Consumer Federation of America

March 9, 2020

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

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

Dear Ms. Countryman,

We are writing on behalf of the Consumer Federation of America (CFA)[1] in response to the proposed revisions to the definition of accredited investor. This issue is of profound importance to the protection of investors and the health of our capital markets because of the gatekeeper function the accredited investor definition plays in determining whether issuers can sell their securities to members of the investing public without providing the essential facts needed to evaluate the investment and value those securities. As we discussed at length in our earlier letter regarding the request for comment on private offering exemptions, an overly expansive definition of accredited investor is one of several deregulatory changes that has, over the past four decades, led to the serious decline of our public markets, with grave attendant risks to both investors and the health of our economy.[2] Instead of taking steps to stem that decline, the Commission is proposing changes to the accredited investor definition that serve once again to expand private capital raising at the expense of our public markets.

Moreover, the Commission is proposing these changes without conducting any meaningful analysis to determine whether the current definition is serving its intended regulatory function of identifying a pool of investors capable of fending for themselves without the protections afforded in the public markets. (Idle speculation about the possible impact of the rise of the Internet or other technological advances does not constitute meaningful analysis.) On the contrary, the Commission appears to be deliberately ignoring extensive evidence that the current definition includes millions of investors who do not have special access to information regarding private offerings, lack the high level of financial sophistication needed to evaluate private

[1] CFA is a non-profit association of more than 250 national, state, and local pro-consumer organizations. It was established in 1968 to advance the consumer interest through research, advocacy, and education.
[2] Letter from Barbara Roper and Micah Hauptman, CFA, to the SEC, Concept Release on Harmonization of Securities Offering Exemptions, Oct. 1, 2019, https://consumerfed.org/wp-content/uploads/2019/10/CFA-Private-Offering-Comment-Letter-10.1.19.pdf. (CFA Letter on Private Offering Concept Release)

offerings based on limited disclosures, and who qualify as accredited investors based solely on retirement savings amassed over a lifetime of work that they can ill-afford to put at risk in illiquid, opaque and speculative private market investments.[3] The Commission has failed to undertake this analysis even though it is mandated to study the accredited investor definition, as it pertains to natural persons, every four years.[4]

Had the Commission based its proposal on a more robust analysis, the proposed changes would not remotely resemble the proposals we have before us in this Release. First and foremost, the Commission would have been forced to seriously consider the impact that inflation has had and continues to have on a definition that relies on financial thresholds that are not indexed to inflation. Second, it would have had to consider the potentially harmful impact on Americans' retirement security of encouraging the marketing of private securities to retirement savers who qualify as accredited investors based on savings they must rely on for income throughout several decades of retirement. Third, it would have had to consider the risks to the economy posed by a huge and rapidly growing private market about which the Commission lacks even the most basic information regarding who invests, how and why they invest, how those investments fare, and what the long-term impact is on sustainable job creation and capital formation.

Unfortunately, this proposal fails to address any of those serious concerns. Instead, the actual proposed changes included in the Release are all designed to further expand the definition, including in potentially harmful ways. An even more dangerous proposals is included in the request for comment. Here, the Commission asks whether it should permit anyone to invest in Reg D offerings based on recommendations from a financial professional. We are encouraged by comments from Chairman Clayton suggesting that he is skeptical of this latter proposal because of its failure to adequately align the interests of the investor and the financial professional. But we are left to wonder how such a reckless and irresponsible idea found its way into the Release at all. The overall result is a set of proposed changes that have the potential to expose investors, our capital markets and the nation's economy to vast and unwarranted new risks.

1) Policymaking in this area should start with a careful analysis of the current definition's effectiveness. The Commission has conducted no such evaluation.

The purpose of the accredited investor definition, as the Commission acknowledges, is to identify a pool of investors who are capable of fending for themselves without the protections afforded in the public markets. Determining whether investors can fend for themselves has traditionally turned on three factors: First and foremost, do they have access to the same kind of information that would be available in a public offering? Are they sufficiently financially sophisticated to evaluate the potential risks and rewards of the investment to determine whether it is appropriate for them? Can they withstand the heightened risks, including liquidity risks and

[3] *See*, e.g., CFA Letter on Private Offering Concept Release at 65-67.

[4] Section 413 of the Dodd Frank Act requires the Commission to conduct a review every four years of the accredited investor definition, as it applies to natural persons, "to determine whether the requirements of the definition should be adjusted or modified for the protection of investors, in the public interest, and in light of the economy." To date, the Commission has released only one such study, in December 2015. *See*, SEC Staff Report on the Review of the Definition of "Accredited Investor," Dec. 18, 2015, https://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf. We understand that the Commission has taken the position that its Concept Release on harmonization of private offering exemptions satisfies its obligation in this regard. For reasons discussed below, we strongly disagree.

risk of loss, typically associated with private securities? As we discussed at length in our comment letter on the private offering Concept Release, adhering to a strict interpretation of these factors is critical to preserving the basic principle behind the '33 Act: that no company should be able to raise capital from the general public without first registering its securities with the SEC and providing the essential facts needed to value those securities.[5]

Consistent with its investor protection mission and its Dodd-Frank mandate, the first question the Commission should ask in undertaking revisions to the accredited investor definition is whether the current definition is effectively fulfilling that regulatory function. There is no evidence that the Commission has done so. Specifically, it has failed to conduct even the most basic analysis needed "to determine whether the requirements of the definition should be adjusted or modified for the protection of investors, in the public interest, and in light of the economy." To date, the Commission has released one such study, in December 2015.[6] While the 2015 Staff Report did a good job of presenting an overview of criticisms of the current definition and the various proposals that have been put forward to adjust the definition, it did not attempt to independently analyze the effectiveness of the definition in identifying a pool of investors who are able to fend for themselves by virtue of their ability to gain access to information, their financial sophistication, or their ability to withstand risks associated with private offerings. We understand that the Commission has taken the position that its 2019 Concept Release on private offering exemptions satisfies its obligation to update that study, but the "analysis" in the Concept Release is even more superficial.[7]

A. The Commission provides no evidence that the current definition identifies a population of investors capable of "fending for themselves," and it ignores evidence that the current definition is vastly over-inclusive.

As the SEC's Investor Advisory Committee noted in its 2014 recommendation regarding the accredited investor definition, there are strong reasons to believe that the current definition is not effective in identifying a pool of individuals capable of "fending for themselves" based on any reasonable interpretation of that term.[8] The IAC noted that income and net worth are a particularly poor proxy for both sophistication and access to information. It cited evidence, for example, that a significant percentage of even the wealthiest investors score poorly on tests of basic financial literacy. Such tests don't begin to measure the financial sophistication necessary to assess the potential benefits and risks of private offerings.

Even as a proxy for ability to withstand losses, the income and net worth thresholds suffer from serious shortcomings, the IAC warned. For example, because the net worth calculation can include non-financial assets, such as an ownership interest in a family farm or other closely-held business, it "does not guarantee that the individual accredited investor will in

[5] CFA Letter on Private Offering Concept Release at 9-13.
[6] SEC Staff Report on the Review of the Definition of "Accredited Investor," Dec. 18, 2015, https://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf.
[7] While the Concept Release includes a chart showing that accredited investors have somewhat higher educational levels than non-accredited investors, it doesn't provide evidence that this equips them well to analyze the potential risks and rewards of private offerings, particularly in the absence of mandatory disclosures. And it doesn't include any analysis of at all regarding their ability to access information or withstand risks.
[8] Recommendation of the SEC Investor Advisory Committee, Accredited Investor Definition, Oct. 9, 2014, https://www.sec.gov/spotlight/investor-advisory-committee-2012/investment-advisor-accredited-definition.pdf.

fact have sufficient liquid financial assets to ensure either that they can hold the securities indefinitely or that they can withstand a significant loss on those investments." The IAC also voiced concern that, "many individuals who meet the net worth threshold will do so based on a retirement nest egg that they rely on to provide regular income that will need to last them throughout their remaining years," making them potentially ill-equipped to weather the risks of private investments. The IAC further noted that the ability to withstand potential risks of private offerings among individuals who qualify as accredited investors based exclusively on income will vary greatly based on a number of factors, "including whether they also have substantial assets, albeit less than the $1 million in net worth required to qualify as accredited, how heavily invested they are in private offerings, and how many working years they have left to recover financially if they suffer a substantial loss." CFA shares these concerns. The Commission has provided no evidence that they are unfounded, or even any indication that they have taken them into account in developing their proposal.

Instead of seeking to assess the effectiveness of the current definition, and the adequacy of the current financial thresholds, the Proposing Release merely asserts the Commission's belief that "the use of financial thresholds as one method of qualifying as an accredited investor is appropriate." It presents no evidence to support that statement of faith. For example, it presents no evidence that income and net worth, at least at the levels set in the current definition, are good predictors of who can gain access to information about Reg D offerings in the absence of mandatory disclosures. Nor does it provide evidence that the income and net worth thresholds are, contrary to the concerns raised by the IAC and others, effective in identifying investors with the financial sophistication to independently assess that information if they are able to gain access.[9] Even for the one factor where financial thresholds in the definition might be expected to demonstrate some degree of efficacy – the ability of accredited investors to withstand the heightened risks associated with private offerings, including liquidity risks and risk of loss – the Commission provides no evidence that this is the case. Nor does the Commission provide any evidence that, if one accepts that financial thresholds can be a useful criterion for the definition, the income and net worth thresholds are currently set at an appropriate level.

That failure is compounded by the absence of any analysis of the impact of inflation on the definition going forward, despite broad support for this most basic change.[10] Instead of using reasonable assumptions to analyze the impact, the Release states merely that, "the Commission will continue to monitor the size of this pool as well as the percentage and types of individuals from this pool who participate in our private markets, including in connection with its quadrennial review of the accredited investor definition required by the Dodd-Frank Act." This is

[9] One of the often overlooked advantages of public markets is that investors do not need to read and analyze 10-k's or other corporate disclosure documents to determine an appropriate price for a company's securities. In the absence of fraud, they can reasonably rely on an efficient market to set an appropriate price. And they enjoy the added assurance that, when they trade on an exchange, even the smallest investor is entitled to receive the best available price for their trade. None of that is true in private markets.

[10] For example, legislation has been introduced in the current Congress, H.R. 4762, that would, in addition to adding new categories for licensed securities professionals and individuals determined by the SEC to have qualifying education or experience, tie the net worth and income thresholds to inflation going forward. It is co-sponsored by Reps. French Hill (R-AR), David Schweikert (R-AZ), Bryan Steil (R-WI), Warren Davidson (R-OH), and Anthony Gonzalez (R-OH). The same bill language (H.R. 1585) passed the House in the previous Congress under suspension with bi-partisan support.

a particularly cynical bit of regulatory sleight of hand, since the just completed Concept Release that the Commission points to as satisfying its quadrennial obligation to review the definition includes no such analysis. Fortunately, Commissioner Herren Lee stepped in to help fill the resulting information gap. Using an estimated annual and constant growth rate for inflation of 1.51%, Commissioner Herren Lee estimated that, absent Commission action to tie the financial thresholds to inflation, approximately 22.7% of U.S. households would qualify as accredited investors within just 10 years, and that the number would approach six in ten households (57.3%) in 30 years.[11] As their already expansive ability to raise capital in private markets is further expanded, companies will have even less reason than they do today to go public, further eroding our already shrinking public markets.

B. The Commission doesn't adequately assess factors beyond the impact of inflation on the definition.

In order to justify its decision not to increase the thresholds, the Commission suggests that, "in evaluating the effectiveness of the current thresholds, it is appropriate to consider changes beyond the impact of inflation." We agree. However, in an oversight that amounts to regulatory malpractice, the Release doesn't even discuss how the explosive growth of defined contribution retirement plans since Regulation D was promulgated has fundamentally altered the make-up of the accredited investor population. In 1982, when the financial thresholds were set, accredited investors represented a tiny sliver of the nation's wealthiest citizens – approximately 1.6% of U.S. households, according to the Commission's estimates. An analysis of the accredited investor population today would inevitably show that many of the 13% of U.S. households that the Commission estimates now qualify as accredited investors are upper middle income households that qualify in large part as a result of a lifetime of savings in a defined contribution retirement account. Such investors are likely to have very different characteristics – and a very different risk profile – than the members of the one percent who made up the accredited investor population in 1982.

Also missing from the Release is any serious consideration of how the increased complexity of financial products – including products sold through Rule 506 offerings – should be taken into account in setting the definition's financial thresholds. An exemption that was once used primarily by operating companies is now dominated by private funds.[12] These funds engage in often complex and opaque investment strategies, and report their costs and performance in non-standardized ways that experts have suggested are beyond the comprehension of many sophisticated institutional investors.[13] Indeed, the Commission itself has previously acknowledged, not only that "private pools have become increasingly complex and involve risks

[11] Commissioner Allison Herren Lee, Statement on the Proposed Expansion of the Accredited Investor Definition, Dec. 18, 2019, https://www.sec.gov/news/public-statement/statement-lee-2019-12-18-accredited-investor.

[12] Scott Baugess, Rachita Gullapalli, and Vladimir Ivanov, Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017, Division of Economic and Risk Analysis (DERA) U.S. Securities and Exchange Commission, August 2018, at 22, http://bit.ly/2mE7b62. ("Since the inception of the electronic Form D filings in 2009, pooled investment funds have accounted for $8.9 trillion of new capital raised through Regulation D offerings and reported on Form D, compared to $1.42 trillion raised by non-funds.").

[13] *See e.g.,* Carmen Germaine, Advisors Don't Know How to Use Alts in Portfolios: BlackRock, Ignites, Nov. 22, 2019 https://www.ignites.com/c/2579713/308903; *See also,* Preston McSwain, Private Equity Access: Should We Beware? CFA Institute Enterprising Investor blog, June 25, 2019 https://blogs.cfainstitute.org/investor/2019/06/25/private-equity-access-should-we-beware/.

not generally associated with many other issuers of securities," but also that there is often "minimal information available about them in the public domain. Accordingly, investors may … find it difficult to appreciate the unique risks of these pools, including those with respect to undisclosed conflicts of interest, complex fee structures and the higher risk that may accompany such pools' anticipated returns."[14] Similarly, the Commission has previously expressed concern that "less sophisticated investors, even those meeting the accredited investor standard, may not possess the understanding or market power to engage a hedge fund adviser to provide the necessary information to make an informed investment decision."[15]

In short, the Regulation D market today is a far cry from the private market that existed when Regulation D was promulgated. Both these major market changes – the democratization of our securities markets as a result of the growth of defined contribution retirement plans and the increased complexity of financial products – would argue for an even more conservative approach to setting the thresholds today than the Commission adopted in 1982. While it does not automatically follow that the financial thresholds were set at an appropriate level in 1982, and are too low now, the question of whether the thresholds are too low deserves far more serious consideration than it receives in the either the recent Concept Release or the current proposal. Asking questions about the topic is a start, but it doesn't excuse the Commission from conducting its own analysis of the issue based on the best available data.

C. The Commission's limited analysis is shockingly superficial.

The limited explanation the Release does offer for the Commission's decision not to adjust the financial thresholds for inflation, or even to index them to inflation going forward, is shockingly superficial. It consists of a handful of paragraphs, the bulk of which are devoted to worrying about the potentially harmful impact restricting the accredited investor population might have on the Rule 506 market.[16] The Release states, for example, that the current income and net worth levels "still exceed, by a large margin, the mean and median household income and household net worth in all regions of the country." It fails to explain why it views that as an appropriate benchmark. It further notes that the value of the primary residence has been removed from the net worth calculation, but it fails to explain on what basis it concluded that this was adequate to ensure the definition's effectiveness in identifying a pool of investors whose access to information, financial sophistication, or ability to withstand losses equips them to fend for themselves in the private markets. The lack of any serious discussion of these issues sends a strong message that the Commission simply doesn't care whether the definition effectively serves its intended regulatory function.

A second argument in the Commission's case against raising the financial thresholds is that, as a result of "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." While that is theoretically possible, the Release provides no evidence that reasonably detailed information about investments sold through Rule 506

[14] The Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, SEC Release Nos. 33-8766 and IA-2576 (Dec. 27, 2006), http://bit.ly/2lOtYfc.
[15] Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission (September 2003), http://bit.ly/2niaIHA at 81.
[16] See, Proposing Release at 78-80.

offerings is commonly available today as a result of these changes. Nor does the Commission discuss the reliability of the information that investors do have access to in private investments or their ability to distinguish between reliable and misleading information.

The Release further notes that, "Technologies such as powerful home computers and mobile computing devices, as well software-based tools with which to evaluate investment opportunities, were not available to investors at the time the accredited investor definition was promulgated." This, too, is accurate without being relevant. Analytical tools are only useful if investors have access to information to analyze, and the Commission has provided no evidence that this is typically the case in Rule 506 offerings. The Commission also fails to discuss the potential for social media and mass communication to be used in ways that increase risks, by exposing investors to more misleading information or to aggressive and deceptive marketing tactics. Again, there is simply no excuse for such an oversight.

Finally, in justifying its decision to retain the current thresholds, the Commission states that it is unaware of "widespread problems or abuses associated with Regulation D offerings to accredited investors that would indicate that an immediate and/or significant adjustment to the rule's financial thresholds is warranted." This may say more about the Commission's lax oversight of the Reg D market than it does about the adequacies of the current definition.[17] State securities regulators, who are on the front line of Reg D enforcement, paint a very different picture. They consistently identify private offerings (including offerings under Reg D) as a problem area on which they are forced to spend a disproportionate share of their enforcement resources. For that reason, they have for years urged the Commission to raise the financial thresholds and tie them to inflation going forward as a partial response to that problem.[18] Meanwhile, an investigation of private offerings by *The Wall Street Journal* documented numerous abuses, including evidence that firms with a high concentration of problem brokers are more likely to be involved in their sale.[19] The Commission does not provide any counter evidence to suggest that these concerns are exaggerated or that they do not rise to the level that warrants a serious reexamination of the financial thresholds. The Commission can't refuse to consider compelling evidence merely because it is at odds with its policy preferences.

D. The Commission fails to consider the potential impact on the public markets and the economy as a whole.

A focus on problems and abuses experienced by accredited investors is necessary, but not sufficient. The definition plays a key role in establishing an appropriate balance between public and private markets. As we discussed at length in our comment letter on harmonization of private offering exemptions, the ability of private companies to access vast amounts of capital in the private markets, in particular through Rule 506 offerings, is a major reason companies are

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[17] The SEC's Office of Inspector General has previously noted that the Commission does not provide extensive regulatory or enforcement oversight of this market on which to base a conclusion that all is well. *See,* SEC Office of Inspector General, Regulation D Exemption Process, Report No. 459 (March 31, 2009), http://bit.ly/2mCJ5sv.

[18] *See, e.g.*, remarks of Ohio Securities Commissioner Andrea Seidt at the November 7, 2019 IAC meeting, Discussion Regarding the SEC's Concept Release on Harmonization of Securities Offering Exemptions https://www.sec.gov/video/webcast-archive-player.shtml?document_id=iac110719.

[19] Jean Eaglesham and Coulter Jones, Firms With Troubled Brokers Are Often Behind Sales of Private Stakes, Wall Street Journal, June 24, 2018 https://on.wsj.com/2FPWsvy. See, also, Jean Eaglesham, Private Pension Product, Sold by Felon, Wipes Investors Out, Wall Street Journal, July 23, 2018 https://on.wsj.com/2FUJJaR.

choosing to remain private for longer or foregoing a public offering entirely. [20] Instead of looking to further expand access to private markets, the Commission should be considering steps to rein in private market excesses. Given pressing concerns about the decline of our public markets, it is irresponsible for the Commission to ignore this issue when considering revisions to the accredited investor definition.

Instead of assessing the potential impact on the public markets of further expanding the accredited investor definition, the Commission wrings its hands over the potentially harmful impact on the Rule 506 market of narrowing the accredited investor definition. Here again, however, the Release provides no evidence that there would be any such harmful impact. For example, it fails to take into account that only a tiny percentage of accredited investors actually choose to invest in Reg D offerings now. And it fails to analyze, either here or in the earlier Staff Report or Concept Release, the difference between those accredited investors who do invest in such offerings and those who do not. Nor does it consider why issuers choose to limit offerings to accredited investors rather than take advantage of the opportunity to seek investments from up to 35 non-accredited investors, which is available for Rule 506 offerings that do not involve general solicitation. Without conducting that analysis, the Commission simply cannot make any meaningful predictions about the impact of changes to the definition. If, for example, the vast majority of those who choose to participate in Rule 506 offerings have incomes or net worth well above the thresholds, adjusting those thresholds upwards might have very little impact, particularly if combined with changes that enable investors who do not meet the thresholds to qualify based on their financial sophistication. If issuers simply aren't interested in attracting very small investors, that too could limit the impact of the proposed changes.

Similarly, the Commission has not seriously analyzed other possible approaches, such as placing limits on the amount that individuals who barely clear the thresholds can invest in private offerings.[21] The Release dismisses the idea, stating that, "Placing limits on the amount that a person may invest under the current income and net worth thresholds could have similarly disruptive effects on the Regulation D market." But the Release fails to include any analysis of the amounts that individual accredited investors, particularly those who barely clear the current thresholds, typically invest in such offerings. Without conducting that analysis, the Commission has no reasonable basis for its conclusions about the likely impact of any such changes to the definition.

Predictably, the Commission's limited "analysis" fails to include any consideration of whether Regulation D offerings actually promote true capital formation and sustainable job creation. While Reg D is highly successful in promoting capital raising, true capital formation is a very different thing.[22] It is certainly possible that Rule 506 offerings make a meaningful

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[20] CFA Comment Letter on Concept Release at 22-25.

[21] The IAC recommended that the Commission consider such an approach. It suggested, for example, that the Commission consider adopting a sliding scale for such investments, with the permissible amounts increasing with income and/or net worth, and with limits being removed entirely at a certain point.

[22] Commissioner Luis Aguilar, Capital Formation from the Investor's Perspective, speech delivered to the AICPA Conference on Current SEC and PCAOB Developments, Dec. 3, 2012, https://www.sec.gov/news/speech/2012-spch120312laahtm. ("Capital formation is much more than just capital raising. By itself, selling a bond or a share of stock doesn't add a thing to the real economy, no matter how quickly or cheaply you do it. True capital formation requires that the capital raised be invested in productive assets – like a factory, store, or new technology – or

contribution to sustainable job growth, for example, but the Commission provides no evidence that this is the case. It is equally possible that such offerings disproportionately result in the kind of churn and burn of job creation and destruction commonly associated with small company capital raising. It is worth noting, moreover, that the largest users of Rule 506 in terms of dollar amount raised are private equity funds, whose record of job destruction has recently garnered increasing attention.[23] As a result of its superficial focus on the amount of capital raised in the Reg D market, rather than the quality of the offerings, the Commission cannot reliably predict what the economic impact of any changes to narrow the definition would be, including any impact on sustainable capital formation and job growth.

As justification for its lack of analysis, the Commission routinely cites the lack of available data regarding the Reg D market. This was, for example, a recurring theme in both the Concept Release on private offering exemptions and the 2015 Staff Report on the accredited investor definition. Time and again, when it comes to questions essential to informed policymaking in this area, the Commission's response is: "We don't know," or in economist parlance, "Due to data limitations, it is difficult to draw rigorous conclusions …"[24] But this lack of data on which to base a credible analysis is self-imposed, the inevitable result of the Commission's refusal to adopt reasonable revisions to its Form D filing requirements designed to provide at least a minimal amount of information about these offerings.[25] It should do so immediately, prior to adopting any further changes designed to expand the Regulation D market. "We don't know" is not a good enough answer when it comes to issues of such critical importance, regarding a market of enormous size, particularly when it is well within the Commission's power to rectify the problem, as is the case here. The clear implication is that the Commission is choosing to remain ignorant.

2) Including a financial sophistication requirement in the accredited investor definition is theoretically sound. However, the Commission's proposal is deeply flawed.

While financial sophistication seems like a natural addition to the accredited investor definition, for decades after enactment of the '33 Act both the SEC and courts insisted that financial sophistication alone, absent access to information, was not sufficient to satisfy the private offering exemption. In 1977, for example, the Fifth Circuit ruled on this question directly,

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otherwise used to make a business more productive. The more productive those assets are, the greater the capital formation from the investment – and, importantly, the more jobs created. ‖Unfortunately, the reverse is true as well: When investor funds are diverted away from productive uses, capital is destroyed. … My experiences as an SEC Commissioner make it clear to me that rules to promote full and fair disclosure, reliable financial information, and accountability for market participants are absolutely necessary.")

[23] *See,* House Financial Services Committee, Legislative Hearing, America for Sale: An Examination of the Practices of Private Funds, Nov. 19, 2019, https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=404650.

[24] *See,* e.g., Concept Release at 23 ("Due to data limitations, it is difficult to draw rigorous conclusions about the extent of fraud in exempt securities offerings."); 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."); 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.").

[25] CFA joins state securities regulators in calling for the Commission to upgrade its Form D filing requirements. Among other things, the Commission should adopt a pre-filing requirement of at least two weeks for Reg D offerings that include general solicitation, a closing filing for all Reg D offerings, an modest expansion in the information collected on those forms, and enhanced enforcement of the filing requirements.

stating that "there must be a sufficient basis of accurate information upon which the sophisticated investor must be able to exercise his skills. Just as a scientist cannot be without his specimens, so the shrewdest investor's acuity will be blunted without specifications about the issuer. For an investor to be invested with exemptive status he must have the required data for judgment."[26] We wholeheartedly agree that financial sophistication cannot substitute for access to information, but we also acknowledge that a truly financially sophisticated individual should know what information they need in order to assess an investment opportunity. They should understand, moreover, what the potential risks are. On that basis, someone with the requisite deep investment expertise can either take steps to gain access to the information needed to make an informed investment decision or take the gamble of investing blind, fully aware of the risks and confident of their ability to withstand them.

That argues for setting a very high bar when it comes to measures of financial sophistication that operate independently of either access to information or financial thresholds. And therein lies the challenge. Inevitably, the Commission will face pressure to interpret financial sophistication too broadly. It must resist that pressure. At first blush, the Commission's proposed amendments, with their focus on relevant securities market expertise, appear to adhere reasonably well to this general guideline. The new category for knowledgeable employees of private funds, in particular, appears to be based on sound principles. We are concerned, however, that the new category for individuals who qualify as accredited investors based on certain licenses, credentials and designations: 1) is likely to be interpreted in a way that is far too broad, and 2) that the procedure for recognizing such designations does not offer sufficient protections against that outcome. We note, moreover, the lack of balance in the Commission's proposed approach. It proposes to expand the accredited investor definition to incorporate measures of financial sophistication, but it doesn't even consider what the harmful implications may be of allowing millions of investors who lack financial sophistication to qualify as accredited investors based on their income and net worth alone.

A. CFA supports the proposal to add a category of accredited investors for knowledgeable employees of private funds, with minor adjustments.

The Commission is proposing to add a category to the accredited investor definition that would enable "knowledgeable employees" of a private fund to qualify as accredited investors for the purpose of investing in the fund at which they are employed.[27] The proposal uses the definition of "knowledgeable employee" in Rule 3c-5(a)(4). As such, it would include, among others, "trustees and advisory board members, or persons serving in a similar capacity, of a Section 3(c)(1) or 3(c)(7) fund or an affiliated person of the fund that oversees the fund's investments, as well as employees of the private fund or the affiliated person of the fund (other than employees performing solely clerical, secretarial, or administrative functions) who, in connection with the employees' regular functions or duties, have participated in the investment activities of such private fund for at least 12 months." As a result of the proposed change, a

[26] James D. Cox, Robert W. Hillman, Donald C. Langevoort, Ann M. Lipton, William K. Sjostrom, Securities Regulation: Cases and Materials, Wolters Kluwer (Ninth Ed. forthcoming), referencing *Doran v. Petroleum Management Corp.*, 545 F.2d 893 (5th Cir. 1977).

[27] Under Rule 3c-5, "knowledgeable employees" of a private fund may acquire securities issued by the fund without being counted for purposes of Section 3(c)(1)'s 100-investor limit on beneficial owners and may invest in a Section 3(c)(7) fund even though they do not meet the definition of "qualified purchaser."

knowledgeable employee who does not meet the accredited investor definition's financial thresholds would no longer be excluded from participating in an offering of the fund under Rule 506 where the offering is limited to accredited investors. The inclusion of knowledgeable employees in the definition of accredited investor would also allow these employees to invest in the private fund without the fund itself losing accredited investor status when the fund has assets of $5 million or less.[28]

CFA is generally supportive of this approach. More than either the current definition, with its reliance on financial thresholds, or the proposed new category for individuals who hold certain licenses and designations, this proposal closely tracks the principles behind the *Ralston Purina* decision, which established the basis for the private offering exemption.[29] In *Ralston Purina*, the court was focused on investors' access to the kind of information that registration under the '33 Act would provide. Particularly relevant to the current proposal, the Court noted that an employee offering "made to executive personnel who because of their position have access to the same kind of information that the Act would make available in the form of a registration statement" might qualify for the exemption. "The focus of inquiry should be on the need of the offerees for the protections afforded by registration," the court explained.

In general, the new category for knowledgeable employees of private funds seems consistent with this approach. Our one question is whether the definition of knowledgeable employees is sufficiently narrow to ensure that this is the case. That would clearly seem to be a valid assumption for "trustees and advisory board members, or persons serving in a similar capacity," as well as for "an affiliated person of the fund that oversees the fund's investments." We are less certain about the exact scope of the category of "employees of the private fund or the affiliated person of the fund" who have participated in the investment activities of the fund. We would appreciate greater clarity from the Commission regarding the full range of employees that would be captured by the definition, in order to ensure that this provision doesn't sweep in those who have no claim to the kind of investment-specific expertise or access to relevant information that the proposal purports to measure.

B. Without revisions, the new category of accredited investor for individuals with certain licenses, certifications and designations may be dangerously overly expansive.

The Commission is also proposing to add a category for individuals to qualify as accredited investors "based on certain professional certifications and designations or other credentials" that demonstrate their "background and understanding in the areas of securities and investing." It preliminarily suggests that holders of the Series 7 general securities representative license, the Series 65 investment adviser representative license, and the Series 82 private securities offerings representative license would be included when the rule proposal is finalized. We recognize the logic of allowing individuals with a professional level of investment expertise to qualify as accredited investors regardless of whether they meet the financial thresholds. While we may question whether every newly minted Series 7 or Series 65 license holder has as sophisticated an understanding of private offering risks as their licensed status may imply, we are prepared to concede that they should, at least in theory, be able to fend for themselves.

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[28] Under Rule 501(a)(8), private funds with assets of $5 million or less may qualify as accredited investors if all of the fund's equity owners are accredited investors.

[29] *S.E.C. v. Ralston Purina Co.*, 346 U.S. 119 (1953).

Moreover, there are other credentials – such as the Chartered Financial Analyst certification – that clearly represent a high level of investment-specific expertise that would make their inclusion in the accredited investor definition appropriate.

We are concerned, however, that the category will not be limited to such credentials. The proposal anticipates that the Commission will in the future add additional licenses, credentials or designations to the accredited investor definition beyond those specified in the proposing Release. Toward that end, it outlines a non-exclusive list of attributes the Commission would use in making that determination. There are several critically important attributes reflected in that list. These include specifying that the examination or series of examinations upon which the designation is based must be "designed to reliably and validly demonstrate an individual's comprehension and sophistication in the areas of securities and investing," and that the "persons obtaining such certification, designation, or credential can reasonably be expected to have sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of a prospective investment."

While headed in the right direction, these principles are highly subjective and could be applied in a way that would cause us grave concern. The Commission could, for example, determine that any CPA, any attorney, or anyone with an MBA meets these criteria. After all, several commenters have suggested that the Commission do just that, and the Release asks for comment on whether this would be appropriate. We would strongly oppose such a broad interpretation, as none of these credentials, in and of themselves, reliably and validly demonstrate an individual's comprehension and sophistication in the areas of securities and investing. Absent some additional investment-specific experience or expertise, individuals with these designations (e.g., CPA, MBA, law degree) cannot reasonably be expected to have sufficient knowledge or experience to evaluate the merits and risks of a prospective investment absent the protections afforded in the public markets (access to comprehensive and reliable information about the offering).

We would note that, while the SEC Investor Advisory Committee advocated that the Commission consider allowing individuals to qualify based on certain credentials, the IAC also warned that there are risks associated with such an approach. Specifically, IAC warned that credentials with little claim "to measure relevant expertise are likely to seek inclusion on a list of qualifying credentials." The Commission might find it uncomfortable choosing winners and losers from among competing credentials and difficult to hold the line against those that do not provide the requisite expertise, the IAC warned. We are not convinced that the proposed criteria for approving additional credentials are strong and clear enough to ensure an appropriate level of rigor. Worse yet, the Commission asks whether it should allow individuals to self-certify as sophisticated. Under no circumstances should it do so, as individuals are notoriously generous in assessing their own expertise and this could easily be subject to abuse.

Finally, we are concerned that the procedure the Commission proposes for adding additional criteria through Commission order doesn't provide a sufficient degree of transparency or accountability. For example, the Release states only that: "We **anticipate** that the Commission **generally would provide** public notice and an opportunity for public comment before issuance of such an order." (Emphasis added.) Quite simply, this vague prediction regarding the process

the Commission generally would follow does not provide adequate assurance that this would always be a transparent process. Nor does it guarantee that the opportunity for comment would be more than pro forma.

The presumed benefit of such an approach is that it provides the Commission with flexibility to remove credentials from the list should concerns arise. But, experience suggests that the Commission is likely to be slower in taking away this sort of benefit than it is in granting the recognition. So the downside of making it easier to add credentials to the list without an appropriately transparent process, and without adequate opportunity for public input, more than outweighs the potential upside of making it somewhat easier to remove designations from the definition. In short, the vague and subjective nature of the criteria to be considered and the lack of a formal process for making such determinations is a dangerous combination. For these reasons, the better approach, if the Commission insists on moving forward with this proposal, is to act through formal notice-and-comment rulemaking. At the very least, more must be done on the front end to ensure a rigorous and transparent process for the addition of credentials to the definition.

Specifically, we urge the Commission to revise the proposal: 1) to clarify that only those credentials that reliably demonstrate a professional level of investment-specific expertise would be included, and 2) to 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. For example, when proposing to add a credential or designation, the Commission should have to make a finding that the credential in question "reliably and validly demonstrate[s] an individual's comprehension and sophistication in the areas of securities and investing" and explain, citing concrete evidence, the basis on which it reached that conclusion. Even with these necessary adjustments, we believe this proposal is likely to be the foot in the door that leads to a dangerous erosion of the accredited investor definition and an increase in investor harm, and we therefore strongly oppose its inclusion in any final rule.

3) Financial thresholds in the definition should not be adjusted to reflect regional differences in income and net worth.

In requesting comment on whether to adjust the financial thresholds, the Commission voices concern that, because of regional differences in income and net worth, "Adjusting the thresholds upward could curtail the ability of many financially sophisticated people in certain parts of the country from investing in local companies, about which they have first-hand knowledge." It requests comment on whether it should "take into account income disparities that may be attributable to different costs of living across the country in establishing financial thresholds in the accredited investor definition?" It should not. First, the Commission has failed to establish that a problem exists that merits the proposed change. Second, trying to adjust the thresholds to reflect regional differences would over-complicate the calculation.

In presenting data regarding differences in net worth by region, the Commission uses average regional net worth values that include the value of the primary residence. This does not present an accurate picture. Given large differences in home values among regions, and the fact that the value of the home is often a major contributor to the net worth calculation, the fact that the value of the primary residence is excluded from the net worth calculation should help to

reduce those regional differences for purposes of the accredited investor definition. At the very least, we would have expected the Commission to base its evaluation on a relevant measure of net worth.

Along similar lines, the Commission expresses concern that "a sharp decrease in the accredited investor pool may result in a higher cost of capital for companies, particularly companies in regions of the country with lower venture capital activity who may rely on 'angel' or other individual investors as a primary source of funding." But, having raised elsewhere the topic of how the internet has changed access to information, the Commission doesn't discuss what effect it may have in ameliorating any such impact on companies' ability to find investors. And, once again, it fails to provide any evidence to support its hypothetical concerns that reducing the pool of investors would have any such effect, given the tiny percentage of accredited investors who choose to invest in private offerings. If, as seems logical, the decrease comes from those least likely to participate in such offerings, the impact could be minimal.

Given the challenge small issuers can face in verifying accredited investor status, the Commission should avoid over-complicating the calculation, particularly with so little evidence that a problem exists that merits this adjustment. Under no circumstances should the Commission consider any such change without also raising the financial thresholds to account for inflation and tying them to inflation going forward. And, if it is consider the disparate impact of regional differences in income and net worth, it should do so based on a balanced consideration that includes the impact on investor protection and not just companies' ability to raise capital through Rule 506 offerings. Given the plethora of offering exemptions available, this exclusive focus on companies' capital raising ability is a particularly narrow lens through which to assess the issue.

4) CFA strongly opposes including any investor that is advised by a broker-dealer or investment adviser in the accredited investor definition.

The Commission requests comment on whether it should permit any investor that is advised by a registered investment adviser or broker-dealer to be considered an accredited investor. It should not. In theory, involvement of a financial professional in a private offering transaction ought to be beneficial, providing the financial sophistication indirectly that the investor may lack on his or her own. However, the reality has proved to be quite different, as actions by state securities regulators and FINRA clearly show. We discussed this evidence of harm at length in our comment letter on the private offering exemption Concept Release.[30]

Particularly relevant to the current question is evidence that brokers often play a central role in perpetuating investor harm. In 2018, a Wall Street Journal investigation found that broker-dealer firms with unusually high numbers of registered reps with disciplinary histories are selling tens of billions of dollars a year of these investments, often targeting seniors.[31] A previous Wall Street Journal analysis found that one in eight brokers marketing private placements had three or more red flags on their records, such as an investor complaint, regulatory action, criminal charge or firing, based on a review of regulatory filings from

[30] CFA Comment Letter on Concept Release at 34-38.

[31] Jean Eaglesham and Coulter Jones, *Firms With Troubled Brokers Are Often Behind Sales of Private Stakes*, Wall Street Journal, June 24, 2018, https://on.wsj.com/2Mnkf81; Jean Eaglesham and Coulter Jones, *Regulators Step Up Scrutiny of Sales of Private Stakes*, Wall Street Journal, July 2, 2018, https://on.wsj.com/2n8uLIg.

September 2008 through 2017.[32] That compares with one in 50 among all active brokers, according to the Journal's analysis. In sum, the Journal identified over a hundred firms where 10% to 60% of the in-house brokers had three or more investor complaints, regulatory actions, criminal charges or other red flags on their records. These brokerages helped sell more than $60 billion in private placements to investors, according to the Journal.

FINRA has also raised concerns about broker-dealers' role in private markets. Specifically, FINRA has raised concerns about firms' failure to comply with their obligation to conduct a "reasonable investigation of the issuer and the securities."[33] Among the problems FINRA identified were: failure to conduct reasonable due diligence and over-reliance on third parties for due diligence, including in cases where those third parties were paid by issuers or where the due diligence was provided by the issuers themselves.[34] These examination findings come almost a decade after FINRA issued Regulatory Notice 10-22, "remind[ing] broker-dealers of their obligation to conduct a reasonable investigation of the issuer and the securities they recommend in offerings made under the Securities and Exchange Commission's Regulation D under the Securities Act of 1933—also known as private placements."[35] FINRA routinely brings enforcement actions against broker-dealers and registered representatives for violations of the securities laws related to private placement sales.[36] We have no way of measuring, however, what percentage of abuses are captured in these actions.

Despite these concerns, CFA has in the past been open to the idea of allowing individuals to qualify as accredited investors based on reliance on advice, but only under tightly limited conditions commensurate with the risks. Specifically, our support was conditioned on the recommendation's coming from a fiduciary adviser with no personal financial stake in the investment being recommended. This includes not receiving any direct or indirect compensation from the issuer, and being held to a meaningful fiduciary duty to act in the best interest of the investor. Unfortunately, as we discussed at length in our comment letter on the private offering exemption Concept Release, neither investment advisers nor broker-dealers are currently held to standards that begin to adequately protect investors from the dangers of conflicted recommendations regarding private securities.[37]

For example, while the Advisers Act theoretically holds investment advisers to a fiduciary duty to act in their clients' best interests, that's not how the SEC has chosen to enforce the standard. Instead, in case after case, the Commission has accepted disclosure alone as satisfying the adviser's fiduciary duty. Worse, the Commission has taken this approach, not only with regard to conflicts of interest, which would be troubling enough, but also with regard to harmful practices.[38] While Congress gave the Commission all the authority it needs to adopt a

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[32] Jean Eaglesham and Coulter Jones, *A Private-Market Deal Gone Bad: Sketchy Brokers, Bilked Seniors and a Cosmetologist*, Wall Street Journal, May 7, 2018, https://on.wsj.com/2lEZ34Y.
[33] FINRA, Report on FINRA Examination Findings, December 2018, http://bit.ly/2l5hCPz.
[34] *Id.* at 8.
[35] FINRA Regulatory Notice 10-22, Regulation D Offerings: Obligations of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings, April 2010, http://bit.ly/2ndIgGO.
[36] *See* FINRA, FINRA Disciplinary Actions Online, http://bit.ly/2lxtNoN.
[37] CFA Comment Letter at 71-77.
[38] U.S. Securities and Exchange Commission, Press Release, J.P. Morgan to Pay $267 Million for Disclosure Failures, Dec. 18, 2015 https://www.sec.gov/news/pressrelease/2015-283.html. ("An SEC investigation found that

tough, explicit fiduciary duty requiring advisers to act in their clients' best interests, and without regard to their own conflicting interests, the Commission chose not to use that authority. Nor has it used its separate authority under Section 913(g) to limit or ban conflicts of interest that could bias the adviser's recommendations. For this reason, the Advisers Act fiduciary standard does not provide adequate protections to serve as a reasonable basis for the accredited investor definition.

Meanwhile, the newly adopted "best interest" standard and conflict mitigation requirements for broker-dealers are completely untested. It is too soon to tell whether they will meaningfully improve on protections afforded by the FINRA suitability standard. What is clear is that they don't preclude brokers from having a financial stake in the recommendations they make, so long as that conflict is disclosed and mitigated at the registered rep level. Given the extensive evidence of abusive practices in brokers' sales of private offerings, an untested regulatory regime that fails to rein in common conflicts of the type that encourage sale of private offerings cannot reasonably serve as the basis for the accredited investor definition.

5) CFA supports updating the list of entities that qualify as accredited investors, but the Commission should first adjust the definition's financial thresholds.

While CFA's primary focus has been, and continues to be, the natural persons prong of the accredited investor definition, we agree that it is appropriate for the Commission to review and update the list of entities that qualify as accredited investors. Furthermore, we agree in principle with several of the changes the Commission proposes to make, such as eliminating inconsistencies in the treatment of comparable entities and adding investment advisers to the list of accredited investors when investing for their own account. Moreover, we don't object in principle to the proposal to add a catchall category for entities that meet certain financial thresholds and that were not formed for the specific purpose of acquiring the securities being offered. Our overriding concern here, as above, is that the Commission has not given careful consideration to whether the financial thresholds specified here are adequate.

Like the financial thresholds in the natural persons prong of the definition, the $5 million in assets threshold for certain entities has been eroded by years of inflation. As a result, it sets a very low bar. Moreover, many of the entities that qualify based on meeting financial thresholds have no particular claim to the sort of investment expertise necessary to evaluate private offerings based on limited disclosures. As a result, if the Commission adheres to the proposed approach, financially unsophisticated entities with limited investment expertise and limited ability to absorb losses are likely to be included in the pool of accredited investors. Before reaffirming the entity threshold, therefore, the Commission should assess whether the threshold

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the firm's investment advisory business J.P. Morgan Securities LLC (JPMS) and nationally chartered bank JPMorgan Chase Bank N.A. (JPMCB) preferred to invest clients in the firm's own proprietary investment products without properly disclosing this preference.") As had been reported elsewhere, the proprietary investment products recommended had higher cost and poorer performance than other available alternatives. *See,* Susanne Craig and Jessica Silver Greenberg, Former Brokers Say JPMorgan Favored Selling Bank's Own Funds Over Others, The New York Times, July 2, 2012 https://dealbook.nytimes.com/2012/07/02/ex-brokers-say-jpmorgan-favored-selling-banks-own-funds-over-others/. ("I was selling JPMorgan funds that often had weak performance records, and I was doing it for no other reason than to enrich the firm," said Geoffrey Tomes, who left JPMorgan last year and is now an adviser at Urso Investment Management. "I couldn't call myself objective.")

is set at an appropriate level. As with the natural persons prong of the definition, the question the Commission should consider is whether the entity definition identifies a pool of investors who are capable of fending for themselves without the protections afforded in the public markets.

If, based on that assessment, the Commission were to find that many entities with $5 million in assets are not able to fend for themselves, it should take action to correct that problem. It should, for example, consider whether the $5 million assets threshold needs to be raised, and if so by how much. The Commission should also consider alternative approaches, including whether a threshold based on investments, rather than assets, would be more appropriate. We believe an investments test is likely to be a better gauge of financial sophistication than assets alone. For that reason, we applaud the Commission's decision to use a threshold based on investments, rather than assets, for its proposed new catchall category of entities. However, we see no reason why that approach shouldn't be adopted more broadly for those categories with no separate claim to investment-specific financial expertise. The Commission provides no explanation, beyond its general concern about the possible impact on the Regulation D market, for its failure to adopt such an approach more broadly.

Conclusion

The Commission, with help from Congress, has for years promoted private capital raising at the expense of both investor protection and our public markets. An overly expansive definition of accredited investor is a major contributing factor. At a moment when evidence suggests our public markets are in serious decline, the Commission should be promoting carefully thought out policies to restore an appropriate balance between public and private markets. That is essential, not just to ensure that investors are adequately protected, but to promote productive, sustainable capital formation and the overall health of our economy. Instead, the Commission continues to advance policies, such as this, that promote private markets at our public markets' expense. And it continues to press that agenda without first collecting the data necessary to assess the state of our private markets and without conducting an even minimally acceptable analysis of the need for or likely impact of its proposed policies. For these reasons, we believe the Commission needs to go back to the drawing board, and conduct a more credible analysis, before acting on proposals to update the accredited investor definition. Failure to do so is an abrogation of the Commission's regulatory responsibilities.

Respectfully submitted,

Barbara Roper
Director of Investor Protection

Micah Hauptman
Financial Services Counsel