The Commonwealth of Massachusetts
William Francis Galvin, Secretary of the Commonwealth
Securities Division

October 12, 2007

Nancy M. Morris, Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

Re: Revisions of Limited Offering Exemptions in Regulation D
Release Nos. 33-8828; IC-27922
File No S7-18-07 – RIN 3235-AJ88

Dear Ms. Morris:

The Massachusetts Securities Division (the "Division") welcomes this opportunity to comment on the U.S. Securities and Exchange Commission's (the "Commission" or the "SEC") proposals to revise SEC Regulation D to provide additional flexibility to issuers and to clarify and improve the application of the exemptive rules (the "Proposals" or the "Release").

The Division is a department within the Office of the Secretary of the Commonwealth of Massachusetts. The Division is charged with the responsibility to implement and enforce the Massachusetts securities laws. As such, the Secretary of the Commonwealth is the chief securities regulator for Massachusetts.

I. Background and Overview

The Commission proposes, among other things, to create a new Rule 507 exemption from the securities registration requirement for offers and sales of securities to "large accredited investors." This exemption would permit limited advertising in an offering where each purchaser meets the definition of "large accredited investor." The Commission also proposes to revise the term "accredited investor" in Regulation D to

clarify and update that definition. In addition, the Commission proposes to shorten the timing required by the integration safe harbor in Regulation D, and to apply uniform disqualification provisions to all offerings seeking to rely on Regulation D. The Commission also solicits comments on possible revisions to Rule 504. Finally, the Commission solicits additional comments on the definition of "accredited natural person" for certain pooled investment vehicles in Rules 216 and 509 under the Securities Act of 1933 (the "Securities Act") that the Commission proposed in December 2006.

Introduction

The Division supports many parts of the Proposals and commends the Commission for its efforts to update Regulation D and address the problems and abuses that regulators have seen in connection with offerings conducted pursuant to claims of the Regulation D exemptions.

The Division strongly supports the Commission's proposal for a "bad actor" disqualification that would be applicable to all of the exemptions under Regulation D, including Rule 506. In light of abusive and fraudulent Rule 506 offerings that the Division and the Commission have seen, the "bad actor" disqualification is necessary and appropriate in the public interest and for the protection of investors.

Furthermore, the Division urges that applying a "bad actor" disqualification to the Rule 506 exemption is entirely consistent with both Regulation D and the exemption provided under Section 4(2) of the Securities Act of 1933 (under which Rule 506 operates as a safe harbor). A hallmark of a transaction that is exempt under Section 4(2) is that it involves offerees who can fend for themselves in the financial markets (due to factors such as wealth, investment sophistication, and familiarity with the issuer)[1]. In offerings involving recidivist violators of the securities laws, it is likely that even sophisticated and wealthy investors will not be able to "fend for themselves." It is appropriate, therefore, to deny the use of the Rule 506 safe harbor to promoters and sponsors of offerings who have committed investment fraud.

The Division's comments will generally track the order of the proposals in the Release.

II. Proposed Revisions of Regulation D

A. Proposed Rule 507 – Exemption for Limited Offers and Sales to Large Accredited Investors

The Division strongly opposes the Rule 507 proposal, which would create a new "limited offering" exemption that would allow for public advertising. We oppose this exemption because it breaks down the longstanding distinction between public offerings, which must be registered, and private offerings which must be conducted pursuant to the conditions of an exemption from registration.

[1] SEC v. Ralston Purina, 346 U.S. 119, 125 (1953)

The Division urges the Commission to maintain the ban on general advertising so that the line between public and private offerings will not be blurred, and private issuers will not be subject to the temptation to accept funds from unsophisticated investors.

In the Release, the Commission cites the increased sophistication and financial literacy of many investors, and states that modern communications technologies make financial information available to large segments of the public. The Division notes, however, that the sophistication of retail investors varies widely, and that fraud operators have used modern communication technology to swindle investors, rather than inform them.

If the Commission nonetheless determines to adopt the Rule 507 exemption, it should be subject to strict limitations to protect unsophisticated investors.

1) "Large Accredited Investor" Standard in Rule 507. The Commission proposes to define "large accredited investor" with higher and somewhat different dollar amount thresholds for investor's asset holdings and income than the current "accredited investor" definition in Rule 501(a). Under the new standard, entities would be required to have more than $10 million in investments, and individuals would be required to own more than $2.5 million in investments or have an annual income of more than $400,000 ($600,000 with one's spouse).

While the Division opposes the adoption of Rule 507, if the exemption is adopted, the greater public access to investors that the exemption would permit warrants high financial qualification standards to assure that investors will be able to fend for themselves in offerings under the exemption.

The Division urges the Commission not to reduce the proposed income and asset thresholds for "large accredited investors" under Rule 507. In particular, we do not support reducing the investments-owned standard to $1 million in investments. The Division also believes that an investment-based test, rather than a total net worth test is a more meaningful measure of an investor's risk bearing ability, particularly for individuals.

2) Limited Advertising Permitted. While the Division opposes the adoption of the Rule 507 exemption, if the exemption is adopted, that rule should require that any advertisement for a Rule 507 offering may contain only strictly limited content and should include mechanisms to allow the Commission to track how the exemption is used.

Under the proposal, the items of information to be included in a Rule 507 advertisement would permit the issuer to identify itself and the offering without creating a highly promotional advertisement. Similarly, the Commission's proposal to limit the description of the issuer's business to 25 words should help safeguard against overly-promotional advertising.

The Division supports adding a requirement that any description of the issuer's business must be fair and impartial; this requirement will be a helpful protection against

aggressive claims and "puffing" by issuers. This requirement is simply prudent: it is likely that any description of the issuer's business that fails to meet the standards of being fair and impartial would also violate the antifraud provisions of the state and federal securities laws. It is the Division's position that the publication of such an advertisement should only be in written form, in order to limit aggressive selling efforts.

The Division urges the Commission to require issuers to file copies of their advertisements with the Commission, and to require issuers to retain copies of their advertisements. These requirements will help the Commission track how the Rule 507 exemption is being used, and they should reinforce compliance with the exemption's limitations on public advertising.

Any advertisement under Rule 507 should include a statement that sales will be made only to large accredited investors, that no money is being solicited or will be accepted by way of the announcement, and that the securities have not been registered with or approved by the Commission or any state, and are being offered and sold pursuant to a federal exemption. This statement should appear prominently in the advertisement. It would also be prudent to require a statement to reinforce the fact that the potential investors may only purchase the securities after receiving the full offering materials for the offering, which will be sent to offerees who respond to the initial advertisement.

The optional "indication of interest" coupon described in the Release, stating that the indication of interest is not binding and that no money should be sent, would help assure that potential investors will make a purchase decision based on complete offering materials, not on the initial advertisement.

The Division disfavors the use of telephone solicitation as part of the limited public advertising that would be permitted under proposed Rule 507. In the experience of the Division, it is unrealistic to expect an issuer to state only the items of information permitted in the limited advertisement over the telephone, and refrain from making additional statements when soliciting the interest of potential investors.

Rule 508 – "Insignificant Deviations." Rule 508 provides that insignificant deviations from the requirements of Regulation D do not result in the loss of the exemption. Rule 508(a)(2) provides, however, that failures with regard to the limitations on the manner of offering are deemed to be significant, *per se*.

If Rule 507 is adopted, compliance with the manner of offering requirements (the restrictions on permitted advertising) under Rule 507 must be a condition of that exemption, and that any failure to comply with those requirements should result in the loss of the exemption. If the rule were applied otherwise, there would be no meaningful distinction between an unregistered public offering conducted in violation of Section 5 of the Securities Act and a Rule 507 transaction that "deviates" from the requirements of that exemption.

The Division strongly urges the Commission not to delete the current Rule 508 carve-out of the manner of sale limitations in the list of insignificant deviations. This carve-out appropriately means that an issuer's failure to comply with the ban on general solicitation under Regulation D can never constitute an insignificant deviation. This same kind of clear line drawing is essential if Rule 507 exemption is to work as the Commission intends.

3) No Sales to Persons Who Do Not Qualify as Large Accredited Investors. If Rule 507 is adopted, issuers relying on that exemption should be permitted to sell securities only to persons who qualify as "large accredited investors." Permitting investors who do not qualify as large accredited investors to invest in Rule 507 offerings would undermine the logic of the exemption and would increase the potential for fraud in such offerings.

The Division agrees with the requirement that the issuer or any person acting on its behalf may provide information in addition to the limited announcement only if the issuer reasonably believes that the prospective purchaser is a large accredited investor.

To ensure that sales are limited to large accredited investors, it would be prudent for the Commission to require issuers to limit internet access to offering information beyond the limited public announcement by means of password-protected websites.

4) Authority for the Exemption. The Commission has proposed the Rule 507 exemption using its general exemptive authority under Section 28 of the Securities Act.

The Commission has determined that the proposed exemption is necessary or appropriate in the public interest and consistent with the protection of investors because the exemption imposes strict controls on advertising and would be limited to offerings sold only to investors who meet high financial qualification standards.

We urge the Commission to be vigilant about how the Rule 507 exemption is used in practice. To some extent, the new exemption will dismantle the traditional distinction between nonpublic offerings that are privately sold and public offerings that are sold using general advertising. The Division is concerned that the Rule 507 exemption may be misused in ways that are difficult to foresee. For this reason, the Commission should evaluate on an ongoing basis whether the Rule 507 exemption adequately protects investors, particularly retail investors. We ask the Commission to revisit the exemption if serious problems emerge.

5) Covered Security Status

The Division notes that, under the Proposals, a large accredited investor that participates in a Rule 507 offering would be a "qualified purchaser" under Section 18(b)(3) of the Securities Act. As such, the securities sold in a Rule 507 offering would be "covered securities," resulting in preemption on state registration/exemption requirements under Section 18 of the Securities Act.

Making securities sold in Rule 507 transactions "covered securities" removes the layer of protection and oversight that state review would provide for these transactions. In view of this, the Division urges that the financial qualifications for any "qualified purchaser" transactions be set at a high level. We also urge, if the exemption is adopted, that the SEC revisit Rule 507 and review whether the operation of the exemption has been in the public interest and consistent with the protection of investors.

The proposed language of Rule 146(c) indicates clearly that the states may impose notice-filing requirements that are substantially similar to those imposed by the Commission on transactions with "qualified purchasers." Such filings will serve the important function of giving the states notice that such transactions are being sold in their jurisdiction. We note that such a filing requirement is entirely consistent with the approach that the National Securities Markets Improvement Act of 1996[2] ("NSMIA") took with respect to offerings exempt under any Commission rule adopted pursuant to Section 4(2) of the Securities Act[3] --the states may require the filing of any form filed with the Commission, a consent to service of process, and a filing fee. Again, we believe the "substantially similar" language in the proposed rule is clear on this issue.

B. Proposed Revisions Related to the Definition of "Accredited Investor"

The Division urges the Commission to correct the longstanding problems of the "accredited investor" definition in Rule 501(a), as it applies to individuals. The financial standards for individuals under that definition are simply too low to protect retail investors from inappropriate high-risk offerings.

The Rule 501(a) net worth and income standards for individuals were adopted in 1982, and have not been adjusted since. As a result, due to the impact of inflation, the accredited investor definition simply does not specify a group of investors who can fend for themselves and who do not need the protections of securities registration. Instead, many unsophisticated investors, including many inexperienced seniors holding the proceeds from the sale of their homes, can be sold risky and illiquid investments. Under Rule 506, such transactions are subject to no mandated form of disclosure, and state review of such offerings is preempted.

The Division urges the Commission to significantly raise the financial thresholds in the definition of accredited investor. If the Commission fails to take this necessary step, small investors will remain vulnerable to fraudulent and abusive private offerings sold pursuant to claims of the Rule 506 exemption.

1) Adding an Alternative Investments-Owned Standard to the Accredited Investor Standards. The Division supports the Commission's proposal to add an alternative "investments owned" standard to the definition of accredited investor. We agree with the Commission's view that the investments owned standard is a potentially more accurate

---

[2] National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (Oct. 11, 1996)("NSMIA")

[3] Securities Act of 1933, Section 18(b)(4)(D), 15 U.S.C. 77r(b)(4)(D)

test for whether an investor may need the protections of registration under the Securities Act. It is also likely that this standard will simplify compliance for issuers and selling persons because this information may be more easily assessed than net worth or annual income.

For individuals, the proposed investments-owned standard would be $750,000; this standard would be a new alternative to the current net worth standard of $1 million or annual income standards of $200,000 ($300,000 with one's spouse). In determining whether an investor meets the threshold under the investments-owned standard, the value of personal residences and places of business would not be included. The Division strongly supports the reasoning behind this alternative. For most investors, their homes and businesses are personal assets that are distinct from their purely financial holdings. Put another way, it would be catastrophic for most investors to have to liquidate their homes or businesses to cover investment losses. We agree that investments-owned approach is a more logical and more accurate way to assess a potential investor's ability to bear the risks of a non-registered securities offering.

2) <u>Proposed Definition of Joint Investments.</u> The Division is in accord with the Commission's proposals relating to the definition of "Joint Investments."

3) <u>Future Inflation Adjustments.</u> The Division supports the Commission's proposal to adjust the dollar-amount thresholds in the accredited investor definition for inflation on a going-forward basis.

4) <u>Adding Categories of Entities to the List of Accredited and Large Accredited Investors.</u> The Commission has inquired whether it should delete the list of legal entities that appears in the Section 501(a)(3) definition of "accredited investor" and simply say that any legal entity that can sue or be sued in the United States, assuming it meets the other standards for becoming an accredited investor, can qualify as an accredited investor. We urge the Commission not to take this step, because it would likely bring into the definition of "accredited investor" entities that have little or no investment sophistication, and that may lack professional management.

5) <u>Proposed Definition of Accredited Natural Person.</u> The Division supports the Commission's initial proposal, in the Pooled Investment Vehicle Release, to adopt a new definition of "accredited natural person" for use in connection with investments in pooled investment vehicles relying on Section 3(c)(1) of the Investment Company Act. The definition of "accredited natural person" would require that an investor meet the Rule 501(a) definition of "accredited investor" <u>and</u> own at least $2.5 million in investments, as defined.

The Division shares the Commission's view that a further level of protection, beyond that provided by the current accredited investor definition, is necessary to safeguard investors who are seeking to invest in such vehicles in light of their risks, including undisclosed conflicts of interest, complex and high fee structures, and the higher speculative risks that

may accompany such vehicles' anticipated returns. The "accredited natural person" definition, as proposed, is a prudent tool to accomplish those goals.

If the Commission revises its proposed definition of accredited natural person in any way, the protection of retail investors must be paramount. The Division is particularly concerned about any standards of investor qualification that are based on an investor's total net worth; such standards may sweep in investors who qualify simply on the basis of having a high-value residence, but who are otherwise unsophisticated.

In all instances, the Commission should adjust the investor qualification thresholds for inflation. To do otherwise would mean that inflation will reduce the qualification standards over time; this would not be good policy and it would be directly contrary to the logic of imposing such standards in the first place.

C. Proposed Revisions to General Conditions of Regulation D

1) Proposed Revisions to Regulation D Integration Safe Harbor. The Division opposes the Commission's proposal to shorten the integration safe harbor period in Rule 502(a) from six months to 90 days. As the Commission has stated, the current six-month time frame of the safe harbor in Rule 502(a) provides a substantial time period that has worked well to clearly differentiate two similar offerings and provide time for the market to assimilate the effects of the prior offering. While we acknowledge that the timing of many aspects of financial markets has sped up since the 1980s, shortening the safe harbor period, particularly in light of other rule changes proposed by the Commission, is unwarranted and dangerous.

In many cases, 90 days is simply not enough time for the marketplace to assimilate the effects of an earlier offering. Moreover, in many transactions, 90 days will not be an adequate period for the market and offerees to "cool off" after a solicitation. Furthermore, in many cases, 90 days will not be an adequate period to make a series of exempt offerings by an issuer truly separate and distinct from each other.

The Division is particularly concerned about how the proposed Rule 507 "public advertising" exemption will work in conjunction with the Rule 506 private offering exemption and the 90-day integration safe harbor. Under the proposed rules, a fraud operator could drum up investor interest in a Rule 507 offering by means of public advertising, take indications of interest from those offerees (whether they were accredited investors, large accredited investors, or non-accredited investors), and re-solicit those offerees for a Rule 506 offering after 91 days.

2. Disqualification Provisions. The Division strongly supports the inclusion of "bad actor" disqualification provisions for all offerings under Regulation D, including offerings pursuant to Rule 506.

Before the enactment of NSMIA, recidivist securities law violators were excluded from most Rule 506 offerings by state disqualification provisions. Because NSMIA preempts

the states from enforcing those provisions with respect to Rule 506 offerings, past securities law violators, including serious fraud operators, have enjoyed unimpeded use of the Rule 506 safe harbor.

The need for this kind of "bad actor" disqualifier is clear. The states have conducted numerous enforcement actions against recidivist fraud operators who have sold fraudulent offerings based on claims of the Rule 506 exemption.[4]

Applying this kind of "bad actor" disqualification to Rule 506 transactions is entirely consistent with the underlying exemption provided under Section 4(2) of the Securities Act and appropriate in light of the purposes of the 4(2) exemption. The Rule 506 exemption is a "safe harbor" that was adopted to provide greater certainty for issuers using the Section 4(2) exemption. We also note that the Section 4(2) exemption is intended to be used for non-public transactions in which the offerees can "fend for themselves." In transactions where fraud is at issue, even sophisticated and/or wealthy investors may not be able fend for themselves when dealing with unscrupulous sponsors and promoters. In such transactions, a "bad actor" disqualification is necessary to assure that the fundamental principles of the 4(2) exemption will be upheld.

Finally, the Division notes that Rule 506 is simply a safe harbor within the Section 4(2) exemption. Applying a "bad actor" disqualification to the safe harbor does not revoke or even condition the 4(2) exemption itself. All issuers can potentially use the statutory 4(2) exemption, even if Rule 506 is made subject to a "bad actor" disqualification.[5] However, such a disqualification would make the advantages provided by Rule 506 unavailable to such bad actors.

D. <u>Possible Revisions to Rule 504.</u> The Division supports the Commission's proposal to make securities that are sold under Rule 504 "restricted securities" for the purposes of Rule 144(a)(3)(ii). Like the Commission, the Division is aware that offerings made under a claim of the Rule 504 exemption have been connected to "pump and dump" schemes, particularly involving securities of non-reporting companies that trade in the over-the-counter markets. Making these securities "restricted securities" would impose a 12-month holding period on non-affiliates receiving securities of non-reporting companies. Such a holding period should be a meaningful impediment to the promoters of "pump and dump" schemes, because such promoters typically want to unload their shares as quickly as possible into a manipulated market.

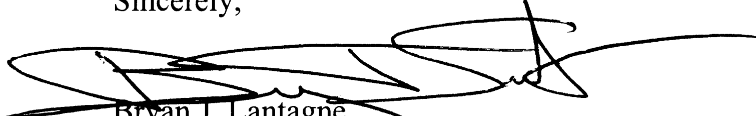
---

[4] *See, e.g.*, <u>In the Matter of enTerra Energy, LLC, Ken-Tex LLP and David G. Rose</u>, Docket No. E-2005-0193 (Massachusetts Securities Division enforcement action)

[5] The Division notes in this regard that Preliminary Note #3 to Regulation D states that "[A]n issuer's failure to satisfy all the terms and conditions of Rule 506 shall not raise any presumption that the exemption provided by Section 4(2) of the Act is not available." 17 CFR Ch. II, Pt. 230, Reg. D, Refs & Annos

Please contact me at (617) 727-3548, if you have questions about these comments or I can assist in any way.

Sincerely,



Bryan J. Lantagne
Director
Massachusetts Securities Division
Office of the Secretary of the Commonwealth