SBIA
SMALL BUSINESS
INVESTOR ALLIANCE

VIA Electronic Mail

October 8, 2014

Kevin M. O'Neill
Deputy Secretary
Securities & Exchange Commission
100 F Street NE
Washington, D.C. 20549-1090

Re: SEC File No. 265-28, Comments on Recommendations of Investor as Purchaser Subcommittee and Investor Education Subcommittee re: Accredited Investor Definition

Dear Mr. O'Neill:

The Small Business Investor Alliance ("SBIA") welcomes the opportunity to comment on the proposed recommendations[1] ("Proposed Recommendations") of the Securities & Exchange Commission's ("Commission" or "SEC") Investor Advisory Committee ("Committee") on the definition of accredited investor as it applies in identifying investors who do not require the protections afforded by the Securities Act of 1933 (" '33 Act").

SBIA is a national association that develops, supports, and advocates on behalf of policies that benefit investment funds that finance small and mid-size businesses in the lower middle market, as well as the investors that provide capital to these funds. Our membership consists of funds that have been licensed or are seeking to be licensed by the Small Business Administration ("SBA") as small business investment companies ("SBICs"), funds registered as business development companies ("BDCs") under the Investment Company Act of 1940, traditional 3(c)(1) and 3(c)(7) private funds, and the accredited investors that invest in these funds, including high net worth individuals, banks, family offices and pension funds.[2]

I. Background On SBIA Members' Utilization of Rule 506

[1] Recommendations of the Investor as Purchaser Subcommittee and the Investor Education Subcommittee: Accredited Investor Definition, Securities Act Release Nos. 33-9647, File No. 265-28 (Septr 17, 2014). [hereinafter "Committee Recommendations"].

[2] SBIA currently enjoys over 400 individual fund members, including 26 BDCs (currently there are 65 BDCs operating in the marketplace.

Our private fund and SBIC members (altogether "Fund Members"), in making their offerings and sales of interests in their funds, overwhelmingly rely on Rule 506 of Regulation D for the exemption from registration under the '33 Act and on section 3(c)(1) and/or 3(c)(7) of the Investment Advisers Act of 1940 for exemption from investment company registration requirements. Accordingly, our Fund Members restrict their offerings to natural persons and entities that qualify as accredited investors, as defined under Rule 501 of Regulation D.

Due to our Fund Members' reliance on Rule 506 for the offerings of their securities to investors, any change of the accredited investor definition under Rule 501 to further limit its scope would have a significant negative effect on the ability of our Fund Members to raise capital for small business investments. Choking off capital would result in fewer funds for investment in small and mid-size businesses around the country; companies that are the primary job creators in the U.S. economy. Moreover, these funds are invested in businesses that can be generally understood by their investors.

We are rightly concerned with the Committee's perceived need to limit the current scope of the "accredited investor" financial thresholds. Additionally, our members are adamantly opposed to any effort to impose an involuntary "toll" on investors seeking to invest in private offerings by forcing them to receive an expensive certification, or to necessarily employ a financial adviser to educate them on these products. However, *so long as the current financial thresholds remain in place as a method to establish sophistication*, SBIA believes it may make sense to provide alternative methods in which investors could be classified as "sophisticated" as has been suggested by the Committee and members of Congress.

II. Any Increase In The Financial Thresholds in the Accredited Investor Definition Will Have Significant Negative Effects on Capital Formation, While Providing Little Investor Protection Benefit

SBIA and our Fund Members believe that any increase in the financial thresholds under the accredited investor definition would significantly damage the ability of small and midsize businesses to raise capital, while providing little investor protection benefit. The financial thresholds was already increased through the 2011 amendments[3] to the accredited investor definition, which excluded the value of an investor's primary residence when calculating net worth for establishing accredited investor status. Further increases, such as those recommended by the Committee, will not only harm capital formation, but also unfairly limit the ability of investors to access promising investment opportunities. Increases could also have detrimental effects for rural areas of the country that already have difficulty in attracting investment capital. Moreover, the Committee has not demonstrated that the current standards have resulted in harm to investors, or were appropriately set when Regulation D was created in 1982. Any change to

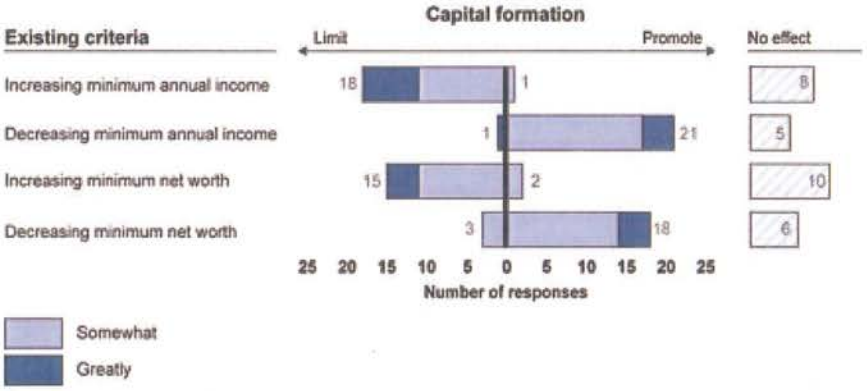
[3] Net Worth Standard for Accredited Investors, Securities Act Release No. 33-9287, File No. S7-04-11, (December 21, 2011).

these financial thresholds would therefore fail to strike the proper balance between investor protection and capital formation.

A. Increasing the Financial Thresholds Will Result in Significant Impacts to Capital Formation & Job Creation

According to the July 2013 Government Accountability Office ("GAO") report on the accredited investor definition, "analysis of federal data on household net worth showed that adjusting the $1 million minimum threshold to approximately $2.3 million, would decrease the number of households qualifying as accredited from approximately 8.5 million to 3.7 million."[4] This would disproportionately impact small business investors. Such a dramatic decrease in the number of potential investors in private placements would be catastrophic to capital formation for small growing businesses.

Figure 4: Market Participants' Opinions on How Existing Criteria Would Affect Capital Formation, as of February-March 2013



Source: GAO analysis of structured interviews.

Note: We asked market participants if a change to the existing criteria would promote, limit, or have no effect on capital formation. We then asked those who responded that a change would promote or limit capital formation if the proposed change would greatly or somewhat strengthen (or weaken) capital formation.

As the above chart from the GAO study illustrates[5], any increase in the annual income and net worth calculations would have significant limiting effects on capital formation. Increasing the financial thresholds would counteract the efforts of Congress and the Administration to spur job creation and ensure that small and mid-size businesses can attract the capital they need – an effort illustrated by the adjustment of capital raising options in the Jumpstart Our Business Startups Act, signed into law in 2012.[6]

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[4] U.S. GOV. ACCOUNTABILITY OFFICE, GAO-13-640 , SECURITIES & EXCHANGE COMMISSION: ALTERNATIVE CRITERIA FOR QUALIFYING AS AN ACCREDITED INVESTOR SHOULD BE CONSIDERED, 18 (July 2013).
[5] *Id.* at 16.
[6] Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. (Apr. 5, 2012).

B. Increasing the Financial Thresholds Will Unfairly Deny Upward Financial Mobility To Millions and Limit Upward Financial Mobility To the Super Wealthy

Increases in the financial thresholds would also unfairly limit the ability of investors to access valuable investment opportunities.[7] The current zero-interest rate investment environment provides very little opportunity for investors to achieve significant yield, to the detriment of investors who are planning for retirement, purchasing a home or trying to build wealth to pass down to their children. Private placement opportunities for investors, including investments with our Fund Members, may provide the one of the only methods for them to receive a reasonable rate of return on their investments.[8] This yield is critical for investors coming close to retirement, as the low-yield environment is expected to continue to persist for the near future. Moreover, many of our Fund Members are smaller funds, around $150 million in total assets under management. Often, they are based in smaller communities and seek investment from friends and colleagues who wish to invest with a fund manager that they know and trust. Increasing the financial thresholds would close this window for the investors that may currently qualify to invest in these higher-yielding investments, and those who wish to invest with local fund managers, at the very time when these investors need to grow their portfolios.

C. Accredited Investor Financial Thresholds Were Already Increased in 2011

As the Committee highlighted in their recommendations, the financial thresholds for accredited investors were already increased by the Dodd Frank Act,[9] further restricting capital for small businesses and limiting the number of investors who can invest in Rule 506 offerings. The new rules, implemented in 2011, excluded the value of the investors' primary residence from being included in the $1 million net worth calculation under the accredited investor definition. For most Americans, their primary residence is the largest asset on their household balance sheet.[10] "At $20.7 trillion, the primary residence accounted for almost one-third, 30% of all assets held by households in 2010. The primary residence represented 62% of the median homeowner's total assets and 42% of the median home owner's wealth."[11] As such, excluding the primary

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[7] Lenny Grover, *The Government is Reserving the Best Investments For the Rich,* THESTREET.COM, Feb 14, 2014, http://www.thestreet.com/story/12366493/2/the-government-is-reserving-the-best-investments-for-the-rich.html.

[8] ["Private equity and venture capital can deliver strong returns, usually outperforming other asset classes on a consistent basis over the longer term. As institutional investors, operating in a low yield environment, search for the returns that are necessary to deliver on long-term commitments they have made to their clients, the performance that private equity and venture capital can deliver....becomes even more valuable."] *See* PRIVATE EQUITY GROWTH CAPITAL COUNCIL & EUROPEAN PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION, [*Long-Term Investment: The Private Equity Contribution,* 2012], *available at:* http://www.pegcc.org/wordpress/wp-content/uploads/130524-context-paper-Final.pdf.

[9] *See* Committee Recommendations at 3; *see also* Net Worth Standard for Accredited Investors, Securities Act Release Nos. 33-9287, File No. S7-04-11, (December 21, 2011).

[10] Michael Neal, *Homeownership Remains a Key Component of Household Wealth,* NATIONAL ASSOCIATION OF HOME BUILDERS, Sept 3, 2013, *http://www.nahb.org/generic.aspx?genericContentID=215073&channelID=311.*

[11] *Id.*

residence from the net worth calculation of $1 million was a significant increase in the financial thresholds since they were put in place in 1982. In fact, the GAO estimated that from 9.04% of households in 2007 who qualified to invest, the 2011 amendments decreased the number of qualifying households to 7.2%, a significant decrease in accredited investors.[12] This excluded 2.14 million households from qualifying as accredited and therefore being able to invest in Regulation D offerings.[13] While the Committee recognizes this in their written recommendations, it discounts the increase by focusing on other non-financial assets –such as a small business or a farm – and indicating that these should be excluded as well. While SBIA and our members may understand the need to protect one's primary residence (due to its ability to provide shelter), there is no need to protect investors from all potential risk in making an investment, as long as suitable disclosures are made. Americans understand risk, and as long as properly informed about the risk, they can then make an appropriate decision. In contrast, by the Committee's measure, no investor should ever take risk in investing in their own small business or farm, because that could result in financial loss if that investment fails.

Moreover, the Committee highlights the risk in the fact that the $1 million net worth threshold is often met through retirement savings (although these individuals must still be receiving an annual income of at least $250,000). The Committee has expressed concern that these high net worth retirees be protected from the potential of losing their significant retirement savings. However, these are not typical retirees who require this "protection" from the risk of loss (the average near-retirement household only has $12,000 in retirement savings, as opposed to the $1,000,000 accredited investor net worth threshold[14]), and would likely be penalized by excluding them from the only source of yield they may receive in their retirement savings (as highlighted above). This assumes that investing in American small businesses is riskier than investing the stock market, which is a false assumption. The Commission should not be penalizing or arbitrarily limiting the investment choices of high net worth investors, nor should they reduce the potential benefits to capital formation and economic growth. Further increases in the financial thresholds, have not been shown as necessary through hard data or research and are merely based on conjecture and unproven assumptions.

D. Increasing the Financial Thresholds Will Negatively Impact Capital Formation In Rural and Underserved Regions

The GAO study also highlighted the issue of regional differences in income and the impact that raising the financial thresholds for accredited investors would have on capital formation in rural

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[12] U.S. GOV. ACCOUNTABILITY OFFICE, GAO-13-640 , SECURITIES & EXCHANGE COMMISSION: ALTERNATIVE CRITERIA FOR QUALIFYING AS AN ACCREDITED INVESTOR SHOULD BE CONSIDERED, 9-10 (July 2013).

[13] *See Id.; see also* 2010 U.S. Census Data, Households and Families, *available at:* http://www.census.gov/prod/cen2010/briefs/c2010br-14.pdf

[14] Nari Rhee, *The Retirement Savings Crisis: is It Worse Than We Think?,* NATIONAL INSTITUTE ON RETIREMENT SECURITY, June 2013, http://www.nirsonline.org/storage/nirs/documents/Retirement%20Savings%20Crisis/retirementsavingscrisis_final.pdf

areas of the country.[15] For areas of the country that have lower average income levels, increasing the financial thresholds could "negatively affect investors' ability to qualify under the standard and make it harder for local start-up companies to seek investors and capital inside the state…"[16] Such an approach would be directly at odds with the current Administration's focus on increasing access to capital for rural small businesses and driving job growth in those rural areas.[17] If the changes suggested by the Committee were adopted, they would be disadvantaged from investing, as they would likely raise the money for these funds through Rule 506 from local investors, who may no longer meet the thresholds for investing.

E. The Committee Fails To Make the Case That the Current Thresholds Are Inadequate

The Committee fails to present any hard data establishing the current standards are a concern for investors and have resulted in significant investor losses and/or hardship. There is also no evidence indicating that the thresholds, as established in 1982, were necessarily appropriate for that time, suggesting that potentially they were too restrictive to balance both capital formation and investor protection. While Dodd-Frank has mandated that the Commission review the definition, it would be a mistake to move forward on any changes to the financial thresholds without first determining if there is a problem or imminent concern with the current thresholds (beyond the mere argument that they have not been raised for inflation). Returning to review the original release in 1982[18] may help the Committee resolve this issue. For instance, in the 1982 release, the Commission noted that their original proposal for the "net worth" test was for $750,000, but that it was subsequently increased to $1,000,000 because some commentators "recommended excluding certain assets such as principal residences and automobiles from the computation of net worth. For simplicity, the Commission has determined that it is appropriate to increase the level to $1,000,000 without exclusions."[19] The fact that the Commission at that time had increased the amount by $250,000 to account for a primary residence should be considered in light of the fact that the 2011 amendments, as explained above, effectively increased the $1,000,000 threshold by excluding the primary residence, when in 1982 that was already accounted for. Moreover, the proposed rule in 1981[20] originally proposed an annual income standard of $100,000, in an effort to address "commentators [that] criticized the current definition of accredited investor as excluding many persons with financial experience and sophistication who invest sums of less than $100,000 who should nonetheless be included in the

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[15] U.S. GOV. ACCOUNTABILITY OFFICE, GAO-13-640 , SECURITIES & EXCHANGE COMMISSION: ALTERNATIVE CRITERIA FOR QUALIFYING AS AN ACCREDITED INVESTOR SHOULD BE CONSIDERED, 14 (July 2013).

[16] *Id.*

[17] Press Release, White House Office of the Press Secretary, President Announces New Jobs Initiatives for Rural America (August 16, 2011).

[18] Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 33-6389, 24 S.E.C. Docket 1166, (March 8, 1982).

[19] *Id.* at 9.

[20] Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, Securities Act Release No. 33-6339, 23 S.E.C. Docket 446, (August 7, 1981).

definition."[21] The proposed rule pointed out that these thresholds were added in response to "concerns consistent with similar types of exemptions followed under several state securities laws and [that were] developed in consultation with NASAA."[22] In sum, an analysis of the proposed rule and adopted rule indicate the "less than scientific process" that the SEC originally used in originally setting these financial thresholds. SBIA suggests the Committee conduct a deeper analysis of the proposed costs and benefits of adopting any adjustment to the financial thresholds, given the fact that the 1982 thresholds were not based on any significant analysis to establish an optimal level, and in particular the fact that the ways in which private placements are utilized have radically changed since these rules were introduced.

III. SBIA Supports The Expansion of Alternative Options to Qualify As An Accredited Investor, In Addition To The Existing Financial Thresholds

The Committee has suggested, in Recommendation 2, that the Commission revise the definition to enable individuals to qualify as accredited investors based on their sophistication, in lieu of qualifying under the existing financial thresholds.[23] Suggested methods in which this could be accomplished would be through investors satisfying their compliance with a list of professional credentials (such as a CFA or CPA), investment experience, and/or a test of relevant financial knowledge. SBIA would support some of these efforts to expand the amount of accredited investors in an effort to democratize these offerings for those that do not meet the existing financial thresholds, with some reservations. However, SBIA would only support the expansion of these rules without increasing the financial thresholds, and only as an exception to the threshold, not as an additional requirement.

A. SBIA Supports The Expansion of Other "Sophistication" Measures, As Long As These Investors Are Not Required To Pay A "Toll" To Invest

SBIA supports the Committee's efforts to expand the accredited investor definition to include those potential investors who have adequate sophistication, but do not meet the current financial thresholds. While we support this effort, we believe that there may be certain implementation issues with this proposal. First, in regard to professional credentials, such as a CFA designation, we are concerned that these certifications (provided by private parties) may act as expensive gatekeepers that exact a "toll" on investors - requiring a particular expensive certification to invest. The CFA designation is an excellent designation, but it is commonly held by private equity fund managers and institutional investors into private equity funds – this does not broaden the ability for additional sophisticated investors to invest. If this is one of many options to qualify for "sophistication, we have less concern.

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[21] *Id.* at 10.
[22] *Id.*
[23] Committee Recommendations at 6-7.

We are more supportive of approaches suggested by members of Congress, or currently instituted in foreign jurisdictions. For instance, there is the approach taken in the United Kingdom, as highlighted by the Committee, which allows sophisticated investors to self-certify.[24] The U.K. statute recognizes "self-certified sophisticated investors" as those who indicate either that (1) they have been a member of an angel investor network for at least six months; (2) have made more than one investment in an unlisted company in the two years prior to certifying; (3) have worked in a professional capacity for two years prior to certification in the private equity sector, or in the provision of finance for small and medium enterprises; or, (4) are currently or have been in the 2 years prior to certification, a director of a company with annual turnover of at least £1 million.[25] Such an approach would allow investors to self-certify and has realistic sophistication suggestions without creating gatekeepers out of specific certification providers.

There are also currently two proposals circulating in the United States that the Committee should consider and SBIA supports. The first is a suggestion by a group of Congressional Representatives that was sent to Chair White on September 22, 2014.[26] The Congressional letter suggested adopting a definition of sophistication based on an individual's professional experience and knowledge, including individuals that meet the following criteria: (1) previous or current investors in an exempt offering under Regulation D; (2) an advanced degree in business or finance or a chartered financial analyst credential or similar designation; (3) work experience currently or formerly as a c-level executive at a company, which during the time of such employment, has sold shares or debt; or (4) successful passage of the broker dealer registration exam.[27] Another helpful suggestion was provided in H.R. 4570, introduced by Congressman Scott Garrett on May 6, 2014, which directs the SEC to revise a specified rule, regarding a Rule 506 offering of a private fund, to characterize as an accredited investor a "knowledgeable employee" of that private fund or the fund's investment adviser.[28] The Committee should closely review these potential options in establishing any sort of alternative method to establish sophistication, particularly the language in H.R. 4570.

In addition to the methods for certification, we also believe that specific investment experience element is also a helpful tool for establishing sophistication. For instance, if someone has experience working with private placements at a private fund or SBIC for a certain period of time, they would be very familiar with the terms and risks and rewards of such an offering.

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[24] *Id.* at 7; *see also* The Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, 2005 No. 1529, Part VI, Article 50A (Eng.): *available at:* http://www.legislation.gov.uk/uksi/2005/1529/article/50A/made.

[25] *See* Sample Statement for Self-Certified Sophisticated Investor, LESMOIR-GORDON, BOYLE & CO. LIMITED, *available at:* http://www.sophisticated-investor.co.uk/pdf/SelfCertified.pdf

[26] *See Letter to Chair White from Congressional Representatives: Jared Polis, Brad Schneider, Ron Kind, Derek Kilmer, John Delaney, David Scott, Cedric Richmond, Scott Peters, Juan Vargas, Bill Owens, Tony Cardenas, John Carney, Suzan DelBene, Mike Quigley and Gerry Connolly* on September 22, 2014. (Attached).

[27] *Id.*

[28] Private Placement Improvement Act of 2014, H.R. 4570, (113th Cong.) (2014) ("H.R. 4570")

Designating "knowledgeable employees" of private funds or investment advisers (as suggested in H.R. 4570), and allow them to invest in their employers' funds without having to qualify under the financial thresholds. SBIA encourages the Committee to look closely at this option.

Finally, as highlighted above, we are concerned that a test for sophistication could also raise the specter of creating unreasonable barriers for investors and establishing gatekeepers and "tolls" that investors would have to pay to invest, by having to establish their sophistication. If a regulatory agency could establish a balanced examination at little to no cost to potential investors, SBIA would support this as one of the other methods in which sophistication could be established, in addition to investment experience or professional background. SBIA would also welcome the opportunity to work with the Committee and the Commission in establishing other methods beyond financial thresholds in which sophistication could be established, so long as the current financial thresholds remain in place.

IV. The Committee Should Continue To Allow 3(c)(1) And 3(c)(7) Funds And Investment Companies, To Continue to Employ Their Existing Methods of Accredited Investor Verification

The Committee has highlighted their concerns in Recommendation 4 that issuers of private offerings have difficulty verifying accredited investor status and should be forced to utilize third party verification providers.[29] The Committee has indicated that such third party providers would likely include securities professionals, including brokers, investment advisers and attorneys.[30]

SBIA believes that because the Committee believes investment advisers and attorneys have sufficient knowledge and expertise to adequately verify accredited investor status, funds that qualify for the 3(c)(1) and 3(c)(7) exemptions under the Investment Company Act[31] should be exempted from requiring the use of a third party verification provider. Likewise, funds that are considered "investment companies" under the Investment Company Act of 1940, such as BDCs, should also be exempt from any new verification requirements. As SBIA's members primarily are 3(c)(1) and 3(c)(7) funds and BDCs, and most of these fund managers are investment advisers, they have adequate expertise to appropriately verify the accreditation status of the investors in their funds. Any changes to impose a third party verification process should exempt these types of entities.

V. SBIA Has Concerns With Aspects Of The Committee's Previous Recommendations On Form D And Regulation D Information Collection & Encourages The Commission To Consider The Impact On Small Funds

[29] Committee Recommendations at 9.
[30] *Id.*
[31] Investment Company Act, 15 U.S.C. § 80a-3(c)(1); 15 U.S.C. § 80a-3(c)(7).

The Committee has recommended to the Commission that it should adopt the Committee's earlier recommendations the Committee made regarding Regulation D information collection, and in particular Form D filing requirements. SBIA commented extensively on these issues in response to the SEC's proposed rulemaking (SEC File No. S-7-06-13) on Regulation D, Rule 156 and Form D.[32] Of particular concern, and highlighted in our letter, is that smaller funds such as SBIA's members may be significantly impacted by additional Form D reporting requirements. Any increase in the amount of reporting obligations and information collection on Form D, including continuing updates, would require these small funds to hire more staff and incur disproportionately higher legal and compliance costs, all for limited benefit to investors. Moreover, as we also highlighted in our letter,[33] SBIA is under the impression that investors, at least in Rule 506(b) offerings, do not rely on information contained in Form D filings. Instead, these investors rely upon the private placement memorandum of the issuer, and questions asked of the issuer. Therefore, any additional information collection would not benefit investors, and result in extra costs and burdens on funds. The SEC should consider these concerns, along with our more lengthy comments in our previous letter, before reviewing the Committee's recommendations.

SBIA appreciates this opportunity to share our thoughts on the Committee Recommendations and stands willing to discuss our comments and any other ways in which the SEC can encourage capital formation and job creation in small, mid-size, and emerging businesses, while preserving sufficient investor protections.

Sincerely,

Brett Palmer
President
Small Business Investor Alliance

[32] *See* SBIA Comment Letter, Proposed Amendments to Regulation D, Form D and Rule 156 Under the Securities Act Offerings, Securities Act File No. S-7-06-13, (Sept 23, 2013).
[33] *Id.* at 5.