Consumer Federation of America

March 24, 2014

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

Re: File Number S7-11-13
Proposed Rule Amendments for Small and Additional Issues Exemptions under Section 3(b) of the Securities Act

Dear Secretary Murphy:

I am writing on behalf of the Consumer Federation of America (CFA)[1] to express our views with regard to the proposed rules implementing Section 401 of the JOBS Act. While there are aspects of the rule proposal that we support, it fails to achieve an appropriate balance between investor protection and capital formation. In particular, we strongly oppose its sweeping preemption of state oversight of Regulation A offerings without regard to congressional intent, to state efforts to streamline the state review process, or to the significant impact such a move could have on the level of market oversight at a time when the Commission's resources are limited. We therefore urge the Commission to withdraw its unwarranted proposal to preempt state offerings.

Background

Congress adopted Section 401 of the JOBS Act in response to evidence that issuers' use of Regulation A to raise capital had dropped dramatically since the late 1990s. As the Proposing Release correctly notes, Congress's intent was to expand and update the exemption to make it more useful to small companies. It sought to achieve this primarily by increasing ten-fold – from $5 million to $50 million – the amount of money that issuers are permitted to raise in reliance on Regulation A in a 12-month period. What Congress failed to fully explore before adopting the legislation was whether the drop in use of the Regulation A exemption was evidence of a

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[1] CFA is a non-profit association of nearly 300 national, state, and local pro-consumer organizations. It was formed in 1967 to represent the consumer interest through research, advocacy and education.

significant capital formation challenge for small companies or simply reflected a choice by issuers to rely on other available options to raise small amounts of capital.

Evidence cited in the proposing release, and in the GAO study mandated under Section 402 of the JOBS Act, suggests that a preference for other options may be a major factor, if not *the* major factor, in the decline in Regulation A offerings.

- While the number of issuers relying on Regulation A dropped significantly after 1998, the number who chose to raise capital in reliance on Regulation D rose sharply during the same period. In recent years, companies have raised billions of dollars each year through thousands of offerings of $5 million or less under Regulation D.

- In addition, issuers have raised much more money – hundreds of millions of dollars each year – through registered public offerings of $5 million or less.

This strongly suggests that issuers who are seeking to raise the small amounts of capital permitted under Regulation A are able to do so, but they choose to do so using other available options.

This apparent preference for other capital raising options may be based on reasons that will not be affected by even by the most sweeping of proposed revisions to Regulation A. Clearly, for example, changes to Regulation D adopted after passage of the National Securities Markets Improvement Act made it a more attractive option for companies seeking to raise capital without going through a full-scale registered public offering. Provisions in the JOBS Act allowing Reg D issuers to engage in general solicitation to promote their offerings are likely to further enhance Reg D's attractions for issuers. Regulation A may simply not be able to compete, particularly in light of the relatively small percentage of non-accredited investors for whom a significant investment in unregistered securities would be an appropriate investment. By creating a new crowdfunding market, the JOBS Act provided the smallest of these issuers with yet another such option. And, if it works as intended, Title I of the JOBS Act could make a registered offering as an emerging growth company an attractive option for issuers that might otherwise have found the increased threshold for Regulation A offerings appealing. Thus, even with the heightened investment threshold adopted in the JOBS Act and even if the Commission moved forward with its unwarranted preemption of state authority, Regulation A may simply not offer enough regulatory relief when compared with a registered offering or enough of an expanded potential investor base when compared with an offering under Regulation D to make it an attractive alternative.

Ultimately, while the Commission must faithfully implement the JOBS Act mandate, it must judge its success in promoting capital formation not merely by measuring any increase in use of Regulation A. To determine whether any change is meaningful, the Commission must also consider whether any increase in use of Regulation A is balanced by a decrease in use of other capital formation options and whether it is achieved at the expense of market efficiency or investor protection. If its efforts to make Regulation A more useful to small issuers simply cause these issuers to choose a Reg A offering over a different type of offering, it will have done little or nothing to promote net gains in capital formation. To the degree that the shift occurs in a way

that diminishes the amount of information available to investors – as would arguably occur if companies that currently choose to raise capital through a registered public offering choose to use Regulation A instead – then it will have the potentially harmful side effect of reducing transparency and thereby undermining the efficiency of the capital allocation process. If offerings that would have been sold exclusively or primarily to accredited investors under Regulation D are instead sold to unsophisticated retail investors under Regulation A, the risks to these less wealthy, less sophisticated investors would increase without any offsetting gain in capital formation.

The potential downsides of promoting use of Regulation A over other types of offerings do not appear to be fully considered in either the discussion of the proposed rules or the economic analysis accompanying the rule proposal. As a result, we do not believe this document provides a balanced analysis of the regulatory options available to the Commission. In light of that lack of balance in the underlying analysis and the highly unconventional approach the Commission has proposed to preempting state authority, we believe the proposed rule would be extremely vulnerable to legal challenge.

Comment on the Proposed Rules

The Commission proposes to implement Section 401 of the JOBS Act by generally retaining the existing standards for Regulation A offerings of $5 million or less and adding a new "Tier 2" of Regulation A offerings in the larger amounts permitted by the JOBS Act. We agree that Congress did not intend, in raising the investment offering threshold for Regulation A offerings, to increase the regulatory obligations for the small offerings previously permitted under Regulation A. Congress did, however, recognize that, as the amount allowed to be raised under Regulation A increases, the need for additional transparency and regulatory protections for investors also increases.

By dramatically increasing the threshold for Regulation A offerings to $50 million a year, with no aggregate cap, the JOBS Act takes Tier 2 Regulation A offerings out of the realm of very small offerings for which the exemption was originally designed. In our view, it is therefore appropriate to impose added requirements for disclosure on offerings that so closely resemble a standard registered offering, and both the statute and the proposed rules reflect that view. As a general matter, while there may be areas where the rules could and should be strengthened (as outlined in several comment letters from the state securities regulators, we believe the regulatory approach outlined in the proposed rules for Tier 2 offerings imposes disclosure and other requirements that are consistent with the level of investor protection needed in light of the significant amounts permitted to be raised through such offerings and the fact that these offerings can be sold to unsophisticated retail investors.

We have not attempted to comment on every aspect of the rule proposals. Instead, our comments focus on a few key issues with a particularly strong potential impact on investor protection.

1. CFA strongly opposes the proposed sweeping backdoor preemption of state oversight.

Based on an inconclusive GAO report about the role of state Blue Sky laws in deterring use of Regulation A and its own unsupported opinion that the revisions being made to Regulation A "would provide substantial protections to purchasers," the Commission proposes to broadly preempt state oversight of Regulation A offerings. It proposes to do so despite the fact that Congress considered preemption, though not as broad as that proposed here, and instead opted to maintain state authority except with regard to securities sold either on a national exchange or exclusively to qualified purchasers. To accomplish its goal of sweeping preemption of state oversight, the Commission proposes to define "qualified purchaser" in this context to mean essentially anyone, thus making a mockery of the congressional intent that the term be used to define "sophisticated investors, capable of protecting themselves in a manner that renders regulation by State authorities unnecessary."[2] We therefore object to this proposal both on its substance and because of the procedurally unacceptable means the Commission uses to achieve its ends.

When Congress first considered legislation to expand the Regulation A offering limit, it included a provision that would have preempted state oversight with regard securities "offered or sold through a broker-dealer." Minority members of the House Financial Services Committee objected to that provision on the grounds that it would create "a class of security not subject to state level review, but which will not receive adequate attention at the federal level."[3] They argued that "Regulation A securities are sometimes high-risk offerings that may be susceptible to fraud, making the protections provided by state review essential." While the amendment they proposed failed in Committee, it was reflected in the final language of the statute. One rarely finds such clear, unequivocal evidence of congressional intent. It is frankly shocking that the Commission would propose not merely to ignore congressional intent in this regard, but to adopt state preemption that is even more sweeping than that specifically rejected by Congress.

The means the Commission proposes to use to accomplish this goal is equally objectionable. As noted above, Congress intended the definition of qualified purchaser to identify a class of "sophisticated investors capable of protecting themselves." As the Commission well knows, a majority of Americans lack basic financial literacy skills, let alone the skills necessary to evaluate disclosures regarding the business plan and financial condition of a small start-up company and determine whether the securities are fairly valued. The Commission's own research as part of its congressionally mandated financial literacy study demonstrates widespread inability among investors to comprehend typical disclosure documents. Yet, against that backdrop, the Commission proposes a definition of "qualified purchaser" that assumes anyone who purchases or is offered shares in a Tier 2 Regulation A offering has the requisite sophistication to protect themselves against fraud without the added protections afforded by state oversight.

While it is true that Congress gave the Commission authority to define the term qualified purchaser differently for different types of offerings, this flexibility was clearly intended to reflect the fact that different types of offerings have different characteristics and thus the

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[2] H. Rep. No. I 04-622, 31-32 (1996)
[3] House Committee Report 112-206, Minority Views on H.R. 1070.

standards for investor protection would vary accordingly. There is no basis for concluding that Congress proposed to give the Commission the authority to define the term in a way that completely obliterates its intended meaning. But that is what the Commission has done in this rule proposal. We therefore urge the Commission to withdraw its proposed definition of qualified purchaser until it can better consider an appropriate definition, perhaps in concert with its reconsideration of the definition of accredited investor.

The Commission justifies its proposal to preempt state authority on the "substantial investor protections embedded in the eligibility requirements, limitations on investment, disclosure requirements, qualification process and ongoing reporting requirements of proposed Tier 2 of Regulation A." Even if the protections were as "substantial" as the Commission maintains, this would not justify the Commission's attempt to substitute its judgment for the judgment of Congress on the question of state preemption. In fact, however, while we strongly support the enhanced disclosure and ongoing reporting requirements, the evidence suggests that many investors will not be able to make good use of this information (as discussed above). Similarly, while we strongly support the proposal to require qualification through Commission order (as discussed below), we remain concerned that the Commission will lack adequate resources to conduct the kind of pre-offering review that would be all the more vital if state review authority were eliminated. The investment limit, meanwhile, is too high to meaningfully limit the risk that investors will suffer unaffordable losses, and it lacks an effective enforcement mechanism (as discussed below). Moreover, if it were interpreted as reflecting a level of investment that would be deemed suitable for most investors, it could actually result in increased investor harm. Under the circumstances, the investment limit certainly cannot be relied on to justify an elimination of state oversight.

Ironically, the Commission proposes this sweeping preemption of state authority without any conclusive evidence that it will result in increased use of Regulation A by small issuers. The GAO report identifies state review as just one of several factors that deter use of Regulation A. Others include the cost-effectiveness of Regulation A relative to other exemptions and the process of filing and qualifying the offering with the Commission. With general solicitation now permitted in Regulation D offerings, the option of a Reg D offering is likely to be viewed even more favorably than it was in the past. Given the ability to raise unlimited amounts of money subject to much looser regulatory requirements under Reg D, there is strong reason to believe that Regulation A will continue to be viewed as a less cost-effective option by many issuers, even with the proposed streamlining of the filing process and the increase in the offering ceiling for Regulation A. Preempting state oversight authority may therefore have little impact on use of the exemption while significantly reducing the level of regulatory oversight provided for those offerings that do occur in reliance on Regulation A.

Finally, the states working through NASAA have set in motion a process for further streamlining and better coordinating state review of Regulation A offerings. That effort has the potential to significantly reduce the cost and delays currently associated with state reviews. (Though, to be clear, it is not evident that state review imposes delays longer than those required for Commission review.) That process deserves to be given time to play out before a decision is made about whether further preemption of state oversight is warranted. And, as noted above, it

is up to Congress, not the Commission, to decide whether preemption beyond the narrow preemption authorized by the legislation is warranted.

Because the current proposal is not supported by the statutory language or congressional intent, is not justified based on the evidence offered, and is premature in light of changes occurring at the state level, we strongly urge the Commission to withdraw its state preemption proposal. Specifically, we urge the Commission to withdraw its proposed definition of qualified purchaser until it can better consider an appropriate definition that identifies a pool of sophisticated investors who do not need the protections afforded by state oversight. Given the similar purposes of the two definitions, and the clear interplay between to two exemptions, this could perhaps best be accomplished in concert with the Commission's reconsideration of the definition of accredited investor for Regulation D offerings.

2. CFA urges clarification that investor limits do not substitute for a suitability analysis.

We appreciate that, in proposing to set a ceiling on investor purchases of Tier 2 offerings, the Commission is trying to limit the potential for investors to suffer unaffordable losses in securities of the small start-up companies likely to raise capital through Regulation A. We are unconvinced, however, that the proposed limit will provide the desired level of protection. First, the proposed limit – based on the greater of 10 percent of the investor's income or net worth – is significantly higher than would be appropriate for all but the wealthiest, least risk averse of the investors permitted to invest in Regulation A offerings. Moreover, this is a per-offering limit, not a limit on an investor's overall investment in such securities. So, even with this limit in place, an investor could conceivably invest all of his or her money in such securities. In addition, the limit is not backed by any sort of effective enforcement mechanisms. As a result, while we do not oppose the proposed limit, we do not believe it offers a meaningful increase in protections for investors in these offerings and therefore cannot be relied on to justify preemption of state oversight.

There could even be an unintended harmful effect of the limit if investors investing in such offerings or brokers making recommendations to customers interpret the limit as reflecting a level that would be deemed suitable for these investors. We urge the Commission to clarify that the investment limit is not intended to substitute for a suitability analysis designed to determine the level of investment in small start-up companies that would be appropriate for a given investor in light of his or her financial situation and risk tolerance. Moreover, the Commission should further clarify that for most investors a suitable percentage of their portfolio holdings in such offerings would be far less than 10 percent of income or net worth permitted under the proposed investment limit.

3. CFA strongly supports qualification by Commission order.

The Commission proposes to eliminate existing procedures that could allow a Regulation A offering to become qualified without prior review by the Commission staff. As the GAO report makes clear, "the process of receiving and addressing comments from SEC could entail

multiple rounds" and often requires issuers "to clarify accounting-related information." While this imposes costs on issuers, it is critical to ensuring that investors receive accurate and reliable information on which to base their investment decision. If the changes to Regulation A do lead to an increase in Regulation A offerings, and if the SEC does not receive additional resources to offset this increased workload, the agency could find it challenging to complete the necessary reviews in a timely fashion. Under such circumstances, it could become all too likely that offerings would be qualified without ever receiving a thorough prior review. Requiring offerings to become qualified through an order of the Commission should help prevent this from occurring, though it does not entirely eliminate the risk that reviews will lack rigor. Because of its potential to help reinforce the review process, we strongly support the requirement that offerings be qualified through order of the Commission. It is absolutely essential if the Commission, against our strong recommendation, decides to move forward with its proposal to preempt state oversight.

4. CFA opposes the proposed elimination of the integration policy for Regulation A offerings.

Regulation A offerings are currently subject to a clear safe harbor such that they are not subject to integration with any other offer or sale made either before the commencement of, or more than six months after, the completion of the Regulation A offering. Transactions that occur concurrently with or soon after a Regulation A offering may or may not have to be integrated, based on the particular facts and circumstances of the offering. The Commission now proposes to exempt all such offerings from integration requirements as long as each offering follows its respective regulatory requirements. As we discussed in our comment letter on the crowdfunding proposal, we believe this is an ill-advised proposal that will be difficult if not impossible to police and thus will inevitably be used to evade regulatory requirements. We are disturbed, moreover, that the Release presents this as a tweaking of the existing integration policy, rather than what is really is: a sweeping elimination of that policy. Such a major policy change deserves more careful consideration and more thorough analysis than it appears to have received in this release.

5. CFA urges the Commission to adopt strengthened audit standards.

We are also concerned that the Commission proposes to allow audits of financial statements to be conducted based on industry (AICPA) rather than independent (PCAOB) auditing standards and to be conducted by non-PCAOB-registered auditors. The Sarbanes-Oxley Act gave PCAOB authority to set auditing standards precisely because, as we noted at the time, the industry standards were so weak as to be unenforceable. They served primarily to protect auditors from liability rather than to promote reliable financial reporting. While we could wish that the PCAOB had moved more quickly to update and strengthen those standards, the changes adopted since PCAOB took over the standard-setting responsibilities have been significant. The Commission has failed to demonstrate that requiring audits to be conducted based on PCAOB standards would create an undue problem for issuers. Absent any evidence (as opposed to speculation) that such a requirement would create a barrier to capital formation, the Commission

should adopt the standards for audits of Regulation A issuers that are appropriate for issuers selling their shares to the public. Those are the standards promulgated by PCAOB. Moreover, because PCAOB oversight provides an important mechanism to ensure that auditors are meeting the appropriate standards, and because the Commission has offered no evidence that this requirement would create a hardship for issuers, the Commission should also require that the audits be conducted by PCAOB-registered auditors.

Conclusion

It remains to be seen whether issuers will view the new Tier 2 Regulation A offering as an attractive option for capital formation. It may be that the significant regulatory protections necessary for such offerings will not be viewed as cost-effective when compared with other options available to raise comparable amounts of capital, including both private offerings under Regulation D and public offerings as an emerging growth company. If that it is the case, it should not necessarily be interpreted as a failure of the proposed regulations. Rather, it may simply reflect the fact that sale of securities to average retail investors demands a level of regulatory protection that is simply not affordable for many companies seeking to raise small amounts of capital and that, for those issuers that can afford the regulatory expense, a public offering that is only incrementally more expensive may simply be a more attractive option. As long as small companies have available options for raising capital – and the evidence suggests that they do – this should not be viewed as a cause for concern. Of far greater concern is the attitude, reflected in this release, that the Commission must do everything in its power to promote use of Regulation A, even at the expense of investor protection. We urge you to reject this approach, which is inconsistent with the central mission of the agency and, to the degree that it undermines confidence in the safety and integrity of the markets, ultimately harmful to capital formation.

Respectfully submitted,

Barbara Roper
Director of Investor Protection

cc: The Honorable Mary Jo White, Chair
The Honorable Luis Aguilar, Commissioner
The Honorable Daniel Gallagher, Commissioner
The Honorable Michael Piwowar, Commissioner
The Honorable Kara Stein, Commissioner