often the only information available about the issuer when an investor calls (e.g., business address, officers, directors, business type, etc.), and it allows state regulators to look for "red flags" indicative of a fraudulent offering. Moreover, because states are preempted from requiring the registration of securities

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[3] SEC Release 33-9416, 34-69960, IC-30595, Amendments to Regulation D, Form D and Rule 156 (July 10, 2013), 78 Fed. Reg. 44806 (July 24, 2013)

[4] According to NASAA enforcement reports from 2013, 2012, 2011, and 2010 (reflecting 2012, 2011, 2010 and 2009) Regulation D Rule 506 offerings were among the top products involved in state enforcement actions.

sold in reliance upon Rule 506, a Form D is the only tool that we have to prevent or stop investor losses. Without the information contained in a Form D, state securities regulators are blind to these offerings.

Some have argued against the SEC's proposal to file a Form D prior to conducting a Rule 506 offering, and again upon the completion of the offering, on the grounds that "multiple" filings impose an onerous compliance burden. The facts do not support those claims. Form D is a short, 11-page form that contains instructions and captures only eight pages of information, including basic information about the issuer. The amount of information required on this form relative to the information contained in an issuer's private placement memorandum or offering document is minimal.

The Private Placement Improvement Act also would prohibit the SEC from adopting proposed rules intended to establish consequences for issuers who fail to file a Form D when conducting a Regulation D, Rule 506 offering, which is a common-sense step that is long overdue. Currently, Rule 503 of Regulation D imposes a Form D filing requirement of no later than 15 calendar days after the first sale of securities in the offering. However, issuers that fail to meet this basic requirement do not face meaningful consequences under Regulation D. Indeed, as reported by the SEC Inspector General in 2009, "*there are simply no tangible consequences when a company fails to file a Form D.*"[5] This current, "voluntary" nature of Form D has significant negative repercussions for state regulators.

The Commission should not be stymied in this long overdue effort to implement minor reforms designed to attenuate the risk to investors from Rule 506 offerings.

NASAA urges you to oppose the Private Placement Improvement Act in its present form.

(3) The Equity Crowdfunding Improvement Act of 2014 (Discussion Draft – Rep. McHenry)

NASAA has significant reservations regarding the Equity Crowdfunding Improvement Act, which would repeal Title III of the JOBS Act in its entirety, and replace it with a new crowdfunding exemption that provides substantially fewer investor protections.

The SEC already has proposed rules to implement Title III of the JOBS Act,[6] extensive public comments have been received, and the SEC has indicated that the final rules will be adopted before the end of this year. While there may be provisions in Title III that may limit its utility for certain issuers, Congress included many of these provisions because it judged them to be essential to minimize the potential for severe investor risk. Until the SEC adopts final rules to implement Title III, and until issuers are able to participate in crowdfunding, it is impossible to evaluate the impact Title III will have on capital formation, job creation and investors' willingness to invest through crowdfunding.

NASAA urges you to oppose the Equity Crowdfunding Improvement Act, or other legislation amending Title III of the JOBS Act, until the SEC has implemented Title III, and its impact on investor protection and capital formation can be assessed.

(4) The Restricted Securities Relief Act of 2014 (H.R. 4554 – Rep. Mulvaney)

Holding privately sold securities for six months, or for twelve months in the case of non-SEC reporting companies, negates an inference that a buyer purchased the securities with a view to distribute (rather than hold those securities for investment). The Restricted Securities Relief Act, by shortening this

[5] As discussed 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. See http://www.sec-oig.gov/Reports/AuditsInspections/2009/459.pdf

[6] SEC Release No. 33-9470; File No. S7-09-13, Crowdfunding (October 23, 2013).

mandatory holding period for securities offered in reliance on Regulation D, Rule 506 from six months to three months, would all but eliminate the protection this well-established and necessary holding requirement affords ordinary investors, effectively sacrificing the interests of such retail investors in order to increase profits for issuers and certain accredited investors.

State securities regulators are concerned that the bill effectively bypasses the protections in Rule 506 of Regulation D, which limit private sales to accredited investors and up to 35 "sophisticated" purchasers. In other words, if H.R. 4554 were enacted in its present form, an issuer could generally advertise an offering under Rule 506 and sell to accredited investors. However, in as little as three months, that accredited investor could then resell the shares to unaccredited investors, thus effectively bypassing the accredited/sophisticated purchaser limitation in Rule 506. Ultimately, Rule 506 shares would be held by unaccredited investors only three months after their original issuance.

It is in an issuer's interest to issue shares to as few initial investors as possible. Thus, if an issuer can avoid selling those shares to unaccredited, retail investors, and sell only to large institutional investors (i.e., mutual funds, hedge funds, investment banks, etc.), issuers can be expected to choose that route. With the changes proposed by this bill, the large investor could buy the shares at a healthy discount and three months later, dump the stock on average, unaccredited retail investors.

State securities regulators are concerned that the impact of H.R. 4554, if enacted, will be to flood the market with Rule 506 offerings that are unloaded by large sophisticated investors on less sophisticated "mom and pop" investors. Because these are resale transactions, if the business fails or becomes insolvent, the issuer will have already received the initial money from large accredited investors, those investors will have received a quick profit, and the retail investors will be left holding worthless shares.

Finally, the bill calls for state preemption of Rule 144A transactions –i.e., sales to Qualified Institutional Buyers. Most states already have an exemption for institutional investors, thus making the preemption proposed in this bill unwarranted. If there are unforeseen problems in this area, preempting the states would eliminate our ability to revise or amend the institutional investor exemption if necessary. Moreover, NASAA is unaware of any large investors who consider state regulation of 144A transactions, where it is required, unduly burdensome or problematic.

NASAA urges you to oppose the Restricted Securities Relief Act in its present form.

Thank you for your consideration of NASAA's views. Should you have any questions, please do not hesitate to contact Michael Canning, NASAA Director of Policy, or Anya Coverman, NASAA Deputy Director of Policy, at (202) 737-0900.

Sincerely,

William Beatty
NASAA President Elect and Washington Securities Director