CENTER FOR FINANCIAL MARKETS
MILKEN INSTITUTE

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January 11, 2016

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Exemptions to Facilitate Intrastate and Regional Securities Offerings; File No. S7-22-15

Via www.regulations.gov

Dear Mr. Fields:

The Milken Institute Center for Financial Markets would like to thank you for the opportunity to provide comments to the United States Securities and Exchange Commission (hereinafter the "Commission") on proposed changes to Rule 147, which provides a safe harbor to companies seeking to issue securities in an intrastate transaction that is exempt under Section 3(a)(11) of the Securities Act of 1933 (the " 1933 Act"), as well as proposed changes to Rule 504 of Regulation D and inquiries about the continued viability of Rule 505 under Regulation D.

The Milken Institute is a nonprofit, nonpartisan think tank determined to increase global prosperity by advancing collaborative solutions that widen access to capital, create jobs and improve health. The Center for Financial Markets (hereinafter "Center") promotes financial-market understanding and works to expand access to capital, strengthen and deepen financial markets, and develop innovative financial solutions to the most pressing global challenges.

The Commission has requested comment and information on its proposed rules which, *inter alia*, make substantive changes to Rule 147, changing it from a safe harbor to an independent exemption and imposing certain limitations on the amount a company can raise and the amount an investor can invest. Additionally, the Commission proposes increasing the amount a company can raise under an offering made pursuant to Rule 504, and is considering amending or removing certain provisions relating to offerings made in connection with state laws that permit sales to accredited investors.

The Milken Institute applauds the Commission's efforts to modernize the framework for intrastate and multi-state[1] offerings as these provide a potentially important source of capital, and as existing regulations have become stressed by technology and inflation. Intrastate and multi-state offerings also present an opportunity for state policy makers and regulators to provide innovative and effective efforts while avoiding distorting the national capital markets. With this in mind, the Center respectfully recommends that the Commission:

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[1] For the purposes of this letter "multi-state" will refer to offerings that can occur in multiple states simultaneously due to the laws of those states, as opposed to interstate offerings that are available nationally under federal law. Rule 504 contemplates certain multi-state offerings where registration and disclosure is stipulated under state law.

- Keep Rule 147 as a safe harbor to Section 3(a)(11) of the 1933 Act, while creating a parallel and substantially similar new exemption for companies that do not qualify for the 3(a)(11) exemption but are effectively engaged in an intrastate offering.

- Avoid imposing substantive requirements on Rule 147 offerings at the federal level, allowing the States to innovate and create laws that meet their needs.

- Remove the confusing "80 percent tests" currently found in Rule 147 in favor of a more flexible and meaningful standard.

- Index the investment limits for offerings under Rule 504 for inflation.

- Exempt securities sold under Rule 147 and 504 from the requirements of Section 12(g) of the Securities Exchange Act of 1934.

- The Commission should not repeal or amend Rule 504(b)(1)(iii).

- The Commission should investigate whether changing Rule 505 to provide an exempt, simple debt-only offering is feasible and could be beneficial for smaller issuers.

General Principles

The Center believes that capital markets can help foster human prosperity by providing efficient access to capital for businesses, leading to both job and wealth creation for entrepreneurs, investors, and employees. As such, the Center supports efforts to make securities regulations more efficient and accessible, while maintaining robust investor protection. In furtherance of this mission, the Center believes that the following principles should be considered while evaluating the proposals:

- *The Commission should seek to harmonize the interests of investor protection and capital formation by drafting rules that provide for sufficient investor protection while allowing companies to access the capital markets without undue burden or expense.*

  The Commission has the dual responsibility of protecting investors and enabling capital formation by companies. While these responsibilities are often cast as contradictory, in reality they are complementary. A market that is not safe, or perceived as safe, will not have sufficient investor engagement to function. Likewise, a market that is smothered by unnecessary and expensive rules will prevent companies from entering the market, denying would-be investors the opportunity to invest. It is in everyone's best interest that regulations enable both protection and capital formation without creating unnecessary exposure to fraud or unduly burdensome requirements.

  While the Commission must be mindful of investor protection it should also consider whether Commission action is necessary to provide it, or whether other actors, including state regulators, are better positioned to do so. Avoiding unnecessarily

redundant regulations will help facilitate capital access without jeopardizing the integrity of the market.

- *The Commission should draft regulations that maximize democratic accountability and respect the role of the states in the context of intrastate offerings.*

  Consistency and uniformity of rules for interstate offerings is important to both the offering's viability and the interests of accountability. As such, federal preemption of state regulations is often called for. Offerings made pursuant to Section 3(a)(11) of the 1933 Act and the proposed Rule 147 are somewhat different, however, as the scope of those offerings are limited to a specific state. This allows potential investors, who are citizens of that state, a direct means of determining the policy they wish securities offerings to be governed by and holding state policy makers and regulators accountable for investor protection. This, coupled with state policy makers' superior understanding of the needs of their particular state, allows for a more tailored and responsive regime relative to federal rules. It also means that a particular state's policies will not distort other states that have different preferences, unlike federal rules that, by necessity, often create a one-size-fits-all standard. Given the unique nature of Rule 147 offerings the Commission should respect the role of state regulators and allow them broad latitude in setting their own policy.

- *The Commission should seek to draft rules that can easily adapt to foreseeable future conditions to preserve their relevance and efficacy over time.*

  The Commission has proposed increasing the annual limit a company can raise under a Rule 504 offering from $1 million to $5 million. This change is driven in large part by the fact that, due to inflation, $1 million is not adequate for many businesses. While the Commission wisely seeks to change this to a more useful $5 million limit, it should take this opportunity to ensure that this new limit remains constant in real terms by indexing it to future inflation.

<u>Changes to Rule 147</u>

Introduction

Rule 147 provides a safe harbor for companies making offerings that are exempt from registration under Section 3(a)(11) of the 1933 Act by virtue of their purely intrastate nature. As such, Rule 147 is not a substantive exemption, but rather a set of criteria that issuers can use to ensure their offering is exempt from registration. Technological advancement, especially the potential to use the Internet as a means of soliciting and transacting investment, has stressed Rule 147 in its current form, making it hard for issuers to conduct offerings using normal industry methods and commonly accepted technology with the confidence that they fit within the safe harbor. This, in turn, has made it more difficult for companies seeking to pursue purely intrastate offerings to access capital effectively.

This problem has been recognized by the Commission's Advisory Committee on Small and Emerging Companies ("Advisory Committee") which promulgated suggestions to modernize Rule 147. The Advisory Committee recommended that the Commission:

- Allow offers made in reliance on Rule 147 to be viewed by out-of-state residents, but require that all sales be made only to residents of the state in which the issuer has its main offices;
- Remove the need to use percentage thresholds for any type of issuer eligibility requirement, and evaluate whether alternative criteria should be used for determining the necessary nexus between the issuer and the state where all sales occur; and
- Eliminate the requirement that the issuer be incorporated or organized in the same state where all sales occur.[2]

To address the problem of Rule 147's obsolescence, the Commission has proposed certain changes to the rule. Some of these changes reflect the suggestions of the Advisory Committee while others are original to the Commission. While many of the proposals will help make Section 3(a)(11) offerings more viable for issuers, others would likely make offerings unduly difficult and expensive, and inappropriately restrict the ability of the states and their citizens to set the policies for security offerings solely within their state as they see fit. This would dilute "the say" of the people most effected by the specific laws an intrastate offering is made under and deprive the country of one of the most valuable potential benefits of purely intrastate offerings – experimentation that can be used to test new and innovative solutions within a limited area with clear democratic accountability. As discussed below, the portions of the proposed amendments to Rule 147 that interfere with this ability should be removed.

What follows is a discussion of several specific proposed provisions that we believe should be modified or abandoned to better serve investors and issuers. That notwithstanding, the Milken Institute commends the Commission's work to modernize Rule 147 and its efforts to improve capital access, investor protection and orderly markets.

The Commission should keep Rule 147 as a safe harbor to Section 3(a)(11) of the 1933 Act, while creating a parallel and substantially similar new exemption for companies that do not qualify for the 3(a)(11) exemption but are effectively engaged in an intrastate offering.

As a threshold matter, given the potential negative consequences for state law, the Commission should reconsider its proposed movement of Rule 147 from a safe harbor for raises pursued under Section 3(a)(11) to a substantive exemption grounded in the Commission's general exemptive authority. The proposed change risks disrupting recent state law reforms designed to improve access to capital which rely on compliance with Rule 147 as grounded in Section 3(a)(11). Instead, the Commission should modernize Rule 147 under Section 3(a)(11) and create a parallel and substantially similar exemption for

[2] Letter to Chair White from the Securities and Exchange Commission Advisory Committee on Small and Emerging Companies, September 23, 2015. Available at: http://www.sec.gov/info/smallbus/acsec/acsec-recommendation-modernize-rule-147.pdf.

companies that fall outside the statutory requirements of 3(a)(11) with regard to state of incorporation but that are otherwise pursuing true intrastate offerings.

Section 3(a)(11) of the 1933 Act exempts from registration with the SEC:

[a]ny security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory[.]

The requirement that a company be incorporated under the laws of the state in which it seeks investment has posed a problem as more companies have moved towards incorporating in a handful of states that offer well-developed and effective systems of corporate law and highly competent business courts. Restricting Rule 147 offerings to only companies that are incorporated under the law of the state where they primarily do business could force companies to choose between the legal and corporate governance regime that best suit them and the market they wish to operate in.

To address this concern, and the statutory limits of the 1933 Act, the Commission proposes to ground the new Rule 147 in its general exemptive authority, rather than under 3(a)(11) of the 1933 Act. The creation of a Rule 147-like safe harbor open to companies that are incorporated in one state but, as a matter of economic reality, exist in another is an important reform. However, removing Rule 147 from 3(a)(11) is likely to have negative and unnecessary side effects for companies and state governments alike.

As the Commission acknowledges, many states have drafted their intrastate securities law with a requirement that the issuer also comply with Section 3(a)(11) and Rule 147.[3] If, as is currently proposed, Rule 147 is no longer tied to Section 3(a)(11) and is instead grounded in the Commission's general exemptive authority there is a significant risk that state securities law and issuers seeking to raise funds under those laws may be left in limbo until and unless the state laws are updated, straining state legislative and regulatory resources.

Fortunately, there is a relatively simple way for the Commission to address this risk. Rather than moving Rule 147 away from Section 3(a)(11), the Commission should modernize Rule 147 consistent with the limitations of 3(a)(11) while creating a parallel and substantially similar exemption under its general exemptive authority that applies to issuers that are incorporated under one state's laws but have a principle place of business in another. This combination of Rule 147 and "Rule 147A" would allow the Commission to modernize the safe harbor for truly intrastate offerings, regardless of where a company is incorporated, without the risk of disruption to state securities law that moving Rule 147 away from 3(a)(11) could create.[4]

[3] Proposed Rule at 11.
[4] Hereinafter "Rule 147" will refer to both Rule 147 and, where appropriate, a hypothetical "Rule 147A".

The Commission should avoid imposing substantive requirements on Rule 147 offerings at the federal level, allowing the States to innovate and create laws that meet their needs.

The proposed Rule 147 (in contrast to the existing provisions of Rule 147) would establish limits on the amount that an investor could purchase in offerings made under state laws, while leaving the exact limits for the states to decide. The proposal would also limit the amount that could be raised to $5 million per year. While these requirements seek to protect investors, they are inappropriate for the federal government to impose given the unique nature of intrastate offerings. By dictating conditions to the states as to how they pursue investor protection, the rule both unduly intrudes on the authority of the states and potentially frustrates their ability to innovate and to respond to their unique situations. The states have ample incentive to pursue robust and tailored investor protection regimes for offerings that occur entirely within their jurisdiction, and should remain free to do so.

While the Constitution places absolute limits on the scope of federal power, prudent policy can in some instances also dictate that, even when the federal government has jurisdiction, it exercise forbearance in deference to the authority of the states. Given their limited scope and the political and economic realities at play, the type of offerings expected to be made under Rule 147 present such a case. To utilize Rule 147, issuers must have a substantial, and for all intents and purposes, exclusive relationship to the state where the offering takes place. Likewise, investors must be residents of that same state. These provisions effectively limit any offering made under Rule 147 to a single state.

State policy makers are likely in the best position to evaluate the unique needs of their market. State law and regulation are therefore the appropriate vehicles to meet those needs. Forcing state policy makers to include limits on the amount an investor can invest, or the total amount of investment a company can raise, as a means of investor protection, will hamper their ability to tailor the law to best meet the needs of the state.

Requiring caps and limits will impose a baseline compliance cost of an offering, both directly through monitoring and enforcement costs and indirectly by decreasing the amount any one willing investor could invest, thus forcing companies to search for more investors. Given this baseline cost, state policy makers may not be able to add additional investor protection provisions, even those they consider more effective, because the cumulative burden created by compliance and uncertainty would be too high. Secondly, the existence of investor caps and limits may discourage innovation in investor protection because policy makers may devote their scarce legislative and regulatory resources to those topics that do not already have federally imposed requirements.

Additionally, imposing federal requirements on what are otherwise state-specific offerings may make them less responsive to the needs of market participants, perhaps without any additional benefit. State lawmakers and regulators are directly and closely accountable to the relevant parties to a Rule 147 offering in a way the federal government is not. Unlike interstate offerings, all of the parties to a Rule 147 offering have a strong connection to a single state and can directly influence that state's policy. This alignment allows for state policy makers to create responsible and tailored laws that fit the policy preferences of their citizens, and allows different states with different preferences to vary without the differences "leaking" beyond the state's borders and impacting people without a say in the policy. The

close fit between citizens and state policy makers also allows for rapid changes in policy, either by policy makers or voters, if they become necessary.

Conversely, changing federal requirements is a relatively difficult and cumbersome procedure, and could create a conflict between states where the limits were seen as appropriate (and which could impose identical limits via state-level policy) and those where the limits are inappropriate or ineffectual. For example, while no state currently has a total investment limit above $5 million, it is not unreasonable to assume that some states might wish to raise the limit given their unique circumstances. Under the current proposals, states would need the Commission to change their regulations to be able to do so, frustrating the state's ability to create an intrastate regime that works for their specific situation.

This is not to argue for or against the efficacy of any given investor protection proposal, rather it is to argue that that states should retain the ability to set their own policy for intrastate offerings. Caps and limits may well be an effective tool, but to the extent they are considered the best option for a particular state, that state is both capable and the appropriate vector of imposing them. Likewise, if state policy makers believe that their investors' needs are best served by another policy, they should not be hamstrung by a federal mandate. In light of this, and the contained nature of the offerings, the Commission should refrain from imposing substantive requirements on offerings made under Rule 147.

If the Commission insists on imposing a limit on the amount a company can raise under Rule 147 it should index that limit for inflation.

As discussed above, state-level policy makers are the best suited and appropriate decision makers for creating substantive requirements for Rule 147 offerings. As such, the Commission should refrain from imposing limits on the amount a company can raise in an offering. However, if the Commission persists in imposing substantive limits it should index the limit to inflation. While this will not address all of the problems with a federally imposed limit, it will at least partially mitigate against the risk that the regulation will be rendered ineffectual due to inflation.

The Commission should remove the confusing "80 percent tests" currently found in Rule 147 in favor of a more flexible and meaningful standard.

Under the current Rule 147 a company must satisfy several requirements to demonstrate they are "doing business" in a state. Among these requirements are:

- derive at least 80 percent of its consolidated gross revenues in-state;
- have at least 80 percent of its consolidated assets in-state; and
- intend to use and use at least 80 percent of the net proceeds from an offering conducted pursuant to Rule 147 in connection with the operation on an in-state business or real property.[5]

[5] 17 CFR 230.147(c)(2)(i-iii).

The proposed rule makes several important and positive changes, including introducing an additional test for whether a majority of a company's employees are based in a particular state and allowing a company to qualify by meeting one of the tests, rather than all of them as currently required. As the Commission acknowledges, the requirement that an issuer have its principal place of business in the state in which it seeks investment limits issuers to a single state.[6] The requirement that the issuer also satisfy any additional criteria only provides further assurance that the issuer is qualified, rather than as the primary check.[7]

Unfortunately, while the disposition of revenues, assets, and expenditures are all rationally related to where a state "does business," the requirement for a precise number (80 percent) can be confusing and difficult for issuers to assess. Additionally, the high and precise threshold can exclude issuers that rationally should qualify. For example, there is little meaningful difference between deriving 80 percent of revenue from a state versus 79 percent, but it could make the difference between qualifying or not. Rather than a precise but arbitrary number, the Commission should adopt a more flexible standard, allowing that if a company derives a majority of its revenue, has a majority of its assets, intends to use, and uses, a majority of its proceeds, or has a majority of its employees in a given state, the company will qualify.

This approach will limit issuers to a single state to which their business has a significant relationship, while also making it much easier for companies to accurately assess whether they qualify. Additionally, moving away from a strict 80 percent requirement in favor of a majority requirement would harmonize these tests with the proposed test for number of employees.

The Commission should exempt securities sold under Rule 147 from the requirements of Section 12(g) of the Securities Exchange Act of 1934.

The Commission's current proposals for Rule 147 do not include any provision to exempt securities sold under Rule 147 from the requirements of Section 12(g). Given the expected local nature of Rule 147 offerings and the likelihood that they will be made to the general public for relatively small amounts, it is very possible that small companies making even modest offerings[8] would accrue sufficient numbers of non-accredited investors to be forced to register with the Commission. Additionally, avoiding 12(g) could result in companies placing restrictions on transfers that were otherwise unnecessary or counterproductive to prevent falling under 12(g) after a sale.

This would make Rule 147 far less viable for the types of companies most likely to benefit from it. Given the intrastate nature of the securities, and the state-level regulation the offering would be subject to, the provisions of 12(g) are unlikely to provide sufficient benefit to justify their cost. As such, the Commission should exempt securities offered under Rule 147 from Section 12(g).

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[6] Proposed rule at 21.
[7] Id. at 22.
[8] For example, a $1million offering with a $500 minimum purchase requirement could result in 2000 shareholders.

Changes to Rule 504 of Regulation D

Introduction

There is concern that the relatively low limit on the amount of money an issuer can raise per year pursuant to Rule 504 ($1 million) has rendered the exemption less attractive to issuers than Rule 506, which has no limitations on amounts raised. This is despite the fact that under certain circumstances, including registration at the state-level, Rule 504 allows for general solicitation to the general public and less restricted resale of securities.[9] The Commission proposes changing the annual limit on offerings made pursuant to Rule 504 of Regulation D from $1 million to $5 million per year in an effort to make Rule 504 a more viable choice for issuers and to help facilitate multi-state 504 offerings.

The Commission should index the investment limits for offerings under Rule 504 for inflation.

Rule 504's current obsolescence is largely a result of the erosion of the dollar's value in real terms. The Commission should make Rule 504 more durable by indexing the limit that a company may raise to inflation so that it automatically adjusts to keep the real value of the exemption relatively constant. Indexing would place Rule 504 in a similar position to Regulation Crowdfunding offerings where, under Section 4A(h)(1) of the 1933 Act the annual dollar amount is to be adjusted for inflation at least every five years.

While indexing the annual limit for Rule 504 offerings would likely require the Commission to ground Rule 504 in its general exemptive authority rather than the small issues exemption authority found in Section 3(b)(1) of the 1933 Act, and in light of the practical benefits to issuers and the possible conservation of Commission resources, the Commission should index the annual limit for Rule 504 offerings to inflation.

The Commission should not repeal or amend Rule 504(b)(1)(iii).

In its proposal, the Commission asks whether Rule 504(b)(1)(iii) should be repealed or amended to place limitations on resale.[10] The Commission should refrain from changing 504(b)(1)(iii) and allow the states to experiment. This will allow for innovation in a tightly controlled environment that may prove useful for other state and federal policy makers.

The Commission should exempt securities sold under Rule 504 from the requirements of Section 12(g) of the Securities Exchange Act of 1934.

Securities sold under Rule 504 face similar issues regarding Section 12(g) as those sold under Rule 147. For the reasons discussed above, the Commission should also exempt securities sold under Rule 504 from the requirements of Section 12(g).

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[9] 17 CFR 230.504(b)(1)(i-iii).
[10] Proposed rule at 66.

The Ongoing Feasibility of Rule 505 of Regulation D

The Commission asks whether, in light of the proposed changes to Rule 147 and Rule 504, Rule 505 is still needed, and what, if any, changes should be made to it. Among the potential criteria the Commission asks commenters to consider are criteria aimed at creating a very small offer aimed at early stage companies.[11] This concept merits further consideration but the Commission may also want to consider whether an exempt, simple debt-only offering is feasible and could be made cost-efficient for smaller issuers.

According to research by the Milken Institute and The National Center for the Middle Market,[12] debt-based financing is the overwhelmingly preferred type of external capital[13] among small and mid-size businesses. This debt-based capital is primarily obtained via loans, as opposed to debt securities offerings.[14] Unfortunately, there is evidence that banks are retrenching from small business lending due to economic and regulatory concerns.[15] The Commission should consider whether an exempt offering focused on simple debt securities could serve the needs of small businesses and investors, and whether the unique nature of simple debt securities may permit more modest compliance requirements relative to an offering type that permits debt and equity offerings, while providing robust investor protection. Such an offering could help main-street companies better access the securities markets, while providing investors with viable investments.

Conclusion

Rules 147 and 504 have the potential to both be important avenues for capital formation for small business and provide the states with a mechanism to tailor the rules and requirements to meet the needs of their investors and entrepreneurs. These rules can also facilitate a valuable testing environment for various methods of investor protection that can potentially be exported to the national stage. The Commission should allow state policy makers, and the voters they represent, to craft solutions and refrain from imposing substantive requirements that may distort or frustrate this effort, and “future-proof” Rule 504 to maintain its long-term usefulness. Additionally, the Commission should consider whether Rule 505 could be remade to better suit the needs of small business, for example by focusing on debt-based financing.

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[11] Proposed rule at 70, Question 64.

[12] Access to Capital: How Small and Mid-size Businesses are Funding Their Future (http://www.milkeninstitute.org/publications/view/706).

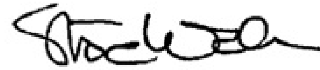
[13] Id. at 3.

[14] Id.

[15] See generally: Mills, Karen, and Brayden McCarthy" The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game. Harvard Business School Working Paper, No. 15-004, 22 July 2014.

We again thank you for the opportunity to comment on the proposed changes to Rules 147 and 504. Please let us know if we can provide any additional information, and we would be honored to have the opportunity to continue this discussion in person as the Commission continues in its efforts to protect investors and help companies access the capital they need to grow and thrive.

Sincerely,



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