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April 23, 2010

The Honorable Christopher Dodd
Chairman, Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

The Honorable Richard Shelby
Ranking Member, Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

Re: Section 926 of S. 3217, the "Restoring American Financial Stability Act"

Dear Chairman Dodd and Ranking Member Shelby:

As the Senate continues to work toward final action on S. 3217, the Restoring American Financial Stability Act of 2010, I write to express our concerns regarding a number of serious problems with Section 926 of the Act entitled "Authority of State Regulators Over Regulation D Offerings." The views expressed in this letter are presented by the American Bar Association Section of Business Law (the "Section") on behalf of its Committee on Federal Regulation of Securities (the "Committee"). These views have not been approved by the House of Delegates or Board of Governors of the American Bar Association and, therefore, should not be construed as representing the policy of the American Bar Association.

The membership of the Committee consists of over 2,700 securities law practitioners from throughout the United States and internationally. The Committee regularly comments to the Securities and Exchange Commission (the "SEC") on their rulemaking initiatives. In our work, we believe we have come to understand and appreciate the importance to our capital markets of achieving an appropriate balance among the three elements of the SEC's mandate: to protect investors; to maintain fair, orderly and efficient markets; and to facilitate capital formation.

We are concerned that Section 926 would effectively eliminate the federal preemption of state securities laws enacted by Congress under the National Securities Markets Improvement Act of 1996 ("NSMIA") in connection with many private offerings by smaller companies. In our view, the adoption of Section 926 would significantly inhibit capital formation without providing any meaningful investor protections. Although we understand the need for the Senate to enact legislation addressing the problems that led

to our recent financial crisis, we submit that the existing federal preemption of state securities laws played no part in the problems that led to the crisis. Instead of helping to resolve the crisis, our concern is that Section 926 would make it significantly more difficult for smaller companies to raise capital in the private markets, and thereby exacerbate the difficulties these companies face in the current economic environment.

We discuss these matters in greater detail below.

Background

Private offerings (that is, those that are exempt from registration under the Securities Act of 1933 (the "Securities Act")) constitute one of the principal means by which businesses, including some of our most entrepreneurial companies, raise capital. To a large extent, private offerings are the lifeblood of our economy. Most start-up and entrepreneurial growth companies, without recourse to bank financing or the public markets, depend upon private investor financing in their early stages of growth. Many of our most successful public companies were sparked into existence and growth by virtue of the capital available pursuant to private offerings, and a material portion of our national wealth derives from the returns private investors have received as a result of such offerings.[1] The ability of smaller companies to obtain capital is, in our view, directly related to the flexibility afforded by the current private offering process.\

The private offering process necessarily involves a balancing act. Because investors in a private offering do not receive all of the protections that would be afforded to them in offerings registered under the Securities Act, the SEC, through its rulemaking process, has established criteria intended to serve as an appropriate substitute for the protections afforded by Securities Act registration. In the case of the exemption from registration under Rule 506 of SEC Regulation D, those criteria are (i) mandating that specified information be furnished to investors who do not meet the SEC's "accredited investor" requirements, (ii) limiting the number of persons other than "accredited investors" who can participate in an offering; and (iii) requiring each non-accredited investor, either alone or with his or her "purchaser representative," has such knowledge and experience in financial and business matters so as to permit the investor to evaluate the merits and risks of the prospective investment. In addition, issuers are restricted in the manner in which information regarding a private offering may be publicized, and investors are required to hold their securities for a period of time before they may be resold publicly. Rule 506 does not prescribe information that must be delivered in an "all-accredited" offering, on the basis that accredited investors possess the knowledge necessary to determine the information they require in order to make informed investment decisions. It is important to note that,

[1] According to a 2009 study, companies that were started with venture capital accounted in 2008 for 12.1 million jobs (or 11 percent of private sector employment) and $2.9 trillion in revenues in the United States in 2008. Such companies include historic innovators such as Genentech, Intel, Microsoft, Amazon, Google, Apple, Cisco and FedEx. From 1970-2008, total venture investments aggregated $456 billion invested in over 27,000 companies. See "Venture Impact – The Economic Importance of Venture Capital-Backed Companies to the U.S. Economy," prepared by the National Venture Capital Association and IHS Global Insight (2009), available at http://www.nvca.org/index.php?option=com_content&view=article&id=255&Itemid=103

notwithstanding the absence of Securities Act registration, purchasers of securities in private offerings are entitled to bring actions under Section 10(b) of the Securities Exchange Act of 1934, and SEC Rule 10b-5 thereunder, against issuers and others based upon material misstatements and omissions in the offering materials, and both private investors and the SEC have regularly availed themselves of these provisions. It is also important to note that, in addition to the remedies available under Section 10(b), investors and state securities regulators are often able to assert claims based upon state law antifraud provisions.

One of the principal strengths of the current private offering regime is that it generally permits issuers to undertake such offerings within a time frame, and at a cost, that is reasonable and efficient. Prior to the adoption of NSMIA, private offerings were often subject to two sets of criteria: those criteria adopted by the SEC as a condition to the exemption from registration under the Securities Act, and those imposed under state securities ("blue sky") laws and regulations. The state regulation of private offerings introduced numerous complications to the offering process. Without dwelling on this matter in too great detail, the effort by issuers to register or qualify securities offerings under state "blue sky" laws and regulations, or to confirm the availability of exemptions from the scope of such laws and regulations, added significantly to the costs of private offerings and often involved significant delays to the offering process while the state regulators reviewed and provided comments on the issuer's filings. This was not a one-state process; issuers were required to comply with (or seek exemption under) the blue sky laws in each state in which an offering was to be made, regardless of whether any sales were actually consummated in the state. Because state securities regulators could, in many cases, review the substantive aspects of the issuer's organization and structure, as well as the disclosures provided to investors, it was not uncommon for an issuer to receive comments requiring an offering to be restructured in some way, or for the proposed disclosure to be materially modified, in order for the offering to proceed in that state. Some states imposed other conditions different than those in Rule 506 or Regulation D, so that an issuer might be subject to different numerical limits on offerees or purchasers, might be required to impose special restrictions and conditions on investors in a given state, or might be required to prepare and file forms which differed from state to state. Compliance with these procedures was sometimes burdensome and was often time consuming. Although we do not question the good faith of the state securities regulators who were involved in this process, securities practitioners often questioned whether the investor protection benefits, if any, justified the cost and delay associated with substantive blue sky regulation.

This changed significantly with the adoption of NSMIA in 1996. NSMIA added Section 18 of the Securities Act, which effectively preempted state blue sky regulation of certain offerings. The statutory preemption was applicable to "covered securities," which included, among other categories, securities offered and sold pursuant to the Rule 506 safe harbor exemption of Regulation D.[2] In the 14 years since the adoption of NSMIA, the private offering market has developed significantly. Although it may be subject to the vicissitudes of the marketplace, such

[2] The preemption did not prohibit a State from imposing notice filing requirements that are substantially similar to those required by rule or regulation under section 4(2) that were in effect on September 1, 1996.

as the bursting of the "tech bubble" in 1999 and the market meltdown in 2008, the private offering market, at least insofar as covered securities are concerned, has not been subject to the significant speed bumps associated with the pre-NSMIA blue sky process.[3]

Section 926 of the Restoring American Financial Stability Act

Section 926 would restructure Section 18(b)(4) of the Securities Act in the following respects:

1. The SEC would have the ability to designate, by rule, a class of securities that it deems not to be covered securities because the offering of such securities is not of sufficient size or scope.

2. In making the foregoing designation, the SEC would be obligated to consider (i) the size of the offering, (ii) the number of States in which the security is being offered, and (iii) the nature of the persons to whom the security is being offered.

3. The SEC would be obligated to review any filings made relating to any security issued under SEC rules or regulations under Section 4(2), other than one which is designated as a non-covered security, not later than 120 days after the filing with the SEC, and in the event the SEC fails to review a filing, the security shall no longer be a covered security, except if the SEC, not later than 120 days of the filing with the SEC, has determined that there has been a good faith and reasonable attempt by the issuer to comply with the applicable terms, conditions and requirements of the filing and upon a review of the filing, the SEC, not later than 120 days of the filing with the SEC, determines that any failure to comply with the applicable filing terms, conditions and requirements are insignificant to the offering as a whole. The non-preemption of pre-September 1, 1996 notice filing requirements would be retained.

[3] A number of reports and studies have addressed the difficulties small issuers face in raising capital. One prominent article suggests that NSMIA's statutory preemption provisions were not sufficiently broad, and encourages the SEC to use its delegated authority to expand the scope of the preemption. See Rutheford B. Campbell, Jr., *The Impact of NSMIA on Small Issuers*, 53 Bus. Law. 575 (1998). In the article, Professor Campbell concludes: "Small businesses may account for 40% of the business activities in this country, but capital formation rules have always discriminated against small businesses and imposed rules that make it unreasonably difficult for small companies to exploit external sources of capital. NSMIA, through its broad statutory delegation to the SEC of the right to expand the preemption of state blue sky laws, provides a unique opportunity for the Commission to deliver much-needed help to small issuers engaged in capital formation and to finally break the hegemonic hold states have over the rules governing capital formation by small businesses, Society will benefit if the SEC moves boldly to implement this delegated authority to expand the statutory preemption of NSMIA." See also Rutheford B. Campbell, Jr., *The Insidious Remnants of State Rules Respecting Capital Formation*, 78 Wash. U. L. Q. 407 (2000). In *Securities Regulations and Their Effects on Small Businesses*, California Research Bureau (2000), (available at http://www.library.ca.gov/crb/00/04/00-005.pdf) pp. 30ff, the author, Rosa Maria Moller, discusses in some detail the difficulties smaller issues face in dealing with the state regulation of securities and notes that, even under NSMIA, most small business offerings do not fall in the definition of covered securities. See also Jill D. Meyer, *Federal Preemption of the Rule 506 Exemption*, 37 Sec. Reg. L.J. 122 (2009).

4. The SEC is required, within 180 days after the Act is enacted, to implement procedures to promptly notify states upon completion of its review.

We believe, for a number of reasons, that the adoption of Section 926 of the Restoring American Financial Stability Act would be significantly detrimental to smaller companies who rely to a greater extent on private financings, and to our capital markets. Section 926 would impose considerable impediments to the private offering process and would largely restore private offerings to their status prior to NSMIA. At the very time that our markets require the confidence of institutional investors and their capital infusion into the private offering markets, the Section would add cost, delay and confusion to the private offering process, without necessarily providing any countervailing investor protection benefits.

Specific Critique of Section 926

Our specific comments with respect to Section 926 are as follows:

1. Section 926 does not specify what "filing" the SEC is expected to review. Presumably, this is Form D, which is the form submitted in connection with Regulation D offerings.[4] However, Form D is merely a notice filing, and includes only general information regarding the offering, and not any of the offering documents. Form D does not provide meaningful information upon which the SEC would be able to determine if an offering complies with the requirements of Rule 506. In fact, a number of conditions to Rule 506 are completely extrinsic to the information that is included in Form D, such as the condition of Rule 502(c) of Regulation D that neither the issuer nor any person acting on its behalf offered the securities by means of a general solicitation or general advertising.

2. The timing reflected in Section 926 does not make any sense to us. Section 926 provides that "the Commission shall review any filings made relating to any security *issued* under Section 4(2)" (emphasis added). Because the SEC's review would occur only *after* a security is issued (and many, if not most, Form Ds are also filed after the security is issued), any determination that the earlier offering and sale were not exempt under state securities laws would be completely untimely. Moreover, were a determination to be made subsequent to the time a security is issued that the security was not a covered security (or if the SEC did not make the necessary review or findings within 120 days after the issuer's filing), the consequences to an issuer could be devastating. The issuer may be required to extend a rescission offer to purchasers of the security, incurring considerable additional costs and effectively "undoing" the offering, notwithstanding the costs it may have incurred in connection with the prior offering.[5] The issuer may also be subject to enforcement proceedings for violation of applicable state securities laws, which could result in the

[4] Form D is available at http://sec.gov/about/forms/formd.pdf
[5] A rescission offer would give new investors a "second look" and require the issuer to offer to redeem the issued securities. Such a redemption would be detrimental to existing investors, and even the possibility of such an offer may be significantly adverse to an issuer.

imposition of fines and other penalties, and subject the issuer to injunctive or other relief. Very importantly, there would be no way an issuer that had completed an offering on the basis of a good faith belief that the security being offered was a "covered security" could avoid this result. An issuer would have no means of knowing whether the SEC will subsequently determine that the security it had issued is a covered security or whether the SEC will even review the filing within the mandated 120-day timetable. The risk that a security may lose its status as a covered security could, in fact, shut down the entire private offering market for smaller companies. Placement agents may determine that the risks they may incur in connection with such offerings do not justify their involvement in this market. Absent clarity as to an offering's state securities law compliance, a placement agent engaged in connection with an offering that is later determined to have been conducted in violation of state securities laws may be subject to liabilities to purchasers of the securities in each of the states where the offers or sales were made, as well as enforcement proceedings by state regulators and others. The chilling effect caused by Section 926 could, therefore, effectively foreclose the efforts of many smaller companies to raise capital.[6]

3. If the Senate's intention under Section 926 is for the SEC to review filings on a pre-issuance basis, the language in Section 926 appears to be completely contradictory to that intention. Because Form D is not required to be filed until 15 calendar days after the date of the first sale of securities in the offering, much of the information in the Form would be unavailable prior to the completion of the offering.[7] Moreover, the Form D does not require that any offering materials be submitted to the SEC. A pre-issuance review would therefore necessitate the creation of entirely new SEC filing obligations. Even if issuers were required to provide the SEC with offering materials used in connection with a Rule 506 offering, in many instances these documents do not exist. For example, in an "all accredited" offering, no private offering memorandum is required; instead, an issuer may satisfy its disclosure obligations by providing investors access to information from the company, and different investors may ask different questions and ask to review different documents.

4. Section 926 does not indicate the nature of the review the SEC would be required to undertake or the matters the SEC would be expected to consider in connection with any review. It is unclear, for example, whether the review process would be equivalent to what the SEC currently undertakes in connection with many registered securities offerings, and whether the SEC would be expected to engage in procedures comparable to the comment letter process applicable to registered securities offerings. A review obligation imposed on the SEC without any specified review parameters would, simply stated, be impossible for the SEC to administer.

[6] Because private offerings by exchange-listed companies would not be affected by Section 926, this segment of the market should continue unchanged. The impact would, therefore, be on the smaller companies, which often have no recourse to capital except through the private offering market.

[7] This includes information about the amount of securities sold (in Item 13 of Form D), the number of non-accredited investors and the total number of investors (in Item 14) and sales commissions and finders' fees expenses (Item 15).

5. Section 926 indicates that if the SEC does not review a filing within the 120-day time period, a security would not be deemed to be a covered security unless the SEC were to make other specified findings within that same 120-day period. We do not believe this process is at all practicable. If the SEC did not review a filing, it is hard to imagine how the SEC would be able to determine whether the issuer had made a "good faith and reasonable attempt to comply with all applicable terms, conditions, and requirements of the filing." It appears to us that such a determination would, at the very least, require a review of the filing, and that any such review by the SEC into the good faith and reasonable efforts of an issuer would require the commitment of considerable resources with respect to each filing subject to this analysis. We are unaware of any other situation under the securities laws where the SEC is expected to make any independent determination of an entity's good faith. The SEC may not even know, until late in the 120-day period, whether it will undertake and complete the review of a filing. To expect that, if it did not perform the review, it would nonetheless be able to make the alternate good faith and reasonableness findings within this same time period does not appear to us to be realistic.

6. Section 926 provides that following the completion of its review, the SEC is to "promptly notify the States." It is unclear to us whether this notification is intended to be simply a statement as to whether or not the SEC has determined that the security is a covered security, or whether any additional disclosure is expected.

7. An issuer would be left entirely in limbo during the review period, not knowing whether the SEC will conduct a review or make the other findings necessary for the security to be treated as a covered security. If the review contemplated by Section 926 is to be made prior to the issuance of securities, the effect of this delay could be to impose an automatic stay, of what might be over four months, on Rule 506 offerings. If the SEC does not confirm that the securities are covered securities (or make the other findings set forth in Section 926), the issuer would be required to then initiate the process of registering or qualifying the securities under state securities laws (or confirming the availability of exemptions therefrom). Although it may, at least theoretically, be possible for an issuer to complete its offering and then defer the closing until after the completion of the review period, this process would not be practicable. [8] An offering process that currently takes only a few months would be extended to many months, including the SEC review period and, if the SEC does not act in time, a further period for the issuer to undertake compliance with state law procedures. During this delayed period, the issuer would be obligated to continuously update its disclosure to investors, and may be required to permit investors to withdraw their subscriptions, thus undermining the efforts of the company and its placement agent to locate committed investors. Many investors may also be unwilling to have their cash subscription payments retained in an escrow account for a period of many months. By the time the issuer would be able to move toward completion of the transaction, it may have exhausted its available financial resources, the markets may have changed, the costs of the offering may

[8] Even this procedure may not be possible. Many states regulate the number of persons to whom offers may be made, and therefore any offer of the security in the state may depend on the SEC's review process.

have increased; additional financial statements may be required to be prepared for more recent fiscal periods and the entire disclosure package required to be provided to investors may need to be updated. If, in lieu of this lengthy process, the issuer assumes that its securities are not covered securities, it would be required to undertake the full blue sky process that the covered security designation of NSMIA was intended to avoid.

8. The SEC received over 25,000 Form D filings in 2006.[9] Since then, the SEC has adopted rules that would make it likely that a significant number of additional filings will be made annually.[10] By contrast, there are approximately 12,000 public companies in the U.S., whose SEC filings are required by statute to be reviewed at least once every three years.[11] Requiring the SEC to review Form D filings would impose considerable costs and burdens on the staff of the SEC, and would most likely require the redeployment of resources that are now needed to perform the SEC's mandated reviews of public company filings. The effect of Section 926 would therefore be to strain the resources of the SEC to unreasonable levels and could lessen the investor protections available to shareholders of public companies.

This list of objections is not intended to be exhaustive. It is instead intended to be illustrative of the unworkability of Section 926. In our view, the appropriate Congressional remedy would not be to eliminate the complexity of Section 926 by revising its language or by simply eliminating Section 18(b)(4)(D). In either case, the consequence would be to impose unreasonable costs, delays and other burdens on the private offering process. The appropriate response would, in our judgment, be to eliminate Section 926 in its entirety. In the absence of compelling testimony and definitive empirical data indicating that the private offering process is seriously flawed, the worst thing the Senate could do, especially against the backdrop of the challenges our economy currently faces, would be to tamper with this significant component of our capital markets.

Additional Considerations

By letter dated March 22, 2010, the Securities Law Committee of the Business Law Section of the Washington State Bar Association submitted to Senator Dodd its thoughtful and persuasive comments on Section 926. We wholeheartedly endorse the views expressed in that letter, and commend it to you for additional information regarding the context of the current regulatory regime relating to private offerings and the deficiencies in Section 926.

We also note that, in an announcement dated April 19, 2010, the President of the North American Securities Administrators Association ("NASAA") stated that the current version of

9 See note 109 at http://www.sec.gov/rules/proposed/2007/33-8814.pdf. Prior to March 16, 2009, Form D filings could be made either on paper or electronically. After that date, all such filings were required to be made electronically. According to EDGAR, issuers filed 20,021 Form D filings with the SEC in calendar year 2008. See page 42 of http://www.sec- oig.gov/Reports/AuditsInspections/2009/459.pdf

10 See "Electronic Filing and Revisions to Form D", SEC Release No. 33-8891, 34-57280, 39-2453, IC-28145 (February 6, 2008) at http://sec.gov/rules/final/2008/33-8891.pdf

11 See Section 408 of the Sarbanes-Oxley Act of 2002 http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_bills&docid=f:h3763enr.tst.pdf

Section 926 offers an unworkable regulatory review process that would impede capital formation. She indicated that "we believe the legislation should instead reinstitute the authority of states to use their so-called 'bad boy' provisions to disqualify recidivist securities violators who are now legally allowed to conduct private securities offerings under Regulation D Rule 506." Before proceeding with a legislative response based on this suggestion, we urge the Senate to consider the implications of implementing such a proposal. In our view, delegating to the states the authority to determine whether a securities offering qualifies for a federal exemption under Rule 506 of Regulation D would add significant complexity and inconsistency to what is intended to be a uniform rule. It could, we fear, add significantly to the burden of capital raising, and create significant confusion based on the many different and inconsistent state "bad-boy" provisions." If disqualification provisions were to be added to the conditions of Rule 506, we believe this should be done administratively by the SEC, after taking into account relevant considerations in order to insure uniformity.

Conclusion

As discussed above, the federal preemption of state securities laws played no role in our current financial crisis, and imposing greater burdens on the access of smaller companies to private capital would risk significantly harming, rather than helping, small businesses.

For the reasons set forth herein, we believe that, as proposed, Section 926 is significantly flawed in many respects and should be eliminated from the final version of the Senate bill. Most importantly, it would impose significant cost burdens and time delays on issuers engaged in capital formation, and would be detrimental to the interests of our capital markets and to our economy.

On behalf of the Section, thank you for considering our views on this important issue. If you have any questions, please contact Jeffrey Rubin, the Chair of our Committee, at 212-918-8224 or me at 813-229-4208.

Very truly yours,

Nathaniel Doliner
Chair, ABA Section of Business Law

cc: Members of the Senate Banking, Housing and Urban Affairs Committee
Jeffrey W. Rubin, Chair, Federal Regulation of Securities Committee, ABA Business Law Section
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