Preliminary Recommendations
Proposed by the
Capital Formation Subcommittee
of the
SEC Advisory Committee on Smaller Public Companies
December 7, 2005

The Capital Formation Subcommittee submits the following recommendations, listed in order of importance, to the full Advisory Committee for consideration.

1. **Adopt a new private offering exemption that does not prohibit general solicitation and advertising for transactions with certain purchasers.** The new private offering exemption would require that sales be made only to certain purchasers ("Eligible Purchasers") who do not require the protections afforded by the securities registration process under the Securities Act of 1933 (the "Securities Act") because of (i) financial wherewithal, (ii) investment sophistication, (iii) relationship to the issuer or (iv) institutional status. An offering whose purchasers consisted solely of Eligible Purchasers would qualify for the exemption regardless of the means by which they were contacted – even through advertising or general solicitation activities.

    a. Eligible Purchasers would be comprised of several categories of natural persons and artificial entities and would be defined in a manner similar to that used in Regulation D to define Accredited Investors.[1] There would be no change in financial, institutional and other standards for artificial entity Eligible Purchasers from those currently in effect under Regulation D.

    b. Natural persons would qualify as Eligible Purchasers based on (1) wealth or annual income, (2) investment sophistication[2], (3) position with or relationship to the issuer (officer, director, key employee, existing significant stockholder, etc.) or (4) pre-existing business relationship with the issuer. Persons closely related to or associated with Eligible Purchasers would also be defined as Eligible Purchasers. For example, this would include spouses, children and relatives sharing the domicile of an Eligible Purchaser, as well as artificial entities substantially owned by Eligible Purchasers.

    c. The financial wherewithal standards for natural person Eligible Purchasers would be substantially higher than those currently in effect for natural person Accredited

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[1] See Rule 501(a) under Regulation D.

[2] Investment sophistication is the ability, acting alone or with the assistance of others, to understand the merits and risks of making a particular investment.

Investors.[3] We suggest $2 million joint net worth, $300,000 in annual income for natural persons and $400,000 for joint annual incomes.[4]

d. The new exemption should be effected by the adoption of a new/amended rule under Section 4(2) of the Securities Act. As a result, the securities sold in reliance on the new exemption would be "covered securities" within the meaning of Section 18 of the Securities Act and generally exempted from the securities registration requirements of individual state securities laws. This recommendation is crucial to the efficacy of the new exemption.

e. The new exemption will need a two-way integration safe harbor similar to that included in Rule 701. Offers and sales made in compliance with the new exemption will not be subject to integration with offers and sales made pursuant to other exemptions, in registered offerings or in violation of Section 5.

Traditionally, both federal and state private offering exemptions have been conditioned on the absence of "advertising or general solicitation." As a result, the number of prospective investors (offerees) that may be contacted and the methods used to contact them are very limited. These concepts and SEC interpretations have not provided bright line objective criteria for issuers and their advisers. Even if all purchasers (A) are accredited investors, (B) have pre-existing business relationships with the issuer, and (C) are contacted in face-to-face meetings, the exemption will nevertheless be lost for the entire offering if other issuer activities are found to have involved general solicitation or advertising. This could occur, for example, if the issuer made offers to 50 prospective purchasers all of whom were social friends of the issuer's principals but with whom the issuer did not enjoy pre-existing business relationships. There would be a similar adverse result if the issuer or an agent of the issuer placed an advertisement on a local cable TV show, Internet Web page or newspaper that featured the issuer's capital formation interests. In both examples, the exemption would be lost (and all purchasers could seek a return of their invested funds) even though none of the offerees contacted in an impermissible manner became purchasers.

The proposed exemption would not remove the SEC's authority to regulate offers. All offering activities conducted under the new exemption would continue to be fully subject to the antifraud provisions of the law. The SEC could adopt antifraud safe harbor disclosure guidelines similar to the existing "tombstone" rules that would be applicable to the new exemption for communications utilizing Internet, television, radio, newspapers and other mass media.

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[3] Under Regulation D as currently in effect, natural person accredited investors require a net worth of $1 million (including property held jointly with spouse) or $200,000 in individual annual income or $300,000 in joint annual income; Rule 501(a)(6).

[4] There was support in the subcommittee for recommending the use of the financial wherewithal standards for natural person Accredited Investor in Regulation D for the Eligible Purchaser standards. It was our impression from informal discussions with federal and state regulatory officials that an increase in the financial wherewithal standards for natural persons was the *sine qua non* for obtaining regulatory support for this proposal.

The proposed exemption is not a radical change in the fundamental regulatory environment for private offerings. In all the private offerings since the beginning of regulatory time, no offeree lost any money unless he or she became a purchaser. The new exemption focuses on the need (or lack thereof) that *actual purchasers* have for the protections afforded by the securities registration process.

The suggested change is generally consistent with the spirit of the recently adopted securities registration reforms. The proposed exemption should be viewed as a logical continuation of an established regulatory trend to loosen the restrictions on what can be done with non-purchasers. There have been other less bold regulatory relaxations on offers. [5] Almost a decade ago, Linda Quinn, the long-time Director of the Division of Corporation Finance, proposed adopting an exemption substantially similar to that being recommended. [6]

Prior to the adoption of Regulation D, the availability of private offering exemptions could turn on the suitability of offerees. One offer to a single unsuitable offeree could destroy the availability of an exemption for all purchasers in the offering.[7] Regulation D removed offeree suitability as a condition of a successful exempt transaction. Twenty plus years ago, this change in the law that we all take for granted today was the subject of sharp criticism and dire warnings that removing offeree suitability from the private offering exemption would open the floodgates to fraud. Those concerns proved to be unwarranted.

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[5] Rule 254, which is available for use only in Regulation A exempt offerings, allows issuers prior to approval of the offering by the SEC to "test the waters" with activities that would otherwise be considered as improper advertising or general solicitation; because of the extremely infrequent use of Regulation A offerings and an incompatibility with comparable state securities laws, "test the waters" has been of little practical utility to the capital formation process. The SEC staff has advised registered broker-dealers that certain limited generic solicitation activities (including Internet based solicitation) would not amount to impermissible advertising or general solicitation (for example, see interpretative letters issued to E. F. Hutton, H. B. Shaine and IPOnet). But for these favorable interpretations, the conduct described in the letters most likely would have amounted to impermissible advertising and general solicitation. In this regard, the staff has not extended its interpretation to cover conduct by issuers (or other non-broker dealers) that would allow them to engage in the solicitation activities described in the broker-dealer interpretative letters.

[6] Expressing her views about securities reform when she was leaving the staff, Ms. Quinn endorsed modifications in the exemption regime consistent with the proposed exemption ("Reforming the Securities Act of 1933: A Conceptual Framework, 10 *Insights* 1, 25, January 1996). Ms. Quinn supported the use of "public offers" in exempt private offerings whose purchasers were limited to "qualified buyers":

> In sum, offers would not be a Section 5 event and therefore would not be a source of Section 12(1) liability . . . . Offering communications would and should still be subject to the antifraud laws . . . . This approach could be effected by the Commission defining these communications as outside the scope of offers for purposes of Section 5 of the Securities Act, subject to conditions deemed appropriate. The test-the-waters proposal makes such use of the Commission's definitional authority . . . . (at 27)

[7] Because the issuer claiming the availability of an exemption bore the burden of establishing each element of an exemption, an exemption could be lost if the issuer failed to maintain records from which the suitability of all offerees could be established.

2. **Private Placement Broker Dealers**. The SEC should spearhead a multi-agency effort to create a streamlined NASD registration process for finders, M&A advisors and institutional private placement practitioners substantially in accordance with the ABA Task Force proposal reported in *The Business Lawyer*.[8] The article in *The Business Lawyer* makes the full case for this proposal in detail. Some of the highlights include:

   a. There is an unregulated underground "money finding" community that services companies unable to attract the attention of registered broker dealers, venture capitalists or traditional angel investors. There is a separate community of unregulated M&A consultants who assist buyers and sellers with services and compensation substantially similar to those provided and earned by traditional registered investment bankers. Virtually all of the services provided in support of capital formation and M&A activities amount to unregistered broker dealer activities that violate federal and state broker dealer registration and regulation law. For the most part the services provided do not involve holding customers' funds, which is a traditional function of registered broker dealers. There is a great reluctance for unregistered service providers to register as traditional broker dealers. The enforcement risk seems minimal. The cost and administrative burdens of the regulatory scheme are daunting to both the money finding and M&A communities.

   b. Some providers of these services are scrupulous and others are not. Issuers cannot use broker dealer registration (or its absence) to differentiate between the good ones and the very bad ones. The proposal seeks to foster a scheme of registration and regulation that will be cost effective for the unregistered community and assist in the investor protection goals of the regulators.

   c. An unregistered money finder will never "come in from the cold' to register if the regulators reserve the right to institute enforcement actions based solely on past failure to register. Accordingly, a workable amnesty program is crucial to the success of the proposal. Regulatory amnesty would not extend to fraud and would not be a defense against private causes of action.

   d. The private placement broker dealer proposal is not new. It has been "on the table" for a number of years. To date, none of the affected regulatory bodies have embraced it. If this proposal is to succeed, the SEC must provide leadership. That leadership must come first from the Commissioners themselves and then must reach out to the NASD and the state regulators.

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[8] 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 (3) Bus Law 959-1028 (May 2005), http://www.abanet.org/buslaw/tbl/tblonline/2005_060_03/home.shtml#1 (last visited December 5, 2005).

3. **Private Placement Exemption Adjustments**[9]

   a. Relax prohibitions against general solicitation and advertising including a rule to parallel the "test the waters" model of Rule 254. This relaxation should be adopted under Section 4(2) of the Securities Act to take advantage of the "covered securities" state registration exemption afforded by NSMIA. *(Note recommendation #1 recommends complete elimination of prohibitions against advertising and general solicitation in certain transactions).*

   b. Clarify the interpretation of or amend the language of Rule 152 integration safe harbor to permit a registered public offering to commence immediately after the completion of an otherwise valid private offering the stated purpose of which was to raise capital with which to fund the IPO process.[10]

   c. Shorten integration safe harbor period from the current 6 months (to 30 or 45 days)

   d. Define "qualified purchaser" as permitted by NSMIA, allowing transactions to involve "covered securities" thereby getting a federal preemption of most state securities registration provisions.[11]

4. **Going Private –** make it easier for smallest public companies to go private (i.e., the lower 1% of total market capitalization).

   a. As a condition to permitting a less rigorous exit from status as a public company, the issuer would be required to undertake to provide it shareholders with periodic financial and other pertinent information, such as unaudited quarterly financial statements, annual GAAP audited financial statements and narrative information about basic corporate governance, executive compensation and related party transactions.

5. **Trading Markets**. The SEC should work in conjunction with the NASD to insure viable trading markets for smaller public companies and work to amend certain rules and practices that inhibit the efficient functioning certain markets. The Pink Sheets market

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[9] The Subcommittee has not thus far considered whether to recommend an amendment to existing Rule 504 of Regulation D that provides a federal securities registration exemption for offerings of up to $1 million.

[10] Rule 152 provides an integration safe harbor to protect a private offering followed closely by a registered public offering. The language of rule requires the issuer to "decide" to file for the public offering "subsequently" to the private offering. By its specific language, the safe harbor would not appear to be available for a private offering the purpose of which was to raise the funds necessary to file a registered offering. Rule 152 was adopted more than 50 years ago and its language has never been amended. Although the staff has indicated informally it does not interpret the rule literally, it is time to amend the language of the rule appropriately.

[11] In 2001, the SEC proposed adoption of definitions for "qualified purchaser" that are substantially identical to those for Accredited Investor under Regulation D. Securities Act Release No. 33-8041 (December 19, 2001) at http://www.sec.gov/rules/proposed/33-8041.htm (last visited December 1, 2005). The SEC has not acted on this proposal.

and the Over the Counter Bulletin Board market, owned by the NASD and run on a contractual basis by NASDAQ can function better for small companies if the following recommendations were adopted.

a. Make public information filed under Rule 15c2-11.

b. Allow compensation to be paid by companies to market making dealers with disclosure of such arrangements by the dealers.

c. Make available Form S-3 for OTCBB securities in resale transactions

d. Make NASDAQ Small Cap stocks and OTCBB listed stocks "covered securities" under NSMIA, thereby exempting them from state review.

e. Increase the size of companies defined by the SEC as "Small Business Issuers" to the "Microcap Company" level.[12]

The OTCBB market is available to dealers to make markets in SEC filing companies according to rules established by the NASD. It is an important venue for smaller public companies that do not meet the listing standards of registered exchanges. The market assists in the capital formation process by creating a trading venue for shareholders even if a company does not become listed. The NASD, which derives its revenue from the securities industry, supports the OTCBB and it seems logical that some of the costs of maintaining the market be shared by the companies that are benefited from its existence. The Pink Sheets market is not supported by the NASD nor the companies that trade on the market. Corporate support can be accomplished by allowing the companies to pay dealers directly for market making activity. The Subcommittee believes this approach will encourage more entry of dealers into the market making function. The other recommendations are designed to add information to the marketplace and reduce costs to the traded companies.

6. **Research**. The SEC should adopt policies that encourage and promote the dissemination of research on smaller public companies. This can, in part, be accomplished by adopting the following:

a. Allow company sponsored research to occur with full disclosure by the research provider as to the nature of the relationship with the company being covered.

b. Maintain soft dollar payments for research under current safe harbor provisions of Rule

The trading markets for smaller public companies are assisted in material measure by the dissemination of quality investment research. Coverage for companies in general, and for smaller public companies, in particular, has declined dramatically over the years as regulatory and market pressures have led industry to dramatic reductions in securities

[12] We defer to the recommendations adopted by the Advisory Committee on August 10, 2005 for specifics on this issue.

research budgets. Linking research coverage to underwriting assignments is prohibited and trading spreads and commission rates have declined for firms that historically used these revenue streams to fund research. New business models to create published research have filled some of the void, but they rely on corporate payments. These types of organizations should be permitted to supply research under SEC rules and settlement agreements.

7. **Rule 701**.[13] The SEC should adopt the following amendments to Rule 701:

   a. Increase from $5 million to $10 million amount of securities sales necessary to trigger financial statement and risk factor disclosures.

   b. Alternative to paragraph 7.a, drop completely or significantly modify financial statement disclosure requirements
      i. If options are non-transferable except by law
      ii. If options may only be exercised on "net" basis with no employee funds paid to employer

8. **Securities Class Registration Relief for Employee Stock Options.** Provide relief from current requirement that treats employee stock options the same as voting securities and requires Exchange Act registration for companies with 500 or more option holders (without regard as to whether the options are currently exercisable).

Other Matters

PIPE Transaction Relief. In previous listings, the subcommittee had included a request for the SEC staff to review how recent Securities Act reforms impact the ability of smaller public companies to effectively raise capital through PIPE transactions. Because the reforms are quite recent, the subcommittee needs more time to analyze the nature of any problems for PIPE transactions under the new securities registration regime. The subcommittee has therefore removed PIPE transactions from its recommendations. The subcommittee intends to continue to communicate with experts in PIPE transactions to determine whether current PIPE regulation is fully compatible with legitimate business practices and objectives. The subcommittee may make recommendations in this area before adoption of the Advisory Committee's final report.

[13] Rule 701 provides an exemption from the securities registration requirements of the Securities Act for certain compensatory benefit plans and, therefore, is not a typical "capital formation" exemption.