October 5, 1981

Ropes & Gray
Washington, D.C.

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Mr. George A. Fitzsimmons, Secretary
Securities and Exchange Commission
500 North Capitol Street
Washington, D. C. 20549

Re: File No. S7-891; Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales

Gentlemen:

The purpose of this letter is to set forth our comments with respect to the Commission's proposed amendment to limited offering exemptions under the Securities Act of 1933. In general, we are in favor of the Commission's efforts to streamline some of the existing regulatory requirements applicable to limited offerings. In particular, we believe that the Commission's efforts to coordinate the various limited offering exemptions should be extremely helpful in facilitating many forms of small business capital formation. Our specific comments on the Commission's proposals are described below on a rule-by-rule basis.

RULE 501

Rule 501(a) — Definition of Accredited Investor. In general, we believe that the Commission should give serious consideration to expanding the proposed list of persons who would qualify as "accredited investors". From our experience, it appears that there are certain kinds of sophisticated investors which regularly participate in private offerings but which are not enumerated in the Rule 501(a) list. In particular, we note that registered investment companies and business development companies regulated under the Investment Company Act of 1940 are included as "accredited investors", whereas many so-called "private investment companies" and "venture capital firms" are not necessarily included as "accredited investors". We would suggest that the Commission consider

adding to the list any company which would be required to be registered as an investment company under the Investment Company Act of 1940 but for the exemption from such registration provided by Section 3(c)(1) of that Act. The requirement that securities of such exempt companies be issued only in transactions not involving a public offering would serve to insure that such companies are made up entirely of investors who are capable of making sophisticated investment choices in managing the investment programs of their companies.

With respect to "accredited investors" described in Rule 501(a)(3), we would like to point out that there are many endowment funds maintained by independent schools, hospitals and other charitable organizations, which receive sophisticated investment advice and regularly participate as purchasers in limited offerings. We suggest that the Commission extend the definition of "accredited investor" in Rule 501(a)(3) to encompass all such charitable and not-for-profit organizations, appropriately defined. We would also point out some slight confusion between the text of Rule 501(a)(3) and the description thereof in Securities Act Release No. 6339. The proposed Rule sets forth an "assets" test of $25 million, whereas the Release describes a test based on "net assets" of $25 million. We believe that the test is appropriately phrased as an "assets" test, to be determined in a given case by reference to generally accepted means of accounting for endowment funds.

With respect to "accredited investors" described in Rule 501(a)(5)(iii), we believe that a test based on payment by means of a full recourse note with a maturity of greater than three years is sufficient to prevent a purchaser from becoming an "accredited investor" simply by virtue of minor financial transactions. The proposed requirement of a letter of credit would impose an undue expense on many creditworthy investors, and, as a matter of policy, we think that the requirement is more specific and regulatory than the Commission's requirements in this area should be.

RULE 502

Rule 502(a) -- Integration. We believe that the proposed integration rules contained in Rule 502(a) might be liberalized in certain respects without significantly detracting from basic investor protections. First of all, we note from footnote 25 to Securities Act Release No. 6339 that the safe harbor provided in Rule 502(a) is not intended to address whether sales pursuant to an employee plan would be integrated with sales to non-employee investors within the 6-month "window periods". As the Commission is probably already well aware, many smaller companies rely on grants of stock or other securities as means of Compensating employees without reducing working capital, but offerings

pursuant to employee plans frequently pose difficult problems under the limited offering exemptions from the registration requirements of the Securities Act of 1933. Proposed Rule 504 goes a long way toward eliminating many of the difficulties now encountered. However, we believe that the considerations raised in footnote 25 may have a chilling effect on the use of proposed Rule 504 for offerings to employees insofar as the traditional five-factor integration analysis is often difficult to apply and raises uncertainties. Thus, we suggest that the Commission indicate in the Preliminary Notes to Regulation D or in some other appropriate place that offerings pursuant to an employee plan involving a significant compensatory element will generally not be integrated with substantially contemporaneous offerings seeking to raise new capital. Such a note would clarify whether such contemporaneous offerings are part of a "single plan of financing" or made "for the same general purpose".

We note that the Commission is proposing to eliminate the safe harbor for successive Section 3(b) offerings within the period during the six-month "window". We believe that such elimination may ignore difficulties frequently encountered by small businesses in arranging financing, predicting their capital needs and fitting those needs within the Regulation D framework. For example, many start-up companies today use Rule 240 to accumulate basic levels of seed money so that more ambitious financing plans necessary to the start-up operations of the company can be undertaken. Under proposed Regulation D, it is still possible that such a company might seek to raise $50,000 under Rule 504 for the disclosed purpose of immediately seeking to raise an additional amount in excess of $450,000 under some other small offering exemption. Such a company might have serious difficulties in managing its financing plans under the proposed rules. Similarly troublesome is the situation in which a small company raises $450,000, only to find that its fixed asset and working capital requirements necessitate the raising of an additional $100,000 within the six-month period following the completion of the original offering. Although we recognize that the Commission is proposing to raise significantly the current Rule 240 offering limitation by proposed Rule 504, we believe that there still might be strong reasons for permitting successive Section 3(b) offerings, particularly successive Rule 504 and Rule 505 offerings.

Rule 502(b) -- Information Requirements. Under this proposed section, the information required to be furnished to prospective investors would be determined by reference to the size of an "offering" and the nature of the purchasers in the "offering". While we note that Rule 501(e) prescribes a means for calculating the size of an offering, we are not entirely sure what the Commission intends by its reference to an "offering" throughout Rule 502(b) and think that some clarification of when an offering has taken place may be necessary. For example, does "offering" refer to the amount of securities which an issuer intends to sell or does it refer to the amount actually sold? The

continuing nature of many small business securities financings should also be considered whenever the term "offering" is used. For example, a company raises, through sales of its securities over a period of time, less than $1,500,000 and in this connection has provided investors with Regulation A-type information pursuant to Rule 502(b)(2)(i)(A), If, as part of a continuing single issue, the company were to then sell securities so that the total amount sold would exceed $1,500,000, would the prior sales be defective under Regulation D for failure to provide the original purchaser with information modeled on Form S-18? (As a practical matter, it appears to us that the difference between information modeled on Form 1A under Regulation A and information modeled on Form S-18 would in most cases be insignificant, except for the different financial statement requirements.) A similar problem might come up under Rule 502(b)(1)(ii) if at the time one group of sales were made, sixty percent or more of the total offering was purchased by one or more institutions as defined by paragraphs (a)(i), (ii) and (iii) of Rule 501. In this case, the issuer might choose to rely on the so-called sixty percent rule and not furnish non-accredited investors with written information of the type required by Rule 502(b)(2). However, if the issuer were to make subsequent sales to non-accredited investors, so that the total percentage of the offering purchased by the institutional purchasers fell to less than sixty percent, would the issuer’s previous reliance on the sixty percent rule have been misplaced? In this regard, we believe that the sixty percent test should be coupled with an alternative test based on a flat dollar amount (for example, $1,000,000) of institutional purchases. It would appear that a large investment of institutional money, regardless of the percentage of the offering it comprises, would be sufficient to insure meaningful negotiation between the institutional purchasers and the issuer.

Under the sixty percent rule as it has been proposed by the Commission, an issuer relying thereon might still be required to provide non-accredited investors with information pursuant to Rule 502(b)(2), if such information is requested. We believe that this possibility would in most cases render the sixty percent rule useless, since any issuer planning an offering must be prepared to generate the Rule 502(b)(2) information and, accordingly will generally be well-advised to prepare the information ahead of time. thus, to the extent that the sixty percent rule was designed to reduce the expenses of an offering, we believe that it fails to accomplish this purpose in its present form.

Another issue raised by the sixty percent rule, which is also raised by existing Rule 242, is the question of when an issuer will be required to furnish non-accredited investors with the same information accredited investors obtain. For example, a small company is exploring a financing both with individual investors and with institutions which would count toward the requisite sixty percent under Rule 502(b)(1)(ii). In a typical case, the institution asks for business plans and financial projections, no matter how preliminary in nature, which the issuer might

not be comfortable in showing to the individual, investors in their preliminary form since they are subject to misinterpretation as hard and fast predictions of future results. However, having made the information available to institutions which night not Ultimately participate in the company 's offering, the company may wonder whether it is required to make the same information available to non-accredited investors who actually decide to participate in the offering. What is the result if non-accredited purchasers purchase first in the offering without receiving information that has been made available to institutional offerees, and some of the institutions subsequently decide to purchase securities in the offering? Again, the Commission should be mindful that many small business offerings take place over an extended period of time with offers and sales being made from time to time. One bright line in this area that could be drawn is a rule providing that non-accredited investors be provided with access to all of the information that has been furnished to accredited investors who have actually purchased securities prior to or at the same time as the non-accredited investors make purchases.

## RULE 503

Exceptions from the Reporting Provisions. We believe that Rule 503 should include either a de minimis exception from the reporting provision or a provision modeled on current Rule 240(h)(2). It has been our experience that some small companies that have not had the initial resources or sophistication to obtain the advice of counsel trained in the federal securities laws have nevertheless been able to comply with the Rule 240 exemption, especially given the leeway in the reporting requirements currently provided for the first $100,000 of sales in reliance on Rule 240. An across-the-board reporting requirement would seemingly have the effect of inadvertently rendering a large number of small businesses in technical non-compliance with the registration requirements. While we believe that the de minimis limit or maximum amount at which Rule 240(h)(2)-type relief is granted might be appropriately set at some number substantially less than the proposed Rule 504 offering limit of $500,000 (for example, $200,000), an exception from the reporting requirements would be very helpful to many small businesses at their inception.

## RULE 504

Uniformity of Exemptions. The increase in the Rule 504 ceiling to $500,000 is the most significant feature of the Commission's proposals as far as the access of truly small business to the nation's capital markets is concerned. In accordance with the Congressional intent expressed in Section 505 of the Small Business Investment's Incentive Act of 1980, it is very important that the same kind of exemptive relief be afforded from state blue sky laws. Small business financing

would be greatly facilitated by the Commission's efforts to work with the members of NASAA so that this uniform pattern of regulation can be achieved through amendments to state laws and regulations. As the Commission recognizes in Securities Act Release No. 6339, many offerings under Rule 504 would be extensively regulated under state law. It should be noted that many offerings which now take place under Rule 240 are conducted in a number of states simultaneously thus resulting in a considerable blue sky compliance burden. Some of the blue sky statutes in question apply to "offers" as well as "sales" resulting in especially difficult blue sky compliance problems which are not dissimilar to those currently raised by Rule 146 under the Securities Act of 1933.

Rule 504(b) -- Aggregate Offering Price. We question whether the calculation of the aggregate offering price should take into account securities sold to promoters, directors and executive officers, which are currently excluded from the offering price calculation under Rule 240. The theory of the exclusion would seem to be the limited nature of the excluded group as persons who would not require the protections of the registration requirements of the Securities Act of 1933. That same theory would appear to be applicable under proposed Rule 504 as well. Also, we question the need to include in the calculation securities issued by "predecessors" within the meaning of Rule 501(h)(1) except in the case of a business succession which meets the requirements of Rule 414 under the Securities Act of 1933.

## RULE 505

Rule 505(a)(6). We are concerned that the reference in this subparagraph to "the relevant state securities administrator" may cause confusion. If the Commission has intended to refer to the state securities administrator of any state in which an offering involving a person under any disability described in Rule 505(a) is intended to be made, then it appears that the Commission has introduced a much too burdensome procedure for resolving the disability question. We would suggest that the reference to the "relevant state securities administrator" be deleted, it being understood that the Commission or its staff could choose in any particular situation to coordinate with any state administrator whose action might be required.

Suitability. We understand that certain states have expressed a desire to adopt certain requirements regarding the suitability of an investment for non-accredited investors. We do not believe that this would be a helpful development from the point of view of small business capital formation, since the proposed suitability determination would reintroduce many of the difficult, subjective determinations which the Commission went a long way toward eliminating by promulgating Rule

242 and which would be further eliminated by the further expanded definition of "accredited investors" in proposed Rule 501(a). Moreover, the introduction of a requirement described as "suitability" creates a question as to whether an issuer must "know" his purchasers in the sense that a broker-dealer is required to "know" his customer.

MISCELLANEOUS CONSIDERATIONS

Statutory basis for individual provisions of Regulation D. While we believe that the Commission's efforts to construct a comprehensive scheme of exemptions in Regulation D are very helpful, the Commission should be mindful to point out the statutory basis for each individual exemption, particularly the exemption provided by Rule 506. While Rule 506(a) strongly implies that the Rule has been adopted under Section 4(2) of the Securities Act of 1933, we believe that this should be made clear in the release promulgating the rule. Many provisions of the federal and state securities laws turn on the applicability of certain specific exemptions under the Securities Act of 1933. Thus, Section 3(c)(1) of the Investment Company Act of 1940 has a requirement that securities be sold only in transactions not involving a public offering, which has been interpreted by the staff of the Commission to include transactions pursuant to Section 4(2) of the Securities Act of 1933 and Rule 146 thereunder. Similarly, the rules contained in Regulation T relating to brokers' activities in arranging credit refer to transactions which are exempt under Section 4(2), and we understand that there are now pending proposed amendments to Regulation T which would refer to transactions exempt under Sections 4(2) and 4(6). Many blue sky laws provide exemptions for transactions not involving a public offering under federal law or, alternatively, transactions qualifying under the exemptions provided by such federal rules as Rule 240 or Rule 146.

Finally, we note that the Commission is considering the repeal of Regulation A, especially in view of the availability of Form S-18. In this connection, we would like to point out that we have used Regulation A on a number of occasions for transactions which did not fit the current scheme of small office exemptions and which could not be fully registered without significantly increased effort and expense. For example, pursuant to a no-action letter from the Staff, we structured a Rule 145 transaction pursuant to Regulation A in a case where it was very difficult for the acquired company to meet the financial statement requirements of Form S-14. Thus, although it may be the Commission's experience that use of Regulation A has significantly decreased since introduction of Form S-18, we suggest that the Regulation be retained for the time being in order to determine whether it has any continued usefulness in view of the proposed expansion of the limited offering exemptions and simplified registration forms.

Respectfully submitted,

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