BETTER MARKETS
TRANSPARENCY · ACCOUNTABILITY · OVERSIGHT

July 14, 2011

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

Re: Disqualifications of Felons and Other "Bad Actors" From Rule 506 Offerings; File No. S7-21-11

Dear Ms. Murphy:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules ("Proposed Rules") of the Securities and Exchange Commission ("Commission"). The Proposed Rules would disqualify a limited and narrow class of persons from relying on the private offering exemption set forth in Rule 506 of Regulation D, but only if those persons were subject to certain types of criminal convictions and other disciplinary events. The Commission has issued the Proposed Rules in accordance with Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). The Commission is also considering applying the disqualification standards in the Proposed Rules uniformly to other registration exemptions under the securities laws and it seeks comment on that proposal as well.

INTRODUCTION

The application of "bad actor" disqualification standards to offerings under Rule 506 of Regulation D is vitally important and long overdue. Rule 506 is just one of several exemptions from registration for limited or private offerings under the securities laws, but it is also one of the most widely used. It has undoubtedly served as a cost-effective way to raise significant amounts of capital for legitimate businesses. At the same time, however, it has also been an attractive vehicle for fraud and abuse by unscrupulous issuers preying on investors and markets alike.

The reasons for this pattern of fraud and abuse in Rule 506 offerings are clear. Rule 506 offerings allow issuers to raise unlimited amounts of money, yet they are subject to

[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

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relatively few regulatory requirements and they receive minimal regulatory oversight. By its own admission, the Commission has not had the resources to review Rule 506 offerings to any significant degree, and state securities regulators have been preempted from doing so under the National Securities Markets Improvement Act of 1996. In addition, unlike other private offering exemptions, Rule 506 offerings have *not* been subject to bad actor disqualification standards.

These circumstances have led to widespread use of Rule 506, accounting for over 90 percent of all offerings under Regulation D. For example, in the 2010 fiscal year, the Commission received over 17,292 initial filings under Regulation D, and 16,027 of those claimed an exemption from registration under Rule 506.[2] Along with increased reliance upon Rule 506 has come a steady increase in the number of those offerings that have proven to be fraudulent.[3]

The opportunity for issuers to raise unlimited funds, coupled with weak regulatory standards and oversight, has for years created a toxic mix for investors, and it prompted Congress to enact Section 926 of the Dodd-Frank Act. Applying disqualification standards is an effective way to help protect investors from fraudulent unregistered securities offerings, while imposing minimal costs and burdens on legitimate issuers seeking to raise capital. Such disqualification standards pose no burdens or obstacles on law abiding issuers who continue to have unfettered access to the Rule 506 offering process. In fact, raising the standards among issuers can be expected to improve investor confidence in private offerings and make them more promising capital raising vehicles for issuers.

Even those issuers disqualified from using Rule 506 offerings suffer a very limited impact. They are still free to seek capital via registered securities offerings, or they can even take steps to cure the disqualifying event that restricts them from using Rule 506.

To address the abuses associated with Rule 506 offerings, Congress required the Commission to fashion disqualification standards that are "substantially similar" to the disqualification provisions currently applicable to exempt offerings made in accordance with Regulation A.[4] In addition, Congress identified two specific disqualifications that the Commission must adopt, one relating to administrative orders of certain state and federal regulatory agencies, and the other relating to criminal convictions in connection with securities transactions.

[2] Release at 31519, n. 8.
[3] Dan Jamieson, *Con Artists Use Reg D Pre-emption as Way to Hold off State Regulators*, INVESTMENT NEWS, Oct. 16, 2006.
[4] Dodd-Frank Act § 926.

The Proposed Rules are based in substance upon these guidelines, as well as some additional provisions that the Commission has included. The Release accompanying the Proposed Rules seeks comment on a wide range of issues concerning the new disqualification standards that would apply to offerings made under Rule 506. Those issues include—

- The persons that should be covered by the disqualification provisions;
- The nature of the events that should trigger disqualification;
- The exceptions and waivers available to issuers under the Proposed Rules; and
- The transition provisions that should apply.

In addition, the Release indicates that the Commission is considering a broader and more uniform application of the standards in the Proposed Rules to a number of other private or limited offering exemptions,[5] at least one of which is not currently subject to any disqualification provisions.[6]

SUMMARY OF COMMENTS

We wholeheartedly endorse the Commission's proposal to apply the disqualification standards in the Proposed Rules to numerous other registration exemptions. It is an extremely valuable step that will help protect innumerable investors from the heightened risks associated with unregistered securities offerings from issuers who have disciplinary histories.

With respect to the Proposed Rules themselves, we regard them as a commendable effort to implement Section 926 of the Dodd-Frank Act. However, to fully achieve the objectives of the Dodd-Frank Act and to protect investors more effectively from unscrupulous issuers, the Proposed Rules must be strengthened and the Commission must resist any inclination to dilute the Proposed Rules in a number of areas identified in the Release. Specifically—

- The Proposed Rules must apply broadly to issuers and their control persons, and they must also encompass investment advisers to issuers involved in exempt offerings.

5 Release at 31532.

6 If the Commission does not apply the standards in the Proposed Rules uniformly to the limited or private offering exemptions, then offerings under Rule 504 of Regulation D will remain unprotected by any disqualification provisions. Release at 31532.

- The Proposed Rules must expand the disqualifying events to include broader forms of fraud, a wider range of administrative orders, and sanctions imposed by foreign authorities.

- The Commission must impose a uniform, ten-year look-back period.

- The reasonable care exception must be subject to a duty of factual inquiry.

- The Proposed Rules must not grandfather disqualifying events that pre-date the effective date of the Proposed Rules.

COMMENTS

The Commission Should Apply the Standards in the Proposed Rules Uniformly to the Registration Exemptions Under Regulations A, D, and E.

In the Release, the Commission seeks comment on whether it should apply the new disqualification provisions under Rule 506 uniformly to other registration exemptions for limited or private offerings, including Regulation A, Regulation E, and Rules 504 and 505 of Regulation D. This is an excellent proposal that serves the interests of investors, regulators, and issuers as well. We strongly endorse it.

First and foremost, uniform application of the standards in the Proposed Rules will enhance investor protection by (a) strengthening the existing disqualification provisions that apply to multiple registration exemptions, and (b) filling a void under Rule 504 of Regulation D, which currently is not subject to any disqualification provisions.

Further, the Commission's proposal will promote simplicity, clarity, and consistency in the regulatory requirements applicable to the registration exemptions. As a result, issuer compliance costs will be reduced. Moreover, issuers will no longer experience any disadvantages arising from the application of disparate disqualification standards to different offering exemptions.

The Commission's proposal will also raise the level of investor confidence in all private or limited offerings by eliminating issuers who cannot be trusted to conduct their offerings within the bounds of the law. This, in turn, will help improve the ability of issuers to raise capital through these streamlined offering mechanisms. All of these benefits will come at little burden and expense to issuers.

For all of these reasons, the Commission should follow through on its proposal and apply the new disqualification provisions under Rule 506 to the other registration exemptions under Regulations A, D, and E.

The Proposed Rules Must Apply Broadly to Issuers and Their Control Persons, and They Must Also Encompass Investment Advisers to Issuers Involved in Exempt Offerings.

To achieve the investor protection goals underlying Section 926, the universe of persons subject to the disqualification standards must be broadly defined. The Proposed Rules largely follow this approach. They would apply to issuers, owners, affiliates, officers, directors, promoters, and other persons in connection with exempt offerings.

The Proposed Rules also include some important enhancements. For example, the Proposed Rules correctly add a new provision to cover managing members of limited liability companies. This expansion is clearly appropriate because it ensures that the rules keep pace with changes that have occurred in the way entities conduct business and raise capital. Similarly, in place of the term "underwriters," the Proposed Rules appropriately substitute a more general descriptive phrase to cover persons who receive "remuneration for solicitation of purchasers." This change accurately reflects the fact that private offerings under Rule 506 do not involve underwriters per se, in contrast with public offerings.

The Proposed Rules also reject certain limitations that the Commission has previously considered.[7] For example, the Proposed Rules would cover beneficial owners of 10 percent of any class of an issuer's equity securities, rather than just those who own 20 percent of the issuer's equity securities. This approach mirrors the provisions of Regulation A, as Congress instructed in Section 926 of the Dodd-Frank Act, and it better serves the goal of protecting investors from those who are presumptively unfit to rely upon the Rule 506 exemption from registration.

In addition, the Proposed Rules would cover all officers of the issuer and any solicitor involved in an offering, not only the executive officers of those entities. On this matter, the Release expresses concern that the category of all officers may be too broad, since a placement agent may have many officers who are not involved in a particular Rule 506 offering and whose disciplinary history would therefore have little relevance.[8]

These concerns are unwarranted. On legal and practical grounds, the Proposed Rules must remain applicable to *all* officers of the relevant entities. As a legal matter, the disqualification provisions in Regulation A cover all officers, not merely executive officers, and this is an important guidepost under Section 926 of the Dodd-Frank Act.

As a practical matter, the disciplinary history of all officers is relevant to the fitness of an issuer to use a registration exemption. It is always possible that an officer with a disciplinary history *may* become involved in a Rule 506 offering, and there is no practical, effective mechanism for guarding against this possibility. Second, officers generally exert a

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7 The Release explains that in 2007, the Commission proposed a number of amendments to Regulation D, including bad actor disqualification rules. Although the Commission did not take final action on those provisions, it has considered the comment letters received in response to the 2007 rule proposal in connection with its development of the Proposed Rules. Release at 31519.

8 Release at 31521.

significant measure of control or influence over a business enterprise, and they help determine the character of a firm. This necessarily raises the concern that an issuer subject to the influence of an officer with a disciplinary history may pose a threat to investors even in connection with exempt offerings that do not directly involve the officer in question.

For these reasons, it is appropriate and necessary to apply the disqualification standards to all officers of the relevant entities, not merely the executive officers.

Finally, the Proposed Rules include an important gap in coverage that must be closed. The Proposed Rules would not cover investment advisers involved in a Rule 506 offering, or the officers and other control persons of those investment advisers. This omission is significant, since a large percentage of the issuers relying on the Rule 506 exemption are funds, typically controlled by investment advisers.[9]

More generally, investment advisers exert significant influence over issuers of all types. Therefore, to achieve the investor protection purposes underlying Section 926, the disqualification provisions must be expanded to cover an issuer's investment adviser, as well as its control persons.

The Proposed Rules Must Expand the Disqualifying Events to Include Broader Forms of Fraud, a Wider Range of Administrative Orders, and Sanctions Imposed by Foreign Authorities.

The Proposed Rules specify the types of disciplinary events that would preclude reliance upon the Rule 506 registration exemption. In general, these events are defined in terms of three factors:

1. the nature of the sanction imposed;

2. the type of regulatory or law enforcement authority that imposed the sanction; and

3. the applicable "look-back" period, which determines the length of time that each sanction has a disqualifying effect.

As currently framed, the Proposed Rules would cover a variety of criminal, injunctive, and administrative sanctions imposed by state and federal authorities, with look-back periods typically of five or ten years.

Although the Proposed Rules generally define the disqualifying events appropriately, and in accordance with Section 926 of the Dodd-Frank Act, they must also be strengthened in a number of ways.

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[9] The Release notes that for the Commission's 2010 fiscal year, 24% of issuers in transactions claiming a Rule 506 exemption described themselves as "pooled investment funds." Release at 31521.

First, with respect to the nature of the sanction, the Proposed Rules must be expanded to cover any criminal convictions involving fraud or deceit, not just the more limited universe of convictions that are linked to securities transactions. Criminal convictions for *any* species of fraud or deceit are appropriate indicators of fitness for purposes of the Rule 506 disqualifications. Investors should be protected from issuers and related parties who have a history of committing criminal fraud, regardless of the specific context.

Also with respect to the nature of the sanction, the Release seeks comment on the degree of "finality" that administrative orders must have before they serve as a basis for disqualification. Administrative orders must be deemed "final" in this context regardless of whether or not they are (a) accompanied by findings; (b) the result of settlement; or (c) subject to appeal. None of these factors should determine the finality of an administrative order since they do not bear on the basic investor protection rationale underlying the Proposed Rules. Moreover, those subject to disqualification are only foreclosed from using the unregistered offering process, and they may pursue other capital-raising vehicles.

Second, the Proposed Rules must also expand the types of regulatory authorities whose sanctions give rise to disqualification. Most notably, administrative orders issued by the Commission and by the Commodity Futures Trading Commission ("CFTC") must, without question, be added to the list of disqualifying orders in Proposed Rule 506(c)(1)(iii). The relevance of Commission orders is obvious. With respect to the CFTC, as noted in the Release, conduct that would typically give rise to a CFTC sanction is similar to the type of conduct that would result in disqualification if it were the subject of action by other regulators in the securities, banking, or insurance fields.[10] Accordingly, there is no basis for excluding CFTC administrative orders from the list of disqualifying sanctions.[11]

The same can be said of orders issued by other agencies with jurisdiction over misconduct in the financial services arena, including the Consumer Financial Protection Bureau and the Federal Trade Commission. Their administrative orders should also be added to the disqualification standards in the Proposed Rules.

Finally, the Proposed Rules must include sanctions imposed by foreign authorities. The criminal convictions, injunctions, and administrative orders issued by foreign tribunals and regulatory bodies are an important test for determining whether an issuer can be trusted to raise capital from investors under the less protective regulatory standards that apply to limited and private offerings. As our markets continue to converge internationally, sanctions imposed by foreign authorities will have an increasingly important role in identifying those issuers who should not be eligible for the registration exemptions and who must instead pursue capital through registered offerings.

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[10] Release at 31526.

[11] Under the same reasoning, orders of expulsion from membership in commodities exchanges or commodities self-regulatory organizations should be included in the Proposed Rules as grounds for disqualification.

The Commission Must Impose a Uniform, Ten-Year Look-Back Period.

The Proposed Rules incorporate a variety of look-back periods, depending on the nature of the sanction. They include definite periods of five or ten years, as well as open-ended periods keyed to the duration of the sanction, such as a bar from the securities industry for a specified length of time.

Among the proposals that the Commission is considering is the imposition of a uniform, ten-year look-back period that would apply to any disqualifying events that are subject to an explicit duration.[12] We support this proposal. It would better serve the investor protection purposes underlying the disqualifications by precluding a larger class of participants with disciplinary histories from taking advantage of the registration exemptions. In addition, the uniform rule would be clearer, simpler, and easier to apply and enforce.

Finally, we see no compelling rationale for the current distinctions between sanctions bearing different look-back periods. For example, it is not at all clear that a misdemeanor conviction arising out of the business of a broker-dealer is necessarily more serious than a court injunction against securities law violations, yet they have different look-back periods. In short, all of the sanctions listed in the Proposed Rules with explicit durations are serious matters, and they all warrant at least a ten-year look-back period in the interest of investor protection.

The Reasonable Care Exception Must Be Subject to a Duty of Factual Inquiry.

The Proposed Rules would include an exception from disqualification for offerings where the issuer establishes "that it did not know, and in the exercise of reasonable care could not have known, that a disqualification existed" under the rules.[13] As noted in the Release, this exception arises out of concern that issuers may be reluctant to use Rule 506 and derive its capital-raising benefits if they fear that, despite good faith efforts to comply, their offerings will later be found ineligible for the registration exemption because a disqualified person was involved.[14]

Creating such an exception inevitably poses the risk that it will allow some disqualified issuers to use the Rule 506 exemption with impunity, to the detriment of investors and in violation of the letter and spirit of the Dodd-Frank Act. To minimize this danger, it is imperative that the Proposed Rules impose a duty of factual inquiry upon issuers. That provision is included in the Proposed Rules, and it must remain.

Only with the duty of factual inquiry can the "reasonable care" standard in the exception have any real, enforceable meaning. Without it, issuers who should be disqualified from using a Rule 506 offering will be free to take minimal steps purportedly

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[12] Release at 31534.
[13] Release at 31529.
[14] *Id.*

to identify disqualified persons in their firms, and, if caught, plead ignorance under the exception. The Proposed Rules must foreclose this possibility.[15]

The Proposed Rules Must Not Grandfather Disqualifying Events That Pre-Date the Effective Date of the Proposed Rules.

The Proposed Rules strike a reasonable balance in addressing transition issues, and the Commission must not waiver in its approach. Under the Proposed Rules, the new disqualification provisions would apply to all sales made under Rule 506 after the effective date, regardless of whether the disqualifying events occurred before the enactment of the Dodd-Frank Act or the effective date of the rules. In the Release, however, the Commission raises concerns about the potential impact of this transition rule on issuers and seeks comment.[16]

The approach under the Proposed Rules is correct and it should not be diluted with a grandfathering clause that insulates prior criminal and disciplinary history from the effects of the disqualification standards. As a matter of statutory construction, the Dodd-Frank Act contains no language suggesting that Congress intended to afford such relief to otherwise disqualified issuers. The policy of investor protection certainly counsels against a grandfather clause, and concerns about fairness to issuers do not justify a different result.

Rule 506 is merely a safe harbor from the more complete safeguards that normally apply to any issuer seeking to raise capital from investors. For the privilege of relying on that exemption, all issuers should at least be subjected to the fundamental fitness standards embodied in the disqualification provisions.

As between issuers and investors, it is far preferable that issuers face the delays or inconvenience necessary to cure disqualifications or register their offerings than for investors to be victimized by an issuer or promoter that was demonstrably unfit to invoke the Rule 506 exemption. The Commission must therefore adhere to the approach to transition reflected in the Proposed Rules.

<u>CONCLUSION</u>

Unregistered securities offerings under Rule 506 can be an important capital raising tool, but they also pose heightened risks to investors, since they lack many of the important regulatory protections that normally apply in the securities markets. Issuers that have flaunted the law in the past should not be afforded the privilege of relying on Rule 506, and should instead be required to subject their securities offerings to the complete registration

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15 Consistent with Regulation A, the Proposed Rules also include a provision allowing issuers to seek waivers from disqualification from the Commission. Release at 31529. The Proposed Rules should provide that before a waiver may become effective, the appropriate state securities regulators must receive timely notice of the waiver request and must concur that the waiver is appropriate under the circumstances.

16 Release at 51530.

process. The Proposed Rules, with the changes outlined above, will be an effective tool for implementing this safeguard.

The Commission's proposal to apply the new disqualification provisions in the Proposed Rules to other registration exemptions in Regulations A, D, and E would significantly enhance investor protection without imposing costly or unfair burdens on legitimate issuers seeking capital. We applaud the Commission for taking this initiative and we urge that the proposal be adopted.

Sincerely,

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