

March 16, 2020

ATTORNEY GENERAL RAOUL OBJECTS TO PROPOSAL TO REDUCE INVESTOR PROTECTIONS

Chicago — Attorney General Kwame Raoul today, as part of a coalition of 11 attorneys general, [filed a comment letter](#) objecting to the Securities and Exchange Commission's (SEC) proposed rule that would significantly diminish protections for individual investors.

The rule would expand the SEC's definition of "accredited investors" to include an increased number of individuals who are not equipped to bear significant losses from non-transparent and risky private non-publicly traded offerings. Additionally, the rule fails to account for almost 40 years of inflation by keeping the same financial thresholds to determine accredited investor status as existed in the 1980s. Doing so leaves millions of investors, including many seniors, at unnecessary risk.

"The SEC's proposed changes would expose investors, especially seniors, to risk," Raoul said. "I will oppose any policy changes that will reduce protections for those investors who can least afford significant losses."

In addition to failing to index financial thresholds to inflation, the SEC proposes allowing individuals who have been advised by a broker-dealer or an investment advisor to qualify as accredited investors, despite evidence that broker-dealers and investment advisors who recommend private offerings are more likely to have conflicts of interest than those who advise in public offerings. An accredited investor is an investor that companies can solicit with no requirement to provide disclosures about the investment. Furthermore, the rule seeks to expand the accredited investor definition to include individuals with qualifications that the SEC unilaterally – and without accountability – deems appropriate.

Raoul and the coalition oppose SEC's proposed rule and instead advocate for the SEC to consider the following recommendations:

- The SEC should raise the accredited investor financial thresholds set in the 1980s to account for inflation and should adjust the thresholds at least every four years going forward.
- Before making any changes to expand the accredited investor definition, the SEC should gather data and study private securities offerings, including outcomes for issuers and investors.
- In light of the significant evidence that individual investors are likely to be harmed, the SEC should reject any proposal to allow individuals advised by broker-dealers or investment advisors to qualify as accredited investors.
- The SEC should abandon the proposed rule's structure, which allows the SEC to decide the qualifications for accredited investors in the future without notice to and comment from stakeholders.

Joining Raoul in filing the comment letter are the attorneys general of California, Connecticut, Delaware, Iowa, Maryland, Massachusetts, New Jersey, New Mexico, New York and Oregon.



State of California
Office of the Attorney General

XAVIER BECERRA
ATTORNEY GENERAL

March 16, 2020

VIA ELECTRONIC SUBMISSION

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: Proposed Rule Amending the “Accredited Investor” Definition, Release Nos. 33-10734; 34-87784; File No. S7-25-19

Dear Secretary Countryman:

On behalf of the undersigned Attorneys General, we write to comment on the Securities and Exchange Commission’s (“SEC”) Proposed Rule Amending the “Accredited Investor” Definition, Release Nos. 33-10734, 34-87784, File No. S7-25-19, 85 Fed. Reg. 2574 (proposed Jan. 15, 2020) (“Proposed Rule”). We appreciate the opportunity to provide comments as the SEC considers modifications to the accredited investor definition. As discussed below, the SEC should reject the Proposed Rule’s expansion of the definition of accredited investor for individual investors. It should instead raise the qualifying financial thresholds and commit itself to improving the available data and to further study of the issue.

I. SUMMARY

Federal securities registration—and the disclosures that go with it—form the cornerstone of the U.S. public markets. As the SEC itself has recognized, regulation of the securities industry “derive[s]” from the “simple and straightforward concept” that “all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment,” which produces an “active, efficient, and transparent capital market” that is critical to “our nation’s economy.”¹ With the Proposed Rule, the SEC reverses this fundamental premise and instead expands the opaque and high-risk private markets and corrodes the more transparent

¹ Sec. & Exch. Comm’n, *What We Do*, <https://www.sec.gov/Article/whatwedo.html> (last visited Feb. 20, 2020).



public markets that have served our nation so well. The Proposed Rule to expand the accredited investor definition reflects a fundamentally misguided approach.

First, the SEC should reject the Proposed Rule's expansion of the accredited investor definition for individual investors for the simple reason that the costs of that expansion outweigh any possible benefits. The Proposed Rule ignores the serious risks that private placement offerings pose for individual investors. The available evidence suggests that private markets are inherently risky and subject to higher rates of fraud than the public market, with no clear benefit for individual investors to account for these risks. At the same time, the SEC's primary justification for the Proposed Rule—that it will promote capital formation—is unsupported by any solid evidence that the proposed expansion will actually result in significantly greater capital formation.² The Proposed Rule's proposal to expand the definition even further by allowing individual investors to gain accredited investor status by purchasing securities through broker-dealers or investment advisors is likely to have particularly dangerous consequences.

Second, the SEC should, at a minimum, raise the accredited investor financial thresholds to account for inflation. The SEC has not adjusted these thresholds since setting them in **1982**, nearly forty years ago. To prevent ongoing erosion of the thresholds, the SEC should also index them to inflation, with adjustments at least every four years when the SEC issues its report about the accredited investor definition.

Third, the SEC should shift course from assuming and intuiting what happens in private offerings to endeavoring to study how private offerings operate, who benefits, and who is disadvantaged. As many commenters (including several of the undersigned Attorneys General) recently commented,³ the SEC lacks critical data on the impact of expanding the private market. But this is a problem of the SEC's own making.

The SEC is uniquely positioned to gather data from issuers and other participants and should engage in a serious and thoughtful assessment of the many proposals stakeholders and academics have made to revise the accredited investor definition. As currently structured, the definition is—by almost all accounts—unsatisfactory. It is over-inclusive because it sweeps in individuals who meet the financial thresholds only through a lifetime of careful savings and hard

² See Letter from Rick A. Fleming, Inv'r Advocate, Sec. & Exch. Comm'n, to Vanessa Countryman, Sec'y, Sec. & Exch. Comm'n 2-5 (July 11, 2019), <https://www.sec.gov/comments/s7-08-19/s70819-5800855-187067.pdf> ("Investor Advocate Comment Letter").

³ See, e.g., Letter from Att'ys Gen. of Cal., D.C., Mass., and Or., to Vanessa Countryman, Sec'y, Sec. & Exch. Comm'n 3-6 (Sept. 24, 2019), <https://www.sec.gov/comments/s7-08-19/s70819-6193375-192522.pdf> ("AG Comment Letter"); Letter from Consumer Fed'n of America to Vanessa Countryman, Sec'y, Sec. & Exch. Comm'n 55-56 (Oct. 1, 2019), <https://www.sec.gov/comments/s7-08-19/s70819-6235037-192692.pdf> ("CFA Comment Letter").

work, rather than through investment savvy. We encourage the SEC to get more information and devise a better solution than either the current definition or the one that it is proposing.

Finally, the SEC should reject the Proposed Rule's structure allowing the SEC to make future orders to revise the categories of credentialed individuals who qualify as accredited investors. The proposed process fails to afford stakeholders an opportunity to provide valuable insight on proposed changes and violates the Administrative Procedures Act ("APA").

II. COMMENTS

A. The SEC Should Not Expand the "Accredited Investor" Definition for Individual Investors.

The SEC proposes two expansions of the accredited investor definition for individual investors: first, to allow individuals with certain credentials to qualify as accredited investors without meeting the financial thresholds in the definition; and second to allow "knowledgeable employees" of investment funds to qualify as accredited investors in the funds at which they are employed.⁴ At first glance, these proposals may seem reasonable, but they are not the result of data-driven inquiry into who should participate in private offerings but rather of assumptions about the potential benefits from participation. The available data suggests that the SEC's assumptions are incorrect. The SEC should not expand the accredited investor definition to include more individual investors.

1. Available Evidence Militates Against Expanding the Definition for Individual Investors.

To the extent that data about private offerings is available, that evidence strongly suggests that private markets are highly risky and are fertile environments for fraud.

For example, in the North American Security Administrators Association's ("NASAA") annual enforcement reports for 2013, 2014, and 2015, which detail the results of surveys of its member states about enforcement trends, unregistered offerings and Regulation D ("Reg D") offerings consistently rank high as sources of fraud.⁵ In its 2017, 2018, and 2019 reports,

⁴ Amending the "Accredited Investor" Definition, 85 Fed. Reg. 2574, 2579 (proposed Jan. 15, 2020).

⁵ Enf't Section, N. Am. Sec. Adm'rs Ass'n, *NASAA Enf't Report: 2015 Report on 2014 Data* 7 (2015), http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/08/2015-Enforcement-Report-on-2014-Data_FINAL.pdf; Enf't Section, N. Am. Sec. Adm'rs Ass'n, *NASAA Enf't Report: 2014 Report on 2013 Data* 7 (2014), https://www.nasaa.org/wp-content/uploads/2011/08/2014-Enforcement-Report-on-2013-Data_110414.pdf; Enf't Section, N. Am. Sec. Adm'rs Ass'n, *NASAA Enf't Report: 2013 Report on 2012 Data* 7-8 (2013), <https://www.nasaa.org/wp-content/uploads/2013/10/2013-Enforcement-Report-on-2012-data.pdf>.

NASAA began reporting on schemes that specifically target senior citizens. The results remained consistent, with unregistered securities topping the list of schemes used to exploit seniors.⁶

The high-risk nature of private markets is also reflected in FINRA's and the SEC's own statements about private markets. For example, in its 2020 Risk Monitoring and Examination Priorities Letter, FINRA listed "private placements" as an area of focus, a continuation from prior reports on its exam priorities and findings.⁷ For its part, the SEC states on its investor education site that "Public Disclosures Protect Investors" and notes that investing in companies that "do[] not regularly report business and financial information to the public" is "riskier as there can be little public information to allow investors to make an informed investment decision."⁸ And its 2018 Enforcement Report warned that "fraud involving unregistered offerings" was an "important" issue impacting individual investors.⁹

Notably, several of the undersigned Attorneys General provided information about NASAA's reports in their comment letter responding to the SEC's June 2019 Concept Release on Harmonization of Securities Offering Exemptions. AG Comment Letter at 3-4. So did the Consumer Federation of America and NASAA itself in their respective comment letters. Letter from N. Am. Sec. Adm'rs Ass'n, to Vanessa Countryman, Sec'y, Sec. & Exch. Comm'n 3-4 (Oct. 11, 2019), <https://www.sec.gov/comments/s7-08-19/s70819-6288085-193367.pdf> ("NASAA Comment Letter"); CFA Comment Letter at 34. These multiple presentations belie the SEC's claim that it is "not aware of widespread problems or abuses associated with Regulation D offerings to accredited investors" or "disproportionate fraud" in the growing accredited investor class. *See* 85 Fed. Reg. at 2594, 2600.

⁶ Enf't Section, N. Am. Sec. Adm'rs Ass'n, *NASAA 2019 Enf't Report, Based on 2018 Data* 8-9 (2019), <https://www.nasaa.org/wp-content/uploads/2019/11/2019-Enforcement-Report-Based-on-2018-Data-FINAL.pdf> (Unregistered securities are by far the most common products used to target seniors in fraudulent schemes); Enf't Section, N. Am. Sec. Adm'rs Ass'n, *NASAA 2018 Enf't Report, Based on 2017 Data* 6 (2018), <https://www.nasaa.org/wp-content/uploads/2018/10/2018-Enforcement-Report-Based-on-2017-Data-FINAL.pdf> (same); Enf't Section, N. Am. Sec. Adm'rs Ass'n, *NASAA 2017 Enf't Report, Based on 2016 Data* 6 (2017), <https://www.nasaa.org/wp-content/uploads/2017/09/2017-Enforcement-Report-Based-on-2016-Data.pdf> (same).

⁷ Fin. Indus. Reg'ry Auth., *2020 Risk Monitoring and Examination Priorities Letter* 1, n.3 (Jan. 9, 2020), <https://www.finra.org/rules-guidance/communications-firms/2020-risk-monitoring-and-examination-priorities-letter>.

⁸ Sec. & Exch. Comm'n, *Public Companies*, Investor.gov, <https://www.investor.gov/introduction-investing/basics/how-market-works/public-companies> (last visited Feb. 20, 2020).

⁹ Div. of Enf't., Sec. & Exch. Comm'n, *2018 Annual Report* 6 (Nov. 2, 2018), <https://www.sec.gov/files/enforcement-annual-report-2018.pdf>.

NASAA, FINRA, and the SEC are right: private offerings are high-risk, and public disclosures protect investors. Headline-grabbing businesses like Theranos and WeWork are particularly stark illustrations of the risks involved with investing in private markets. Companies that become sizeable while still private are not subject to the discipline of the public market, where corporate governance and public disclosures are meant to shed important light on companies' operations.¹⁰ Without the oversight of the market—and regulators who also review public filings—companies can operate in incredibly risky ways with few consequences for negligently or even intentionally misusing investor funds.

2. The SEC Offers Almost No Evidence to Support Expanding the Accredited Investor Definition for Individual Investors.

In the proposed rule package, there is a notable dearth of evidence showing, or even suggesting, that individual investors benefit from participation in private offerings. Instead, the SEC admits that it lacks reliable data about how private offerings even operate, let alone whether they are advantageous for individual investors. The SEC has no idea how many individual investors participate in private offerings¹¹; the amount they invest¹²; the size of the gains or losses they sustain¹³; or the outcomes for issuers who participate in private offerings.¹⁴ The SEC cannot even say with reliability how many private offerings take place.¹⁵

The SEC nevertheless justifies its proposed amendments in part by arguing that issuers will benefit from increased capital formation.¹⁶ The SEC also suggests that expanding the accredited investor definition for individual investors will allow them to participate in lucrative private offerings. The SEC's lack of data to support these propositions is telling.

¹⁰ See Renee M. Jones, *The Unicorn Governance Trap*, 166 U. Pa. L. Rev. Online 165, 178-79 (2017),

https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1211&context=penn_law_review_online.

¹¹ 85 Fed. Reg. at 2602 (“[F]rom the information reported on Form D, we do not have the ability to distinguish accredited investors that are natural persons from accredited investors that are institutions.”); 2602 n.265 (“Form D data and other data available to us on private placements do not allow us to estimate the number of unique accredited investors that participate in exempt offerings.”).

¹² *Id.*

¹³ *Id.* at 2600 (“We are mindful that it is difficult to reach rigorous conclusions about the typical magnitude of investor gains and losses in exempt offerings. Therefore, it is difficult to determine definitively how the benefits to accredited investors of expanded access to the exempt market compare to the loss of protections provided by registration.”).

¹⁴ See generally *id.* at 2604-05 (no data about issuer outcomes in private offerings in description of potential benefits to issuers from proposed rule).

¹⁵ *Id.* at 2601 n.259.

¹⁶ *Id.* at 2604.

The Investor Advocate has highlighted the fallacy of the SEC's logic that expanding the pool of individual investors under the accredited investor definition will increase capital formation.¹⁷ The Investor Advocate pointed out that, according to the Federal Reserve Board's Survey of Consumer Finances, individual investors who do not already qualify under the financial thresholds are unlikely to exhibit much demand for exempt offerings because of low savings.¹⁸ For those individuals who fall just short of the current thresholds, the vast majority of their wealth lies in their retirement accounts.¹⁹ The accredited investor definition already exposes the retirement accounts of qualified individual investors to high-risk private markets; increasing that exposure cannot benefit the public.

Illustrating the Investor Advocate's point is the equity crowdfunding market, which has largely been underwhelming expectations despite significant deregulation to allow individual investors all along the financial spectrum to participate.²⁰ Instead of a booming marketplace, equity crowdfunding has remained a niche market with fundraising falling well below the statutory caps and issuer-generated maximum targets for their offerings.²¹

More critical is the complete lack of data supporting the SEC's assumption that individual investors benefit by participating in private offerings. Institutional investors who participate in private offerings generally have sufficient resources to spread their risk over numerous private investments.²² Individual investors, especially under the current financial thresholds, are far less likely to have sufficient wealth or income to diversify their risk. Absent data showing that individual investors regularly benefit from investing in private offerings, there is no justification to expand the definition to those who do not even meet the financial thresholds, regardless of their purported level of sophistication.

¹⁷ Investor Advocate Comment Letter at 2-5.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.* at 4-5.

²¹ Staff, Sec. & Exch. Comm'n, *Report to the Commission: Regulation Crowdfunding* 15 (June 18, 2019), https://www.sec.gov/regulation-crowdfunding-2019_0.pdf. The results in equity crowdfunding points to a further issue that the SEC fails to consider: whether issuers with the most promising businesses even want numerous individual investors. *Id.* at 58 (“[I]ssuers have elected not to pursue an offering under Regulation Crowdfunding because, without an SPV, a large number of investors on an issuer’s capitalization table can be unwieldy and potentially impede future financing.”).

²² See *Understanding Venture Capital*, FundersClub.com, <https://fundersclub.com/learn/guides/vc-101/understanding-venture-capital/> (last visited Feb. 21, 2020) (the average VC fund contains \$135 million, which is usually spread between 30-80 startups).

In lieu of data, the SEC offers only assumptions that individual investors could benefit if they participate in private offerings.²³ But these assumptions do not justify exposing even more individual investors to high-risk private offerings.

3. The SEC Should Not Expand the Accredited Investor Definition to All Individual Investors Advised by Broker-Dealers or Investment Advisors.

The SEC has sought comment on whether to expand the accredited investor definition to include individual investors advised by broker-dealers or investment advisors.²⁴ This proposal is particularly pernicious and should be rejected.²⁵ The available evidence shows that such an expansion is likely to result in a significant degradation of investor protections.

First, broker-dealers and investment advisors often have conflicts of interest in their relationships with individual investors. Broker-dealers generally receive compensation in the form of commissions and fees received for the sale of particular securities.²⁶ Investment advisors may also receive commission-based compensation or may be part of dual-registrant firms.²⁷ Those conflicts are heightened in the context of private offerings, where sales

²³ See, e.g., 85 Fed. Reg. at 2605 (“We believe that newly eligible accredited investors could benefit from the proposed amendments as they would gain broader access to investment opportunities in private capital markets and greater freedom to make investment decisions based on their own analysis.”); see also Comm’r Robert Jackson, Statement on Reducing Investor Protections around Private Markets (Dec. 18, 2019), <https://www.sec.gov/news/public-statement/statement-jackson-2019-12-18-accredited-investor> (“[T]he release repeats by rote the intuition that exposing investors to these markets comes without corresponding costs.”).

²⁴ 85 Fed. Reg. at 2596.

²⁵ The SEC should also reject the suggestion to expand the definition to individuals with education credentials, such as advanced degrees in accounting, business, or law. *Id.* at 2583. There is research that only 27% of young people (defined as individuals between the ages of 23 and 28, notably an age when attainment of advanced educational degrees is possible) possess financial literacy, let alone financial sophistication. Annamaria Lusardi, et al, *Financial Literacy among the Young: Evidence and Implications for Consumer Policy*, Boettner Center for Pensions and Retirement Research 1, 6 (Aug. 2009),

<https://pensionresearchcouncil.wharton.upenn.edu/wp-content/uploads/2016/09/BWP2009-01.pdf>. The research noted that “often-used indicators thought to proxy for financial literacy, such as education, do a poor job of measuring respondents’ financial knowledge.” *Id.* at 2.

²⁶ Staff, Sec. & Exch. Comm’n, *Study on Investment Advisers and Broker-Dealers* 10-11 (Jan. 2011), <https://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

²⁷ *Id.*; see also Sec. & Exch. Comm’n, *Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation*, SEC.gov, <https://www.sec.gov/investment/faq-disclosure-conflicts-investment-adviser-compensation> (last visited Feb. 21, 2020).

commissions are often significantly higher than for publicly-filed securities.²⁸ The SEC's proposal exposes investors to the risk of a double injury: exposing them to inherently risky private offerings and making them pay significantly higher fees for the privilege.²⁹

Second, compounding the risk to individual investors, data suggests that broker-dealers who market securities in private offerings are more likely to be the subject of complaints to FINRA. Data gathered by Commissioner Jackson's staff highlights this issue by showing a correlation between private offering sales and customer complaints and regulatory inquiries into broker-dealers.³⁰ That correlation was also recognized by the *Wall Street Journal*, which analyzed complaints about broker-dealers against information about private placements and discovered that firms selling securities in private offerings were much more likely to have individual brokers with numerous complaints against them.³¹

Third, this expansion of accredited investor status is likely to swallow the general rule that private placements are limited to a select pool of accredited investors. Because so many individual investors interact with the securities market through a broker-dealer or investment adviser, the Proposed Rule would allow practically any individual investor to be an accredited investor by proxy. This would likely have the dual deleterious impact of: (1) shifting capital formation efforts from the vibrant public market space to the riskier private marketplace; and

²⁸ See, e.g., Bruce Kelly, *GPB Paid B-Ds and Reps Steep Commissions To Sell Troubled Private Placements*, Investment News (June 24, 2019), <https://www.investmentnews.com/gpb-paid-b-ds-and-reps-steep-commissions-to-sell-troubled-private-placements-80110> (company paid 9.3% in fees to brokers for selling private shares).

²⁹ Broker-dealer and investment advisor conflicts of interest already pose serious challenges to existing and proposed regulations administered by the SEC and FINRA. See, e.g., Richard G. Ketchum, Remarks From the 2015 FINRA Annual Conference (May 27, 2015), <https://www.finra.org/media-center/speeches-testimony/remarks-2015-finra-annual-conference> (“[O]ur examinations and enforcement dockets continue to reveal unacceptable instances of unsuitable sales of more complex products without the appropriate disclosure to clients of the downside risks and fees associated with the products.”); see also Fin. Indus. Reg’y Auth., *Conflicts of Interest*, FINRA.org, <https://www.finra.org/rules-guidance/key-topics/conflicts-of-interest> (“Conflicts of interest represent a recurring challenge that contributes to compliance and supervisory breakdowns. These breakdowns can compromise the quality of service that firms and representatives provide to their clients.”) There is no reason to exacerbate those challenges by expanding broker-dealer and investment advisor roles to advising individual investors on private market investments with far less transparency and far higher risk.

³⁰ Comm’r Robert J. Jackson Jr., Statement on Reducing Investor Protections around Private Markets (Dec. 18, 2019), <https://www.sec.gov/news/public-statement/statement-jackson-2019-12-18-accredited-investor>.

³¹ Jean Eaglesham & Coulter Jones, *Firms With Troubled Brokers Are Often Behind Sales of Private Stakes*, Wall St. J. (June 24, 2018), <https://www.wsj.com/articles/firms-with-troubled-brokers-are-often-behind-sales-of-private-stakes-1529838000>.

(2) allowing the riskiest companies far easier access to investors through conflicted financial professionals.

In light of this evidence, the SEC should refrain from adopting any proposal allowing individual investors advised by broker-dealers or investment advisors to qualify as accredited investors on that basis alone.

B. The SEC Should Raise the “Accredited Investor” Financial Thresholds for Natural Persons.

Instead of expanding the accredited investor definition for individual investors, the SEC should return to the high financial barriers for accredited investor status originally implemented. The financial thresholds under the definition are nearly forty years old, and the SEC has never indexed them to inflation, despite recommendations by numerous stakeholders and its own staff to do so.³² Over that time, as the pool of individual investors who qualify under the thresholds has steadily grown,³³ the ability of these individual investors to withstand significant losses has concomitantly shrunk.³⁴ The SEC should reverse this trend by raising the thresholds to account for inflation over the last 38 years and should index the thresholds to inflation going forward.

1. The Current Financial Thresholds Do Not Ensure That Qualifying Individuals Are Financially Sophisticated.

As numerous commentators have observed, neither annual income nor net worth are a satisfactory proxy for financial sophistication.³⁵ The means by which individuals achieve certain income or wealth thresholds may have nothing to do with financial sophistication. Individuals

³² See, e.g., NASAA Comment Letter at 4; CFA Comment Letter at 70; Staff, Sec. & Exch. Comm’n, *Report on the Review of the Definition of Accredited Investor* 7, 90-91 (Dec. 18, 2015), <https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf> (“SEC Accredited Investor Report”); see also 85 Fed. Reg. at 2593 n.203 (listing commenters supporting indexing the thresholds to inflation).

³³ 85 Fed. Reg. at 2593.

³⁴ *Id.*; Jean Eaglesham and Coulter Jones, *Opportunities to Invest in Private Companies Grow*, Wall St. J. (Sept. 23, 2018), <https://www.wsj.com/articles/opportunities-to-invest-in-private-companies-grow-1537722023>.

³⁵ See, e.g., NASAA Comment Letter at 5; CFA Comment Letter at 66; AG Comment Letter at 7; see also Christopher R. Zimmerman, *Accredited Investors: A Need for Increased Protection in Private Offerings*, 114 Nw. U. L. Rev. 507, 521 (2019); Syed Haq, *Revisiting the Accredited Investor Standard*, 5 Mich. Bus. & Entrepreneurial L. Rev. 59, 69-70 (2015); Larissa Lee, *The Ban Has Lifted: Now Is the Time to Change the Accredited-Investor Standard*, 2014 Utah L. Rev. 369, 384-85 (2014); Wallis K. Finger, *Unsophisticated Wealth: Reconsidering the SEC’s Accredited Investor Definition under the 1933 Act*, 86 Wash. U. L. Rev. 733, 748 (2009).

may inherit their wealth or work in high-paying industries that do not require financial sophistication.³⁶

The SEC acknowledges this logic within the proposed rule package. In its proposed catch-all provision for entities to qualify as accredited investors, the SEC rejected using a threshold of \$5 million in assets, observing that “certain types of entities that would be covered by [a \$5 million asset test], such as governmental entities, may have \$5 million in non-financial assets such as land buildings and vehicles, but not have any investment experience.”³⁷ That logic applies with equal force to individual investors. Annual income and net worth poorly correlate with financial sophistication.

In fact, the majority of individuals who currently qualify under the financial thresholds are over 55 years old.³⁸ Their wealth accumulation is as likely to be the result of a lifetime of saving for retirement as the result of financial sophistication.³⁹ In fact, studies show that seniors are one of the least financially literate age demographics.⁴⁰ And, they are the most vulnerable demographic for investment losses because they have less time to recover from those losses.

2. The SEC Should Raise the Financial Thresholds to Account for Inflation and Should Index the Thresholds to Inflation Going Forward.

As the proposed rule package acknowledges, the current thresholds—\$200,000 in annual income for single individuals; \$300,000 in annual income for joint individuals; \$1 million in net worth, excluding primary residences—were the equivalent in 1982 (1988 for the joint threshold) to \$520,000 in annual income for single individuals, \$632,000 for joint individuals, and \$2.5

³⁶ For example, doctors on average earn approximately \$223,000 in annual income. Brian O’Connell, *How Much Do Doctors Make?*, The Street (Feb. 18, 2020), <https://www.thestreet.com/personal-finance/how-much-do-doctors-make-14779617>. Lawyers only two years out of law school who work at one of the top law firms in the country make \$200,000 per year. Ryan Lane, *Big Law: What It Is and What Salary You Should Expect*, NerdWallet (July 23, 2019), <https://www.nerdwallet.com/blog/loans/student-loans/big-law-salary/>.

³⁷ 85 Fed. Reg. at 2588.

³⁸ Jean Eaglesham and Coulter Jones, *Opportunities to Invest in Private Companies Grow*, Wall St. J. (Sept. 23, 2018), <https://www.wsj.com/articles/opportunities-to-invest-in-private-companies-grow-1537722023>.

³⁹ Tao Guo, et al, *The Unsophisticated “Sophisticated”: Old Age and the Accredited Investors Definition*, The CLS Blue Sky Blog (Oct. 7, 2015), <https://clsbluesky.law.columbia.edu/2015/10/07/the-unsophisticated-sophisticated-old-age-and-the-accredited-investors-definition/> (Older investors “did not necessarily accumulate wealth through active investment in complex financial securities. Many workers invest in default investments that do not require a great amount of involvement or expertise.”).

⁴⁰ Annamaria Lusardi & Olivia S. Mitchell, “The Economic Importance of Financial Literacy: Theory and Evidence,” 52 J. of Econ. Literature 5, 17 (Mar. 2014).

million in net worth in 2019.⁴¹ The number of individual investors who qualify has grown from 1.6% of the American population in 1983 to 13% in 2019.⁴² The SEC offers essentially no data about the ability of these additional qualifying individuals to withstand losses from investments.

Despite this dramatic expansion of the population of accredited investors, the Proposed Rule fails to adjust the financial thresholds to account for inflation. The SEC should craft a rule that limits accredited investor status to the narrow slice of the population for which it was originally intended.

First, the SEC should raise the thresholds to account for inflation in the years since they were adopted. That action would ensure that individual investors who participate in private offerings have at least the same amount of wealth and income that the SEC determined were appropriate when it instituted the definition.⁴³ An increase in the thresholds also tracks Congress's instructions to the SEC in the Dodd-Frank Act, which requires the SEC to study the accredited investor definition every four years and modify the definition as warranted by its study.⁴⁴

Second, the SEC should index the thresholds to inflation going forward, with the thresholds being adjusted at least every four years when the SEC completes its study of the accredited investor definition. In the studies it has conducted, SEC Staff notably has recommended that the thresholds be indexed to inflation.⁴⁵ Doing so will help prevent future erosion of the thresholds.

The SEC's reasons for not raising the thresholds wither under even minimal scrutiny. For example, the SEC observed that "in 1982, the calculation of net worth included the value of the primary residence," the value of which the SEC excluded from the net worth calculation in 2011, pursuant to Congressional directive.⁴⁶ The removal of primary residences from the net

⁴¹ 17 C.F.R. § 230.501(a)(5), (6); 85 Fed. Reg. at 2593; Jean Eaglesham and Coulter Jones, *Opportunities to Invest in Private Companies Grow*, Wall St. J. (Sept. 23, 2018), <https://www.wsj.com/articles/opportunities-to-invest-in-private-companies-grow-1537722023>.

⁴² 85 Fed. Reg. at 2593.

⁴³ If the SEC insists on maintaining the current financial thresholds, the SEC should at least consider imposing caps on the amount of investments individual investors can make, as its staff recommended in the last report on the accredited investor definition. SEC Accredited Investor Report at 7, 90-91. One model could be the investment caps in Regulation Crowdfunding. See 15 U.S.C. § 77d(a)(6)(B); 17 C.F.R. § 227.100(a)(1), (2).

⁴⁴ Section 413 of the Dodd-Frank Act requires the SEC to undertake a study of the accredited investor definition every four years 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." Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 413(b)(2)(A), 124 Stat. 1376, 1577-78 (2010).

⁴⁵ SEC Accredited Investor Report at 7, 90-91.

⁴⁶ 85 Fed. Reg. at 2594.

worth threshold did nothing to change the income thresholds.⁴⁷ And as the SEC's own data reflects, inflation has still affected the net worth calculation, even accounting for the removal of primary residences.⁴⁸

The SEC raised geographic disparities in income and wealth as one reason why it has not raised the financial thresholds and is proposing an alternative means of qualification under the accredited investor definition.⁴⁹ But the SEC offers no evidence that these disparities impact the principal protection the financial thresholds provide: investors' ability to withstand significant losses.

The SEC also argued that "the rise of the internet, social media, and other forms of communication" has allowed "information about issuers and other participants in the exempt markets" to be "more readily available to a wide range of market participants."⁵⁰ The SEC conducts no real analysis about how advances in technology and supposedly increased information availability support lower financial thresholds. Evidence suggests that these changes are not helpful to investors. Research conducted by one cybersecurity company shows that cybercriminals are willing to produce both positive and negative disinformation campaigns about companies for a few thousand dollars.⁵¹ These disinformation campaigns can include published articles even in mainstream news outlets.⁵² The SEC itself has engaged in several enforcement cases where individuals have used social media and internet sites to publish disinformation with the goal of manipulating stock prices.⁵³

⁴⁷ *Id.* at 2593 ("These financial thresholds have not been adjusted for inflation since they were adopted.").

⁴⁸ *Id.* at 2594 n.210 (SEC excluded value of primary residence in its 1983, 1989, and 2016 data analyses).

⁴⁹ *Id.* at 2594.

⁵⁰ *Id.* at 2594.

⁵¹ Insikt Group, *The Price of Influence: Disinformation in the Private Sector*, (Sept. 30, 2019), <https://www.recordedfuture.com/disinformation-service-campaigns/n>

⁵² *Id.*

⁵³ Press Release, Sec. & Exch. Comm'n, SEC Charges: False Tweets Sent Two Stocks Reeling in Market Manipulation (Nov. 5, 2015), <https://www.sec.gov/news/pressrelease/2015-254.html> (SEC charged Scottish trader with using false tweets to cause sharp drops in stock prices); Press Release, Sec. & Exch. Comm'n, SEC Charges Penny Stock Company CEO and Purported Business Partner for Defrauding Investors With False Press Releases (July 18, 2014) <https://www.sec.gov/news/press-release/2014-140> (SEC charged two men with using press releases with false information about company to rapidly increase value of company's stock); Press Release, Sec. & Exch. Comm'n, SEC Charges Two Canadians With Fraudulently Touting Penny Stocks on a Website, Facebook and Twitter (June 29, 2010), <https://www.sec.gov/news/press/2010/2010-114.htm> (SEC charged Canadian couple who "fraudulently touted penny stocks through their website, Facebook and Twitter").

No wonder, then, that the SEC warns individual investors that social media “presents opportunities for fraudsters.”⁵⁴ The SEC cautions individual investors that “[t]hrough social media, fraudsters can spread false or misleading information about a stock to large numbers of people with minimum effort and at relatively low cost” and can “conceal their true identities by acting anonymously or even impersonating credible sources of market information.”⁵⁵

The SEC also argues in support of leaving the thresholds in place that it is “not aware of widespread problems or abuses associated with Regulation D.”⁵⁶ That conclusion ignores evidence offered in responses to the Concept Release on Harmonization of Securities Offering Exemptions—and presented again in this letter—that state securities regulators regularly see fraud in offerings under Reg D and that Reg D regularly is at or near the top of surveys regarding schemes associated with fraud.⁵⁷

On their own, the SEC’s reasons for not raising the thresholds are weak. Compared to the compelling reasons to increase the thresholds and index them to inflation going forward, the SEC’s reasoning suggests it has not seriously considered the impact of keeping the thresholds as they are. The SEC should reverse course and raise the thresholds and index them to inflation.

C. The SEC Should Gather Data and Study Private Offerings and Related Topics.

Although the SEC has attempted in the past to expand its data-gathering for private offerings,⁵⁸ it has yet to finalize a rule that would require issuers relying on the exemptions in Rules 506(b) or (c) to provide more comprehensive data about their offerings. Nor has the SEC finalized a rule with meaningful penalties for issuers that fail to provide even the limited information currently required. In other words, the SEC has failed to use all means at its disposal to understand what happens in the \$2.9 trillion private markets. The SEC should shift course and use its powers to gather data about private offerings.⁵⁹

First, the SEC should re-propose its 2013 amendments to Reg D and Form D, specifically 1) the requirement for a closing amendment to Form D; 2) the requirement for issuers to identify whether investors are institutional investors or natural persons; and 3) the disqualification for a

⁵⁴ Sec. & Exch. Comm’n, *Updated Investor Alert: Social Media and Investing—Stock Rumors*, Investor.gov (Nov. 5, 2015), <https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/updated-investor-alert-social-media-investing-0>

⁵⁵ *Id.*

⁵⁶ 85 Fed. Reg. at 2594.

⁵⁷ See AG Comment Letter at 3-4; CFA Comment Letter at 34; NASAA Comment Letter at 3-4.

⁵⁸ See Amendments to Regulation D, Form D and Rule 156, 78 Fed. Reg. 44,806, 44,806 (proposed July 24, 2013) (proposal to, among other things, require issuers to file closing amendments to Forms D and to disqualify issuers who failed to comply with Form D requirements from relying on the exemption for one year).

⁵⁹ See, e.g., 15 U.S.C. §§ 77s, 77sss.

year of issuers who fail to comply with the Form D filing requirements from relying on Reg D exemptions.⁶⁰

Second, the SEC should go further in the information it requires from issuers. The SEC should require: (1) ongoing reporting about the viability of issuers, such as a simplified annual report and/or notice of major events like mergers, acquisitions, or winding down of the business; and (2) disclosure of the size of the investments by each investor.

Third, the SEC should seek data from other sources. It should request information from custodians for alternative investment IRAs, which likely have data about the performance of private offerings. It should study complaints filed under FINRA Rule 4530 to evaluate how broker-dealer and investment advisor performance relates to the sale of private offerings. These additional pieces of data are vital to the SEC learning about outcomes for both issuers and investors in private offerings.

Finally, armed with this data, the SEC should study how the existing accredited investor definition has helped or harmed individual investors and what changes should be made consistent with the SEC's mandate to protect investors, facilitate capital formation, and maintain fair, orderly, and efficient markets. There are numerous proposals for rethinking the accredited investor definition, from implementing a licensing system,⁶¹ to capping the amount of investments,⁶² to requiring certain disclosures to individual investors,⁶³ to basing financial thresholds on discretionary income,⁶⁴ and excluding retirement savings from the net worth calculation.⁶⁵ Determining which, if any, of these proposals will protect investors while facilitating capital formation should occur only after the SEC has taken the time to actually learn about the private market.

D. The SEC's Proposed Structure for Determination of Qualifying Credentials Is Problematic and Unlawful.

The SEC's proposal allows the Commission to determine, without any stakeholder input, which licenses, credentials, or certifications qualify under the criteria it has listed.⁶⁶ The SEC

⁶⁰ 78 Fed. Reg. at 44,806, 44,816.

⁶¹ See Wallis K. Finger, *Unsophisticated Wealth: Reconsidering the SEC's Accredited Investor Definition under the 1933 Act*, 86 Wash. U. L. Rev. 733, 760-62 (2009).

⁶² Larissa Lee, *The Ban Has Lifted: Now Is the Time to Change the Accredited-Investor Standard*, 2014 Utah L. Rev. 369, 387 (2014).

⁶³ *Id.*

⁶⁴ So-Yeon Lee, *Why the Accredited Investor Standard Fails the Average Investor*, 31 Rev. Banking & Fin. L. 987, 993-94 (2012).

⁶⁵ Christopher R. Zimmerman, *Accredited Investors: A Need for Increased Protection in Private Offerings*, 114 Nw. U. L. Rev. 507, 535-37 (2019).

⁶⁶ 85 Fed. Reg. at 2581.

states that it “anticipates,” but notably does not appear to believe it is required, to seek notice and comment before issuing an order changing the licenses that qualify.⁶⁷ This poses two problems.

First, the fact that this list of credentials will be published exclusively on the SEC’s website, and not in the Federal Register,⁶⁸ is highly problematic because that process fails to create a record of the Commission’s actions or allow stakeholders to weigh in on the potential impact of the Commission’s proposed changes. It provides the SEC with far too much power—and almost no accountability—to significantly expand who qualifies as an accredited investor.

Second, the SEC’s proposal violates the notice-and-comment provisions of the Administrative Procedures Act.⁶⁹ The APA requires that for all “legislative” rules, federal agencies must publish proposed rules in the Federal Register and “give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments.”⁷⁰ Only “interpretative” rules, which are defined as those rules that are “issued by an agency to advise the public of the agency’s construction of the statutes and rules which it administers,” are exempt from the APA’s rulemaking requirements.⁷¹ Interpretative rules “do not have the force and effect of law and are not accorded that weight in the adjudicatory process.”⁷² “Legislative” rules, on the other hand, must go through notice and comment.⁷³ They “create new law, rights, or duties, in what amounts to a legislative act” and have the force of law.⁷⁴ Commission orders adding to or removing credentials, qualifications, or licenses from the definition of accredited investors surely “create new...rights,” and therefore are most likely subject to the APA. If the SEC nevertheless adopts the proposed structure, it should make it clear that the APA requires the Commission to provide notice in the Federal Register and an opportunity to comment for any proposed licenses, credentials, or qualifications it seeks to add to the accredited investor definition and that the SEC will comply with those requirements.

III. CONCLUSION

The SEC should not expand the accredited investor definition for individual investors; the available evidence strongly weighs against doing so. Instead, the SEC should raise the financial thresholds, index the thresholds to inflation going forward, and use its rulemaking and other authority to gather data about private offerings. With that data, the SEC should engage in careful study of the private markets and consider the numerous and thoughtful suggestions about how to

⁶⁷ *Id.*

⁶⁸ *Id.* (“To assist members of the public, the professional certifications and designations or other credentials recognized by the Commission as satisfying the above criteria would be posted on the Commission’s website.”)

⁶⁹ 5 U.S.C. § 553 *et seq.*

⁷⁰ 5 U.S.C. § 553(b), (c); *Perez v. Mortgage Bankers Ass’n*, 575 U.S. 92, 96-97 (2015); *N.Y. City Emps.’ Ret. Sys. v. SEC*, 45 F.3d 7, 12 (1995).

⁷¹ *Perez*, 575 U.S. at 96-97 (internal citations, quotations omitted).

⁷² *Id.*

⁷³ *Id.*; *N.Y. City Emps.’ Ret. Sys.*, 45 F.3d at 12.

⁷⁴ *N.Y. City Emps.’ Ret. Sys.*, 45 F.3d at 12.

revise the accredited investor definition to craft a well-informed, data-driven definition that balances investor protections and capital formation.

We appreciate the opportunity to comment on this important proposal and hope that the SEC will take our suggestions under consideration as it moves forward.

Sincerely,



XAVIER BECERRA
California Attorney General



WILLIAM TONG
Connecticut Attorney General



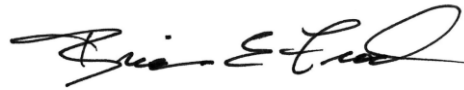
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