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NASAA

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By email to: rule-comments@sec.gov

Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

RE: File No. S7-25-19: Amending the "Accredited Investor" Definition

Dear Ms. Countryman:

On behalf of the North American Securities Administrators Association, Inc. ("NASAA"),[1] I am writing in response to U.S. Securities and Exchange Commission (the "SEC" or "Commission") Release No. 33-10734, *Amending the "Accredited Investor" Definition* (the "Proposal"),[2] under which the Commission proposes to provide no additional investor protection or oversight of high-risk private securities offerings, but nevertheless proposes to expand the population of investors who would qualify to invest them.

I. Introduction

Over the years, the SEC has put forth numerous proposals and studies to update or modernize the accredited investor definition.[3] What sets the current Proposal apart from prior

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[1] Organized in 1919, NASAA is the oldest international organization devoted to investor protection. NASAA's 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] The Proposal is available at https://www.sec.gov/rules/proposed/2019/33-10734.pdf.

[3] *See*, *e.g.*, *Proposed Rule: Amendments to Regulation D, Form D and Rule 156*, SEC Release No. 33-9416 (Jul. 10, 2013), *available at* https://www.sec.gov/rules/proposed/2013/33-9416.pdf; *Proposed Rule: Revisions to Limited Offering Exemption in Regulation D*, SEC Release No. 33-8828 (Aug. 3, 2007) ("2007 Rule Proposal"), *available at* https://www.sec.gov/rules/proposed/2007/33-8828.pdf; *Proposed Rule: Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles*, SEC Release No. 33-8766 (Dec. 27, 2006), *available at* https://www.sec.gov/rules/proposed/2019/33-10734.pdf; *SEC*

efforts is the failure to offer any additional investor protections or improvements to the oversight of the private markets. On the contrary, the Proposal is a deregulatory effort that is singularly focused on expanding the private markets while showing little regard for its potential adverse effects on retail investors and the public markets.

In particular, the Commission's desire to add an additional means for retail investors to become accredited through testing and certification is deeply flawed. Despite proposing sweeping changes to the accredited investor definition, the Commission admits that it needs basic data about the private markets.[4] The Proposal also gives short shrift to evidence of the prevalence of fraud in the private markets. Further, evidence that promising and successful private companies have significant access to institutional private capital strongly suggests that the only companies eager to sell to accredited retail investors are speculative and suspect enterprises. For these reasons, while the Proposal contains certain acceptable refinements to the accredited investor definition, the Commission should not move forward with it as proposed. Instead, the Commission should gather additional data on the private markets to ensure that a future rulemaking in this area is supported by evidentiary foundations.

However, if the Commission insists on moving forward with the Proposal, several modifications are essential. First, the Commission should substantially raise the current income and net worth thresholds for natural persons and index those thresholds to inflation. Second, the Commission should exclude agricultural land and machinery, as well as retirement accounts, from calculations of net worth. Third, the Commission should continue to require that all natural persons meet the income or net worth thresholds in order to be deemed accredited investors. Fourth, the Commission should require that natural persons have significant investment experience before qualifying as accredited investors.

II. The Proposal Ignores Fundamental Differences Between Registered and Private Offerings and Stands to Further Undermine the Public Markets.

As a threshold matter, much of the Proposal appears predicated on an assumption that expanding retail investor access to unregistered securities offerings is good public policy. It is not. Securities registration is a hallmark of our securities markets. Features of registered offerings – such as fulsome disclosures, audited financial statements, and Commission staff review – exist to ensure that all investors, but especially retail investors, are protected from a whole host of investment dangers, including poor corporate management, unsound business plans, weak

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Staff Report on the Review of the "Accredited Investor" Definition (Dec. 18, 2015) ("2015 SEC Staff Report"), *available at* https://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf.

[4] *See*, *e.g.*, Proposal at 122 (stating that "comprehensive, market-wide data on the returns of private investments is not available due to a lack of required disclosure on these investment returns, the voluntary nature of disclosure of performance information by private funds, and the very limited nature of secondary market trading in these securities").

financial statements, and outright frauds.[5] Securities registration exposes issuers to market forces and the sunlight of public disclosure, which disciplines management behavior and fosters strong corporate governance. Registration also allows all investors to participate on an equal footing.

It is important to recognize that all of these virtues of registration, developed through decades of experience, do not exist in the private markets. Instead, private offerings are often characterized by opaque disclosures, related party transactions, illiquidity, minimal financial information and, unfortunately, fraud.[6] It takes significant investment experience to identify these sorts of shortcomings. Further, expanding the pool of accredited investors to include investors who may be financially unable to withstand losses in such investments serves no policy interest. Indeed, the Proposal seems incongruous given this Commission's retail-investor-focused initiatives, such as the Retail Strategy Task Force,[7] the Teachers' Initiative and the Military Service Members' Initiative.[8]

What is also missing from the Proposal is any appreciation for the effect that expanding the pool of accredited investors will have on the public markets. The strength of American securities markets – in terms of the efficient and effective allocation of capital to sound businesses and the rewards that investors reap from investing in those businesses – is found in the public markets. The mere possibility raised by the Commission that investors may benefit from access to early stage companies,[9] pales in comparison to the proven strength of investment in the public markets to allow investors to build wealth over time. Yet, a clear effect of the Proposal would be to further diminish the public markets by drawing investors away into riskier, illiquid private alternatives. Indeed, enhancing the ability of companies to stay private by increasing their access to accredited investors can undermine the quality of capital allocation itself. Capital trapped in

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5 Recent SEC enforcement actions involving private offerings include: *SEC v. Richard Eden et al.*, Case No. 19-cv-09358 (C.D. Cal. filed Oct. 31, 2019); *SEC v. Mallion*, Case No. 19-cv-62532 (S.D. Fla. filed Oct. 10, 2019); *SEC v. Hologram USA Networks and Alkiviades David,* Case No. 19-cv-09013 (S.D.N.Y. filed Sep. 27, 2019); *SEC v. Andres Fernandez and Edison Denizard*, Case No. 19-cv-01843 (M. D. Fla. filed Sep. 25, 2019); *SEC v. Gerald Parker*, Case No. 19-cv-23943 (S.D. Fla. filed Sep. 23, 2019); *SEC v. Jonathan Lucas*, Case No. 19-cv-08771 (S.D.N.Y. filed Sep. 20, 2019); *SEC v. ICOBox and Nikolay Evdokimov*, Case No. 19-cv-08066 (C.D. Cal. filed Sep. 18, 2019); and *SEC v. Emmanuel Kouyoumdjian*, Case No. 19-cv-61773 (S.D. Fla. filed Jul. 16, 2019).

6 Large private offering frauds include actions against the Woodbridge Group of Companies, Inc., in which the SEC charged the defendants with a $1.2 billion offering fraud (*see* SEC Press Release 2017-235, *SEC Charges Operators of $1.2 Billion Ponzi Scheme Targeting Main Street Investors* (Dec. 21, 2017); Medical Capital Holdings, Inc., in which investors lost hundreds of millions of dollars (*see* Bruce Kelly, *MedCap Trustee to Pay Investors $114m*, Investment News (Apr. 29, 2013)); and Provident Royalties LLC, in which the SEC obtained an asset freeze of $485 million (*see* SEC Litigation Release No. 21118, *SEC Obtains Asset Freeze in $485 Million Nationwide Offering Fraud* (Jul. 7, 2009)).

7 *See* SEC Press Release 2017-176, *SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors* (Sep. 25, 2017), *available at* https://www.sec.gov/news/press-release/2017-176.

8 *See* SEC Press Release 2019-85, *SEC Announces Enforcement and Investor Initiatives to Protect Teachers and Military Service Members* (Jun. 3, 2019), *available at* https://www.sec.gov/news/press-release/2019-85.

9 *See* Proposal at 120 (stating that "[a]llowing more investors to invest in unregistered offerings of private firms thus may allow them to participate in the high-growth stages of these firms").

poor-performing illiquid companies by virtue of superficial disclosures and reporting is a threat to the markets overall.

The Proposal's focus on preserving and enhancing the Regulation D market[10] is therefore myopic because it comes at the expense of the public markets, which are essential to the health of the economy. The SEC should focus its efforts on the growth and promotion of the public markets rather than incentivizing issuers to conduct their capital raising in the private markets.

III. The Commission Should Raise Financial Thresholds and Exclude Certain Assets.

A. The Commission Should Revise the Rule 501(a)(5) and (a)(6) Financial Thresholds for Natural Persons.

NASAA believes that investor protection requires the strengthening of investor accreditation financial thresholds. The Proposal recognizes but then disregards the fact that accredited investor thresholds have deteriorated over time. When the Commission first adopted Regulation D in 1982, approximately 1.6% of American households qualified as accredited under the personal income and net worth thresholds set forth in Rule 501(a). While the SEC has amended the accredited investor definition three times since 1982, it has not materially increased these thresholds, except to exclude the value of an investor's primary residence.[11] Four decades of inflation have eroded these thresholds so that today approximately 13% (or 16 million) of American households qualify.[12] This neglectful expansion bears no relation to the ability of retail investors to invest in the private markets properly, nor does it reflect any consideration for whether it is suitable for retail investors to be investing in the private markets generally.

The Commission's 2007 Rule Proposal noted that "[b]y not adjusting the dollar-amount thresholds upward for inflation, we have effectively lowered the thresholds in terms of real purchasing power."[13] It is implausible that 16 million American households currently have both the financial sophistication and the capacity to bear the kinds of investment losses that courts and

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10 *See*, *e.g.*, Proposal at 22 (acknowledging that "the impact of investment losses on [investors deemed accredited by certifications, designations, and credentials] could be significant," but that "[a]dding this new category of individual accredited investors may potentially expand the pool of investors eligible to . . . provide capital to[] the Regulation D market"); at 24 (discussing recommendations that the SEC "expand the pool" of accredited and sophisticated investors); at 79 (stating that increasing the current financial thresholds "could have disruptive effects on the Regulation D market"); at 80 (same, about placing limits on the amount that a person can invest under the current financial thresholds); at 80 (stating that increasing the current financial thresholds "may result in a higher cost of capital for companies"); at 135 (speculating that "an immediate catch-up inflation adjustment could thus have disruptive effects on capital raising activity in the Regulation D market").

11 *See* Proposal at 20 (discussing the three SEC amendments to the accredited investor definition). The exclusion of an investor's primary residence is a sound precaution that should remain part of the financial thresholds for accredited investors.

12 *See* Proposal at 77, 134.

13 *See* 2007 Rule Proposal, *supra* note 3, at 42.

prior Commissions have considered essential prerequisites for participation in private offerings.[14] In particular, many elderly Americans may meet current income and net worth thresholds solely through asset accumulation and savings, which they need for retirement and which should not be exposed to illiquid, high-risk private offerings.[15] The Proposal does nothing to protect these investors.[16] As we pointed out in our October 11, 2019 comment letter regarding the Concept Release on Harmonization of Securities Offering Exemptions, the Commission should raise the financial thresholds found in Rule 501(a)(5) and (a)(6) and index them to inflation going forward.[17]

The Commission's refusal to propose indexing these thresholds to inflation, or even to grapple with the issue, is particularly concerning. Without indexing or adjustment, the current thresholds will continue to erode. The Proposal does not explain why the Commission is unwilling to propose even this minimal step, which the Commission has suggested in prior releases.[18] Given that recent bi-partisan legislation has supported the idea of indexing the accredited investor thresholds to inflation,[19] the Proposal is out of step with sound approaches to revise the thresholds in ways that address investor protection.

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[14] *See* Proposal at 16.

[15] *See, e.g.*, Michael S. Finke and Tao Guo, *The Unsophisticated Sophisticated: Old Age and the Accredited Investors Definition* (Working Paper, Sep. 22, 2019) (finding "strong evidence that older households are at risk of meeting the accredited investor definition without having the sophistication needed to avoid high agency costs in a largely unregulated securities market"); *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2634818&download=yes; John E. Girouard, *The Sophisticated Investor Farce*, Forbes (Mar. 24, 2009), (stating that "often people whose net worth puts them in the accredited category . . . may be smart and successful in their fields, but most are confused about the basics of investing and managing money"), *available at* https://www.forbes.com/2009/03/24/accredited-investor-sec-personal-finance-financial-advisor-network-net-worth.html#30630526184b.

[16] NASAA has found previously that seniors are often the targets of fraudulent unregistered offering schemes. *See NASAA 2019 Enforcement Report, Based on 2018 Data*, at 8 (2019) (finding that unregistered securities are the most common products used to target seniors in fraudulent schemes), *available at* https://www.nasaa.org/wp-content/uploads/2019/11/2019-Enforcement-Report-Based-on-2018-Data-FINAL.pdf; *NASAA 2018 Enforcement Report, Based on 2017 Data*, at 6 (2018) (same), *available at* https://www.nasaa.org/wp-content/uploads/2018/10/2018-Enforcement-Report-Based-on-2017-Data-FINAL.pdf; *NASAA 2017 Enforcement Report, Based on 2016 Data*, at 6 (2017) (same), *available at* https://www.nasaa.org/wp-content/uploads/2017/09/2017-Enforcement-Report-Based-on-2016-Data.pdf.

[17] *See* Letter from Christopher Gerold to Vanessa Countryman, NASAA Comment Letter Regarding Concept Release on Harmonization of Securities Offering Exemptions (Oct. 11, 2019), *available at* https://www.sec.gov/comments/s7-08-19/s70819-6288085-193367.pdf NASAA would not opine on the appropriate levels for the thresholds without the support of data or econometric studies on this issue. However, the thresholds posited by the SEC staff in 2015 to simply adjust the thresholds upwards for inflation – to $500,000 of individual income (or $750,000 of joint income) and a $2.5 million net worth exclusive of primary residence – would significantly enhance investor protection. *See* 2015 SEC Staff Report, *supra* note 3, at 91.

[18] *See* 2007 Rule Proposal, *supra* note 3, at 16-17; 2015 SEC Staff Report, *supra* note 3, at 114-16.

[19] For example, H.R. 4762 in the current Congress and H.R. 1585 in the previous Congress propose to legislatively index the accredited investor standards in Rule 501(a)(5) and (a)(6) to the rate of inflation. *See* H.R. 4762, 116th Cong. (2020), *available at* https://www.congress.gov/bill/116th-congress/house-bill/4762/text?q=%7B%22search%22%3A%5B%22%5C%22accredited+investor%5C%22%22%5D%7D&r=1&s=1; H.R. 1585, 115th Cong. (2018), *available at* https://www.congress.gov/bill/115th-congress/house-bill/1585.

B. The Commission Should Exclude Agricultural Land and Equipment, as Well as Retirement Accounts, from an Investor's Net Worth.

Under Rule 501(a)(5), a person's primary residence does not count towards the $1 million net asset threshold required for accredited investor status. The Commission should add to this rule an exclusion for the value of agricultural land and machinery held for production, and for the value of any defined benefit or defined contribution tax-deferred retirement accounts.

American farmers and ranchers often meet the $1 million net worth threshold due to their ownership of land and equipment necessary for their businesses. These assets should not count towards their potential status as accredited investors. NASAA members in rural states have seen many farming and ranching households victimized by private securities offerings due to the fact that farmers and ranchers often technically qualify as accredited investors but lack relevant experience in the securities markets which can make them easy targets for fraudsters.

In addition, retirement accounts are often a large portion – if not the largest portion – of retail investors' financial portfolios. Given the decline of pension benefits over the years, defined contribution accounts are a primary source of retirement security. Assets held in tax deferred retirement accounts (such as accounts maintained under the Employee Retirement Income Security Act, individual retirement accounts, or accounts established pursuant to employer-sponsored 401(k) or 403(b) retirement plans) should be excluded from the accredited investor calculus. Like a home, these accounts should be considered essential components of a person's financial well-being, and therefore off limits to speculation in private offerings. The fact that an individual has saved dutifully over a lifetime has no bearing on whether that person should be deemed accredited and able to invest in private securities offerings.

IV. Tests of Sophistication Alone Are Not a Sufficient Basis to Grant Accredited Investor Status.

A. Metrics for Sophistication Should Be Combined with Experience.

NASAA has previously recognized that certain tests or certifications can be one aspect in assessing an investor's financial sophistication. NASAA supports the Proposal's attempt to isolate suitable metrics of investor sophistication as a means to gauge who should or should not be deemed accredited. But tests or certifications should not in and of themselves be sufficient. Rather, such metrics should be coupled with demonstrable experience.[20] As we have argued before, we believe

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[20] The Commission suggests that "passing the requisite examinations and maintaining an active certification, designation, or license would be sufficient to demonstrate the individual's financial sophistication to invest in Regulation D offerings, even when the individual is not practicing in an area related to the certification or designation." Proposal at 32. We disagree. Perhaps recognizing that successful test takers should not rush into private investing, the Commission also asks "[w]ith respect to certifications and designations for which an individual does not need to be sponsored by a member firm, should we consider imposing a waiting period following an individual's attainment of the credential or designation before the individual can invest in an offering

five years is an appropriate minimum standard, coupled with the wherewithal to sustain losses.[21]

Should the Commission nevertheless decide to move forward and recognize the passage of certain examinations or the attainment of certain certifications as *per se* qualifications for accredited investor status, the Commission should do so in a deliberative way through formal rulemakings and not, as proposed, by the means of subsequent Commission orders without an opportunity for notice and comment.[22] Implementing these new standards through Commission orders would be bad policy because it would, among other things, tend to encourage a 'race to the bottom,' as competing testing or certification standard bearers sought to expand the use of their metric to confer accredited investor status. Such a policy would also potentially violate the Administrative Procedure Act, as the new accredited investor standards would likely constitute legislative rules, for which public notice and comment are required.[23]

Further, any testing or certification metrics that confer accredited investor status must be coupled with demonstrated experience. NASAA has made this point previously.[24] The ability to pass a test is no substitute for demonstrable investing or financial services experience. Therefore, any use of a professional designation or exam as one aspect of a more fulsome assessment of financial sophistication for purposes of determining accredited investor status should also include significant relevant experience.

Finally, some measures discussed in the Proposal are insufficient on their face to assure investment sophistication, and accordingly they should have no place in the determination of accredited investor status. Specifically, the Securities Industry Essentials examination is insufficient to serve as a benchmark for the necessary investment sophistication. Other suggested measures – namely, qualification as a certified public accountant or certified management accountant, or the possession of a juris doctor or masters of business administration degree – also are not appropriate because of the variability of practice areas within each discipline, and the

as an accredited investor?" Proposal at 36. As we have commented previously, we believe five years of experience should accompany certification in order to establish sophistication.

[21] The Proposal suggests the Series 7, Series 65 and Series 82 examinations are sufficiently indicative of sophistication – and that other tests or certifications could be as well – but does not include a means-based test for the ability to sustain investment loss. *See* Proposal at 33-39.

[22] *See* Proposal at 28. While the Proposal offers a set of preliminary certifications tied closely to the financial services industry, the Commission signals that it would like to designate other qualifications in its discretion in the future. Against this uncertain backdrop of future certifications, NASAA believes it is all the more important that a certification alone should not establish sophistication, but should instead be accompanied by demonstrable experience which shows that an investor can make investment decisions properly.

[23] *See, e.g.*, *Perez v. Mortg. Bankers Ass'n*, 575 U.S. 92, 95-97 (2015). If the SEC insists on implementing these new standards through Commission orders, the SEC should, at a minimum, (1) expressly clarify that only those credentials that reliably demonstrate a professional level of investment-specific expertise would be included, and (2) lay out a procedure in the rule text that guarantees adequate notice and a robust opportunity for comment before any action is taken to add additional designations to the category.

[24] *See* Letter from Judith Shaw to Brent J. Fields, NASAA Comment Letter Regarding the SEC Staff's Report on the Review of the Definition of "Accredited Investor," at 4-5 (May 25, 2016), *available at* https://www.sec.gov/comments/4-692/4692-34.pdf.

overall fact that these standards are not focused on investing. Self-certification by investors would also be unacceptable because it would be subject to no standards whatsoever. Ultimately, NASAA would not support the use of any test that is not developed, administered and controlled by regulators in order to ensure timely, high-quality content and rigorous testing protocols.

B. Sophistication Must Be Combined with the Ability to Bear Losses.

As the Supreme Court explained in *SEC v. Ralston Purina*, whether an investor has access to the private securities market should turn on the investor's sophistication, access to relevant information, <u>and</u> ability to withstand losses.[25] All elements of this traditional test must be part of any proper accredited investor standard for natural persons. The Proposal disregards the second and third elements of this test, and instead suggests that sophistication alone is sufficient to confer accredited investor status and protect investors from losses.[26] The Proposal then offers unfounded predictions that this expansion will not harm investors.[27] It is naïve to think that, by taking a test, a person immediately becomes able not only to choose investments well, but to do so in a way that protects that person from the possibility of unbearable losses.

The longstanding rationale for including a means-based component to accredited investor status makes sense because it realistically appreciates that losses are part of investing and, more importantly, extraordinary losses are characteristic of private offerings.[28] When Congress first considered creating a registration exemption for sales to accredited investors, it envisioned that the appropriate model would be an investor willing to part with at least $100,000 who would demand to "meet with the company management" and "decide what information is needed" as a basis for

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25 *See SEC v. Ralston Purina*, 346 U.S. 119, 125-26 (1953) (stating that "[a]n offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering'," and that an offering may be exempt where the offerees "have access to the same kind of information the [Securities] Act [of 1933] would make available in the form of a registration statement").

26 *See* Proposal at 22 (stating that "we believe that the concept of financial sophistication encompasses not only an ability to analyze the risks and rewards of an investment but also the capacity to allocate investments in a way to mitigate or avoid risks of unsustainable loss") and 126 (stating that "the proposed amendments are intended to better identify investors' financial sophistication, which includes an ability to assess and avoid a risk of loss that the investor cannot sustain").

27 *See*, *e.g.*, Proposal at 30 (stating that "individuals who have passed the necessary examinations and received their certifications or designations . . . *may not need* the protections of registration under the Securities Act") (emphasis added).

28 According to data from the Bureau of Labor Statistics, more than half of private companies tend to fail within five years of inception. *See* Bureau of Labor Statistics, Table 7, *Survival of Private Sector Establishments by Opening Year*, https://www.bls.gov/bdm/us_age_naics_00_table7.txt. The failure rate cannot be explained solely by a perceived lack of access to capital, as even higher failure rates have been observed among start-ups that receive venture capital funding. *See* Erin Griffith, *Conventional Wisdom Says 90% of Startups Fail; Data Says Otherwise*, Fortune (Jun. 27, 2017) (stating that of 27,259 venture-backed start-ups studied by one global investment firm from 1990 to 2010, the observed failure rate ranged from close to 60% up to a high of 79%), *available at* https://fortune.com/2017/06/27/startup-advice-data-failure/.

making an investment.[29] The expansions put forth in the Proposal bear no relationship to the limited nature of accredited investor status envisioned by Congress.

C. Sophistication Is No Substitute for Meaningful Access to Accurate Information.

The SEC has stated that "widespread access to company information is a key component of our integrated disclosure scheme, the efficient functioning of the markets, and investor protection."[30] In the Proposal, the SEC speculates that, "[g]iven the rise of the internet, social media, and other forms of communication, information about issuers and other participants in the exempt markets is more readily available to a wide range of market participants."[31] However, the Proposal includes no assessment of the quality, reliability or relevance of the information available.[32] The amount of credible information available in the private markets is limited, due largely to a lack of mandated disclosure.[33] Retail investors generally will not have the leverage or bargaining power to obtain the information needed to make informed decisions about private offerings.[34] In fact, recent examples and experience suggest that social media and mass communication will expose investors to even more misleading information,[35] as well as aggressive marketing.

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29 *See* 126 Cong. Rec. 11260 (May 14, 1980) (discussing S.B. 2699, which would later be enacted as the Small Business Investments Incentive Act of 1980, Pub. L. No. 96-477). It should also be noted that the common dynamic for sales of private offerings – by brokers soliciting from lists of accredited investors – puts further distance between investors and issuers, and therefore makes it even more difficult for an individual investor to gain access to material information.

30 *See Report of Investigation Pursuant to Section 21(a) of the: Netflix, Inc., and Reed Hastings, SEC Release No. 34-69279*, at 3 (Apr. 2, 2013), *available at* https://www.sec.gov/litigation/investreport/34-69279.pdf.

31 Proposal at 79.

32 *See Ralston Purina*, 346 U.S. at 125-26 (explaining that an offering may be exempt where the offerees "have access to the same kind of information the [Securities] Act [of 1933] would make available in the form of a registration statement"); *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893 (5th Cir. 1977) (holding that district court erred in concluding that the offering at issue was an exempt private placement "in the absence of findings of fact that each offeree had been furnished information about the issuer that a registration statement would have disclosed or that such offeree had effective access to such information").

33 *See* Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. Pa. La. Rev. 179, 207-11, 214-16 (2012). *See also* notes 42-47, *infra*, and accompanying text.

34 *See* Pollman, *supra* note 33, at 211-213; *see also* Julie Verhage, *Here's What Morgan Stanley Is Telling Its Wealthiest Clients About Uber*, Bloomberg (Jan. 14, 2016) (discussing the inability of wealthy investors to obtain access to financial statements justifying the valuation of Uber Technologies, Inc.), *available at* https://www.bloomberg.com/news/articles/2016-01-14/here-s-what-morgan-stanley-is-telling-its-wealthiest-clients-about-uber.

35 *See* SEC Press Release 2018-219, *Elon Musk Charged with Securities Fraud for Misleading Tweets* (Sep. 27, 2018), *available at* https://www.sec.gov/news/press-release/2018-219.

V. The Proposal Lacks Sufficient Data to Support an Expansion of the Accredited Investor Population.

Implicit in the Proposal is a notion that retail investors are clamoring to invest in private offerings, and that legitimate private companies with bona fide products or services are eager to sell securities to retail investors. Neither idea is supported by evidence.[36] On the contrary, evidence shows that the best private companies are able to attract capital from a small number of wealthy backers, such as venture capital and sovereign wealth funds. For promising and successful private companies, this is the simplest and easiest way to raise money. For these companies, there is no dearth of capital available in the marketplace.[37]

A question must therefore be asked as to what sort of companies are eager to raise capital from a new population of retail accredited investors. It would inevitably be private companies that fail to attract interest from angel investors, venture capital firms, investment banks or hedge funds.[38] Experience has shown that these are the very sorts of companies that retail investors should avoid; they are the kinds of companies that will likely one day find themselves the subject of an SEC press release or litigation release.[39] Further, analyses of Rule 506(b) offerings show that, although issuers are permitted to accept investments from non-accredited investors, the vast majority of such offerings do not seek these types of investors.[40] Put simply, based on available data expanding the pool of accredited investors will neither spur capital formation nor provide

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[36] *See* Letter from Rick A. Fleming, SEC Office of the Investor Advocate, to Vanessa Countryman, Re: Concept Release on Harmonization of Securities Offerings (Jul. 11, 2019) (summarizing data from the U.S. Federal Reserve and private researchers to show that companies will be unlikely to want to seek out investments from individual investors who do not already qualify as accredited and that "small-dollar investors may be driven into investment structures in which they bear the downside risk of losing their entire principal while their potential for profits is severely restricted"), *available at* https://www.sec.gov/comments/s7-08-19/s70819-5800855-187067.pdf.

[37] *See* Dana Olsen, *The State of U.S. Venture Capital in 15 Charts*, *Pitchbook.com* (Oct. 29, 2018), *available at* https://pitchbook.com/news/articles/the-state-of-us-venture-capital-activity-in-15-charts; Bain & Co., *Global Private Equity Report 2020*, at 11 (2020) (stating that private equity uncalled capital "has been rising since 2012" and "hit a record high of $2.5 trillion in December 2019 across all fund types"), *available at* https://www.bain.com/globalassets/noindex/2020/bain_report_private_equity_report_2020.pdf.

[38] *See Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017*, SEC Division of Economic and Risk Analysis, at 34 (Aug. 2018) ("2018 DERA Report") (stating that "[t]he mean number of investors per offering (14) is significantly larger than the median (4), indicating the presence of a small number of a small number of offerings with a large number of investors. Offerings by pooled investment funds and REITs have the largest average number of investors (both accredited and non-accredited) per offering, while those by non-financial issuers have the smallest."), *available at* https://www.sec.gov/files/DERA%20white%20paper_Regulation%20D_082018.pdf.

[39] *See supra* note 5.

[40] *See* 2018 DERA Report, *supra* note 38, at 34-35 (stating that between 2009-2017, only 7% of Rule 506(b) offerings had at least one non-accredited investor). It may be that private issuers do not exercise this option because of the enhanced disclosure obligations that must be met for sophisticated, but not non-accredited investors.

opportunities for retail investors to invest in the early stages of promising startups.[41] Understanding this, the Commission should appreciate that expanding the accredited investor definition as proposed would most likely serve as a conduit, at best, for lack luster companies to waste retail investors' money. At worst, the Proposal could become an engine for fraudulent exploitation of vulnerable investors.

VI. An Expansion of the Accredited Investor Pool Needs to Be Based on Solid Data and Analysis.

Before undertaking any expansion of retail investor access to the private markets, the SEC should at a minimum ensure that there is sufficient evidence to support the proposed changes. Right now, such data are lacking. The Proposal acknowledges this when it states that "while we have information to estimate the number of some categories of accredited investor entities, we lack comprehensive data that will allow us to estimate the unique number of accredited investors across all categories of entities under Rule 501(a)."[42] The Proposal also concedes that its projected impact on investors and private issuers are inherently speculative by stating that adding new categories of individual accredited investors "*may potentially expand* the pool of investors eligible to participate in, and provide capital to, the Regulation D market,"[43] while issuers "*may be better able* to fulfill their financing needs" at "*possibly lower* costs."[44] The Commission has repeatedly cited a lack of data on the Regulation D market, due in large part to the lack of mandated disclosure requirements and filing requirements.[45] Enacting regulation not grounded in data or sound analysis increases the risk that the Commission could harm investors.

The Commission proposed to remedy this lack of data in 2013 pursuant to a companion release to amendments to Regulation D implemented in accordance with the Jumpstart Our Business Startups Act. In particular, the Commission proposed to amend Regulation D to require: (i) the filing of a Form D in Rule 506(c) offerings before issuers engaged in general solicitations; (ii) the use of written general solicitation materials in Rule 506(c) offerings (including certain legends and other disclosures); (iii) the submission of written general solicitation materials used

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41 As succinctly explained by Professor Elisabeth de Fontenay, "retail investors are not needed to provide capital to emerging companies, and promising companies do not appear to want them." Elisabeth de Fontenay, *Examining Private Market Exemptions as a Barrier to IPOs and Retail Investment*, Written Testimony Before the U.S. House Committee on Financial Services Subcommittee on Investor Protection, Entrepreneurship and Capital Markets (Sep. 11, 2019), *available at* https://financialservices.house.gov/uploadedfiles/hhrg-116-ba16-wstate-defontenaye-20190911.pdf.

42 *See* Proposal at 78.

43 *See* Proposal at 22 (emphasis added).

44 *See* Proposal at 115 (emphasis added).

45 *See* Concept Release on Harmonization of Securities Offering Exemptions, SEC Release No. 33-10649, at 23 (Jun. 18, 2019) ("Due to data limitations, it is difficult to draw rigorous conclusions about the extent of fraud in exempt securities offerings."), *available at* https://www.sec.gov/rules/concept/2019/33-10649.pdf; *id.* at 24 ("Due to data limitations, it is also difficult to draw rigorous conclusions about the average magnitude of investor gains and losses in exempt securities offerings."); *id.* at 36 ("We estimate households and not individuals due to data limitations because the database underlying our analysis measures wealth and income at the household level.").

in Rule 506(c) offerings to the Commission; and (iv) the filing of a post-closing Form D after completion of the offering.[46] These proposed amendments, unfortunately never adopted, would have provided the Commission with substantially greater visibility over the Regulation D market than it currently possesses.[47] It is irresponsible for the Commission to propose regulations after recognizing the need for greater data, and then choosing not to act to obtain that data. Rather than expanding the scope of the accredited investor definition now in the absence of such data, the Commission should implement the previously proposed revisions to Regulation D as a prerequisite to potential future rulemaking.

VII. Additional Comments on the Proposal

A. Accreditation Should Not be Based on Advice from any Financial Intermediary.

The Proposal asks whether accredited investor status should be extended to clients of financial intermediaries such as registered investment advisers or broker-dealers.[48] This idea was offered in a 2017 report from United States Treasury Department.[49] The report does not explain why the Treasury Department considered this to be a good policy proposal, but it most certainly is not.

The potential unintended negative consequences of such a policy are not hard to imagine. Responsible, reputable investment advisers will be unlikely to recommend private offerings to clients unless they are already sophisticated and wealthy enough to qualify as accredited. The only investment advisers who would do so are those whose business models are conflicted in favor of private issuers. Further, a review of suitability cases brought by NASAA members, the Financial Industry Regulatory Authority ("FINRA"), and in private FINRA arbitrations reveals that conflicted investment advice is not uncommon. Financial services professionals unfortunately can, and often do, put their own interests ahead of their clients.[50] Conflicts of interest, fraud, and

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[46] *See* Proposed Rule: Amendments to Regulation D, Form D and Rule 156, SEC Release No. 33-9416 (Jul. 10, 2013), *available at* https://www.sec.gov/rules/proposed/2013/33-9416.pdf.

[47] It is also true that imposing such prescriptive requirements on issuers who offer securities under Regulation D would allow for greater enforcement of offering violations and more opportunities for the Commission to curtail fraud.

[48] *See* Proposal at 83.

[49] *See* Steven T. Mnuchin and Craig S. Phillips, *Report to President Donald J. Trump: A Financial System that Creates Economic Opportunities – Capital Markets*, U.S. Department of the Treasury, at 44 (Oct. 2017) (stating that the "accredited investor" definition could be broadened to include any investor who is advised on the merits of making a Regulation D investment by a fiduciary, such as an SEC- or state-registered investment adviser), *available at* https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

[50] *See, e.g.*, *In re Primesolutions Secs., Inc.*, File No. 1300447 (IL Sec. State, Feb. 10, 2016) (suitability regarding private placements); *In re Kenneth Edward Volkerding*, Case No. AP-16-03 (MO Sec. State, March 30, 2016) (annuity suitability); *Genovesi v Ball*, FINRA Case No. 15-00981 (Feb. 25, 2016) (Anciello, Marsan, Berman, Arb.); *Booth v Crown Capital Securities, L.P.*, FINRA Case No. 14-00614 (Dec. 22, 2015) (Getzels, Taylor, Jr., Seff, Arb.).

even negligent advice are not unique to broker-dealers and their agents. It is also well-documented that firms with high concentrations of agents with disciplinary histories are more likely to be involved in the sale of private offerings, and they often target seniors.[51]

Further, the supposed expertise of an intermediary is no substitute for the investor's own sophistication, experience and wherewithal. In many instances, financial intermediaries can act on the basis of conflicted interests if they disclose them. Also, intermediaries make mistakes in their recommendations. An investor who is not able to meet an accredited investor standard in his or her own right is also not likely to understand when an intermediary offers bad advice. To allow individual investors to invest in private offerings simply because an adviser or broker-dealer recommends them would open investors to tremendous abuse by unscrupulous, or simply negligent, financial professionals.

B. The Proposal's Treatment of Spousal Equivalents and the Note to Rule 501(a)(8) are Reasonable.

The Proposal would add the term "spousal equivalent" to the term "spouse" for purposes of calculating joint income and net worth thresholds.[52] NASAA supports this revision, as this will keep the accredited investor definition consistent with other SEC rules (such as Regulation Crowdfunding). In addition, the proposed "look through" note to Rule 501(a)(8) is reasonable.[53] This note would clarify that for an entity or fund where all the natural persons who are investors in the entity/fund are themselves accredited, then the entity or fund itself will also qualify as accredited. This clarification is reasonable, as accredited investors should not lose their status when they come together to invest as a group.

C. The Proposal's Additions of Investment Advisers, RBICs, LLCs, and Other Entities as Potential Accredited Investors are Reasonable. However, the Minimum Asset Threshold Should be $10 Million and "Knowledgeable Employees" Should Not be Deemed Accredited.

The Proposal would expand accredited investor status to certain categories of registrants or entities. Although NASAA disagrees with the Proposal's proffered treatment of natural persons, NASAA does not object to expanding accredited investor status as to investment advisory firms

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[51] *See* Commissioner Robert J. Jackson Jr., *Statement on Reducing Investor Protections around Private Markets* (Dec. 18, 2019), *available at* https://www.sec.gov/news/public-statement/statement-jackson-2019-12-18-accredited-investor (concluding that "even supposedly sophisticated investors under our current standards have difficulty avoiding high-risk brokers in the private-placement market"); Jean Eaglesham and Coulter Jones, *Firms With Troubled Brokers Are Often Behind Sales of Private Stakes*, Wall Street Journal (Jun. 24, 2018), *available at* https://on.wsj.com/2Mnkf81; Jean Eaglesham and Coulter Jones, *Regulators Step Up Scrutiny of Sales of Private Stakes*, Wall Street Journal (Jul. 2, 2018), *available at* https://on.wsj.com/2n8uLIg.

[52] *See* Proposal at 65-67.

[53] *See* Proposal at 59-60.

(whether SEC registered or state registered),[54] rural business investment companies ("RBICs"),[55] nonprofit limited liability companies ("LLCs"),[56] or family offices and other entities.[57] However, where the Proposal would set a minimum assets threshold of $5 million, this minimum threshold should be raised to $10 million. A $10 million threshold would be more likely to capture investors who can reasonably be expected to have the sophistication and ability to withstand economic losses as to enable them to fend for themselves.

This expansion of the accredited investor definition as to firms or other non-natural persons should not extend, however, to so-called "knowledgeable employees." All natural persons should be subject to the same accredited investor standards; insiders to these organizations should not be favored on account of their insider status.

VIII. Conclusion

The Commission should not move forward with the Proposal as currently presented. Although the proposed expansions of accredited investor status as to certain organizations or entities are not unreasonable, the Proposal widely misses the mark in its proposed treatment of natural persons. Before rulemaking in this area, the Commission should first gather data on private offerings to natural persons with an aim to better understand the types of companies and investors that reasonably should be dealing with one another. One thing the Commission can and should do now, though, would be to raise the income and net worth thresholds for natural persons. The current, feeble standards in Rules 501(a)(5) and (a)(6) are in desperate need of modernization. These thresholds should be raised significantly, modified to exclude agricultural and retirement assets, and indexed to inflation going forward in order to continue serving the interests of retail investor protection. The SEC has considered implementing many of these changes in the past; it is high time the Commission did so.

If the Commission does insist on moving forward with the Proposal's expansion of access to the private markets by retail accredited investors, several modifications are essential; namely, the Commission should: substantially raise the current income and net worth thresholds for natural

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54 *See* Proposal at 47-49. The expansion to investment advisers should only apply to advisory firms, however, not natural persons who are registered investment advisers. Individuals who are registered as investment advisers should be treated the same as other natural persons and evaluated under the sophistication and means tests discussed above.

55 *See* Proposal at 50-51.

56 *See* Proposal at 51-54.

57 *See* Proposal at 55-57 and 60-63. Ironically, the Commission proposes to "add a new category in the accredited investor definition for any entity owning investments in excess of $5 million that is not formed for the specific purpose of acquiring the securities being offered," but maintains that the test for such an entity should be $5 million in investments rather than assets because doing so "may better demonstrate that the investor has *experience in investing and is therefore more likely to have a level of financial sophistication similar to that of other institutional accredited investors.*" *Id.* at 57 (emphasis added). It is confounding that the Commission would propose that investing experience should be a requirement for some entities, but not for retail investors, and it suggests that the Proposal is not internally consistent.

persons and index those thresholds to inflation; exclude agricultural land and machinery, as well as retirement accounts, from calculations of net worth; continue to require that all natural persons meet the income or net worth thresholds in order to be deemed accredited investors; and require that natural persons have significant investment experience before qualifying as accredited investors. To deviate from longstanding standards for accredited investor status in favor of the concepts offered in the Proposal would represent a significant departure from precedent in this area and would likely lead to material harm for the retail investing public.

Thank you for considering these views. We look forward to continuing to work with the SEC on our shared mission of protecting investors. Should you have questions, please contact either the undersigned or NASAA's Executive Director, Joseph Brady, at (202) 737-0900.

Sincerely,

Christopher Gerold
NASAA President
Chief, New Jersey Bureau of Securities