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Brent J. Fields, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Report on the Review of the Definition of "Accredited Investors"

Dear Sir:

I am writing to provide my personal comments to the Securities and Exchange Commission staff report titled *Report on the Review of the Definition of "Accredited Investor"* dated December 18, 2015 (the "Staff Report"). The Staff Report I found to be most useful if it was read in conjunction with the statistical analysis by SEC staffers Scott Bauguess, Rachita Gullapalli and Vladimir Ivanov of the Commission's Division of Economic and Risk Analysis, *Capital Raising in the U.S.: An Analysis of the Markets for Unregistered Securities Offerings, 2009-2014,* dated October 2015 (the "Statistical Analysis"). Therefore, my comments assume many of the facts found in the Statistical Analysis.

By way of background, I have practiced in law firms in the Dallas-Fort Worth area since 1977. I do not know the total value of the private placements on which I have advised, but the total is in excess of $1 billion. In 1996, I started my own law firm. Much of this firm's practice focused on small businesses, but not exclusively. Regulation D, Rule, 506 is a staple of my clients' capital-raising.

Important Considerations

As noted in the Statistical Analysis, non-financial issuers (*i.e.,* excluding pooled investment funds) that filed Forms D were $133 billion. Compared to the other exemptions from registration under the Securities Act of 1933, Regulation D, specifically Rule 506, is a tremendous success.[1] Based on published information I have seen, operating companies in the category that primarily used Regulation D comprise over one-half of all private sector employment. Therefore, any changes to the definition of "accredited investor" need to preserve the user-friendly attributes of Rule 506.

[1] All references to Rules are the rules within Regulation D, unless otherwise indicated.

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Second, the exemption under Rule 506 for an offering made only to accredited investors achieves two results that issuers consider important. The exemption from the registration requirements of the state securities laws afforded by Section 18(b)(4)(F) of the Securities Act of 1933 is the first benefit. The other and perhaps even more important is the ability to draft or prepare disclosures based on materiality, rather than the formal requirements outlined in Rule 502(b)(i).[2]

Complexity and extra requirements increase the costs and preparation time for offerings. Among small businesses, the effects of these are all negative. They range from preventing offerings to partial or zero compliance with the securities laws. All are bad and, and half-hearted compliance and no compliance serve to defeat the protections afforded by the securities laws.[3] [4] I believe that the current sentiment among the Members of Congress and the President is to reduce the barriers to capital-raising by small businesses, thereby facilitating economic growth and employment.

Specific Comments

With respect to specific proposals in the Staff Report. I have the following comments.

<u>Rule 501(a)(3) Replacing "Assets" With "Investments"</u>. In several parts, the Staff Report discussed changing the accredited investor requirement for business entities from $5 million in *assets* to $5 million in *investments*. This change would be ill-advised, and would exclude many prospective investors, particularly outside of large urban areas where the financial support of local companies is crucial to the local economy. Let me illustrate with a hypothetical.

> *<u>Hypothetical 1.</u> Juanita is the controlling owner of Flyover Zone Widget Co. based in a small community. Flyover is very successful and has over $100 million of assets. While Flyover maintains an ample amount of cash in its bank accounts, it holds no investments. In fact, Flyover can obtain a far better return by reinvesting profits in the company than it can on Wall St.*
>
> *Mary would like to start a small business. She is an expert on the proposed business, but she needs $250,000. The only source Mary knows for that amount of investment is the company run by her friend Juanita. In addition to Flyover's money, Mary would like to call on Juanita's business acumen. Mary*

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[2] Do not assume that reliance on materiality as the standard means lessened disclosure. In some cases, the quantity of disclosure is in fact greater.

[3] My experience is that non-compliance with the securities laws is more common than one would think. In certain geographic areas, business people are less acquainted with the securities laws and their requirements. Other persons and even industry groups are scofflaws. In my locale, I have noted a belief among real estate executives that securities law compliance is not needed for small real estate investments owned by limited partnerships and the risk of any adverse consequences is very remote.

[4] Also, compliance costs among small private placements are not readily scalable. Therefore, offering expenses in offerings of $1.0 million or less can be problematic.

> *believes that, if Flyover had a financial stake, Juanita would be an excellent mentor for the new company.*
>
> *Juanita and Mary strike a deal for Flyover to invest $250,000, and Mary's lawyer says the best option would be to do the deal under Rule 506(b) if Flyover is an accredited investor.*[5]

If the proposed change of "assets" to "investments" in Rule 501(a)(c) were made, Flyover would not be an accredited investor unless all of its owners are accredited investors. [6]

Rule 501(a)(8). Rule 501(a)(8) provides accredited investor status to entities that are entirely owned by accredited investors. Over the years, I have seen this feature to be useful in private placements.

In recent years, however, I have been confronted with more entities, either existing or newly formed, that are controlled by accredited investors but have non-accredited investors. The first of these involve entities in which successful individuals are seeking to allow children and grandchildren to participate in private placements. Family partnerships and other similar entities are examples. The children and grandchildren often fail to meet accredited investor status.

In other cases, companies will allow employees to participate in the equity of newly formed entities created to invest in private placements. The employee interests could involve contributed capital or might be carried (profits) interests.

I believe that the accredited investor standard in Rule 501(a)(8) should be expanded to include existing or newly formed entities in which (a) the investment decisions are made exclusively by accredited investors and (b) accredited investors have provided a supermajority of the capital to be invested (*e.g.*, 75-80%).

In addition, entities that are taxed as partnerships under Subchapter K of the Internal Revenue Code of 1986 should be able to grant profits or carried interests to non-accredited investors without those interests preventing the entity from qualifying as an accredited investor under Rule 501(a)(8). [7] As seen in Hypothetical 3, these interests usually require no capital contribution by the recipients.

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[5] For the sake of simplifying the hypothetical, I have ignored other exemptions that likely would apply to these facts.

[6] Rule 501(a)(8).

[7] Despite the bad publicity given carried or profits interests in investment funds, in Hypothetical 3 below those same interests are an effective tool to give junior employees an opportunity to participate in investment profits. I believe that here these interests are consistent with the Congressional policy of encouraging employee ownership in the companies for which they work. Legislative examples of this goal are the laws providing for employee stock ownership plans (ESOPs) and incentive stock ownership options (ISOs).

Here are two hypothetical situations.

Hypothetical 2. Parents are both accredited investors and have formed a limited partnership, and the parents, through the general partner entity control all investment decisions. Two children each have 35% capital interests, with Parents having the remaining 30% capital interests. Because the Parents gave the capital to the children for their capital interests (or gave the partnership interests to the children), the limited partnership is an accredited investor. This is because over 75-80% of the capital came from accredited investors, and accredited investors control the investment decisions.

Hypothetical 3. Acme Energy Co. forms an investment limited liability company (Mgmt. Oil & Gas LLC) that is taxed as a partnership. Mgmt. O&G invests in oil and gas interests and oilfield ventures occasionally offered to Acme that, although attractive, do not meet Acme's operational criteria.[8] *Through the limited liability company agreement, all investment decisions are controlled by Acme's CEO and CFO, both accredited investors. The CEO and CFO have Class A interests that they contributed capital to purchase. They have contributed 95% of the capital and are initially allocated the same percent of profits. Jane, a key employee who has just gone through a financially disastrous divorce, is not an accredited investor. However, she invests 5% of Mgmt. O&G's initial capital and receives 5% of the Class A interests in Mgmt. O&G.*

In addition, the CEO and CFO cause Mgmt. O&G to grant to Jane and other employees Class B interests that never require any capital contributions and participate in 35% of all profits after the Class A interests have been allocated an amount equal to their initial capital contributions plus X%.

The Class B Units require no capital contributions and do not participate in profits until a future contingency is achieved. Therefore, they should be excluded from the ownership in the accredited investors test. Because Jane's Class A interest is only 5%, Acme O&G is an accredited investor.

Subjective Standards. The Staff Report in several places suggests adopting standards that demonstrate financial sophistication.[9] I have been practicing long enough to have advised on Rule 146 (which in 1982 Regulation D superseded), and I can assure you that the objective standards for accredited investor are superior to subjective standards such as those in Rule 146. First, issuers and placement agents will always pressure their counsel to find that a prospective investor is sophisticated. This pressure is directly proportional to the amount the prospective investor desires to invest. Under Rule 146, I remember two financially successful business owners, each with high school diplomas, who wished to invest in an oil and gas tax shelter. The prospective investors had no experience with the energy business, however I as counsel was

[8] Some of these investments may not be "securities". See, T. Hazen, *Treatise on the Law of Securities Regulation,* (6th ed. 2009) § 1.6[17].

[9] See for example of this discussion see Section IV.D and V.B of the Staff Report.

pressured to conclude (and later give a legal opinion) that these gentlemen possessed the requisite sophistication.[10]

Also, telling an investor that he or she lacks the requisite sophistication can be offensive to the prospective investor.

Finally, use of subjective standards invites litigation. Despite the best of intents and the most comprehensive disclosures, some deals go bad. I can foresee investors, who at the time of the offering profess to be the reincarnation of both Benjamin Graham and David Dodd, then later swear in court that they really are widows or orphans because the deal has gone badly.

In my practice, limiting offerings only to investors who are accredited investors has been an effective risk-management tool for issuers, their controlling persons and the professionals involved. Accredited investors are not only more likely to be sophisticated but also to appreciate the risks of privately placed investments. Interjecting subjective, non-economic standards lessens this protection. Accredited investors should be capable of the loss of their investments, regardless of their sophistication.

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Thank you for considering my comments.

Sincerely yours,

Patrick A. Reardon

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[10] For some reason that I have long forgotten, these individuals did not use an "offeree representative" to provide the needed sophistication.