NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.
750 First Street N.E., Suite 1140
Washington, D.C. 20002
202/737-0900
Fax: 202/783-3571
www.nasaa.org

NASAA

June 15, 2016

The Honorable Jeb Hensarling
Chairman
House Committee on Financial Services
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
House Committee on Financial Services
Washington, DC 20515

Re: June 15, 2016 Full Committee Markup

Dear Chairman Hensarling and Ranking Member Waters:

I am writing on behalf of the North American Securities Administrators Association (NASAA),[1] to express our concerns with a number of bills that the Financial Services Committee is scheduled to consider on June 15, 2016. I appreciate your consideration of NASAA's views.[2]

1. The National Securities Exchange Regulatory Parity Act (H.R. 5421)

The National Securities Exchange Regulatory Parity Act would amend Section 18 of the Securities Act of 1933 to allow the SEC to recognize *any* exchange of *any size or quality* as a "national securities exchange," and all securities listed on such exchanges as "covered securities" thereby preempting currently applicable state laws.

NASAA is strongly opposed to H.R. 5421, which threatens the core tenets of modern securities market regulation. Under existing law, a listing on a national securities exchange affords securities "covered security" status such that state registration requirements are preempted.[3] An appropriate balance was struck regarding the level of rigorousness in listing standards that would afford such "covered security" status and preemption of state law in 1996, with the enactment of the National Securities Markets Improvement Act (NSMIA). The benchmark for preemption established by Congress under NSMIA is that an exchange must have rigorous listing standards comparable to those of the major national stock exchanges, such as the New York Stock Exchange (NYSE), or have "substantially similar" listing standards, as the SEC may determine by rule. The rationale is that investors purchasing securities listed on an exchange that has sufficiently rigorous listing standards do not require the added protection afforded by blue sky registration.[4] This bill would upend the balance struck in NSMIA and remove vital investor protections afforded by state securities laws.

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators, Inc. was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.
[2] This letter does not address H.R. 4538, The Senior$afe Act of 2016, which the Committee is scheduled to consider on June 15th. However, NASAA strongly supports H.R. 4538. For additional information please see the NASAA website: nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2013/10/NASAA-Letter-Re-HR-4538-The-SeniorSafe-Act-Feb.-16-2016.pdf
[3] Exchanges with less stringent listing standards (e.g., the Miami International Securities Exchange) do not provide "covered" status.
[4] See: Section 18(b)(1)(A)-(B)) of the Securities Act of 1933 and Rule 146.

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Given the number and variety of exchanges currently in existence, it is not clear why H.R. 5421 is necessary to create national securities exchanges.[5] Further, current law also allows the creation of exchanges with varied listing requirements, including alternative marketplaces.[6] By removing the statutory references to recognized national securities exchanges like the NYSE, and the attendant requirement that all national securities exchanges with covered security status maintain meaningful listing standards that are "substantially similar" to such major exchanges, H.R. 5421 undercuts the distinction between national exchanges with rigorous listing standards, and all other exchanges, including local or regional exchanges with no regard to the applicable listing standards. It also creates confusion with alternative trading systems, a secondary trading platform.[7] Ultimately this bill will create marketplace confusion and adversely impact the quality of securities listed on recognized national exchanges.

2. The Micro Offering Safe Harbor Act (H.R. 4850)

The Micro-Offering Safe Harbor Act seeks to amend Section 4 of the Securities Act to create three new exemptions from registration. As originally proposed, H.R. 4850 would have exempted offerings that met any of the following three criteria: (1) each purchaser has a substantive pre-existing relationship with the issuer, or with a shareholder holding 10 percent or more of the issuer's shares; (2) there are no more than 35 purchasers of securities from the issuer during the preceding 12 months; or (3) the aggregate amount raised during the 12-month period preceding the transaction does not exceed $500,000. The bill also preempts state regulation of those securities offerings. NASAA shared its concern with H.R. 4850 when it was introduced in April 2016, and noted then that the legislation stood to "expose investors, including retail investors, to literally unlimited investment risk." NASAA understands that the Committee may consider an amendment in the nature of a substitute that could modestly improve H.R. 4850 by making the exemptions conjunctive. However, state securities regulators remain strongly concerned about H.R. 4850, as amended by the substitute, for the reasons set forth below.

First, H.R. 4850 as amended, would still create an overly broad federal exemption that would allow public solicitation and sales to any investor regardless of sophistication or financial wherewithal, subject only to the requirement that there be a previously existing relationship—a standard that is not difficult to establish. We also question why an issuer would need to engage in public solicitation if it had a previously-existing relationship. Further, the practical necessity of the proposed exemption remains unclear, just as basic questions about what issuers it would serve remain unanswered. In fact, there are already several provisions at the state and federal level that small, microcap, issuers can rely upon for limited offerings.[8] Congress should consider the relationship between the new exemption

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[5] There are currently 19 national securities exchanges registered with the SEC, and 10 recently approved securities exchange applications. See: sec.gov/divisions/marketreg/mrexchanges.shtml.
[6] Various alternative marketplaces currently exist, such as the OTCQX, OTCQB, and OTC Pink. In fact, OTC Markets refers to the OTCQB as "The Venture Marketplace.
[7] If an entity is conducting secondary trading and meets the criteria of a national securities exchange, they must register under Section 6 of the Securities Exchange Act of 1934. An entity that does not meet the criteria of a national securities exchange, depending on their activities and trading volume, may alternatively register as a broker-dealer and comply with Regulation ATS.
[8] For example, an issuer can raise funds under Rule 504, Rule 505, Section 3(a)(11) of the Securities Act of 1933 ("1933 Act") and its safe harbor Rule 147, and Section 4(a)(2) of the 1933 Act. Most states also have de minimus offering exemptions, allowing issuers to raise money with a limited number of purchasers through self-executing exemptions with little or no notice filing requirements. Finally, the amendments recently proposed by the U.S. Securities and Exchange Commission to Rules 147 and 504 will significantly increase the utility of those exemptions. Small issuers can similarly rely on federal crowdfunding rules.

that H.R. 4850 proposes to create and an existing, popular, exemption—Rule 506(b)—that allows an issuer to sell its securities to up to 35 non-accredited, sophisticated, investors.[9]

Finally, H.R. 4850 would preempt state authority to register or review securities offering that are by their nature local, state-based offerings. Preemption for this type of localized offering makes no sense. This legislation would handcuff the very regulators best positioned to regulate these offerings. In short, there is no valid public policy basis for Congress to prevent state officials and their constituents from making decisions about purely local or regional matters.

3. The Fix Crowdfunding Act (H.R. 4855)

The Fix Crowdfunding Act proposes a variety of revisions to Title III of the JOBS Act. One of the more interesting features of H.R. 4855 is Section 3(b) of the bill, which provides for investments in crowdfunding through single purpose funds. The bill would also make additional changes to the existing federal crowdfunding rules including: (i) increasing the offering cap from its current $1 million to $5 million; (ii) providing for a "greater of" rather than "lesser of" approach in the investment limits, (iii) establishing a grace period of 5 years for funding portals to comply with the rules and institutes only a "good faith" standard for portals to comply with the rules; (iv) giving funding portals the express authority to disqualify certain issuers based on a broader "reasonable basis" analysis; (v) restricting funding portal liability, who would no longer be considered issuers under Section 4(A)(c) of the Securities Act, (vi) removing SEC rulemaking authority to condition the Section 12(g) exemption, thus granting a wholesale exemption from Section 12(g) and; (vii) allowing testing the waters prior to any filing and eliminating potential liability for those activities by deeming them not an "offer" of securities.

State securities regulators understand the appeal of several of the proposals. However, the critical issue is that the rules have been in effect for less than a month and there is little to no data on what changes are necessary, relevant or useful in this new market. We encourage Congress to evaluate any proposed changes after the federal exemption has been in effect over the course of the next year. We also encourage Congress to evaluate important considerations in the use of a single purpose fund, such as, for example, fund management and the provision of investment advice, compensation of fund managers or a lead investor, potential conflicts of interest, shareholder rights (i.e., rights to information, appraisal rights, etc.), and the intent of crowdfunding to engage and access the "wisdom of the crowd."

4. The Private Placement Improvement Act (H.R. 4852)

The Private Placement Improvement Act would prohibit the SEC from adopting proposed rules to implement common-sense reforms for Regulation D, Rule 506 offerings. As NASAA has testified on several prior occasions, state securities regulators oppose any action by Congress to further diminish the ability of the SEC to address investor protection concerns associated with these offerings, or gather quantitative and qualitative data, in the private marketplace.

Title II of the Jumpstart Our Business Startups ("JOBS") Act repealed the long-established prohibition on general solicitation and advertising of securities under Rule 506. When the SEC adopted rules to implement Title II, on July 10, 2013, it also voted to propose rules that could mitigate the risk to ordinary investors from 506 offerings, including by requiring a pre-filing of "Form D" when issuers

[9] Under 506(b), however, the non-accredited investors must nevertheless be sophisticated, must receive a disclosure document containing certain information, and cannot be solicited via general solicitation.

intend to advertise Rule 506 securities to the general public, and by imposing meaningful penalties on issuers who fail to file a Form D.[10] H.R. 4852 would effectively prohibit the Commission from adopting those proposed rules.

Proponents of H.R. 4852 have opposed a Form D filing requirement prior to conducting a Rule 506 offering, and again upon the completion of the offering, on the grounds that multiple filings would impose an onerous compliance burden. Form D, however, is a short, 11-page form that contains instructions and captures only eight pages of information, including basic information about the issuer (e.g., business address, officers, directors, business type, etc.). The amount of information required on this form relative to the information contained in an issuer's private placement memorandum or offering document is minimal. These additional, modest filing requirements provide limited but important information to regulators and are particularly important in gathering data to capture a $1 trillion market in unregistered Regulation D, Rule 506 securities.

State securities regulators, pursuant to their antifraud authority, are the primary regulators of offerings conducted under Regulation D, Rule 506. Fraudulent offerings involving Rule 506 offerings are routinely among the most frequently reported by state securities regulators. We believe it would be a mistake for Congress to weaken the few existing investor protections in Rule 506, and we urge the Committee to reject the bill.

5. The Supporting America's Innovators Act (H.R. 4854)

The Supporting America's Innovators Act expands an exemption from registration under the Investment Company Act of 194011 by increasing the investor limitation from 100 to 500 persons for a qualifying venture capital fund.

As explained in the testimony of William Beatty on behalf of NASAA during the Capital Markets Subcommittee hearing in April of this year, expanding 3(c)(1) in the manner proposed by the bill would not only allow another investment vehicle to operate without regulatory oversight, but also allow an investment adviser that is not licensed or examined to manage funds raised from a pool of investors that would be five times the size of that currently permitted (i.e., 100 to 500). The Dodd-Frank Act took steps to bring more regulatory oversight of these important market participants. Expanding the exemptions as contemplated by this bill would undermine important investor protections by allowing more firms to avoid regulatory scrutiny.

6. Investment Advisers Modernization Act (H.R. 5424)

Finally, NASAA opposes the Investment Adviser Modernization Act. Although the bill purports to be an updating of the framework for the regulation of investment advisers, it is in fact little more than an effort to shield advisers to private funds from the scrutiny of SEC registration and

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[10] Amendments to Regulation D, Form D and Rule 156, SEC Release Nos. 33-9416, 34-69960, IC-30595. 78 Fed. Reg. 44806. (2013, July 24). Retrieved from gpo.gov/fdsys/pkg/FR-2013-07-24/html/2013-16884.htm

[11] The Investment Company Act defines an "investment company" as an issuer which is "engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading in 'securities," or "proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire 'investment securities' having a value exceeding 40 percent of the value of its total assets." If an investment company is organized or otherwise created under the laws of the United States or of a state, meets the definition of an investment company, and cannot rely on an exception or an exemption from registration, generally it must register with the Commission and must register its public offerings under the Securities Act.

examination oversight. Through several exceptions, the bill removes the independent asset verification requirement applicable to advisers who have custody of client funds, or authority to obtain possession of them, through a pooled vehicle structure. Among several exceptions, the bill creates exceptions to this independent asset verification requirement for (i) "friends and family" of the adviser and (ii) other persons who were given the opportunity to invest via personal relationships with the advisor. The bill also broadly removes the requirement that advisers maintain records relating to the investments they select if such materials were provided under a confidentiality agreement, and instead expressly provides that such records may be destroyed.[12] Because investment selection goes to the heart of the work of an investment adviser and are part of the documents a regulator may review, these records should be preserved.

NASAA strongly agrees with SEC Chair White and others who have pointed out that having advisers to private equity funds registered with and examined by the SEC directly serves an important investor protection function.[13] Indeed, the SEC's efforts to examine this population of advisers have already yielded significant investor protection benefits.[14] We urge the Committee to reject H.R. 5424, and other proposals would repeal or dilute the modest amount of transparency that Congress sought to ensure with respect to private equity advisers when it enacted Title IX of the Dodd-Frank Act.

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Thank you again for considering NASAA's views. Please do not hesitate to contact me or Michael Canning, NASAA's Director of Policy, at (202) 737-0900, if we may be of any additional assistance.

Sincerely,

Judith M. Shaw
NASAA President and Maine Securities Administrator

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[12] This exemption would mean that key records relating to investment selection and due diligence would simply be unavailable to regulators, potential litigants, and law enforcement.

[13] In a 2013 speech before the Managed Fund Association, Chair White said that"[r]equired registration and reporting have been critical to increasing transparency and protecting investors in private funds." She noted that "[e]xcessive leverage, lack of liquidity, and asset concentrations have in the past been at the root of financial crises, and we now have the regulatory tools to help better identify and appropriately mitigate potential problems." See: sec.gov/News/Speech/Detail/Speech/1370539892574

[14] In May 2014, the Director of the SEC's Office of Compliance Inspection and Examination reported that of the approximately 150 private equity advisers examined by OCIE between October 2012 and May 2014, the OCIE "identified what we believe are violations of law or material weaknesses in controls over 50% of the time." See: sec.gov/News/Speech/Detail/Speech/1370541735361