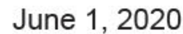

June 1, 2020

Via email (rule-comments@sec.gov)

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Attention: Vanessa Countryman, Secretary

Re: Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets (File Number S7-05-20)

Dear Ms. Countryman:

eShares, Inc. d/b/a Carta, Inc. ("Carta") appreciates the opportunity to comment on the Securities and Exchange Commission's (the "SEC" or "Commission") Proposed Rule on Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets (the "Proposal").

Introduction

Carta was founded in 2012 to develop software to digitize paper stock certificates and manage capitalization tables for private companies. Carta recognized that private equity, including venture capital, was suffering from a paper crisis that rivaled the "Back Room Crisis" that crippled public equities markets in the late 1960's and early 1970's.[1] Rather than solving this crisis through centralization and share *immobilization* as was done in public equities, Carta developed a centralized registry of private asset ownership that simplified share *mobilization* through modern technology.

Since then, Carta has evolved into a multi-faceted financial technology company that helps issuers, investors, and employees manage and value equity ownership. Today, Carta has over 800 employees across 9 offices in the US and abroad. Together we support over 900,000 security holders at more than 14,000 companies who manage over $800 billion in equity value across Carta's platform. We provide portfolio management and reporting tools for thousands of investors and employees, and provide valuation and fund administration services to hundreds of venture capital firms. This is just the beginning, as Carta continues to drive forward to fulfill our mission to create more owners, reduce income inequality, and pull more wage-earners out of the debt stack and into the equity stack.

[1] See *Revolution on Wall Street: the Rise and Decline of the New York Stock Exchange*, Ch. 7, Marshall E. Blume, Jeremy J. Siegel & Dan Rottenberg (1993).

Carta supports the Commission's Proposal and appreciates its work to improve the regulatory framework that governs capital formation in exempt offerings.

This trend has been documented extensively, but the data bears repeating: According to the SEC, in 2014, registered offerings totaled $1.35 trillion in new capital, while private offerings totaled $2.1 trillion.[2] By 2018, registered offerings totaled $1.4 trillion compared to approximately $2.9 trillion raised through exempt offerings.[3] And in 2019, although both channels declined from the prior year, registered offerings accounted for $1.2 trillion (30.8 percent) of new capital, compared to approximately $2.7 trillion (69.2 percent) raised in the exempt offerings.[4] Given the growing concentration in the private offering space, we appreciate the SEC's work to review what is working, what is not, and how to improve the regulatory framework.

Our response will (i) share our foundational perspective with respect to capital formation to help provide context, (ii) discuss the impact of a liquid secondary market on capital formation; and (iii) provide feedback on certain aspects of the Proposal.

Foundational Perspective

To anchor our response, Carta started with core principles that guide our thinking, specifically our desire to create more owners, enhance liquidity, and create a securities marketplace that functions as a spectrum.

Carta's mission is to create more owners. We believe equity ownership is a critical component in driving economic opportunity and narrowing the wealth gap. We strive to incentivize and make it easier for employers to issue equity to employees. This aligns incentives across the enterprise and enables employees to benefit from the upside they helped create. Ownership, however, does not stop at the employee: we want more investors to be able to own equity in diverse asset classes, including the private market, and we support policies that expand that opportunity.

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[2] Scott Bauguess, Rachita Gullapalli, and Vladimir Ivanov, "*Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009–2014*," Securities and Exchange Commission, October 2015, https://www.sec.gov/dera/staff-papers/white-papers/30oct15_white_unregistered_offering.html

[3] *Concept Release on Harmonization of Securities Offering Exemptions. pp. 78. Securities Exchange Act Release No. 33-10649 (June 18, 2019), 84 FR 30460 (June 26, 2019) (the "Concept Release"). https://www.sec.gov/rules/concept/2019/33-10649.pdf*

[4] *Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets*, Securities and Exchange Commission: File Number S7-05-20. pp. 8 https://www.sec.gov/rules/proposed/2020/33-10763.pdf

Liquidity is essential to realize the benefits of ownership. Owning an asset that cannot transact, or does so only rarely, erodes its value. Building a framework that facilitates sufficient liquidity will make primary offerings more attractive to investors. This lowers the cost of capital for an issuer and ultimately helps owners -- whether they are employees who helped build the enterprise or early-stage investors -- actualize the value of their hard work or investment.

The securities market should operate as a continuum, not a binary construct where a large chasm separates the private and public markets. Instead, we recommend policymakers craft a regulatory framework that enables issuers to raise capital from their earliest stages to their most mature state, with tailored and appropriate disclosure regimes, compliance requirements, and investor access at each phase. A continuum empowers an issuer to select the right offering vehicle versus fit into a category that may not be appropriate for its needs.

We will elaborate further on these principles as we respond to the Proposal.

Secondary Markets

Streamlining primary offerings should be done in tandem with creating a more robust and liquid secondary marketplace for those offerings. As the Commission noted in its earlier *Concept Release on Harmonization of Securities Offering Exemptions*, "secondary market liquidity is a key concern of investors and may have a significant impact on an issuer's choices with respect to capital raising . . . an investor's willingness to participate in an exempt offering and the price he or she would be willing to pay may depend on the investor's assessment of whether, when, and on what terms the security can be resold."[5] Carta agrees with the Commision and believes that a lack of secondary market liquidity in private markets affects primary offering capital formation.

Secondary market liquidity, or lack thereof, affects an issuer's cost of capital. Businesses "trying to attract capital often struggle because potential backers are reluctant to invest unless they are confident there will be an exit opportunity."[6] Without secondary market liquidity, issuers will pay higher premiums or be unable to attract capital. In this situation, investors apply meaningful illiquidity discounts to private market investments that increase the cost of capital for private issuers. The illiquidity discount ranges, but some experts project that it can reduce the value of an asset by the expected cost of trading that asset over its lifetime; those experts estimate these discounts can range between 20% and 30% of market value.[7] Creating a more liquid

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[5] *Concept Release on Harmonization of Securities Offering Exemptions. pp. 14. Securities Exchange Act Release No. 33-10649 (June 18, 2019), 84 FR 30460 (June 26, 2019) (the "Concept Release"). https://www.sec.gov/rules/concept/2019/33-10649.pdf*

[6] Letter from SEC Advisory Committee on Small and Emerging Companies (May 2017) pp.1 https://www.sec.gov/info/smallbus/acsec/acsec-recommendation-051517-secondary-liquidity-recommendation.pdf

[7] See Aswath Damodaran, *The Cost of Illiquidity*, at 13, 27, available at http://people.stern.nyu.edu/adamodar/pdfiles/country/illiquidity.pdf

market for private securities that could reduce the illiquidity discount applied to private market investments by even 50 percent would have unlocked an additional $270 to $405 million in available investment, based on 2019 numbers when $2.7 trillion was raised in exempt offerings.

Further, an illiquid secondary market not only increases the cost of capital for the issuer, but also impairs the investor's ability to sell the security when he or she would like to realize a gain, exit a position, and reallocate capital to additional investments. This has knock-on economic effects. Illiquid and liquid value are not perfect substitutes. Research shows that investors measure consumption relative to liquid wealth, given its ability to meet day-to-day needs.[8] As an investor's illiquid holdings increase in proportion to total wealth, consumption decreases, diminishing broader economic activity. Second, the same research indicates that "...illiquidity leads to a large reduction in the allocation to both illiquid and liquid assets..."[9] Essentially, as a larger percentage of one's wealth is illiquid, he or she is more risk-averse. This leads to decreasing capital allocation across asset classes. Lastly, as a private market security increases in value, owners may seek to realize the gains and allocate that capital to additional growth opportunities. Illiquid assets hinder that from occurring.

This moves into another key consideration: investor protection. Carta believes liquidity is a critical component of investor protection. An illiquid secondary market for private securities limits an investor's ability to liquidate holdings at a time of his or her choosing. For employees who may have become shareholders by virtue of employment, increased liquidity in the secondary market helps them meet financial needs and provide for their households. It also allows them to build portfolios with diverse holdings that mitigate risk. This is, of course, true of investors as well who seek to invest in this growing asset class of private market offerings. Such investors should be able to invest and exit a position when they deem appropriate. We recognize that the foundational tenets of the exempt offering framework partially stem from the idea that some investors are "able to fend for themselves" and therefore don't need the protections afforded by registration.[10] However, we believe that consistent with the Commission's core mission of investor protection, all investors should be afforded a fair, efficient, and orderly secondary market in which to liquidate positions.

<u>Recommendations for Consideration</u>

We strongly support the Commission's proposed adjustment. We would, however, like to offer some additional recommendations that in our view would strengthen the Proposal, specifically

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[8] See Andrew Ang, Dimitris Papanikolaou, Mark Westerfield. "Portfolio Choice with Illiquid Assets" Working Paper 19436, pp. 16. National Bureau of Economic Research https://www.nber.org/papers/w19436.pdf

[9] *Id*. at 29. Note, models are relative to the Merton benchmark where trading opportunities arise continuously and a standard calibration indicated that if the expected time between liquidity events is once a year, the investor should cut her investment in the illiquid asset by 33% relative to an otherwise identifiable but dully liquid asset.

[10] See *SEC v. Ralston Purina*, 346 U.S. 119 (1953).

with respect to changes related to offering limits and parameters, investor access, and the interaction between federal and state securities laws.

Offering Limits and Parameters

Carta supports the Commission's Proposal to increase offering limits for Regulation A Tier 2, Regulation Crowdfunding, and Rule 504 of Regulation D. Raising these limits will make offerings more cost-effective and attractive to a broader group of issuers.

Respondents will take various positions, but we believe the Proposal provides a suitable incremental increase to reflect growing capital formation demand in the private market, while maintaining the filing and reporting requirements to provide appropriate information to investors. We encourage the SEC to implement this Proposal, while also working to establish and track appropriate data to illustrate its effect and drive further reforms.

Further, we recommend offering caps be linked to inflation. Although the Proposal points out that "adjusted for inflation since enactment of the JOBS Act in April 2012, the staff estimates that the Tier 2 offering limit would be $55.845 million as of December 31, 2019"[11], and therefore would not be outside of the new limits, we cannot predict future inflationary pressure. As such, we support tethering adjustments to reflect changing market conditions rather than potentially constraining issuers in the future based on outdated standards.

Importantly, the Commission proposes raising the ceiling for secondary sales under Regulation A Tier 2 from $15 million to $22.5 million, a level commensurate to maintain the 30 percent ratio relative to the newly proposed primary offering level.[12] As we noted above, a robust secondary market affects cost of capital in primary offerings and liquidity opportunities for owners. We appreciate the Commission's decision to adjust the ceiling for secondary sales, though recommend the Commission consider raising the cap beyond the 30 percent ratio.

Investor Access

We support policy efforts to streamline and expand investor access into private markets. We will not rehash many of the recommendations we provided in our response to the Commission's *Proposed Rule: Amending the "Accredited Investor" Definition*[13], but instead bolster areas in this Proposal that will yield expanded ownership.

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[11] See *supra* comment 4, at 121 n. 253.
[12] SEC Proposed Rule for Small and Additional Issuer Exemptions Under Section 3(b) of the Securities Act. File No. S7-11-13. https://www.sec.gov/rules/proposed/2013/33-9497.pdf
[13] See Response by Henry Ward, CEO, Carta https://www.sec.gov/comments/s7-25-19/s72519-6960372-212770.pdf

The Commission proposes scaling financial disclosure requirements for non-reporting companies that sell to non-accredited investors under Rule 506(b) to align with disclosure requirements for Regulation A Tier 1 and 2 offerings. The Proposal would not change nonfinancial disclosure requirements, such as business descriptions, and applies to the Regulation D offering where there is no general solicitation. As such, we agree with the Commission's assessment that this may lower the cost of sales to non-accredited investors and therefore expand access to capital for some issuers.

In its Proposal, the Commission seeks to alter investment limits for accredited and non-accredited investors in Crowdfunding offerings. In particular, the Proposal would lift investment limits on accredited investors for Regulation Crowdfunding, treating such investors the same as they are treated in Regulation A offerings. For non-accredited investors participating in Regulation Crowdfunding offerings, the Proposal would maintain limits, but instead of using the lesser of an investors income or net worth, it would be the greater of the two. Carta supports these revisions.

The Proposal would also enable investors to combine in a special purpose vehicle (SPV) to invest in a single underlying security offered through Regulation Crowdfunding. The purpose of this is to allow investors the same level of economic exposure and voting power as if they invested directly themselves, while simplifying the issuer's capitalization table and reducing its administrative burdens. For the most part, securities issued pursuant to Regulation Crowdfunding are conditionally exempted from Section 12(g)'s holder of record constraint, but we commend the Commission for proposing that the SPV be treated as a single holder of record to minimize any concerns around this threshold for those issuers who may have concerns. We note, however, that although those 12(g) thresholds may not broadly apply to Regulation Crowdfunding, and the established levels may be appropriate for the broader offering framework at this time, as we see the continued growth in the capital formation via exempt offerings and the secondary market, these limitations may impede capital formation for certain entities down the road. We recommend the SEC monitor whether these thresholds begin to constrain offerings and, if necessary, consider ways to mitigate any negative effects.

Blue Sky Laws and Federal Preemption

As the Commission considers ways to improve the exempt offering framework, it must also weigh the role of Blue Sky laws and when it may be appropriate to extend federal preemption. These are not easy considerations and the Commission should carefully consider the delicate balance between the burden of disclosure on issuers and investors, and the utility to investors in the context of secondary market transactions.

In this Proposal the Commission asks commenters whether it should extend federal preemption to secondary sales of Regulation A Tier 2. Carta supports extending preemption in this case. We agree with the SEC's Small Business Advisory Committee, "Regulation A provides for the

preemption of state securities law registration and qualification requirements for securities initially offered or sold in Tier 2 offerings; however, secondary sales of these same Tier 2 Regulation A securities require compliance with disparate state law requirements. This means willing sellers and buyers in the secondary trading market must find exemptions on a state by state basis. There are substantive differences in the various state exemptions. This lack of uniformity inhibits the development of a national secondary trading market."[14] The resulting diminished illiquidity in the secondary market for these securities increases transaction costs, lowers the price investors receive when selling, and ultimately, as we detailed earlier, increases the cost of capital for issuers during their primary offering.

Decisions around federal preemption are challenging and we appreciate the Commission seeking input and weighing the pros and cons in such a deliberate fashion.

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We thank the Commission for its continued work to support capital formation and provide investors access to private markets. We appreciate the opportunity to comment. If you have any questions, please contact Anthony Cimino, Head of Policy, at [redacted] or [redacted].

Sincerely,

Henry Ward
CEO

Anthony Cimino
Head of Policy

[14] Letter from SEC Advisory Committee on Small and Emerging Companies, *supra* note 6, at 1