Consumer Federation of America

September 23, 2013

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

Re: File No. S7-06-13

Dear Secretary Murphy:

I am writing on behalf of the Consumer Federation of America[1] in response to the Commission's request for comments regarding proposed amendments to Regulation D, Form D, and Rule 156. CFA strongly supports strengthened protections for investors in private offerings under Rule 506 of Regulation D. We have previously voiced our strong opposition to the Commission's decision to permit general solicitation without taking any meaningful steps to ensure that investors are adequately protected. So we welcome the Commission's proposal to address those concerns, albeit belatedly, through new filing and content requirements for Form D and new warnings on solicitation materials. Unfortunately, the reforms put forward in this release are far too weak to effectively counter the increased risk of fraud caused by lifting the general solicitation ban, to prevent misleading private fund advertising practices, or even to alert investors to the risks of investing such offerings. If the Commission is to fulfill its investor protection mission, it must first significantly strengthen these proposals and then adopt them without further delay.

Background

The Regulation D market is a huge and thriving market that, while dominated by private fund offerings, offers an important venue for small start-up companies to raise capital. With thousands of often tiny offerings occurring each year and limited regulatory oversight, however, the Regulation D market also offers a perfect venue for swindlers seeking to raise money from investors with no intention of ever operating a legitimate company. The number of offerings in and of itself is a serious impediment to effective oversight by under-funded regulators. Moreover, under existing rules for Form D filings, regulators typically receive no advance warning of offerings and only minimal information about offerings even after they have

[1] The Consumer Federation of America (CFA) is an association of nearly 300 non-profit consumer organizations that was established in 1968 to advance the consumer interest through research, advocacy, and education.

commenced.[2] This lack of advance notice further undermines the ability of even the best intended regulators to detect and deter fraud. Given this fertile environment for fraud, it should come as little surprise that Regulation D offerings are a leading source of enforcement actions by state securities regulators.[3] As Commissioner Luis Aguilar has previously noted, however, it is a sad fact that defrauded investors' money is likely to be "long gone by the time the fraud is identified and an action can be brought."[4]

By lifting the ban on general solicitation and advertising, the JOBS Act simultaneously increased the risk of fraud in Rule 506 offerings and deprived the Commission of its most effective tool to combat that fraud. Lifting the solicitation ban was intended to make it easier for issuers to attract investors, but it also makes it easier for con artists to reach a wider range of victims with their scams, and to do so without automatically triggering regulatory scrutiny. Previously, the mere existence of general solicitation provided an immediate "red flag" of a possibly fraudulent offering. Regulators could quickly and efficiently shut down such an offering for violating the solicitation ban without first having to go through a potentially lengthy, fact-intensive exercise to prove the offering was fraudulent. In legalizing general solicitation, the JOBS Act eliminated both the red flag that warned regulators of potential fraud and their best available tool for shutting down fraudulent offerings before investors' money is irretrievably lost.

The most important question the Commission faces now, therefore, is how best to respond to this heightened fraud risk without unduly limiting legitimate issuers' ability to raise capital. With this in mind, the top regulatory priority should be to make this market less attractive to swindlers, to ensure that regulators receive advance warning of potentially fraudulent offerings, and to provide them with new tools to shut down any such offerings quickly while it is still possible to recover at least a portion of investor funds. The benefits to investors of such an approach are obvious. But legitimate issuers should also reap rewards: 1) if investors are able to trust in the integrity of the market and thus are more willing to invest in private offerings and 2) if money that could have gone to support legitimate businesses isn't diverted into fraudulent schemes. The addition of a pre-solicitation Form D filing requirement could provide an effective tool for addressing this risk, but only if that provision is expanded and strengthened. It is essential, for example, that the Commission has enforcement tools available that allow it to quickly halt an offering that has failed to comply with the pre-filing requirement. The proposed approach does not appear to provide those tools.

Less dramatic but still a significant problem in need of prompt regulatory attention is the potential for misleading general solicitation and advertising practices by otherwise legitimate issuers. Past experience in the mutual fund market has provided ample evidence that, absent basic performance reporting standards, funds are likely to make performance claims that are at best confusing and at worst misleading. Yet the proposing rules do nothing to ensure that private

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[2] This lack of information is extensively documented in the proposing release.

[3] In 2011, state regulators took more than 200 enforcement actions related specifically to Rule 506 offerings (more than 250 in 2010; 175 in 2009), according to figures compiled by the North American Securities Administrators Association.

[4] "Increasing the Vulnerability of Investors," Statement by Commissioner Luis A. Aguilar, U.S. Securities and Exchange Commission Open Meeting, August 29, 2012.

funds that include performance claims in advertising and solicitation materials base those claims on a generally accepted methodology and report them in ways that reduce the potential to mislead. Indeed, the Commission appears to suggest that even clearly misleading practices – such as reporting performance gross of fees – would go unchallenged. Adding boilerplate legends to solicitation materials is not an adequate response.

An additional regulatory priority should be collecting the kind of information about Regulation D offerings necessary to inform Commission policymaking and enforcement efforts. Supporting materials for this rule proposal and the recently finalized general solicitation rule make clear just how limited the data is on which important policies are being based. Indeed, Congress fundamentally altered the division between public and private markets, and the Commission implemented that radical policy, based on shockingly paltry information about its likely economic consequences. Improving the Commission's ability to gather and analyze data about the private offering market is a laudable goal, made more important than ever by the recent decision to allow "private" offerings to be marketed publicly. We support these efforts, which are reflected in the proposals to enhance the content requirements for Form D, to restore the requirement to amend the filing at the closing of the offering, and to require the filing, albeit on a temporary basis, of written general solicitation materials.

We are nonetheless frankly bewildered by the Commission's seemingly single-minded focus on this issue of data collection in justifying its regulatory approach in this rule proposal. By focusing almost exclusively on information collection, rather than on investor protection, the Commission has ignored the strongest arguments for strengthened regulatory protections. As a result, it has proposed rules that are too weak to promote the kind of market integrity and transparency on which capital formation thrives. On the other hand, without the market information these proposals would provide, the Commission cannot hope to adequately oversee this increasingly important market, let alone assess the impact on either capital formation or investor protection that lifting the ban on general solicitation will have. We therefore urge the Commission to act promptly to adopt the proposed reforms, with strengthening amendments, as discussed below.

I. CFA Supports the Proposed Form D Pre-Filing Requirement but with Stronger Sanctions for Non-Compliance

The single most significant provision in this otherwise timid set of proposed rules is the proposal to require issuers who wish to engage in general solicitation to file an "Advance Form D" 15 days prior to conducting any general solicitation activities. Pre-filing offers two important benefits. First, state securities regulators – who as the proposing release notes "routinely review Form D filings" to identify potentially problematic offerings – would get that information earlier, while there is still a chance to prevent investor harm. Second, under such an approach, engaging in general solicitation without first filing an Advance Form D would, in and of itself, serve as a red flag of a potentially fraudulent offering, just as engaging in solicitation in violation of the ban has done in the past.[5] This latter point is particularly important, since most con artists are likely

[5] We are not suggesting that all offerings that failed to comply with the pre-filing requirements would be fraudulent, only that it would provide a useful danger sign that could help regulators to know where best to focus their oversight efforts.

to ignore the legal niceties of complying with filing requirements. In a market that includes thousands of offerings, providing a mechanism to help regulators focus their oversight on those that pose the greatest risk is essential. Effectively implemented, the pre-filing requirement has the potential to provide that mechanism, significantly improving regulators' ability to detect and deter fraud.

We question the Commission's decision to apply this requirement only to offerings that include general solicitation activities, however. Many of the benefits ascribed to this approach, such as making it easier for state regulators to identify offerings that include the participation of "bad actors" or that otherwise don't qualify for the exemption, are not limited to offerings in which general solicitation occurs. While we agree that offerings that include general solicitation represent the greatest threat, there are considerable risks and oversight challenges in the rest of the market as well. As noted above, Regulation D offerings were already a leading source of state enforcement actions even before the solicitation ban was lifted. Moreover, having one clear set of rules for all Regulation D offerings should reduce the potential for confusion regarding compliance obligations.

Predictably, some industry members have questioned the feasibility of complying with a pre-filing requirement. This strikes us as patently absurd. The 15 days advance notice the Commission proposal calls for is hardly onerous. The information required to be filed in advance is minimal. And the mechanism for filing the form makes compliance extremely easy. The fact that some industry participants might prefer to act more quickly is not sufficient reason to deprive the Commission of this important investor protection tool. We therefore urge the Commission to ignore the calls to weaken this provision which, as we have already noted, is the only provision in the entire rule proposal that attempts to address the most serious regulatory problem facing the Commission – the increased risk of fraud.

On the contrary, we believe the Commission must strengthen the penalties that apply to violations of the pre-filing requirement to reap the full benefits of this regulatory change. In thinking about penalties, one goal should be to create an incentive for compliance by legitimate issuers. This appears to be the thinking behind the Commission's proposed approach of disqualifying individuals who violate the pre-filing requirement from participating for a year in future Rule 506 offerings. This is an improvement over the existing system, which requires court action to trigger disqualification. Effectively implemented, it should provide a greater incentive for compliance by otherwise legitimate issuers who have become complacent about compliance in the absence of consequences for compliance failures.

But the proposed sanction will only serve even this limited purpose if the Commission is consistent in imposing that sanction. Toward that end, waivers must only be granted in rare instances of truly innocent compliance failures by well-intended issuers who act quickly to address the problem once it is brought to their attention. Otherwise, the penalty will become just one more meaningless sanction that is rarely imposed, perpetuating the current cynical disregard of filing obligations. The proposal suggests that this is all too likely to be the case, since it in essence removes the sanction entirely for those who complete the required filing within a cure period after the filing is due. By automatically exempting from sanction both knowing and accidental failures to meet the pre-filing deadline, this proposed approach sends the clear message that the Commission does not in fact take the filing requirement seriously and is not prepared to enforce it. Late filings are likely to become the norm if this lax approach to enforcement is adopted.

Furthermore, while the proposed approach might be sufficient for basically conscientious legitimate issuers, assuming it were actually enforced, stronger sanctions are called for in the case of repeat offenders and others who demonstrate a reckless disregard for the law. At a minimum, such offenders should suffer a longer, or even permanent, disqualification. A different challenge is posed by the con artists for whom disqualification is unlikely to provide any meaningful deterrent. The priority in these cases is to quickly shut down the fraud, minimizing investor losses. The proposed sanction does not provide that mechanism. This is a major weakness in the current proposal that must be fixed before the rule is finalized.

One weakness in all these proposals is that they rely on Commission action to be effective. Commission oversight of this market has been notably weak. The JOBS Act increased the enforcement challenge, but Congress does not appear likely to provide the additional funding needed to help the Commission meet that challenge. Thus, we think investors would be better served by an enforcement mechanism that is less dependent on Commission action. In that regard, the proposed approach of conditioning reliance on the Regulation D exemption on compliance with the pre-filing requirement strikes us as a much better approach. The argument against this approach – that it would impose "disproportionate" consequences for failure to file a form that is intended primarily to provide information to the Commission – fails to take into account either the importance of the filing requirement for fraud prevention efforts or the lack of Commission resources for effective enforcement. In addition, it fails to acknowledge the degree to which the sanction can be appropriately softened through combination with an appropriate cure period to correct unintended filing failures or other technical errors while still relying on the Regulation D exemption.

II. Stronger Rules are Needed to Prevent Misleading Advertising Practices

While the JOBS Act was sold as a measure to promote small company capital formation, the biggest beneficiaries of the general solicitation rules are private funds. As the release notes, roughly 80 percent of the money raised through Rule 506 offerings is raised by private funds rather than by operating companies. Moreover, while investor money is concentrated in a relatively small number of very large private funds, there are literally thousands of smaller private funds competing to attract investor capital. It is these smaller, sometimes struggling, funds that are, in our view, most likely to engage in general solicitation to attract investors.

Past experience suggests that a significant number of these funds will engage in questionable advertising practices in the process. Specifically, funds that are struggling to attract capital are likely to engage in precisely the sort of misleading advertising practices that mutual funds engaged in the 1980s, before the rules for mutual fund performance claims were strengthened. Likely problems include: using questionable methodologies to calculate performance; reporting performance for time periods selected to create an artificially inflated picture of fund performance; or reporting performance gross of fees, a particularly troubling practice for private funds where the fees can be exorbitant. The proposed rules are completely inadequate to address this concern.

In justifying its decision not to impose content restrictions, the Commission cites the argument put forward by some industry commenters that "the risk of investor harm is limited because only accredited investors can purchase private funds offered under Rule 506(c)." But the Commission offers no evidence that individual (as opposed to institutional) accredited investors have the sophistication to see through these confusing and deceptive advertising practices. In fact, as the Commission acknowledges elsewhere in the release, the financial thresholds in the accredited investor definition have been seriously eroded over time. And wealth alone has never served as a very good proxy for financial sophistication. It is particularly disappointing that the Commission continues to delay action to address fundamental shortcomings in the accredited investor definition while using the accredited investor restriction as a justification for failing to adopt other needed investor protections.

The other justification put forward in the Release for inaction on this issue is that antifraud provisions provide sufficient recourse against misleading practices. But the Release itself suggests that the Commission has no intention of using that authority to rein in misleading practices. For example, the Release makes clear that the Commission intends to permit private funds to include performance data that does not reflect the deduction of fees and expenses in their written general solicitation materials. The only requirement the Commission is proposing in such cases is a legend stating that fees and expenses have not been deducted and that, if such fees and expenses had been deducted, "performance may be lower than presented." So, not only does the Commission clearly intend to permit a practice that is inherently misleading, but it intends to require only the most absurdly weak boilerplate disclosure to ameliorate the potential harm. Moreover, the proposed sanction for failing to include the required disclosure would require a court injunction to trigger disqualification. This is precisely the approach that the Commission acknowledges rarely using to enforce the current Form D filing requirement. Under the circumstances, there is no reason to believe it will be effectively enforced in this context.

In addition to the proposed legends specifically for private funds, the rule proposals also include additional requirements for all offerings under Rule 506(c). With the ban on general solicitation lifted, accredited and non-accredited investors alike will be exposed to marketing materials for "private" offerings. We share the concern expressed in the Release that, as a result, "prospective investors may not be sufficiently informed as to whether they are qualified to participate in these offerings, the type of offerings being conducted and certain potential risks associated with such offerings." In response to this concern, the Commission has proposed to require a series of legends to be included on written solicitation materials for offerings made in reliance on Rule 506(c). Importantly, the Commission makes clear that including these legends does not relieve issuers of their responsibility to verify that purchasers are accredited investors.

While we support this action, we are not persuaded that the proposed legends will provide adequate warning of the risks involved in investing in private offerings. First, the messages to be conveyed do not adequately highlight the potential risks. A general warning that investing in securities carries risks, for example, fails to convey the added risks associated with private offerings. Disclosure that the securities are being sold under an exemption from the Securities Act of 1933 does not adequately convey the looser standards that apply to these offerings, where little verifiable information may be available to assess the company's financial status or prospects. Disclosing that the securities can only be sold to accredited investors who meet certain income or net worth requirements doesn't adequately convey the reason behind this restriction – that it is intended to ensure that the risky offerings are sold only to those investors who can fend for themselves without the protections afforded in the public markets.

This shortcoming in the proposed legends is exacerbated by the fact that the proposal would permit issuers to choose their own wording for the legends. The combination of vague messages and issuer flexibility in conveying those messages is an invitation to ineffective disclosures. Under such an approach, the burden of proof will inevitably fall on the Commission to show why vague or even misleading disclosures do not satisfy the requirements. Given its limited resources, we question the ability of the Commission to enforce this requirement in a way that ensures that legends are clear and not misleading.

Instead, in order to reap the intended benefits of this approach, the Commission should sharpen the messages to be conveyed through the required legends. In doing so, the Commission should test the proposed disclosures to determine whether they are likely to be effective in conveying the risks associated with private offerings and then require the use of those legends that testing shows to be most effective. If the Commission finds, as a result of that testing, that it cannot develop disclosures that are effective in communicating the risks of investing in Rule 506 offerings, it would need to rethink its approach. Among other things, such a finding would reinforce concerns that the current accredited investor definition does not provide adequate assurance that purchasers of Regulation D offerings are sufficiently financially sophisticated to understand the risks.

III. The Proposed Form D Changes Should Help to Improve Market Oversight and Analysis

The proposed rules also include changes to the content of Form D along with the addition of a new filing requirement at the closing of the offering. Together, these changes should provide the Commission with better information to use in overseeing these markets. The supporting materials in both this rule proposal and the recently finalized rule lifting the ban on general solicitation make it abundantly clear that the Commission lacks even the most basic information on which to base its policy decisions. Among other things, it is apparently unable to provide complete and reliable information about the nature of issuers who raise capital through such offerings, the investors who purchase them, the size or success of the offerings, the methods used to verify accredited investor status of purchasers, or the methods used to attract investors. Given that private markets have come to rival our public markets in size and importance, this is a serious gap in our regulatory system.

The Commission's proposal to add new items to Form D and to require the filing of a revised Form D at the closing of the offering should help to close that regulatory gap. In particular, we strongly support the Commission's proposal to:

- Require disclosure of the name and address of "any person who directly or indirectly controls the issuer," which should help to prevent the indirect involvement of "bad actors" in the offering;

- Eliminate the "decline to disclose" option with regard to the size of the issuer for issuers who otherwise make that information publicly available or make no effort to protect its confidentiality;
- Require additional information about the number of accredited and non-accredited investors, the percentage who are natural persons, and the amount of money raised from those investors;
- Elicit additional information about how the proceeds will be used, which is essential information for purchasers of the securities to understand;
- Require information about the types of general solicitation to be used for Rule 506(c) offerings; and
- Require information about the methods to be used to verify accredited investor status.

Reinstating the requirement for a closing Form D would further enhance the benefits of this approach by providing additional information on the size and characteristics of this market.

In light of the Dodd-Frank Act requirement that the Commission periodically assess the accredited investor definition, we believe the Commission should consider what information it will need to conduct that assessment. For example, in addition to requiring information on whether accredited investors who are natural persons meet the income or net worth test, the Commission should consider collecting additional information about their level of income or net worth. If the Commission found, for example, that the vast majority of private fund investors met the qualified purchaser definition, it could assume that raising the income and net worth thresholds for the accredited investor definition would have little if any impact on investment in these funds. If on the other hand further analysis showed significant participation by investors clustered near those financial thresholds, that might suggest that more extensive investor protections are needed to protect a more vulnerable investing population. We therefore believe the Commission may want to consider including further information along these lines to better inform its rulemaking.

IV. The Proposal to Require Submission of Solicitation Materials Should Be Made Permanent

The proposal also includes a temporary requirement that issuers who wish to engage in general solicitation submit their written solicitation materials to the Commission not later than first use of the materials. The Commission has pledged to provide enhanced oversight of the Regulation D market in order to monitor practices in the market now that general solicitation is permitted. Among other things, it has said it intends to study the types of solicitation practices engaged in and materials used in order to determine whether additional investor protections are needed. We do not see how the Commission can fulfill this commitment without collecting better data on solicitation practices, as this rule proposal would allow.

However, the potential benefits of this proposal go beyond those of studying the impact of the elimination of the solicitation ban. First and foremost, having direct access to solicitation materials would make it easier for state regulators and the Commission itself to identify certain offerings that seem to pose increased risks of fraud, as well as those where the solicitation materials are misleading. Because this potential benefit is ongoing, the requirement to submit solicitation materials should also be permanent. Furthermore, we see no reason to assume that solicitation practices will remain unchanged in the years to come. If the Commission ends the requirement as proposed after two years, it will lose the opportunity to easily monitor that change and respond promptly when needed. Moreover, in light of rapid changes in communication technology, a focus simply on written materials strikes us as too narrow. At the very least, the Commission should seek to capture written, video, and audio materials through this program, which could be easily accomplished with today's technology.

If this program is expanded and made permanent, it could significantly enhance the Commission's ability to monitor this important market.

V. The Accredited Investor Definition Must Be Strengthened

Throughout this and its previous general solicitation rule proposal, the Commission justifies its failure to take stronger action to protect investors on the grounds that sales in Regulation D offerings are largely limited to accredited investors. This is, for example, one justification the release offers for not taking steps to adopt standards governing performance claims in private fund solicitation materials. But the Commission has offered no evidence that individual accredited investors do in fact typically have the level of financial sophistication, or even the wealth to withstand financial losses, that would justify such an approach. We are therefore gratified that the Commission is finally beginning deliberations on whether the accredited investor definition should be amended and, if so, how.

To the first question of whether the definition should be amended, we believe the answer is an unequivocal "yes." We realize that certain industry groups are likely to push back against any significant strengthening of the definition. But the burden of proof should be on those groups resisting change to demonstrate that the existing threshold satisfies the Supreme Court test of identifying a group of investors with the financial sophistication to understand the risks of investing in private offerings and the financial wherewithal to withstand potential losses. We have little doubt that, to the degree that it ever did, the current definition has long ceased to identify a population of investors who are capable of "fending for themselves" without the added protections afforded in the public markets. As we discussed at some length in our October 3, 2012 letter to the Commission, financial wealth is a poor proxy for financial sophistication, and the erosion caused by inflation has left the current thresholds also inadequate to identify a population with the financial wherewithal to withstand potential losses. And yet the definition has become more important than ever with the lifting of the ban on general solicitation.

Answering the question of whether the definition should be amended is easier than answering the question of how the definition should be adjusted. We will comment at more length in the future with our ideas in this area. In the meantime, we encourage the Commission to consider the following thoughts. The simplest solution, adjusting the thresholds to account for inflation, may not be sufficient given the added importance of the definition under the new market conditions. We also question whether income alone, absent any past significant experience with investing, should satisfy the definition. Retirees are a vulnerable population that should be given special consideration when the Commission considers both the adequacy of the current definition and various options for changing that definition. Finally, the approach taken in the current definition – of relying on income and net worth alone – appears to be much narrower than Congress anticipated when it passed the Small Business Investment Incentive Act. That legislation included financial sophistication, knowledge and experience among the factors to be considered as part of an accredited investor definition. We would encourage the Commission, as it explores this issue, to consider how it can best incorporate such factors into the definition.

Conclusion

We have made no secret of our view that, in lifting the ban on general solicitation without adopting appropriate investor protections, the Commission abrogated its central responsibilities to protect investors and promote market integrity. While we welcome the Commission's belated attention to these issues, we are concerned that the rule proposals put forward by the Commission in this Release are simply too weak to address effectively the central concerns of increased fraud and misleading practices that arise as a result of the solicitation ban's being lifted. At least in part, the weakness of these proposals seems to flow from the Commission's failure to formulate a sound basis for regulatory action. In particular, the Commission has failed to give adequate consideration to how regulations could and should be strengthened to reduce the risk of fraud, to improve the Commission's ability to act in the face of fraud, and to prevent confusing and misleading advertising practices. We urge the Commission to strengthen its proposed approach to address these central concerns.

Respectfully submitted,

Barbara Roper

Barbara Roper
Director of Investor Protection

cc: Chair Mary Jo White
Commissioner Luis A. Aguilar
Commissioner Daniel M. Gallagher
Commissioner Michael S. Piwowar
Commissioner Kara M. Stein