# Keith Paul Bishop

KBishop@post.harvard.edu


October 1, 2007

**Via Email (rule-comments@sec.gov)**

Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE,
Washington, DC 20549-1090

Re: File No. S7-18-07

Dear Ms. Morris:

I am writing to comment on the Securities and Exchange Commission's (the "**Commission**") proposal to amend Regulation D under the Securities Act of 1933, as amended (the "**1933 Act**").[1]

## 1. Background.

I am an attorney in private practice in Irvine, California and an Adjunct Professor of Law at Chapman University Law School. I am writing in my individual capacity and not on behalf of my law firm, the law school or any of my law firm's clients.

I previously served as California's Commissioner of Corporations and in that capacity administered and enforced California's securities laws.[2] On July 24 1997, I testified at an oversight hearing on securities litigation abuse conducted by the Subcommittee on Securities of the U.S. Senate Banking, Housing and Urban Affairs Committee.[3] At that hearing, I testified in support of federal legislation adopting uniform

---

[1] 15 U.S.C. §§ 77a et seq.

[2] I have also served as Co-Chairman of the Corporations Committee of the Business Law Section of the California State Bar and Chairman of the Business and Corporate Law Section of the Orange County (California) Bar Association. As indicated above, this letter is written in my individual capacity and not on behalf of either of these groups.

[3] As a result of the testimony received at the hearing, Senators Gramm, Dodd, Boxer, Faircloth, Hagel and Moseley-Braun and seven other Senators introduced S. 1260, the Securities Litigation Uniform Standards Act of 1997. Senate Banking Committee Report No. 105-182 (May 4, 1998). In 1998, Congress enacted the Securities Litigation Uniform Standards Act, Pub. L. No. 105-353, 112 Stat. 3227 (Nov. 3, 1998).

standards for class action lawsuits. In my remarks, I emphasized my belief that state securities regulators have an important role in our national securities markets as the local "cop on the beat". However, I also testified that in our national securities markets state laws should be consistent, complementary and competitive with federal securities regulation.[4] This same analytic framework should be applied in the Commission's analysis of this proposal.

**2. The Commission should permit general solicitations in connection with offers and sales to large accredited investors.**

Registration under the 1933 Act, as amended, and qualification under state securities laws impose substantial costs on prospective issuers.[5] In small offerings, these costs are likely to represent a greater percentage of the anticipated gross offering proceeds than larger offerings. In other words, there can be certain economies of scale associated with larger offerings. Recognizing the inefficiency of small, registered offerings, many issuers rely upon exemptions from registration and qualification. Historically, the most heavily used exemptions are for so-called private placements.[6] There have been several unintended consequences to the emphasis on private placement exemptions. These include:

**(a) Prohibiting general solicitation and advertising adversely impacts minority and women owned businesses**. It is a condition to Rules 505 and 506 that neither the issuer nor anyone acting on its behalf shall offer or sale the securities by any form of general solicitation or general advertising.[7] Similarly, California's limited offering exemption prohibits the publication of any advertisement.[8] These restrictions

---

[4] Consonant with these principles, as Commissioner of Corporations, I drafted AB 721 (Firestone), 1997 Cal. Stat. ch. 391, which brought California's Corporate Securities Law of 1968, Cal. Corp. Code §§ 25000 et seq., into conformity with federal law. For these same reasons, I supported in my testimony to the Subcommittee on Securities the reaffirmation by Congress of the Section 3(a)(10) exemption under the 1933 Act. *See* Written statement of Hon. Keith Paul Bishop, Commissioner, California Department of Corporations, submitted to the Senate Committee on Banking, Housing and Urban Affairs' Subcommittee on Securities "Oversight Hearing on the Private Securities Litigation Reform Act of 1995," Serial No. 105-182, at 3 (July 27, 1998).
[5] The question of whether these costs are justified is worthy of serious consideration in light of the slight tangible proof that that the benefits to investors of mandatory disclosure under the federal securities laws outweigh the costs. Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation,* 107 Yale L. J. 2359 (1998).
[6] Under the 1933 Act, the statutory exemption is Section 4(2), 15 U.S.C. § 77d(1). The Commission has adopted Rule 506, 17 C.F.R. § 230.506, which deems offers and sales in satisfaction of the conditions of that rule to be transactions not involving a public offering within the meaning of Section 4(2) of the 1933 Act. In California, the principal limited offering exemption is Corporations Code Section 25102(f).
[7] 17 C.F.R. § 230.502(c).
[8] Cal. Corp. Code § 25102(f)(4).

give an advantage to the well-connected issuer because there is no need to engage in a general solicitation if the issuer already has ready access to prospective investors. Minority and women owned businesses that are not part of the "old boys' club" may not enjoy these advantages and therefore face greater obstacles in obtaining capital. The ability to engage in a general solicitation under Rule 504 can put minority and women owned businesses on a more equal footing with companies that may be better connected to possible sources of capital.

**(b) Prohibiting general solicitation and advertising encourages the use of unregistered finders.** Issuers that do not have preexisting relationships with prospective investors are likely to utilize the services of a finder. For a fee, finders will make their contacts available to issuers. In other words, "if you don't know them, buy them". In many instances, however, finders are not registered as securities brokers. The American Bar Association's Task Force on Private Placement Broker-Dealers has issued a report observing that private placement broker-dealers were critical to the success of smaller and emerging companies obtaining early stage financing, particularly for raising capital in an amount less than $5 million.[9] The use of unregistered brokers or finders is more likely in a small offering because registered brokers are likely to find that it is uneconomical for them to act as underwriters or placement agents in small offerings. This is yet another example in which small businesses are at a disadvantage to larger businesses in the capital formation process. While the use of an unregistered finder may be permissible in limited circumstances, it presents a variety of risks to the issuer.[10] If it is subsequently determined that the finder should have been registered, the issuer may be subject to regulatory action and the purchasers may have a right of rescission.[11] The

[9] Task Force on Private Placement Broker-Dealers, ABA Section of Business Law, “Report and Recommendations of the Task Force on Private Placement Broker-Dealers,” 60 Business Lawyer 959, 960 (May 2005).

[10] The staff of the Commission's Division of Market Regulation has indicated that in certain circumstances it will not recommend enforcement if a finder does not register as a broker under the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a et seq. (the "1934 Act"). *See, e.g.,* Paul Anka (July 24, 1991). For a general discussion of the "finders exception", see John Polanin, Jr., *The Finder's Exception from Federal Broker-Dealer Registration*, 40 Cath. U. L. Rev. 787 (1991). In December 2006, the California Commissioner of Corporations issued an invitation for comments from interested persons to address whether the Department should adopt an exemption and/or limited registration system for finders and private placement broker-dealers. *See* www.corp.ca.gov/pol/rm/3106notice.pdf

[11] Several issuers have included a risk factor concerning possible rescission rights arising under Section 29 of the 1934 Act, 15 U.S.C. §78cc. *See, e.g.*, registration statement on form S-3 filed by Microware Systems Corp. on May 17, 2001. As a practical matter, the existence of such a right may not be of much value. If the per share value implied by the new investors is higher than the per share price payable upon rescission, the investors holding the right would not exercise the rescission right. However, the existence of a right of rescission might cause new investors to discount the purchase price because the right gives its holders an opportunity, not shared by the new investors, to cash out should

ability to engage in a general solicitation reduces the incentive for issuers to use unregistered finders by making it possible for such issuers to solicit investors directly.[12]

**(c) Prohibiting general solicitations and advertising puts small businesses at a bargaining disadvantage vis-à-vis large accredited investors.** Although federal and state securities laws are ostensibly focused on investor protection, small businesses often lack both sophistication and bargaining position in dealing with large accredited investors that by definition must be wealthy. For example, many small businesses receive funding from venture capital companies that are professional investors with substantially greater net worth. A small business that is prohibited from engaging in a general solicitation is necessarily limited in its ability to establish a competitive buyers market. Thus, they can be faced with "take it or leave it" situations in which they have no legal method of finding alternative buyers. One effect of prohibitions on general solicitation is to foster monopsony conditions.

**(d) Prohibiting general solicitations and advertising increases investor risk by limiting public exposure of information to the market.** The federal securities laws are premised on a disclosure philosophy.[13] It is therefore ironic that the limitations on general solicitation proposed by the Commission are at complete odds with this fundamental principle. Rather than encouraging disclosure, it discourages it.[14] In this respect, limitations on general solicitation actually increase rather than diminish risk to

---

the stock value subsequently decline. If the per share price implied by the new investors is lower, then it is unlikely that new investors would invest only to see a portion of its proceeds used to cash out existing investors. In any event, it is unclear what policy goal is achieved by redistributing wealth from the new investors to prior round investors because a third party failed to comply with a licensing requirement.

[12] In the proposing release, the Commission acknowledges that limited advertising "may provide issuers with a competitive alternative to using finders and private placement agents to locate prospective purchasers in exempt offerings."

[13] U.S. Supreme Court Justice Louis Brandeis emphasized the beneficial effects of disclosure in his seminal work, other people's money: "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." However, there is a giant step from acknowledging the benefits of disclosure to concluding that mandatory disclosure is beneficial. *See* Frank Easterbrook and Daniel Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW 288 (1991).

[14] The Commission has requested comment numerous specific issues related to the content of a Rule 507 announcement. Because I believe that limitations are counterproductive, I am not commenting on each of these issues. However, I do note that some of the proposed alternatives represent radical deviations from the historical approach of the federal securities laws. For example, the Commission has asked whether the rule should require that the description of the issuer's business be "fair and impartial". These terms are so vague as to defy objective application. Moreover, imposition of a "fair and impartial" standard would represent a significant break with the focus of the federal securities laws on whether there have been material misstatements and omissions.

investors by requiring that issuer effect offerings in the shadows rather than in the sunlight of disclosure.

**(e) Requirements of a preexisting relationship encourage affinity fraud.** Although Regulation D does not explicitly require that investors have a preexisting relationship with the issuer, the staff of the Commission has considered the existence of such a relationship as a significant factor in determining whether a general solicitation has occurred.[15] This requirement therefore encourages offers and sales to persons known to the issuer. Unfortunately, this will have the unintended consequence of directing sales to persons who may be more trusting *because of their relationship to the issuer*.[16] Indeed, persons are likely to be less trusting of persons they don't know than those they do.[17] The ability to engage in a general solicitation may actually reduce risk to all investors by making the offering subject to more extensive examination by the market.

**3. <u>The Commission should not impose resale limitations on large accredited investors</u>.**

Permitting large accredited investors to resell securities to other large accredited investors without restriction will reduce investor risk and the cost of capital.

**(a) Imposing limitations on the resale of securities concentrate risk and limit liquidity.** Restrictions on resales ultimately increase investor risk by requiring at a minimum an inefficient after-market. The Commission should not adopt a rule that negatively impacts investors.

---

[15] *See, e.g.,* Mineral Lands Research and Marketing Corp. (Nov. 3, 1985) ("The types of relationships with offerees that may be important in establishing that a general solicitation has not taken place are those that would enable the issuer (or a person acting on its behalf) to be aware of the financial circumstances or sophistication of the persons with whom the relationship exists or that otherwise are of some substance and duration.").

[16] The Commission itself has made this point, stating: "These scams [affinity fraud] exploit the trust and friendship that exist in groups of people who have something in common." Commission Investor Alert, *Affinity Fraud: How to Avoid Investment Scams that Target Groups*. In a 1999 press release, the California Department of Corporations made this same point: "In affinity frauds, members of ethnic, religious and professional groups are targeted by individuals claiming to be members or friends of those groups, *relying on the fact that many people tend to trust those who claim to be like themselves* and to want to help them get a piece of the American dream." (emphasis added)

[17] Inherent in the requirement of a preexisting relationship seems to be the perverse policy preference that if you are going to engage in securities fraud, society somehow prefers that you defraud your friends, relatives and business associates rather than strangers. Ironically, this peculiar regulatory preference in favor of affinity fraud is reinforced by the fact that it may well be easier to defraud those whom you know than those whom you don't know.

**(b) Imposing limitations on the resale of securities materially increases the cost of capital.** From the issuer's perspective, the costs of capital will necessarily be greater because investors will discount the price of securities in consequence of the lack of liquidity. The Commission has itself recognized this cost. In adopting the 1999 amendments to Rule 504 under Regulation D, the Commission recognized that limitations on resale result in liquidity discounts: "The amendments will preserve an avenue for small businesses to issue freely tradable securities *and not suffer deep liquidity discounts* . . ." .[18] The Commission now claims that restrictions on resales are "likely to have a deterrent affect [sic] on abusive practices, such as 'pump and dump' schemes." However, the Commission notes in the release that it has taken enforcement action against numerous such schemes. If these schemes are already prohibited and the Commission is taking enforcement action, what additional deterrent effect can be expected from the proposed rule change?

**4. <u>The Commission should adopt neither mandatory disqualification nor disclosure</u>.**

In proposing mandatory disqualification, the Commission set forth a number of questions about the types of offenses that would, or should, result in disqualification. The fact that the Commission has raised these questions illustrates the difficulty in trying to list what the Commission *supposes to be important to investors.* Moreover, the questions demonstrate the inherent arbitrariness of any list. In some cases, for example, investors may not regard a recent violation as important while they may in other cases regard a long past violation as very significant. In addition, the imposition of mandatory disqualification deprives investors of the opportunity to make their own decisions about what is or is not material to their investment decision. The Commission should recognize that a regulator, no matter how well intentioned, is simply unable to prescribe what may or may not be material to investors in each and every situation that might arise. Therefore, the Commission should eschew prescriptive approaches in favor of a market-based approach. Offerings under proposed Rule 507 will be subject to state and federal antifraud statutes and rules. The possibility of significant civil and criminal penalties both deters and provides the opportunity for retribution.

**5. <u>The definition of "large accredited investor" should exclude purchasers in transactions exempt from registration under the 1933 Act pursuant to Section 3(a)(11) of the 1933 Act</u>.**

There is very little legislative history regarding Section 3(a)(11) of the 1933 Act which exempts any security which is part of an issue offered and sold only to persons resident within a single state or territory when the issuer is a person resident and doing business within or, if a corporation, incorporated by and doing business within such state

[18] Securities Act Release No. 7644 (Feb. 25, 1999) (emphasis added).

or territory.[19] However, two fundamental policy decisions necessarily inhere in Section 3(a)(11):

- Congress intended that such offerings not be subject to federal registration requirements; and

- The decision to impose registration or qualification requirements on such offerings was to remain at the state level.[20]

The Commission's proposal would eliminate state authority to require registration or qualification of offers and sales to large accredited investors when the offer and sale is exempt from registration pursuant to Section 3(a)(11) of the 1933 Act. While the National Securities Markets Improvement Act of 1996 (the "**NSMIA**") represents Congress' attempt to address the very real and substantial problems associated with costly, inconsistent, redundant and ultimately ineffective state and federal regulation of securities, the act was focused on the *national* securities market.[21] Indeed, this is evidenced by the very title of the act, the *National* Securities Market Improvements Act. The NSMIA, therefore, does not necessarily represent a Congressional effort to eliminate local regulation of local offerings.

Because I believe that state merit review hurts investors and issuers (and small issuers in particular), it is tempting to concur in the Commission's proposal to preempt such requirements with respect to transactions exempt under Section 3(a)(11).[22] However, because Section 3(a)(11) by its very terms encompasses only local offerings, principles of federalism require that the Commission not preempt state authority to require registration of such offerings.[23] In the case of local offerings, states should be

---

[19] 15 U.S.C. § 15c(a)(11). For a discussion of the legislative history to Section 3(a)(11), see Louis Loss & Joel Seligman, 2 SECURITIES REGULATION 1295 (3rd ed. 1999).
[20] This is not necessarily to say that Congress intended that states impose registration or qualification requirements. Rather, only that Congress did not override the states' authority to make decision on whether such requirements should be imposed.
[21] Pub. L. 104-290, 110 Stat. 3416 (Oct. 11, 1996).
[22] As Commissioner of Corporations, I drafted and unsuccessfully supported the adoption of The Capital Formation and Securities Fraud Enforcement Act of 1996, AB 2465 (Goldsmith). *See* Therese Maynard, *Commentary: The Future of California's Blue Sky Law* 30 Loy. L. Rev. 1573 (1997) and Staff Briefing Paper, Capital Flows and Leaky Buckets: Regulation of Securities in California, Joint Hearing of the Senate Finance, Investment and International Trade and Assembly Banking and Finance Committees (October 26, 1996).
[23] "Federalism is rooted in the belief that issues that are not national in scope or significance are most appropriately addressed by the level of government closest to the people." Executive Order No. 131321 ¶2(a) (Aug. 1999). Although the Commission as an independent regulatory agency (as defined in 44 U.S.C. § 3502)) is not subject to

able to "continue to strike their own balances and thus continue to make their own individualized rules respecting the offer and sale of securities within their own borders".[24]

**6. <u>Conclusion</u>**

Ironically, the Commission's regulatory approaches have been counterproductive – resulting in increased investor risk and higher costs of capital. Furthermore, many of these approaches have disadvantaged small businesses vis-à-vis big business. The Commission should rethink these historical approaches in connection with any changes to Regulation D. In particular, the Commission should permit general solicitations in connection with offers and sales to large accredited investors and eliminate restrictions on resales of securities to other large accredited investors. Finally, the Commission should seek to foster a market approach to securities regulation that encourages competitive federalism.

Very Truly Yours,

/s/ Keith Paul Bishop

---

Executive Order No. 131321, it should voluntarily apply the criteria and requirements of the order.

[24] Rutheford Campbell, Jr., *The Insidious Remnants of State Rules Respecting Capital Formation*, 78 Wash. U. L.Q. 407, 434 (2000).