



NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

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May 25, 2016

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

RE: File 4-692; SEC's "Report on the Review of the Definition of 'Accredited Investor'" prepared by the staff of the U.S. Securities and Exchange Commission (December 18, 2015).

Dear Mr. Fields,

The North American Securities Administrators Association, Inc. ("NASAA")¹ submits the following comments in response to the *Report on the Review of the Definition of "Accredited Investor"* ("Report")² prepared by the staff of the U.S. Securities and Exchange Commission ("SEC" or "Commission"). We applaud the work of the SEC staff in preparing the extensive Report and appreciate the opportunity to comment on the Report's recommendations. While we support certain recommendations in the Report, we are concerned that other recommendations could harm investors. Preserving the current pool of accredited investors should not be the primary factor the Commission considers in implementing changes to the definition. While an adequate population of accredited investors is important for capital formation, the primary goal of the Commission's rulemaking should be to ensure that anyone deemed an accredited investor is financially sophisticated and has the ability to sustain the risks of loss associated with investing in private placement offerings.

¹The oldest international organization devoted to investor protection, NASAA was organized in 1919. NASAA's membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico, and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

² *Report on the Review of the Definition of "Accredited Investor"* (December 18, 2015), available at <https://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf>.

I. The Important Role of State Securities Regulators in Capital Formation.

State securities regulators have a direct interest in modernizing the accredited investor definition. This interest stems from the work of state securities regulators supporting responsible capital formation, policing Regulation D (including Rule 506 offerings) through the states' anti-fraud authority, and the proximity of state regulators to members of the investing public.

State securities regulators routinely interact directly with small businesses seeking to use state and federal securities registration exemptions to raise investment capital. State regulators appreciate that successful securities offerings benefit local businesses and investors, and potentially convey broader economic benefits to their states and regions. At the same time, state regulators know from experience that many individuals who qualify as accredited investors under the Commission's current income or net worth standards lack the wealth or financial sophistication envisioned by the Commission when it first promulgated the accredited investor definition.

Regulation D, Rule 506 offerings are consistently among the most reported products or schemes investigated by state securities regulators.³ While state registration of Regulation D, Rule 506 securities is limited under Section 18 of the Securities Act of 1933, state regulators consistently and effectively exercise their anti-fraud authority against Rule 506 schemes. Through expending these resources and policing this marketplace, states in effect serve as the primary overseers of Rule 506 offerings. Notwithstanding this central role in protecting the investing public against fraud in the Rule 506 marketplace, state regulators have no authority to amend Rule 506 or the accredited investor definition. Therefore, NASAA is very interested in any revisions the SEC may be contemplating in this area, as federal regulatory developments will directly impact state enforcement programs.

The intent of the accredited investor definition is to provide a meaningful carve-out from the protections afforded through the securities registration process for offerings made to investors with the financial means and sophistication to evaluate for themselves the risks in the offering. This must remain the overriding goal of the Commission as it considers updating the accredited investor definition. Ultimately, the challenge for the SEC in defining the term accredited investor is to achieve an optimal balance between investor protection and the ability to raise capital outside the sunlight provided in the registration process. NASAA urges the Commission not to compromise the investor protection goals of the accredited investor definition for fear of criticism that may come as a result of shrinking the current pool of accredited investors.

³ See *NASAA Enforcement Report: 2015 Report on 2014 Data*, NASAA Enforcement Section (September 2015) available at http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/08/2015-Enforcement-Report-on-2014-Data_FINAL.pdf; *NASAA Enforcement Report: 2014 Report on 2013 Data*, NASAA Enforcement Section (October 2014) available at http://www.nasaa.org/wp-content/uploads/2011/08/2014-Enforcement-Report-on-2013-Data_110414.pdf.

II. Amendments to the Accredited Investor Definition Should Prioritize Accounting for Inflation and Enhancing Investor Protections.

Any proposed changes to the accredited investor definition must account for the severe impact inflation has had in eroding the protective nature of the financial thresholds which currently stand at meeting either a \$200,000 individual (\$300,000 joint) income test or a \$1 million net worth test. In addition, consideration of non-financial measures must truly reflect the financial sophistication that is imputed to accredited investors, and be considered in combination with measures that account for financial thresholds. This combination will ensure the available pool of accredited investors possess the requisite financial knowledge and wherewithal to invest in private placements.

a. Revisions to the Accredited Investor Definition Must Account for the Effect of Inflation

Inflation has significantly eroded the real income and net worth thresholds included in the accredited investor definition in 1982.⁴ As a result, there has been a dramatic increase in the percentage of U.S. households that qualify as accredited investors.⁵ We strongly support the staff's recommendation to index the income and net worth thresholds to inflation on a going-forward basis every four years.

While we support an inflation adjustment to the current financial thresholds to account for the effect of inflation since the inception of the definition, we are mindful of the dramatic effect such a change would have on the total number of investors who would qualify as accredited investors. However, preserving the total pool of persons that currently qualify as accredited investors should not be the primary factor the Commission considers in implementing changes to the accredited investor definition. Maintaining an adequate pool of investors is important to capital formation in the private marketplace and the businesses that use Rule 506. However, a pool consisting of a large number of investors lacking in sophistication or adequate financial resources serves no legitimate capital raising or investor protection purpose. To the contrary, a pool consisting of investors lacking true sophistication may further incentivize violative conduct by promoters of private offerings.

We generally support the staff's recommendation to keep the current financial thresholds in place subject to an investment limitation.⁶ In the absence of an investment limitation, the financial thresholds must be adjusted to fully account for the impact of inflation since 1982. Furthermore, the financial thresholds for both tiers of accredited investors must be indexed to inflation on a going-forward basis in order for the limitation to have any true meaning.

⁴ See 47 FR 11262, Mar. 16, 1982, as amended at 53 FR 7868, Mar. 10, 1988; 54 FR 11372, Mar. 20, 1989.

⁵ According to the Accredited Investor Report, "[t]he 1.51 million households qualifying as accredited investors in 1983 represented approximately 1.8% of U.S. households, while the 12.38 million qualifying in 2013 represented approximately 10.1% of U.S. households." See *Report* p.48.

⁶ We believe an investment limitation would also be appropriate for the 35 "other purchasers" eligible to invest in a Regulation D Rule 506(b) offering.

b. Revising the Accredited Investor Definition for Entities Must Include a Look-Through Provision

We support the staff's recommendation to expand the definition to encompass all entities as long as there is a "look-through" provision to ensure the purpose of an entity's formation is not solely for investment activities to evade the accredited investor minimum standards. Absent this specification, we are concerned that individuals who otherwise do not qualify as accredited investors will have the ability to pool their assets in order to reach accredited investor status for the purpose of investing in private placements.

We also support replacing the \$5 million assets test with a \$5 million investments test.⁷ NASAA has long supported an investments test as an additional prerequisite to accredited investor status.⁸ An investments test is a better gauge of financial sophistication than simply analyzing net worth or income. Although we would like to see an investments test implemented for natural persons as well, we are pleased to see such a test contemplated for entities.

c. Individuals with Certain Professional Credentials Could be Allowed to Qualify as Accredited Investors, Though the SEC Should Proceed with Caution with All Non-Financial Alternatives to Evaluating Accredited Investor Status.

We applaud the staff's outside-the-box thinking in proposing non-financial alternatives to ascertaining sophistication and, ultimately, accredited investor status. However, we believe several of these alternatives are unworkable and accordingly we do not support their implementation. We agree that allowing professionals who hold certain professional credentials (specifically the Series 7, Series 65, or Series 66,) to qualify as an accredited investor could provide an "objective indication of sophistication," provided that bestowing accredited investor status upon a licensed individual also includes a requisite minimum amount of professional experience. Any use of non-financial measures should include measures of financial sophistication and the ability to withstand risk. Certain methods of "non-financial" qualification may prove effective in measuring an investor's sophistication – specifically, knowledge and experience regarding investments and the ability to evaluate risks and merits – although such methods may not adequately demonstrate such investor's ability to withstand the economic risk of private placement offerings, including the economic risk of loss of investment.

i. Qualification as an Accredited Investor Through Examinations Should Include a Professional Experience Component and Reliance on an Existing Test.

Qualification as an accredited investor absent any sort of experiential requirement does not objectively satisfy the sophistication requirement. The Commission should require a

⁷ We support utilizing the definition of "investments" found in Rule 2a51-1(b) under the Investments Company Act of 1940.

⁸ See Comment Letter from David S. Massey, NASAA President and Deputy Securities Commissioner, North Carolina Department of the Secretary of State, to Ms. Elizabeth M. Murphy, Secretary, SEC (March 10, 2011) (in response to Release Nos. 33-9177; IA-3144: IC-29572; File No. S7-04-11), available at http://www.nasaa.org/wp-content/uploads/2011/07/8-Accredited_Investor031011.pdf.

minimum of five years of experience in the field corresponding to the professional designation or credential to ensure an individual has obtained sufficient industry experience to demonstrate financial sophistication. Allowing an avenue to accredited investor status absent experience paves the way for people who are merely successful test takers to qualify as accredited investors. Furthermore, passing a test does not equate to product knowledge, as shown by the innumerable suitability cases brought by states and FINRA against registered brokers.⁹

In addition, NASAA strongly recommends that if the Commission decides to recognize passage of an examination as evidence of financial sophistication for purposes of investing in private offerings, it should limit the type of exam that would convey such status. At a minimum, such tests should be those that measure bona-fide financial industry knowledge, such as the Series 7, 65, 66, and CFP or CFA exams. We do not support allowing individuals to achieve accredited investor status solely by earning a juris doctorate or passing a state bar exam.

Although we support a revised pathway to accredited investor status through passing an existing licensing exam accompanied by relevant experience, we do not support the creation of a new exam with the sole purpose of bestowing accredited investor status upon an individual. We believe an accredited investor exam presents tremendous workability concerns in its creation and implementation. We also believe that such an exam standing alone would inevitably fail to properly account for financial industry experience and investment experience. We are also concerned that providing a pathway to accredited investor status based solely on obtaining certain professional credentials (such as a *juris doctorate*) perpetuates the fallacy that certain licensed professionals should be presumed not to require the protections afforded by securities registration.

- ii. Additional Staff Suggestions for Accredited Investor Status Based on Experience in Exempt Offerings or other Private Funds Experience are Unworkable.

Accredited investor status should not be based on an individual's prior experience investing in exempt offerings. As a preliminary matter, such individuals will likely already qualify as accredited investors, having invested previously in exempt offerings. Regardless, it would be difficult to objectively assess that an individual's experience investing in an exempt offering has given rise to financial sophistication. Given the variety of registration exemptions and the multitude of platforms that host private placements, it would be unworkable for regulators (or offerors) to verify whether individuals had indeed invested in all the claimed prior placements.

We also have concerns about accredited investor status conveyed to "knowledgeable employees" of private funds solely for the purpose of investing in their employer's funds. Such an approach could raise suitability issues, may be difficult to verify, and ultimately has a negligible impact in improving capital formation efforts.

⁹ See, e.g., *In re Primesolutions Secs., Inc.*, File No. 1300447 (IL Sec. State, Feb. 10, 2016) (suitability regarding private placements); *In re Kenneth Edward Volkerding*, Case No. AP-16-03 (MO Sec. State, March 30, 2016) (annuity suitability); *Genovesi v Ball*, FINRA Case No. 15-00981 (Feb. 25, 2016) (Anciello, Marsan, Berman, Arb.); *Booth v Crown Capital Securities, L.P.*, FINRA Case No. 14-00614 (Dec. 22, 2015) (Getzels, Taylor, Jr., Seff, Arb.).

III. NASAA Encourages the SEC to Update Regulation D, Rule 506 to Include Both Pre-Filing Requirements and a Closing Amendment.

NASAA encourages the SEC to take steps to update the Regulation D, Rule 506 regulatory framework. Improving the Regulation D, Rule 506 framework through enhanced filing requirements would also allow for better investor protection and increased information to the SEC and state securities regulators. Enhanced filing requirements should include pre-filing and closing amendment requirements, as described below.

a. Form D Pre-Filing Requirement

NASAA continues to support requiring a pre-filing of Form D for Rule 506(c) offerings.¹⁰ A pre-filing of Form D prior to sale would also be beneficial for Rule 506(b) offerings. The information contained in Form D is crucial to state securities regulators who regularly encourage investors to “inform yourself before you invest.” When investors contact their local state regulators (particularly after hearing about the offering through an advertisement or solicitation), states must be able to point to timely, relevant information. A Form D notifies the state that the issuer is conducting the offering and anticipates relying on an exemption from registration. The information on Form D is often the only data readily available about the issuer (*e.g.*, business address, officers, directors, business type) to provide to an investor, and it allows state regulators to look for “red flags” indicative of a potentially fraudulent offering. Currently, the information on Form D is generally filed with states only within 15 days after the first securities sale – if at all.

b. Post-Offering Closing Amendment with Sales Data

A post-offering closing amendment with sales data would provide an important source of information about private offerings for both the SEC and state securities regulators. A Form D closing amendment would allow regulators to better understand the relative success of a Rule 506 offering and who is investing in specific offerings.¹¹ This would in turn provide the Commission with important information regarding potential future enhancements to the accredited investor definition, a process which will have to be repeated, and to the use of Regulation D generally. The marketplace for Rule 506 offerings is far too large, and the accredited investor designation far too important, not to have access to such data.

NASAA has on multiple occasions encouraged the Commission to require the filing of a closing amendment to Form D upon completion of an offering.¹² The filing of a closing

¹⁰ See Comment Letter from William Beatty, NASAA President Elect and Washington Securities Director, to Chairman Hensarling & Ranking Member Waters, House Committee on Financial Services (May 6, 2014), available at <http://www.nasaa.org/wp-content/uploads/2013/10/NASAA-JOBS-2-0-Markup-Letter-Final-Draft.pdf>.

¹¹ The SEC staff noted a lack of information pertaining to the actual number of accredited investors who invest in an offering since an amended Form D is not required post-offering. See *Report* at 108.

¹² *E.g.*, Comment Letter from A. Heath Abshire, NASAA President, to Ms. Elizabeth M. Murphy, Secretary, SEC (September 27, 2013), available at <http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Comment-Letter-re-Form-D.pdf>.

amendment will facilitate improved tracking of the uses of the Rule 506 exemption. The filing of such an amendment would require little effort on the part of issuers, as they could easily file the amendment with the SEC through EDGAR and with 45 states/jurisdictions through NASAA's Electronic Filing Depository ("EFD") system.¹³ As outlined below, the benefits would be vast, especially considering the seamlessness of the EDGAR and EFD systems.

c. Proposed Penalties for Failure to Meet Filing Requirements

Pre-filing requirements and post-closing amendments must be mandatory. Issuers must have an incentive to meet these requirements, however, outright loss of the exemption could be too burdensome. Rather, NASAA believes that a one-year ban on the use of the Rule 506 exemption would be an appropriate penalty for an issuer's failure to meet these filing requirements.¹⁴

Ultimately, the value of the high-quality information uncovered with mandatory pre-filing requirements and closing amendments outweighs any incremental burden issuers may face. The data provided will allow the SEC to make thoughtful recommendations leading to meaningful enhancements of the exemptions which will only drive economic growth; furthermore, the pre-filing requirement will result in significant additional investor protections.

Conclusion

The contours of the accredited investor definition remain a core concern for state securities regulators as they continue to combat fraud within private offerings.¹⁵ We do not want to see any of their residents fall prey to fraud simply because they meet an outdated and insufficient net worth or income test. The success of the private placement marketplace, as well as the accredited investor carve-out, depends upon an informed and nuanced understanding of the marketplace by accredited investors. Enhancing the financial thresholds of the accredited investor definition to account for inflation in addition to ensuring accredited investors attain the necessary level of financial sophistication is a strong step in the right direction towards providing greater protection to investors while ultimately driving meaningful economic growth.

Finally, we would like to re-emphasize the importance of imposing both Form D pre-filing requirements and post-offering closing amendments. The wealth of information derived from such requirements will provide guidance to the Commission in developing worthwhile enhancements to the accredited investor definition, as well as the Regulation D, Rule 506 exemption generally.

¹³ EFD is an internet accessible database that allows issuers to submit Form D for Regulation D, Rule 506 offerings and pay related fees to state securities regulators. EFD also allows the public to search Form D filings free of charge. In calendar year 2015, the system processed just over 33,958 notice filings (including Form Ds filed in multiple states, as well as amendments and renewals). This total number of notice filings includes just over 28,342 new notice filings, almost 3,754 renewal notices and approximately 2,420 amendments.

¹⁴ See Comment Letter from Heath Abshire (September 27, 2013) *Id.*

¹⁵ In addition to Rule 506, accredited investors receive special consideration in Regulation A – Tier 2 offerings, as well as on the secondary market under Regulation Crowdfunding (where accredited investors are not limited in the amount of securities they may purchase in the secondary market after an initial offering, *see* 17 CFR § 227.501(a)(2)).

Mr. Fields
May 25, 2016
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If you would like further clarification, please contact me or NASAA's General Counsel,
A. Valerie Mirko, at [REDACTED]

Sincerely,

A handwritten signature in blue ink that reads "Judith M. Shaw". The signature is enclosed in a thin black rectangular border.

Judith Shaw
NASAA President
Maine Securities Commissioner