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Congress Should Increase Access to Private Securities Offerings

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In 2016, U.S. businesses raised about $1.7 trillion in capital by means of private offerings.[1] Because companies are going public much later than in the past, those who invest in private offerings generally receive a higher share of returns generated by successful entrepreneurial ventures than those who invest in relatively late-stage public companies.[2] Yet the securities laws restrict who can invest in private offerings to the most affluent 7 percent to 10 percent of U.S. households.[3] Congress should democratize access to these private offerings so that they are available to more investors.

The House has passed legislation sponsored by Representative David Schweikert (R–AZ) that could be a small step in this direction,[4] although it contains a significant drafting error that needs to be corrected if it is to have its intended effect. Senator Thom Tillis (R–NC) and Senator Catherine Cortez Masto (D–NV) have introduced better-drafted legislation that would make more substantial, although still modest, reforms to increase access to private offerings.[5] Both of these bills are called the Fair Investment Opportunities for Professional Experts Act.

Background

The Securities Act of 1933 makes it generally illegal to sell securities unless the offering is registered with the Securities and Exchange Commission (SEC).[6] Making a registered offering (often called going public) is a very expensive proposition and well beyond the means of most small and start-up companies. In addition, the costs of complying with continuing disclosure and other obligations of being a registered, public company are quite high.[7] The Securities Act, however, exempts various securities and transactions from this requirement. The exemption of the greatest importance to entrepreneurs is the exemption for private offerings.[8] The primary means of implementing this exemption is Regulation D.[9]

The SEC adopted Regulation D in 1982 during the Reagan Administration.[10] Although private offerings do not necessarily have to be in compliance with Regulation D, Regulation D provides a regulatory safe harbor such that if an issuer meets the requirements of Regulation D, the issuer will be treated as having made a private offering (often called a private placement). As discussed below, Regulation D investments are generally restricted to "accredited investors," who are affluent individuals or institutions. The vast majority of Americans are effectively prohibited from investing in Regulation D securities.[11]

Under Rule 506 of Regulation D,[12] a company may raise an unlimited amount of money and sell securities to an unlimited number of "accredited investors," and up to 35 non-accredited but sophisticated investors. Under Regulation D, an "accredited investor" is, generally, either a financial institution or a natural person who has an income of more than $200,000 ($300,000 joint) or a residence-exclusive net worth of $1 million or more.[13] Unlike under Rule 505, under Rule 506 all non-accredited investors, either alone or with a purchaser representative, must be "sophisticated."[14]

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SEC data show that 90 percent of offerings involve only accredited investors and even those that are not exclusively composed of accredited investors are composed overwhelmingly of accredited investors.[15] Thus, in practice, sophisticated investors without high incomes or net worth are unable to invest in the companies with the most profit potential. People that fall in this category are disproportionately young. It also means that young entrepreneurs seeking to raise capital from their non-wealthy peers find it more difficult to raise capital.

Congress Should Increase Access to Private Offerings

Congress, or the SEC on its own initiative, should change the definition of "accredited investor" for purposes of Regulation D to include persons who have met specific statutory bright-line tests that determine whether an investor has the "knowledge and experience in financial and business matters" to be "capable of evaluating the merits and risks of the prospective investment." Specifically, Congress should provide that someone is an accredited investor for purposes of Regulation D who has:

1. Passed a test demonstrating the requisite knowledge, such as the General Securities Representative Examination (Series 7); the Securities Analysis Examination (Series 86); the Uniform Investment Adviser Law Examination (Series 65);[16] or a newly created accredited investor exam testing for substantive investment knowledge;

2. Met relevant educational requirements, such as an advanced degree in finance, accounting, business, or entrepreneurship; or

3. Acquired relevant professional certification, accreditation, or licensure, such as being a certified public accountant, chartered financial analyst, certified financial planner, registered representative, or registered investment advisor representative.

The Fair Investment Opportunities for Professional Experts Act

On November 11, 2017, the House passed the Fair Investment Opportunities for Professional Experts Act (H.R. 1585), introduced by Representative Schweikert. This legislation would codify the current income ($200,000 single; $300,000 joint) and net worth (residence exclusive $1 million) thresholds.[17] It would provide the SEC authority that it already has to deem as accredited "any natural person the Commission determines, by regulation, to have demonstrable education or job experience to qualify such person as having professional knowledge of a subject related to a particular investment, and whose education or job experience is verified by the Financial Industry Regulatory Authority."[18] Lastly, it would provide that "any *natural person* who is currently licensed or registered as a broker or investment adviser" is an accredited investor.[19] (Emphasis added.)

This last provision is a drafting error. People often refer to their "stock broker" by which they mean the individual they speak to at the brokerage firm. However, as a matter of law, the "broker" is the firm, not an individual or "natural person" who works at the broker-dealer.[20] In 2017, there were 3,726 securities firms (brokers) that employed 630,132 registered representatives (natural persons).[21] Broker-dealers are legal entities, usually corporations or limited-liability companies. Currently, there are no natural persons who are brokers.[22] What the bill's authors undoubtedly intend is for licensed individuals who work for brokers to be treated as accredited. Those individuals are registered representatives, not brokers. There are over 13,000 investment advisers registered with the SEC. All, or virtually all, of them are firms not natural persons.[23]

Thus, unless changed, the "broker" and "investment adviser" provisions in the bill will accomplish nothing because there are no brokers who are natural persons and no, or virtually no, investment advisers who are natural persons. Instead of, or in addition to, using the term "broker," the bill should use the term "registered representative," and instead of, or in addition to, the term "investment adviser," the bill should use the term "investment adviser representative."[24]

The version of the Fair Investment Opportunities for Professional Experts Act introduced by Senators Tillis and Cortez Masto is better drafted than the House-passed legislation, and would increase access to private offerings to a much greater degree.[25] Like the House bill, it would codify the current income and net-worth thresholds.[26] It would, however, index them for future inflation.[27] It would treat as accredited "any natural person who is currently licensed or registered as a broker, dealer, *registered representative,* investment adviser, or *investment adviser*

representative."[28] (Emphasis added.) The bill does not, therefore, have the same drafting error discussed above that is contained in the House bill. It would have the effect of allowing registered representatives and investment adviser representatives who provide investment advice to others to make investments in private offerings themselves. The bill also instructs the SEC to issue regulations treating as accredited any natural person that the SEC determines to have demonstrable education, job, or professional experience, sophistication or knowledge, to qualify such person as an accredited investor and sets forth criteria that the SEC should use in drafting the rule.[29] Provided the SEC adopted bright-line tests in its rule, this provision could be highly useful.

Conclusion

Congress should democratize access to private offerings so that they are available to more investors. The Tillis–Cortez Masto version of the Fair Investment Opportunities for Professional Experts Act would take important steps in that direction. The House-passed version would only do so if the drafting error is corrected.

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Endnotes

1. This is more than all registered (public) offerings combined ($1.5 trillion in 2016, of which only about $25 billion were equity IPOs). U.S. Securities and Exchange Commission, Division of Economic and Risk Analysis, "Access to Capital and Market Liquidity," *Report to Congress*, August 2017, pp. 31–36, https://www.sec.gov/files/access-to-capital-and-market-liquidity-study-2017.pdf (accessed August 27, 2018). See also Jay R. Ritter, "Initial Public Offerings: Updated Statistics" (professor at University of Florida), May 14, 2018, https://site.warrington.ufl.edu/ritter/files/2018/07/IPOs2017Statistics_July11_2018.docx (accessed August 27, 2018).
2. See, for example, Ernst & Young, "Looking Behind the Declining Number of Public Companies: An Analysis of Trends in US Capital Markets," May 2017, https://www.sec.gov/spotlight/investor-advisory-committee-2012/ey-an-analysis-of-trends-in-the-us-capital-markets.pdf (accessed August 27, 2018); U.S. Securities and Exchange Commission, "Small and Emerging Companies Advisory Committee," meeting transcript, February 15, 2017, https://www.sec.gov/info/smallbus/acsec/acsec-transcript-021517.pdf (accessed August 27, 2018); and Jamie Hutchinson, "Why Are More Companies Staying Private?" presentation to SEC Small and Emerging Companies Advisory Committee, February 15, 2017, https://www.sec.gov/info/smallbus/acsec/hutchinson-goodwin-presentation-acsec-021517.pdf (accessed August 27, 2018).
3. "Report on the Review of the Definition of 'Accredited Investor,'" Securities and Exchange Commission, December 18, 2015, Table 4.2, pp. 48, 100, and 101, https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf (accessed August 27, 2018); Rachita Gullapalli, "Accredited Investor Pool," Securities and Exchange Commission, Division of Economic and Risk Analysis, presentation, December 17, 2014, https://www.sec.gov/spotlight/acsec/ai-pool-dera-12-17-2014.pdf (accessed August 28, 2018); David R. Burton, "Don't Crush the Ability of Entrepreneurs and Small Businesses to Raise Capital," Heritage Foundation *Backgrounder* No. 2874, February 5, 2014, http://thf_media.s3.amazonaws.com/2014/pdf/BG2874.pdf; and U.S. Government Accountability Office, "Securities and Exchange Commission: Alternative Criteria for Qualifying as an Accredited Investor Should Be Considered," GAO–13–640, July 2013, http://www.gao.gov/assets/660/655963.pdf (accessed August 27, 2018).
4. H.R.1585, 115th Congress, passed the House, as amended, by voice vote on November 1, 2017.
5. S. 2756, 115th Congress.
6. See § 5 of the Securities Act of 1933. The Securities Act of 1933, Public Law 73–22, 48 Stat. 74, 15 U.S. Code § 77a et seq., Securities Act of 1933: As Amended Through Public Law 115–174, enacted May 24, 2018, http://legcounsel.house.gov/Comps/Securities%20Act%20Of%201933.pdf (accessed August 27, 2018).
7. The SEC has estimated that "the average cost of achieving initial regulatory compliance for an initial public offering is $2.5 million, followed by an ongoing compliance cost, once public, of $1.5 million per year." U.S. Securities and Exchange Commission, "Crowdfunding; Proposed Rule," *Federal Register*, Vol. 78, No. 214 (November 5, 2013), p. 66509 (col. 2), http://www.gpo.gov/fdsys/pkg/FR-2013-11-05/pdf/2013-25355.pdf (accessed August 27, 2018).
8. Section 4(a)(2) of the Securities Act exempts "transactions by an issuer not involving any public offering," 15 U.S. Code § 77d(a)(2). Prior to the JOBS Act, the exemption was in § 4(2). This exemption is typically called the "private placement" or "private offering" exemption. There is no definition in the statute or, for that matter, in the securities regulations, of a "public offering" or, conversely, of what is not a public offering. Investors and their attorneys must rely on various court cases, SEC interpretive releases, SEC concept releases, SEC policy statements, SEC staff interpretations, SEC staff legal bulletins, and SEC "no action" letters to make judgments about what will be deemed a public offering. The leading Supreme Court case interpreting this statutory provision is *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953).
9. 17 C.F.R. § 230.500 et seq. See also Securities and Exchange Commission, "Exempt Offerings," https://www.sec.gov/smallbusiness/exemptofferings (accessed August 27, 2018). Rule 506 accounts for the overwhelming majority of private offerings.
10. "Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers of Sales" (Release No. 33-6389), *Federal Register*, No. 47 (March 16, 1982), p. 11251. Regulation D is found at 17 C.F.R. § 230.500 through § 230.508. See "Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1993 for Transactions Involving Limited Offers of Sales" (Release No. 33-6339), *Federal Register*, No. 46 (August 18, 1981), p. 41791, for the original proposed rule.
11. Thaya Brook Knight, "Your Money's No Good Here: How Restrictions on Private Securities Offerings Harm Investors," Cato Policy *Policy Analysis* No. 833, February 9, 2018, https://object.cato.org/sites/cato.org/files/pubs/pdf/pa833.pdf (accessed August 27, 2018).
12. Ninety-nine percent of capital raised using Regulation D is raised via Rule 506 rather than Rule 504 or Rule 505. See Scott Bauguess, Rachita Gullapalli, and Vladimir Ivanov, "Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009–2014," Securities and Exchange Commission, October 2015, Figure 4, p. 12, https://www.sec.gov/files/unregistered-offering10-2015.pdf (accessed August 27, 2018). This is primarily because Rule 506 offerings do not have to comply with state blue sky laws. See Rutheford B. Campbell Jr., "The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions," *The Business Lawyer*, Vol. 66 (August 2011), pp. 919–942, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1971200 (accessed August 27, 2018).
13. The statutory basis for the use of an accredited investor in Regulation D is § 2(a)(15) of the Securities Act, 15 U.S. Code § 77b(a)(2). 17 C.F.R. § 230.501(a) defines "accredited investor" for purposes of Regulation D.
14. 17 C.F.R. § 230.501(a)(7) (Definitions) does use the term "sophisticated person" in reference to Rule 506(b)(2)(ii). "Sophisticated investor" is an almost universal shorthand for an investor who has "sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment"—the language actually used in Rule 506(b)(2)(ii). Given the ambiguity of this sophisticated investor definition and the fact that the price of failing to comply with Regulation D is that the entire offering may be treated as unlawful, the vast majority of issuers sell only to accredited investors.

15. See Bauguess, Gullapalli, and Ivanov, "Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009–2014," pp. 34 and 35.
16. Financial Industry Regulatory Authority, "Series 7 Exam–General Securities Representative Examination (GS)," http://www.finra.org/industry/compliance/registration/qualificationsexams/qualifications/p011051 (accessed August 27, 2018).
17. H.R. 1585, 115th Congress, § 2(a)(2), proposed Securities Act Section 2(a)(15)(B)–(C).
18. Ibid., proposed Securities Act Section 2(a)(15)(E).
19. Ibid., proposed Securities Act Section 2(a)(15)(D).
20. See Securities Exchange Act §3(a)(4)–(5) for the definition of broker and dealer.
21. Financial Industry Regulatory Authority, "Statistics," https://www.finra.org/newsroom/statistics (accessed August 27, 2018).
22. U.S. Securities and Exchange Commission, "Company Information About Active Broker–Dealers," March 2007–August 2018, https://www.sec.gov/help/foiadocsbdfoiahtm.html (accessed August 27, 2018). None of the 3,847 registered broker–dealers are natural persons.
23. U.S. Securities and Exchange Commission, "Information About Registered Investment Advisers and Exempt Reporting Advisers," June 2006–August 2018, https://www.sec.gov/files/data/information-about-registered-investment-advisers-and-exempt-reporting-advisers/ia080118.zip (accessed August 27, 2018). The author has not individually reviewed all 13,000 registrations, but a perusal of the list indicates that no less than 99 percent of registered investment advisers are entities.
24. An investment adviser representative is a natural person who works for an entity, the registered investment adviser.
25. S. 2756, 115th Congress.
26. Ibid., § 2(a), proposed Securities Act section 2(a)(15)(A)(ii)–(iii).
27. Ibid.
28. Ibid., proposed Securities Act section 2(a)(15) (A)(v).
29. Ibid., proposed Securities Act section 2(a)(15)(A)(vi)–(vii).