CENTER FOR FINANCIAL MARKETS
MILKEN INSTITUTE

March 2, 2015

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Comments on Proposed Changes to Exchange Act Registration Requirements to Implement Title V and Title VI of the JOBS Act; S7-12-14

Dear Mr. Fields,

The Milken Institute Center for Financial Markets would like to thank you for the opportunity to provide comments to the Securities and Exchange Commission (the "Commission") on proposed changes to the registration requirements under the Securities Exchange Act of 1934 (the "Exchange Act") to implement Titles V and VI of the Jumpstart Our Business Startups (JOBS) Act.

The Milken Institute is a nonpartisan, nonprofit, think tank with a mission of improving lives around the world by advancing innovative economic and policy solutions that create jobs, widen access to capital, and enhance health. The Center for Financial Markets 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*, relate to the change in number of holders of record[1] an issuer must have before it is required to register with the Commission pursuant to Section 12(g) of the Exchange Act. The Milken Institute applauds the Commission for highlighting many of these questions and inviting input from the public. While these changes may appear merely technical, they can have significant implications for companies and investors, especially those utilizing the new or revised exemptions from registration created by the JOBS Act. These companies are often the least able to bear the cost of overly-burdensome regulations and finding the best way to protect investors while allowing a robust market to develop is vital to their survival. With this in mind, the Milken Institute respectfully recommends that the Commission:

- Provide a non-exclusive safe harbor for issuers that allows issuers who have previously developed an initial reasonable belief in the investor's accredited status to:

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[1] The Milken Institute understands that a holder of record does not necessarily need to be the beneficial owner, with entities such as certain brokerages, able to serve as the holder of record for underlying investors (i.e. holding in "street name"). However, not all securities are held this way, and private securities -- especially those issued by smaller, less sophisticated issuers – may be more likely to be held by the investor directly. The Commission should consider the costs in cases where all of an issuer's holders of record are individuals when assessing any requirements to be imposed on issuers.

- ☐ rely on investor self-certification going forward, unless the issuer has information that would make such reliance unreasonable

- ☐ treat an investor's failure to respond as an endorsement of the status quo, unless the issuer has information that would make such reliance unreasonable

- ☐ only query enough holders-of-record to ensure the issuer has under 500 unaccredited holders-of-record, instead of requiring the issuer to query all holders-of-record

- ▪ Refrain from imposing additional disclosure requirements on private securities until and unless it is determined that existing laws and market forces are not providing sufficient protection.

Guiding Principles

What follows are the guiding principles that we believe should inform the Commission's decisions regarding the final disposition of the rules in light of the needs of both investor protection and capital formation. These principles are informed by an understanding of the nature of private capital markets, the need of entrepreneurs and investors – especially those using or anticipating using newly created means of capital access such as those provided for by the JOBS Act – to have regulatory certainty to help frame their decisions, whilst mantaining an appropriate balance between investor protection and economic reality. They are:

- ▪ *The Commission should seek to draft regulation with an eye towards harmonizing the interests of investors and issuers by implementing requirements that help protect investors while also allowing issuers to participate in capital markets without unnecessary 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 being contradictory, in reality they are complimentary. A market that is not safe, or percieved of 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 access without creating unnecessary exposure to fraud or unduly burdensome requirements.

  Provisions within the JOBS Act are designed to expand access to early investments to a broader group of investors than was previously possible. While this has the potential to create a market with more equitable oppurtunity and greater capital, there are very real risks as well. By allowing new investors, many of whom may lack experience in early-stage investing, to enter the market there are dangers that investors will be defrauded by unscrupulus operators, or that investors will mistake the high legitimate failure rates of early-state companies as indicative of fraud. Investor education and access to information, coupled with strong enforcement of anti-fraud provisions, are essential to mitigating these risks and allowing new investors to make considered and informed decisions and avoid fraud. The more informed these new investors are the better the market will function for issuers as well, as informed investors will be more decisive, engaged, and willing to accept the reality of the risky nature of early-stage investments.

However, while informed investors are important, any regulations must take into consideration the fact that compliance drains money, time, and attention from issuers, three things that companies, especially early stage companies, tend to lack. Excessive compliance costs will prevent legitimate companies from seeking investment, and may result in more companies failing than the market would otherwise dictate. Such an outcome would not only be bad for the companies, their employees, and the broader economy, but also investors who are deprived of possible successsful investments. This is not to say that essential investor protections should be neglected, but that the Commission should avoid redundancy and structure such requirements to be as easy to comply with as possible.

- *The Commission should consider that one of the main purposes of the JOBS Act was to enable companies outside traditional funding hubs, who were often unable to effectively obtain private capital because they did not have access to enough investors, to seek investment from a broader audience, while providing sufficient protection to investors. The Commission should avoid imposing any requirements that frustrate this purpose.*

The JOBS Act was passed partially in response to the reality that many companies cannot effectively engage in private capital raising, for reasons other than the merit of their business. Private capital is concentrated geographically in a few locations[2], and many entrepreneurs outside of those locations lack access to local investors. The JOBS Act's response was to allow companies to use the internet to seek investors[3] so that companies could more easily seek funding from outside their local area.

These companies are less likely to have personal relationships with their investors than companies using traditional methods of private capital raising. As such, they are less likely to be able to develop a reasonable belief as to their investors' accreditation status simply through day-to-day interactions with the investors. The Commission should be mindful that while the JOBS Act now requires companies to have, at least in certain circumstances, a reasonable belief as to the accredited status of their holders-of-record, rules governing how that belief is established that are too onerous or ambiguous will defeat the JOBS Act's purpose of facilitating capital formation. As such, the Commission should avoid imposing requirements that will be so burdensome as to frustrate or unfairly disadvantage companies relying on the new exemptions from registration. Likewise, the Commission should provide a clear safe harbor to avoid ambiguity that could discourage investment.

- *The Commission should consider all the costs attendant to its proposal, including costs incurred by changes to market participant behavior that are reasonably foreseeable as a result of either*

[2] For example, three states, California, New York, and Massachusetts dominate venture funding (http://www.pwc.com/en_US/us/technology/assets/pwc-moneytree-q3-2014-summary-report.pdf), with at least one report indicating that California based companies received over half of the total venture capital funds invested domestically in 2014 (https://www.cbinsights.com/blog/california-venture-capital/).

[3] While the different relevant provisions of the JOBS Act place different limits on the nature of the companies' solicitations, they all allow for issuers to seek investment from investors who have no previous relationship with the issuer.

a requirement mandated by the Commission or regulatory uncertainty created by a failure to provide clear guidance or safe harbor, when evaluating different options, rather than just comparing the direct costs of compliance with the proposal to those of registration.

The Commission has asked for comparisons between the costs of various means of investor accreditation verification and the costs of registration. This should not be the only metric used when evaluating the costs of a proposal. Rather, the Commission should also consider how the market will react to any additional requirements it might impose. The Commission has received information previously on the cost and potential market impact of various investor accreditation methods in connection with its rules on 506(c) offerings[4]. Similar issues are at play here, but the impact is likely to be greater since while a verification performed in connection with a 506(c) offering is a one-time event, verifications related to the current proposal could potentially have to be regularly performed until such time as the issuer registers a class of securities with the Commission, or in perpetuity if the issuer never registers.

Given the potentially unlimited duration of any requirements, the Commission should consider not only the direct cost of a specific requirement compared to registration, but also the indirect costs those requirements will impose, including those relating to market participants changing their behavior, when determining how to proceed.

- *The Commission should keep in mind the potential fragility of the market for private securities offered pursuant to exceptions found in the JOBS Act, and the companies that rely on them, and avoid issuing new and burdensome regulations before determining whether current law or market forces are sufficient to protect investors.*

As part of its analysis the Commission should evaluate whether preexisting laws, regulations, and market forces already have the ability to limit potential negative outcomes, and whether the potential benefits of new requirements going beyond what the statute would dictate are exceeded by the costs such requirements might inflict. This is especially important given the newness and possible fragility of the market created by the JOBS Act. For this market to survive and thrive investors must have sufficient access to information, and be sufficiently protected, so that they can confidently buy and sell securities. Without this confidence the market will stagnate, depriving both companies and investors of the benefit a functioning market could provide. While providing this investor protection is essential to the health of this market new regulations may not be required to achieve this goal. Further, unnecessary regulations could smother the nascent market before it has an opportunity to develop, denying investors and issuers the benefits the JOBS Act sought to create and denying the Commission the information necessary to tailor any additional regulation to what is actually required.

The Commission may ultimately decide that the changes to the law brought about by Titles V and VI of the JOBS Act, directly or indirectly, give rise to a need for additional disclosure requirements, but it should be cautious in acting before it analyzes how the

[4] Those comments are available at: http://www.sec.gov/comments/s7-07-12/s70712.shtml

market functions to determine whether current legal and market tools can sufficiently protect investors.

Comments on Proposed Rules

A. Standard for Verification of Investor Accreditation

Changing the threshold for registration from 500 holders of record to 2000 holders of record, not more than 500 of which can be unaccredited, implies that in at least some circumstances an issuer must have a reasonable belief as to the accredited status of those holders-of-record. The basis for this belief, and the work required to obtain that belief, could have a major impact on the ability of companies to attract and retain investment, limit potential liability, and compete. The Commission should structure any requirements so that they do not unfairly disadvantage companies making online offerings, provide clear and accessible safe harbors, and minimize the cost and burden to both investors and issuers.

i. *The Commission should create a safe harbor that sets out how issuers may establish a reasonable basis for belief as to a holder's accredited status*

In its proposing release the Commission asked whether it should provide a safe harbor or guidance to issuers on how an issuer can establish a reasonable belief in the accredited status of a holder of the issuer's security[5]. A properly structured safe harbor will provide both issuers and investors with certainty and let both less sophisticated and well-capitalized issuers have confidence they can pursue investment while maintaining compliance. As such, the Commission should opt to provide a safe harbor instead of merely providing guidance or leaving issuers to make judgments based purely on their own legal analysis.

Titles II, III, and IV of the JOBS Act were designed to expand access to the private securities markets[6] for both issuers and investors[7]. Many issuers taking advantage of these new methods are less likely to have a personal relationship with their investors than issuers pursuing more traditional private placements, since the investor relationship will be developed over the internet rather than in face-to-face meetings. Additionally, while accredited status was traditionally relevant to issuers only at the time the securities were being offered, the JOBS Act has now made it relevant to issuers on an ongoing basis. These changes could, in the absence of a clear safe harbor, lead to regulatory uncertainty where issuers are uncertain how to achieve compliance. This is especially true for those issuers who lack experience, personal relationships with their investors, and assets to pay for expensive legal counsel -- in short, many of the very issuers the JOBS Act was enacted to help.

By providing a clear safe harbor the Commission can help create certainty and predictability for issuers and investors. It is true that guidance would be of some benefit, but it would likely not provide sufficient clarity for less sophisticated issuers to act with confidence. The provision of a safe harbor will avoid cumbersome "one size fits all" solutions while allowing issuers and investors to avoid unnecessary and often paralyzing uncertainty.

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[5] Proposing Release pg. 22, question 6.

[6] Specifically Title II (Removing the ban on general solicitation in certain offerings made pursuant to Regulation D), Title III (Crowdfunding), and Title IV (Certain offerings made pursuant to Regulation A) create or expand unregistered securities offerings.

[7] Investors in an offering made under Title III do not count towards an issuer's 12(g) threshold.

ii. *The safe harbor should allow issuers to assume an investor's accreditation status remains the same absent knowledge to the contrary*

The Commission has asked for comment on what the requirements for a safe-harbor should be if the Commission decides to create one[8]. To be effective and consistent with the overarching purpose of the JOBS Act the safe harbor should balance the interests of investor protection with respecting investor privacy, facilitating access to capital, and fairness among different issuers. It should be clear and feasible for all issuers, especially less sophisticated issuers or those who cannot afford experienced legal counsel, and should avoid imposing unduly expensive, burdensome, or invasive requirements on issuers or investors, which could end up discouraging investors from participating in private offerings out of concern that they will face repetitive questions involving sensitive private information or diminished returns to their investment.

To facilitate these ends the safe harbor should allow issuers to assume that an investor's status has remained constant, absent information to the contrary. This could be accomplished by allowing issuers to come to a reasonable belief as to the investor's status either at the time of sale of the security or at some point after as needed[9]. Once the investor's status has been determined the issuer could then query investors as needed as to whether they remain accredited but rely on the investor's response, or lack of response, to establish the investor's status. This could be accomplished via a written communication from the issuer to the holder-of-record indicating the current definition of an accredited investor, the investor's status as known by the issuer, and a query as to whether that status continues to be accurate. The investor could then update the issuer as to the investor's status. In the event that the investor does not respond the issuer should be allowed to assume the investor's status has not changed unless the issuer possesses other information that makes such an assumption unreasonable[10].

This treatment would be consistent with the Commission's previous decision to allow accredited investors who had invested in an issuer's Rule 506(b) offering to subsequently qualify as accredited for purposes of that same issuer's 506(c) offering with only self-certification[11]. While this proposal differs from the Commission's position with respect to accreditation in a Rule 506(c) offering in that this proposal allows for negative assent while the 506(c) rule requires positive affirmation, this distinction is appropriate given the fact that in the 506(c) sale context the issuer and investor are actively engaged in a securities transaction while here the investor is merely passively holding their securities without any additional money or securities being transferred between the parties.

Failure to allow issuers to rely on an investor's previous status (absent knowledge to the contrary), could discourage investment, force issuers to engage in unnecessarily difficult and expensive verification efforts, and would unfairly disadvantage issuers outside of major funding hubs. To understand why forcing issuers to regularly determine an investor's accreditation status and how this could discourage

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[8] Proposing Release pg. 23, question 7.

[9] Certain types of unregistered offerings, such as those under Section 506 of Regulation D, would require the issuer to have a reasonable belief as to the investor's accredited status at the time of sale. Others, such as those under Regulation A do not. In those cases the issuer can, when appropriate, do what is necessary under the relevant facts and circumstances, to form such a belief.

[10] It should be noted that there are many reasons an investor may not respond to such a query, including simple laziness. As such, no negative inference should be automatically drawn from a simple failure to reply absent other information.

[11] 17 C.F.R. 230.506(c)(2)(D).

investment, the Commission should consider the comments received in the context of investor verification for 506(c). In that context, both accredited investors and investment platform operators discussed how onerous investor verification requirements would cause investors to refuse to participate in 506(c) offerings. Reasons included concerns about privacy[12], the time and burden on the part of the issuer to provide the needed information[13], the costs of verification depressing the issuer's returns and increasing the risk of failure[14], and the concern that an issuer failing to satisfy the technical requirements for investor verification may place all of its investors' investment at risk if a disgruntled investor seeks rescission of their investment[15]. One platform operator estimated that at least 15 percent of angel investors refused to participate in 506(c) offerings because of the burdensomeness of the investor verification requirements[16]. These concerns were voiced in the context of a one-time check on an investor's status. It seems obvious that investors would be more concerned, and less likely to participate in private offerings, if they knew they would face similarly burdensome inquiries on a yearly basis.

Allowing issuers to rely on investors' previous status will best balance the interests of investor protection with respecting investor privacy, facilitating access to capital, and fairness among different issuers. This safe harbor would not, as some might fear, mean that issuers could avoid communicating with their investors or remain intentionally ignorant, but it would allow them to avoid repetitive and invasive questioning of their investors that could discourage potential investors from participating in private offerings.

iii. *The Commission should only require issuers to develop a reasonable belief in the ongoing accredited status of enough investors to ensure it has under 500 unaccredited holders-of-record*

The question of how many investors must be subjected to an accreditation analysis is as important as what that analysis should contain. Even the reasonable safe harbor described above will require both issuers and investors to expend money and time complying. Further, from a compliance perspective there is no value to unnecessary queries, such as when it is mathematically impossible for an issuer to trigger the 500 unaccredited holder-of-record limit. As such, the Commission should only require issuers to query enough investors to be confident that they have no more than 499 unaccredited holders-of-record, rather than having to query every investor regularly. Such a requirement would allow issuers to form the reasonable belief necessary to satisfy the law without unnecessary expense or inconvenience. Investors would likewise benefit by not being queried by the issuer unless absolutely necessary.

In practice, such a rule would allow an issuer to not query the accredited status of any of their holders-of-record until they have over 500 holders-of-record[17]. Once an issuer has over 500 holders-of-record it should only be required to query enough holders-of-record to feel confident they do not have 500 or more unaccredited holders-of-record. For example, if an issuer has 600 holders-of-record it should only need to establish a reasonable basis for belief that at least 101 are accredited to be in compliance,

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[12] Name withheld, letter submitted Aug. 18, 2013.
[13] Naval Ravikant, letter submitted Jun. 3, 2014.
[14] Ralph Mayer, Board Member of Angel Capital Association and Chairman Emeritus, Tech Coast Angels, letter submitted Aug. 21, 2013.
[15] Jo Ann Corkran, Loretta McCarthy, Peggy Wallace, and Vanessa Wilson, Golden Seeds LLC, letter submitted Aug. 9, 2013; Marianne Hudson, Executive Director, Angel Capital Association, letter submitted Nov. 4, 2013.
[16] Naval Ravikant, letter submitted Jun. 3, 2014.
[17] Issuers may be required to check the investors' status for other reasons, for example to comply with the requirements of the exemption they used to issue the securities.

rather than querying their entire investor base.

By making it clear that issuers only need to establish a reasonable belief that they do not have 500 or more unaccredited holders-of-record, rather than a reasonable belief as to the accreditation status of all of their holders-of-record, the Commission will reduce uncertainty and allow issuers to conserve scarce resources and lower the burden for both issuers and holders-of-record without compromising compliance.

B. Information Required for Freely-Tradable Shares from Unregistered Companies

The commission has expressed concern that the higher registration and reporting thresholds would lead to more shareholders of freely tradable securities lacking current disclosure information about the issuer, creating possible investor protection issues in the secondary market. The Commission has asked what these issues may be and how they might be addressed. In assessing whether additional action, in the form of new requirements, is needed, the Commission should consider the impact of the current legal and market environment, and what the potential cost of new regulations would be to a relatively new market. The changes to the registration threshold contained in the JOBS Act do not operate in a vacuum. Rather, they operate within a large and overlapping network of legal and market forces that will, at least in some cases, help to provide investors and potential investors with access to current disclosure information or otherwise serve to mitigate the possible risks to investors that the lack of registration may provide. As such, the Commission should evaluate whether existing regulations and market forces properly balance the needs of investor protection with that of investor opportunity and capital formation prior to mandating any new disclosure requirements.

For example, while an issuer with more than 500 holders-of-record may no longer need to register with the Commission it may be required to provide ongoing disclosure information as a condition of the exemption they originally used to sell shares, such as in the case of Tier II of Regulation A (as proposed)[18], which would allow an issuer to sell securities to the general public that are freely tradable, but also requires issuers to provide robust annual disclosure as a condition of the exemption[19]. The venue in which a secondary sale occurs, or the participants in the sale, may also create disclosure requirements. For example, under Rule 15c2-11[20] brokers or dealers cannot, with certain exceptions, offer quotations for securities without possessing a significant amount of current disclosure information about the issuer and having a reasonable belief that the information is accurate. Brokers and dealers are also required by law to investigate the offers they make to investors[21]. As such, in cases where brokers or dealers are making markets for securities that were originally privately placed in the secondary markets, there are at least some pre-existing legal requirements that would help provide transparency and protection to investors.

In addition to regulations, there are market forces that will likely encourage issuers and secondary market facilitators to provide disclosure. If an issuer utilizes an exemption that permits the securities sold in reliance on it to be freely resold, part of the security's value to the initial investors is the ability to resell. As such, issuers of freely-tradable securities competing for investors have an incentive to ensure

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[18] 79 FR 3926
[19] *Id.* at 4003
[20] 17 CFR §240.15c2-11
[21] *See* Hanley v. SEC, 415 F.2d 589, 595-596 (2nd. Cir. 1969)

there is enough transparency to support a secondary market for their security[22]. Facilitators of secondary markets, such as broker-dealers or marketplaces that allow securities holders to offer their securities for sale would also have an incentive to mandate disclosure as a condition of utilizing the platform. By providing enhanced transparency, a platform could help establish a reputation as a high-quality secondary market facilitator, encouraging buyers to prefer their platform to the competition, and therefore attracting sellers.

Concern over liability may also motivate greater transparency. The anti-fraud provisions of the Exchange Act, other state and federal laws, and common-law torts, could create criminal and civil liability for a party selling a security in cases of fraud or material misstatements. Even if a claim is ultimately baseless, the cost and reputational risk of litigation imposes a strong incentive for sellers and facilitators to provide buyers with sufficient information that the buyer can make an informed decision. These sellers, who are also investors in the issuer, are likely to pressure the issuer to provide current information, or favor offerings using exemptions that require ongoing disclosure, providing an incentive to issuers to provide that information.

Given these pre-existing forces that encourage disclosure in the secondary market, the Commission should hesitate before mandating new requirements. Any additional ongoing requirements will increase the cost of capital to issuers, which can not only be harmful to the issuer but also to its investors, since expensive capital leaves businesses with less wherewithal to survive in bad economic conditions and grow in good ones. It may also encourage issuers to restrict secondary trades in their securities simply to avoid the cost of compliance, as opposed to operating in the best interests of their business. This would not only harm the business, but would also harm their investors who want or need the liquidity and potential secondary investors who would benefit from a the secondary market.

While investors possessing sufficient information the make infomed decisions is essential to both investor protection and the longterm functioning of the market, and mandating additional disclosure may ultimately be called for, at present it is unclear whether it is required. Rather than risk stifling the market with requirements that are ultimately duplicative or unnecessary, the Commission should clarify what existing provisions of the law it considers to be applicable to market participants. The Commission should collect information about the private secondary market and determine whether investors are sufficiently informed and protected by current law and market forces. By waiting, the Commission can allow the market to develop, better understand where there are problems and, to the extent new regulation is needed, craft the regulation to meet that need with minimal cost and disruption.

Conclusion

The JOBS Act was enacted to enable companies to access capital, and investors to make investments, more easily. Of particular concern to Congress when drafting the legislation were companies that had trouble developing relationships with investors locally. While innovations like lifting the ban on general solicitation and proposed Tier II of Regulation A provide an opportunity for companies to meaningfully access investment outside of their local region, overly burdensome requirements or regulatory ambiguity could render these innovations unviable, frustrating the purpose of the JOBS Act and harming the companies and investors they were intended to help. To avoid this, the Commission should provide

[22] Issuers may not want to encourage a secondary market for their security for other reasons, but presumably those issuers would favor exemptions that do not permit securities to be freely traded, or limit the ability of investors to resell their securities via the initial investment agreement.

a non-exclusive safe harbor along the lines described above, clarify existing disclosure rules as they apply to the secondary market for freely-tradable private securities, and refrain from instituting new disclosure rules until the Commission determines that current regulations and market forces are not meeting.

We again want to thank you for the opportunity to comment on the proposed regulations to implement Title V and VI of the JOBS Act. 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 implement the JOBS Act.

Sincerely,

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Center for Financial Markets
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Staci Warden
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