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Securities and Exchange Commission
100 F St. NW
Washington, DC 20549-9303
Rule-comments@sec.gov

Re: Definition of accredited investor

File No. S7-25-19

Dear SEC:

In summary:

- The U.S. has evolved a caste system of investing that perpetuates inequality by preserving the highest return investment opportunities for the richest investors.
- If Regulation Best Interest works as planned, it will make this caste system obsolete. It reduces the risk that retail investors will get sold inappropriate products.
- The caste system is really about who gets what disclosure. The SEC should replace the current hodge-podge with a coherent classification of disclosure regimes that clearly communicate the level of available information.
- The expansion of the definition of accredited investor is a good but incremental idea.

[1] All opinions are strictly my own and do not necessarily represent those of Georgetown University or anyone else.

- Accredited status should be given to those who have a given level of investor sophistication or the wealth to hire such sophistication. These include:
    - Chartered Financial Analyst (CFA) charter holders
    - Certified Financial Planner (CFP ®) certificants
    - College graduates from AACSB accredited schools with undergraduate or graduate degrees in business, including MBA and Master of Finance (MSF) degrees
    - People who have passed the Securities Industry Essential (SIE), Series 7, or Series 65 exams.
- Verification of accredited status can and should be simplified to an attestation by the investor.

Introduction

In a 153-page release, the Commission is proposing to expand the definition of an accredited investor to include those with various educational and professional credentials and to likewise expand the definition of a qualified institutional buyer.[2] I support these incremental expansions. As I am already an accredited investor, my comment letter is different from the many "I wanna be accredited because …" comment letters that have been submitted.

Rather than just tinker with the accredited investor definition, this is a good time to step back and totally rethink the U.S. caste system of investors along with the related issue of the appropriate scaling of disclosure requirements for issuers. Over the years, the SEC, Congress, and the courts have gradually created a complex caste system that specifies who can invest in various financial instruments.[3] Indeed, the notion of "accredited investor" is an SEC creation that was later codified by Congress.[4] These castes have been created in an ad-hoc manner for specific applications, and there has been little systematic examination of the big picture. As many of these incremental decisions have been codified into statute, it is ultimately up to Congress to rethink the big picture. However, the Commission does have authority with its broad rulemaking powers and broad exemptive authority to move in the right direction. Given the slow speed of regulatory change, it is never too early to begin the conversation.

These castes include:

- Accredited investors
- Sophisticated investors who are not accredited.[5]

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[2] The Proposing Release can be found at https://www.sec.gov/rules/proposed/2019/33-10734.pdf

[3] Under the Ralston Purina doctrine, (SEC v Ralston Purina, 346 U.S. 119, 125 (1953),

[4] See Proposing Release, page 15.

[5] For example, the note to Rule 506 states

> (ii) Nature of purchasers. Each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is

- Qualified purchasers under the Investment Company Act of 1940
- Qualified clients under the Investment Advisers Act of 1940
- Qualified institutional buyers ("QIBs") as defined in Rule 144A under the Securities Act

Inextricably intertwined with the caste system of investors is the complex system of required disclosures for different types of offerings. Indeed, the logic behind the caste system, as expressed by the Commission, is to figure out which groups of investors don't need "the protections of the Securities Act's registration process."[6] As the main thrust of the Securities Act is fraud-free disclosure, this boils down to figuring out what levels of disclosure are required for which investors. It should be noted that nowhere does the Securities Act say that the SEC should prevent risky investments from being sold to retail investors.[7] The "protections" of the Act are the disclosures provided to the investors. The philosophy embodied in the Securities Act is to prevent fraud and ensure that investors have sufficient information to make their own decisions.

Like the caste system for investors, the system of required disclosures is a complex system that has accreted incrementally over the years in an ad-hoc manner. The SEC has long struggled with the appropriate way to scale disclosure to meet the needs of different classes of issuers as well as investors.

Do we need this caste system at all? There are two main rationales behind the caste system:

1. The caste system benefits issuers by reducing issuance costs. As products sold to high-caste members (e.g. QIBs) require less disclosure, issuance costs are reduced. It is presumed that high-caste investors are sophisticated enough to make their own decisions about whether the amount of disclosure is adequate for them. Taxpayers do not need to expend scarce regulatory resources to protect the rich guys. Likewise, issuers may feel more protected from class-action suits alleging lack of disclosure as well.
2. The caste system protects low-caste investors from losing money by speculating in stuff they don't understand. In other words, the castes are a creeping form of merit regulation. Retail investors can only purchase instruments that have been vetted by risk-averse government officials. In particular, the caste system makes it harder for sleazy miscreants to ram fraudulent paper down the throats of naïve retail investors.

There are some downsides to the caste system, however. In particular, this system exacerbates inequality by reserving the highest expected return investments to the higher castes. If one is a high-caste friend of

capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description.

[6] See Proposing Release, page 16.

[7] The word "risk" is only mentioned 13 times in the Securities Act, as amended. Most of these are in Section 4A regarding the requirements on intermediaries in crowdfunding transactions.

the likes of Bain & Co, one gets access to the best deals. If one is not, then one only gets access to the crumbs dropped from the private equity banquet table.

In addition, the arbitrary nature of the caste definitions leads to situations in which deserving investors are denied investment opportunities while other investors may be denied disclosure. Notice that I say disclosure rather than protection. We often conflate disclosure with investor protection, and those are two totally different things. Our current registration system for public offerings provides little effective communication to retail investors. Under our current system, one can sell the dodgiest piece of organic fertilizer to an unsophisticated investor, as long as the 500-page disclosure document states, among the hundreds of other risk factors, that the investment may have an unpleasant odor.

Another problem is that the wealth test in the current definition is a poor proxy for financial sophistication. There are many unsophisticated investors who have sufficient assets to qualify as accredited investors. Example include lottery winners, workers who receive lump sum settlements of their lifetime pension accruals, injured parties that receive large settlements, and inheritors of wealth. While these investors may have the financial means to hire competent financial advisors, they may lack the sophistication to find and evaluate competent financial advisors.

Furthermore, by imposing disproportionately high regulatory burdens on public issuers, the current system promotes private offerings and contributes to the decline in our public markets.

Regulation Best Interest should make the caste system obsolete.

Under the newly implemented Regulation Best Interest, brokers can only recommend securities that are in the best interest of their retail clients.[8] They must have policies and procedures to make sure that the products they sell are in the best interest of at least some clients as well as in the best interest of a particular retail client. In theory, this significantly reduces the risk that an unsophisticated investor will be sold something wrong for them. Time will tell how effectively the SEC and FINRA will implement this new rule.

If it lives up to its promise, Regulation Best Interest will make the caste system, with its regulatory and enforcement headaches, obsolete. If and when Regulation Best Interest has proven itself, the Commission should scrap the caste system altogether and devote its scarce regulatory resources elsewhere.

[8] Brokers can still sell the dodgiest insurance products, however, without violating SEC rules. As insurance is regulated at the state level, the standard of care required of insurance sales personnel varies greatly from state to state. The SEC has broad authority under section 913 of Dodd Frank to regulate broker dealer and RIA sales practices. This authority is NOT limited to sales practices of securities. This means that the SEC can regulate how broker dealers and RIAs sell non-security products. The SEC thus has enough of a hook to require brokers to act in the best interest of their retail clients for all of the financial products they sell, not just securities. The SEC should do this to protect investors.

It's time for a coherent classification of disclosure regimes.

So what would a better system look like that best achieves the objectives of investor protection, economic growth, economic stability, market efficiency, and capital formation? We need one that clearly communicates (as opposed to obfuscates) the right amount of information to investors and that gives maximum freedom of choice to investors. As long as investors have the ability to know whether they have enough information to proceed, they should be able to make their own decisions.

There is a hodge-podge of different disclosure requirements for different categories of issuers. These categories include

- Well-known seasoned issuers (WKSIs)
- Emerging growth companies
- Business development companies
- Blank check companies
- Other SEC registrants
- Former SEC registrants
- Crowdfunding companies
- Shell companies
- Foreign private issuers
- Various exempt offerings

A coherent approach would be to classify each type of offering on a particular scale of disclosure categories. These disclosure categories could be given a scale, similar to but distinct from the ratings used by credit agencies. For example, a disclosure scale could look like D-1, D-2, D-3, et cetera, with D-1 being the highest and most frequent level of disclosure. All offering documents would clearly state on the cover the level of disclosure along with a simple graphic to communicate the disclosure level that could look like this:

Level of Disclosure: D-2 (Emerging Growth Company)						
D-7	D-6	D-5	D-4	D-3	D-2	D-1
Lowest level of disclosure						Highest level of Disclosure
					This offering	

So which investors should be accredited?

What do investors need to be able to know before investing? As a finance professor who teaches investments at the university level, I believe investors need to be able to do the following:[9]

- Understand the business model of the proposed investment.
- Read the offering document and identify red flags.
- Read the financial statements and understand the financial position of the firm.
- Understand their own level of financial sophistication and know where to go for additional information when needed.
- Understand the importance of portfolio diversification.
- Understand the expected risk and return of their other assets and how the proposed investment fits in with their entire portfolio.
- Understand their own financial position and their ability to tolerate the loss of the entire investment.

[9] I am also Chartered Financial Analyst and Certified Financial Planner.

There is a tradeoff between Type I (rejecting sophisticated investors) versus Type II (accepting ignorant investors) errors: Regulation Best Interest reduces the consequences of Type II errors.

Any investor with this level of knowledge has the capability of deciding for themselves whether an investment opportunity is appropriate for them and should have the freedom to decide for themselves. The question that the Commission faces is how to identify those investors efficiently. The Commission faces a classic problem of balancing Type I errors (rejecting an investor who is sophisticated enough to make their own decisions) against Type II error (letting an ignorant person into a deal with inadequate information.)

As mentioned above, Regulation Best Interest now reduces the cost of Type II errors because broker dealers can only sell to retail investors products that are in their best interest. The Commission should thus worry less about Type II errors and concentrate on reducing Type I errors. Therefore, the Commission should be generous in awarding accredited investor status. This will both promote capital formation by increasing the pool of capital available for private placements, and also make it possible for more investors to reap the rewards of investing in private deals.

CFA charter holders and CFP® certificants should be accredited.

As a Chartered Financial Analyst, I can attest that the CFA Body of Knowledge covers this material.[10] In addition to passing three rigorous exams, candidates but also have three years of work experience in the financial industry.[11]

Likewise, as a Certified Financial Planner®, I can also attest that the CFP® program covers this material. There is a comprehensive test after the educational requirement has been completed, along with a work experience requirement.[12] There is also a continuing education requirement.

Series 7 or 65 passers should be accredited.

It certainly makes sense that licensed people in the securities industry who are allowed to sell private offerings to their clients should also be allowed to invest in those same offerings as accredited investors.[13]

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[10] The CFA Body of Knowledge includes can be found at https://www.cfainstitute.org/en/programs/cfa/curriculum/cbok

[11] In June 2019, the pass rates for Levels I, II, and III were 41%, 44%, and 56%, respectively. https://www.cfainstitute.org/-/media/documents/support/programs/cfa/cfa-exam-results-since-1963-2019b.ashx

[12] The subject matter for the CFP exam can be found at https://www.cfp.net/get-certified/certification-process/exam-requirement/about-the-cfp-exam/what-youll-be-tested-on

[13] The material covered in the Series 65 exam can be found at https://www.nasaa.org/wp-content/uploads/2016/02/Series-65-Test-Specs.pdf

Securities Industry Essential (SIE) exam passers should be accredited.

I have also taken and passed the SIE exam. The SIE is a single exam and covers less material than the CFA and CFP® exams, so this is a more difficult call.[14] However, the SIE does cover quite a broad level of material. The pass rate for the first 16,000 people taking the exam was only 74%, indicating some degree of rigor.[15] While the SIE is clearly less rigorous than the CFA, CFP®, Series 7, or Series 65 exams, I still think that it should count on the grounds that Regulation Best Interest reduces the risk of bad products being shoved down the throat of an unsophisticated investor. Someone who can pass the SIE should be able to figure out if they have enough information to proceed.

No special Accredited Investor exam is needed as they could take the SIE or Series 65.

With regard to question as to whether there should be special Accredited Investor examination, I don't think one is needed, as long as one could take the SIE or Series 65.

College graduates with accredited business degrees should be accredited.

Both undergraduate and graduate business programs cover the managerial, accounting, and financial topics needed to be a sophisticated enough investor. Even non-finance majors are required to take accounting, economics, and finance in addition to other courses such as marketing and strategy.

The American Association of Colleges of Business (AACSB) is the accrediting organization for business programs.[16] Graduates with an undergraduate degree in business, along with MBA and MSF (Master of Science in Finance) degrees from AACSB accredited schools should be deemed to be accredited investors.

"Reasonable steps" for verification of accredited investor status should be interpreted more reasonably to permit self-certification.

Under SEC Rule 506(c), the SEC defines the statutory required "reasonable steps" to verify accredited investor status as follows:

> The issuer shall take reasonable steps to verify that purchasers of securities sold in any offering under paragraph (c) of this section are accredited investors.

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[14] The Content Outline for the SIE can be found at https://www.finra.org/sites/default/files/SIE_Content_Outline.pdf

[15] https://blog.achievable.me/sie-exam-difficulty/

[16] AACSB accreditation standards can be found at https://www.aacsb.edu/-/media/aacsb/docs/accreditation/business/standards-and-tables/2018-business-standards.ashx?la=en&hash=B9AF18F3FA0DF19B352B605CBCE17959E32445D9

The issuer shall be deemed to take reasonable steps to verify if the issuer uses, at its option, one of the following non-exclusive and non-mandatory methods of verifying that a natural person who purchases securities in such offering is an accredited investor; provided, however, that the issuer does not have knowledge that such person is not an accredited investor:

(A) In regard to whether the purchaser is an accredited investor on the basis of income, reviewing any Internal Revenue Service form that reports the purchaser's income for the two most recent years (including, but not limited to, Form W-2, Form 1099, Schedule K-1 to Form 1065, and Form 1040) and obtaining a written representation from the purchaser that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year;

(B) In regard to whether the purchaser is an accredited investor on the basis of net worth, reviewing one or more of the following types of documentation dated within the prior three months and obtaining a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed:

(1) With respect to assets: Bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments, and appraisal reports issued by independent third parties; and

(2) With respect to liabilities: A consumer report from at least one of the nationwide consumer reporting agencies; or

(C) Obtaining a written confirmation from one of the following persons or entities that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months and has determined that such purchaser is an accredited investor:

(1) A registered broker-dealer;

(2) An investment adviser registered with the Securities and Exchange Commission;

(3) A licensed attorney who is in good standing under the laws of the jurisdictions in which he or she is admitted to practice law; or

(4) A certified public accountant who is duly registered and in good standing under the laws of the place of his or her residence or principal office.

(D) In regard to any person who purchased securities in an issuer's Rule 506(b) offering as an accredited investor prior to September 23, 2013 and continues to hold such securities, for the same issuer's Rule 506(c) offering, obtaining a certification by such person at the time of sale that he or she qualifies as an accredited investor.

Although the rule does not explicitly require those purportedly "non-mandatory methods," the implication is pretty clear to any compliance officer: Do it this way, or else. Following those steps creates a safe harbor. Doing it any other way invites the wrath of FINRA and OCIE. So much for "non-mandatory"! No competent compliance officer would dare do it any other way.

This is an unduly dangerous as well as burdensome process. Many people, including myself, don't necessarily want to share such unnecessary confidential data with anyone, let alone an issuer with uncertain privacy or cybersecurity policies. Given the risks of cyberattacks, the fewer people who have such information the better. Such information that can be useful for identify theft or to alert kidnappers as to deep pocket victims.

Particularly annoying is that the third party attestation available under part (C) is limited to three months. Most people's financial situations don't change that much in three months. This is an unnecessary paperwork impediment to capital formation that raises issuance costs and deters investors at the same time.

Instead, the SEC can now safely rely upon self-certification by investors that they meet the requirements to be accredited investors because of the increased protections of Regulation Best Interest. Selling to accredited investors does not relieve broker dealers of their Regulation Best Interest responsibilities, so the SEC can and should relax this standard. Any investor who is willing to commit securities fraud by fraudulently attesting that they meet the accredited investor standard is one who does not deserve "the protections of the Securities Act's registration process." Legitimately accredited investors should not be penalized with a dangerous, costly, and intrusive process because of a few liars who would only be harming themselves, if at all.

Respectfully submitted,

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