



# BETTER MARKETS

March 16, 2020

Mrs. Vanessa A. Countryman  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549-1090

Re: Amending the “Accredited Investor” Definition (Release Nos. 33–10734; 34-87784; File No. S7–25–19).

Dear Secretary Countryman:

Better Markets<sup>1</sup> appreciates the opportunity to comment on the above-captioned rule proposal (“Release” or “Proposal”) noticed for public comment by the Securities and Exchange Commission (“SEC” or “Commission”). Previously we have offered our comments on the Commission’s Concept Release on Exempt Offerings,<sup>2</sup> and some of the commentary here will reinforce those points, as this Release seems to have ignored our and others’ concerns.

The Release,<sup>3</sup> among other changes, proposes to create a mechanism by which the Commission could either in the final rule following this Proposal or in the future designate certain groups of investors as “Accredited Investors” regardless whether these investors meet the income or the wealth thresholds under the current definition of Accredited Investors. Throughout this Release, the Commission claims by expanding the ranks of Accredited Investors, the Commission would make more investment opportunities available to investors who have the knowledge of the risky nature of the unregistered securities but may lack the financial wherewithal to qualify as an Accredited Investor. The Commission also hopes that the Proposal would enable funding-starved issuers to gain access to new pool of investors, and with that grow their companies and hire and reward employees.

Our comment letter would focus on these themes and argue that there is no evidence to show that currently non-Accredited Investors are clamoring to invest in companies that disclose at

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<sup>1</sup> Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans’ jobs, savings, retirements, and more.

<sup>2</sup> See Better Markets Concept Release on Harmonization of Securities Offering Exemptions (Release Nos. 33–10649; 34–86129; IA– 5256; IC–33512; File No. S7–08–19), *available at* <https://bettermarkets.com/sites/default/files/CL%20SEC%20Exempted%20Offering%209-19-19%282%29.pdf>, incorporated as if fully set for herein.

<sup>3</sup> See, Release Nos. 33–10734; 34-87784; File No. S7–25–19, 85 Fed. Reg. 2574 (January 15, 2020) *available at* <https://www.federalregister.gov/documents/2020/01/15/2019-28304/amending-the-accredited-investor-definition>.

best stale information about themselves and their prospects, or at worst, are total frauds. Our comment letter would also discuss that given the size and growth of the exempt offering space, companies that have reasonable prospects of success are able to find funding. We will also argue that only those companies that have been turned down by their friends and family, angel investors, local or national banks, private equity or venture funds, and other “smart money” are maybe having challenges raising funds, but that investors who do not have the financial wherewithal to withstand the highly-probable loss should not be permitted to be exploited by financial professionals who will peddle these unregistered securities.

We may supplement this comment letter with additional commentary.

## **DESCRIPTION OF THE PROPOSAL**

The Commission is proposing to amend the “Accredited Investor” definition in Rule 501(a) of Regulation D by:

- (1) Authorizing itself to add new categories in the definition that would permit natural persons to qualify as Accredited Investors based on certain professional certifications or designations or other credentials, or with respect to investments in a private fund, as a “knowledgeable employee” of the private fund;
- (2) adding certain entity types that have in excess of \$5 million in investments to the current list of entities that may qualify as Accredited Investors;
- (3) adding family offices with at least \$5 million in assets under management and their family clients to the definition;
- (4) adding the term “spousal equivalent” to the definition, so that spousal equivalents may pool their finances for the purpose of qualifying as Accredited Investors; and
- (5) codifying certain staff interpretive positions that relate to the Accredited Investor definition. The Commission is also proposing to amend the definition of “qualified institutional buyer” in Rule 144A to expand the list of entities that are eligible to qualify as qualified institutional buyers.<sup>4</sup>

## **SUMMARY**

Our comment letter will focus on the Commission’s proposal to authorize itself to add categories of natural persons to the list of Accredited Investors. We are generally supportive of the Commission’s proposal to define entities that have investments in excess of \$5 million as Accredited Investors. We also generally support Commission’s proposal to add “spousal equivalent” to the definition so that spousal equivalents may pool their finances for the purposes of qualifying as Accredited Investors. We also support Commission’s proposal to expand the list of qualified institutional buyers. Finally, we are supportive of the proposal to permit “knowledgeable employees” of private funds to qualify as Accredited Investors, with the caveat

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<sup>4</sup> See Release at 2599.

that these employees are indeed knowledgeable and have appropriate understanding of the risky nature of unregistered offerings.

## **COMMENTS**

### **The Accredited Investor Construct Is One of the Commission’s Most Important Retail Investor Protections and Should Not Be Diluted.**

The “Accredited Investor” construct is one of the Commission’s most important retail investor protection methods. For decades, the Accredited Investor construct has allowed the Commission to effectively draw a line between investors who have the financial means and financial knowledge to fend for themselves and those who lack such sophistication or wherewithal. This clear demarcation has helped the Commission to better protect those who need such protection, and has allowed market participants, including broker-dealers, underwriters and companies to more effectively target their solicitations and offerings. The SEC should not tamper with this time-tested and time-proven construct.

If anything, inflation has already caused hundreds of thousands of more investors to qualify as an Accredited Investor since the definition was set in law in 1982 (and updated in 1989). Table below shows this enormous change:

**TABLE 4—HOUSEHOLDS QUALIFYING UNDER EXISTING ACCREDITED INVESTOR CRITERIA**  
[Standard errors are in parentheses]

Basis for qualifying as accredited investor	1983		1989		2019	
	Number of qualifying households (millions)	Qualifying households as % of U.S. households	Number of qualifying households (millions)	Qualifying households as % of U.S. households	Number of qualifying households* (millions)	Qualifying households as % of U.S. households*
Individual income <sup>208</sup> threshold (\$200,000) .....	0.44 (0.10)	0.53 (0.12)	4.3 (0.4)	4.7 (0.5)	11.2 (0.3)	8.9 (0.2)
Joint income threshold <sup>209</sup> (\$300,000) .....	N/A	N/A	2.1 (0.3)	2.3 (0.4)	5.8 (0.2)	4.6 (0.2)
Net worth <sup>210</sup> (\$1,000,000) .....	1.18 (0.17)	1.4 (0.20)	4.5 (1.0)	4.8 (1.1)	11.8 (0.3)	9.4 (0.2)
Overall number of qualifying households <sup>211</sup> .....	1.31 (0.18)	1.6 (0.21)	6.8 (1.0)	7.3 (1.1)	16.0 (0.3)	13.0 (0.2)

Source: Release at 2593.

In 1983, only 1.6% of U.S. households qualified as Accredited Investors, whereas today, 13% do so. As Commissioner Lee analyzed in her dissent, if the current thresholds are not significantly raised, using an annual inflation rate of 1.51%, over 22% of the U.S. households will qualify as Accredited Investors in ten years; almost 40% in twenty years; and, in thirty years, over 57% of U.S. households will qualify as Accredited Investors.<sup>5</sup>

This should give concern to the SEC as there may indeed now hundreds of thousands of investors who have become qualified as Accredited Investor solely on the virtue of inflation of their asset prices but who otherwise lack necessary financial sophistication to carefully weigh the risks associated in investing in exempt offerings. These newly minted Accredited Investors are

<sup>5</sup> See Commissioner Allison Lee’s dissenting statement (December 18, 2019), *available at* <https://www.sec.gov/news/public-statement/statement-lee-2019-12-18-accredited-investor>.

often seniors with diminishing mental abilities and other vulnerabilities, and the SEC should devote its regulatory attention to the protection of these investors, and not attempt ways to dangerously increase the number of Accredited Investors in its misguided effort to spur capital formation.

The Commission should also exercise its authority under Section 413 of the Dodd-Frank Wall Street Reform and Consumer Act of 2016 to revise this threshold upwards. At a bare minimum, the Commission should peg the threshold to inflation going forward.

Commission Assumes, Without Providing Data, that Deregulation Will in Fact Spur Further Capital Formation, and Ease Viable and Growing Companies' Access to Financing.

Despite data showing that companies which are viable and investment-worthy have no significant challenge finding and raising necessary funding, the Commission, throughout the Release, seems to suggest that access to capital is still curtailed. The fatal flaw in such a suggestion is that the Commission fails to distinguish between investment-worthy companies and those that have little to no prospect of ever returning a profit for their shareholders. It is not unreasonable to assume that “in our current glut of capital, firms that still cannot attract capital from institutional or high-net-worth investors are likely the smallest firms with the very worst prospects, which are wholly unsuitable investments for retail investors.”<sup>6</sup>

As discussed above, given the glut of funding<sup>7</sup> available to viable companies (including, historically low levels of interest rates which cause lenders and investors to compete to find viable borrowers/issuers), companies that have challenges finding investors, and therefore need to resort to soliciting non-Accredited Investors, would need to have been denied by sophisticated investors and those who know the business or company's executives well. This means the company would need to be passed by their friends and family, local angel investor groups, local community banks or credit union, national banks, Regulation A+ (which permits companies to raise \$50 million a year), venture capital funds, private equity funds, Business Development Companies, strategic acquirers, and other institutional investors. Put another way, all the “smart money” would need to decline such a company for it to make economic sense to undergo the expense of soliciting small-dollar non-Accredited Investors.

But this also is the strongest signal sophisticated investors send to other market participants, that this company is unacceptably high-risk and investors should stay away.<sup>8</sup> This also means that, unlike in the public markets, where non-Accredited Investors<sup>9</sup> and institutional investors operate on a relatively level playing field in making investment decisions,<sup>10</sup> in private

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<sup>6</sup> See Elizabeth de Fontenay testimony (“de Fontenay Testimony”) before House Financial Services Committee, Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets, “Examining Private Market Exemptions as a Barrier to IPOs and Retail Investment,” p.4, September 11, 2019.

<sup>7</sup> See also Rick Fleming, Investor Advocate of the SEC, Comment Letter (Investor Advocate Letter), July 11, 2019, available at <https://www.sec.gov/comments/s7-08-19/s70819-5800855-187067.pdf>, p.5.

<sup>8</sup> See Investor Advocate Letter, p.5.

<sup>9</sup> Retail investors are also often aided by third-party analysts and information providers.

<sup>10</sup> For example, by assessing a company's value using the market-clearing prices of its security, or having access to the same disclosure documents at the same time.

markets, given the disparate share class structures, non-Accredited 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.”<sup>11</sup>

The Commission Fails to Show Whether Current Non-Accredited Investors Could Afford or Want to Invest in Exempt Offerings or Would Fare Better When Investing in Exempt Offerings Versus Public Markets.

The Commission offers *no evidence* that non-Accredited Investors could afford to invest in exempt offerings. As detailed in the SEC Investor Advocate’s letter, “companies may not be able to raise a lot of money from retail investors who do not already meet the definition of accredited investor” since “the top 10% of U.S. households by net worth—a segment of the population that would include most accredited investors—hold 77.1 percent of the wealth in this country.”<sup>12</sup> The Investor Advocate further documents that “when one looks beyond that top decile of households, the likelihood of stock ownership falls off dramatically. Even more remote is the likelihood that a household would have a portfolio of securities that is large enough for a financial professional to reasonably recommend the purchase of securities that are exempt from registration.”<sup>13</sup>

Finally, given Federal Reserve’s data that the bottom 50% of American households hold less than \$10,000 in financial assets<sup>14</sup> and that median brokerage account balance of all U.S. investors is only \$6,200,<sup>15</sup> it is reasonable to assume that non-Accredited Investors—who are **not** ill-served by their investment professionals or defrauded to by struggling companies—would not prefer to invest their precious savings into illiquid and high-risk exempt offerings. They simply cannot afford to do it, and any broker who recommends such unsuitable investments would likely violate even the very weak new Regulation Best Interest rules.

There is also *little evidence* showing that non-Accredited Investors actually want to invest in exempt offerings. The experience with Regulations A+ and Crowdfunding is the strongest signal that non-Accredited Investors are sending that, in fact, they do not care for exempt offerings. As detailed in the Investor Advocate’s letter, “both of these [Reg A and Reg Crowdfunding] exemptions were explicitly designed to allow companies to offer their securities to non-accredited investors...[O]f the completed offerings under Regulation Crowdfunding, the average amount raised was \$208,300, well below the \$577,385 maximum that was sought in the average offering.”<sup>16</sup> Given that early-stage companies have much higher rates of failure, and the fact that non-Accredited Investors (given the dearth of their investable funds) cannot adequately diversify

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<sup>11</sup> See Investor Advocate Letter, p.5; see also, de Fontenay Testimony, p.15, “expect retail investors to fall to the bottom of the heap in the private markets, behind the enormous amount of ‘smart money.’”

<sup>12</sup> See Investor Advocate Letter, p.2.

<sup>13</sup> See Investor Advocate Letter, p.2.

<sup>14</sup> See Board of Governors of the Federal Reserve System, 2016 SCF Chartbook, <https://www.federalreserve.gov/econres/files/BulletinCharts.pdf>, at 145.

<sup>15</sup> See Brokerage Accounts in the United States, Advanced Analytical Consulting Group and Deloitte, November 30, 2015, available at <https://www.dol.gov/sites/default/files/ebsa/researchers/analysis/retirement/brokerage-accounts-in-the-us.pdf>.

<sup>16</sup> See Investor Advocate Letter, p.5.



among high-risk firms—like venture capital and private equity investors are able to do—it is only reasonable to expect that rational non-Accredited Investors would not flock to exempt offerings.

The Commission also offers *no evidence* how investors (be they institutional or accredited) currently fare when investing in exempt offerings. In fact, given by their very nature of unregistered offerings, the Commission admits that it lacks evidence about their performance. Nothing else in the Release attempts to answer the fundamental question: Given the SEC's mandate of investor protection, how will investors fare when they invest in exempt offerings? These offerings have scant information about the issuer and the securities themselves—to the extent they can even be traded—are very illiquid. Finally, non-Accredited Investors would be at a disadvantage compared to deep-pocketed and sophisticated investors who have ability and leverage to gain more information. This informational asymmetry would mean that when a company issuing the exempt offering is in trouble, the sophisticated investors would be able to detect it (or know) sooner and liquidate sooner, leaving the non-Accredited Investors further disadvantaged.

Throughout the Release, the Commission seems to be suggesting that supposedly non-Accredited Investors are missing out on high-growth companies that only offer exempt securities. But as Professor de Fontenay has shown, these claims are based “more on faith than evidence,” and that “available research suggest that retail investors would do materially worse on average in the private markets than in the public markets.”<sup>17</sup>

At a bare minimum, the SEC must—before promulgating any rule exposing currently non-Accredited Investors to the barrage and peddling and solicitation of unregistered offerings—definitively know that non-Accredited Investors, given their financial and other limitations, would in fact do better when investing in unregistered offerings versus what they could achieve, for example, by investing in the public markets or low-cost market index funds.

Any Future Designation Must Only Be Approved After Public Notice And Comment And Must Include Rigorous Economic Analysis.

In the Release, the Commission contemplates that it may in the future, at its discretion, the Commission may designate several other new groups as Accredited Investors. While the Commission anticipates doing the designation after a public notice and comment,<sup>18</sup> **it does not commit to such process.** We urge the Commission to commit to designating in the future only after it notices such designation for public comment, subject to all applicable requirements of the Administrative Procedures Act.

Notwithstanding the above serious concerns, we are not arguing that the Commission should not explore ways to more accurately assess an investor's financial sophistication. We also are not advocating that Accredited Investor construct should never evolve. But any such evolution must be based on real data. The Commission has not produced any rigorous data or analysis to support its claims that there is a real demand from non-Accredited Investors to invest in companies that provide little to no information. The Commission has also failed to show that investment-

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<sup>17</sup> See de Fontenay Testimony, p.4.

<sup>18</sup> See Release at 2581.

worthy companies are lacking funding. Without passing these two fundamental tests through a rigorous economic analysis, the Commission should not amend the Accredited Investor definition.

## **CONCLUSION**

We hope the Commission finds our comments helpful. The Commission has not answered in the Release some of the fundamental questions raised in our letter, and we urge the Commission to revise the Proposal according to that commentary and re-Propose for public comment.

Sincerely,



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