September 24, 2019

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

**Re: Concept Release on Harmonization of Securities Offerings, 17 CFR Parts 210, 227, 230, 239, 240, 249, 270, 274, and 275; Release Nos. 33-10649; 34-86129; IA-5256; IC-33512; File No. S7-08-19 RIN No. 3235-AM27**

Dear Ms. Countryman:

Iownit Capital and Markets, Inc. ("Iownit") welcomes this opportunity to comment on the Securities and Exchange Commission's ("Commission" or "SEC") Concept Release on Harmonization of Securities Offering.[1] Indeed, Iownit was built on the principle of building a more inclusive, transparent ecosystem of exempt offerings—greater access for issuers and investors.

Iownit is a financial services and technology firm, focused on developing and implementing an innovative blockchain-based capital raising platform, which uses enterprise-grade distributed ledger technology to make private securities offerings completely digital and reduces the cost for market participants and increases opportunities for secondary market liquidity.[2] We are dedicated to building regulatory compliant solutions that bring 21st century technology to new segments of capital markets.

We recognize that the exempt offering framework is "an elaborate patchwork"[3] that is complex and difficult for issuers to navigate, and unfairly excludes many individual investors who should have access to these investment opportunities. A comprehensive review of the framework is much needed, especially given the recent extensive changes to this framework in a similar patchwork style by the Jumpstart Our Business Startups Act of 2012 ("JOBS Act"),[4]

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1 U.S. Sec. & Exch. Comm'n, *Concept Release on Harmonization of Securities Offering Exemptions*, 17 CFR Parts 210, 227, 230, 239, 240, 249, 270, 274, and 275, Rel. Nos. 33-10649; 34-86129, available at https://www.sec.gov/rules/concept/2019/33-10649.pdf ("Concept Release").

2 *See generally,* www.iownit.us.

3 U.S. Sec. & Exch. Comm'n, Speech, Chairman, Chairman Jay Clayton, *Remarks on Capital Formation at the Nashville 36|86 Entrepreneurship Festival*, (Aug. 29, 2018), available at https://www.sec.gov/news/speech/speech-clayton-082918.

4 Pub. L. No. 112-106, 126 Stat. 306 (2012).

Fixing America's Surface Transportation Act of 2015 ("FAST Act"),[5] and the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 ("Economic Growth Act").[6] We recognize that simplifying and harmonizing the securities laws is no easy feat and an ongoing endeavor, as the securities laws in general have been referred to as "regulatory chop suey" and a "patch quilt" dating back to 1973.[7]

In light of the Commission's broad discretion to exempt persons, securities, transactions, or classes thereof from the Securities Act of 1933 ("Securities Act")[8] and the Securities Exchange Act of 1934 ("Exchange Act"),[9] with a thoughtful analysis that evaluates the assumptions underlying the securities laws and whether those assumptions apply today, the Commission can improve access to capital and investor access to opportunities to invest, while maintaining investor protections, as well as fair, orderly, and efficient markets.[10] We commend the Commission for undertaking this review and requesting comments.

**Summary of Comments and Recommendations**

In reviewing the patch quilt that comprises the exempt offering framework, consideration must be given to the fundamental purposes underlying the creation of the federal securities regulatory regime as well as to how the exemptions work together, the overlap or gaps between them, how complicated and costly the rules are, as well as the assumptions underlying the

5 Pub. L. No. 114-94, 129 Stat. 1312 (2015).

6 Pub. L. No. 115-174, 132 Stat. 1296 (2018).

7 Sara Hanks*, Rule 144A: Another Cabbage in the Chop Suey*, 24 Geo. Wash. J. Int'l L. & Econ. 305 (1990) ("*Chop Suey*") (quoting McCauley, *The Securities Laws—After 40 Years: A Need for Rethinking*, 48 Notre Dame Law, 1092, 1093 (1973)).

8 Section 28 of the Securities Act provides that,

> The Commission, by rule or regulation, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter or of any rule or regulation issued under this subchapter, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

15 U.S. Code § 77z–3.

9 Section 36(a)(1) of the Exchange Act provides that,

> [N]otwithstanding any other provision of [the Exchange Act], the Commission, by rule, regulation, or order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this chapter or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

15 U.S.C. § 78mm.

10 "The Commission has a unique obligation to consider the effect of a new rule upon 'efficiency, competition, and capital formation' . . .") *Bus. Roundtable and Chamber of Commerce v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011).

current rules and whether those assumptions are accurate today. The general principles underlying the recommendations are predominantly three-fold. *First*, the exemptions are unnecessarily complex and cost-prohibitive, thus, there should be a simplification and merger of exemptions to ease the complexity and reduce the costs, such that issuers can move swiftly through private offerings under Rule 506 of Regulation D, to a Regulation A+ offering, to a registered offering. *Second*, investors should be given the opportunity to invest if they can adequately "fend for themselves,"[11] which would include having a registered financial professional assist them. *Third*, investment fund exemptions should be expanded to bring consistency among them and increase investors access to these pooled investment vehicles. Applying these three overarching themes, as well as the Commission's tri-part mission of capital formation, investor protection, and facilitating fair, orderly, and efficient markets, provides a thoughtful principle-based approach to the comprehensive analysis and harmonization of the private offering regulatory framework.

Among other possible revisions to the exempt offering rules and regulations, the Commission should consider the following:

- <u>Expand the definition of an accredited investor.</u> The definition of an accredited investor is unnecessarily narrow and is unreasonably skewed toward older investors. Specifically, the definition of an accredited investor should include anyone who is advised by a registered financial professional, either as a broker or an investment advisor, provided that the professional is not compensated based on the transaction. In addition, the accredited investor definition is currently based on net-worth and income tests and seems to ignore the prevalent "age-based risk tolerance" metric.

- <u>Abandon certain limitations to Rule 506(b) of Regulation D.</u> The usefulness of Rule 506(b) is severely restricted by the limitation to only 35 nonaccredited investors, the burdensome information disclosure to nonaccredited investors, and the prohibition on general solicitation. Enabling more nonaccredited investors to participate is in everyone's interest, provided adequate investor protections are taken, such as:

    - limit the percentage of an offering's total amount raised to nonaccredited investors;

    - allow issuers with substantial institutional ownership or good governance to be exempted from the more burdensome information disclosures; and

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11 *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953) (in discussing the private offering exemption from registration under Securities Act § 4(a)(2), the court stated that "the design of the [Securities Act] is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions . . . The natural way to interpret the private offering exemption is in light of the statutory purpose. Since exempt transactions are those as to which there is no practical need for . . . [the bill's] application, the applicability of [§ 4(a)(2)] should turn on whether the particular class of persons affected need the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction not involving any public offering.") (internal citation and quotation marks omitted).

  - permit general solicitation to offerings in which a certain percentage of the offering is sold to institutional investors with experience, nonaccredited investors receive the same terms, and the offering is conducted through a registered intermediary.

- Elimination of Rule 504 of Regulation D. Rule 504 of Regulation D is not actively used and may confuse issuers. Rather, Rule 506 should be amended to better serve all issuers; those issuers who would rely on Rule 504 should be able to rely on a revised Rule 506.

- Allow investments by pooled crowdfunding vehicles that are advised by registered investment advisors. A disincentive and disadvantage to issuers who avail themselves of capital from crowdfunding is their unwieldly capitalization table, which in turn, can render the company less attractive to other capital sources. In addition, there is increased likelihood of prematurely triggering registration due to the number of investors, and particularly the number of nonaccredited investors. Accordingly, Regulation Crowdfunding should be amended to provide for investments by pooled crowdfunding vehicles advised by registered investment advisors so that investors can have their equity held by intermediaries in street name.

- Lift certain restrictions on pooled investment funds. The identified restrictions inhibit issuers' access to capital and hinder investors' ability to participate in pooled investment vehicles. Namely, performance related fees can be an important incentive for registered investment advisors to facilitate investments in private companies, thus, they should be permitted to charge performance fees—on exit from the investment—to all clients, independent of "qualified client" status. In addition, while the concept release does not specifically raise the following issues, we recommend that they be considered as part of the comprehensive review.

  - Private funds face two different limits on the number of investors—100 under one exemption,[12] and fewer than 2,000 under a different exemption.[13] This causes confusion and should be normalized to make both exemptions available for less than 2,000 accredited investors.[14]

  - Funds relying on the "Venture Capital Exemption"[15] should be allowed to purchase securities in the secondary market in excess of the 20% limit.

  - Private funds should be able to facilitate secondary trading on their own securities between investors to allow for liquidity.

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12 Investment Company Act of 1940 ("Investment Company Act") § 3(c)(1).

13 Investment Company Act § 3(c)(7).

14 Once the number of holders of record of an equity security reaches 2,000, or other thresholds are met, the Exchange Act § 12(g) requires the issuer to register the class of equity securities.

15 Investment Advisers Act of 1940 ("Investment Advisers Act") § 203(l).

- Private investment funds should be considered accredited even if total assets are less than $5 million if a registered investment advisor advises the fund.

- Stimulate the use of analysts in the private markets. In considering the exempt framework overall, it would be significantly improved and facilitate the flow of capital if there was more information sharing, particularly from independent research analysts. This consistent communication with investors regarding the performance of the issuer and the market would considerably foster and improve capital formation, investor protection with added information, and the fairness, orderliness, and efficiency of the private markets.

**Discussion**

**1. Accredited Investor Definition**[16]

As discussed more fully below, the definition of an "accredited investor" has evolved over time, and the Commission should continue to adapt the definition to best achieve the purposes of the federal securities laws. The Commission introduced the concept of an accredited investor when in it adopted Rule 242 in 1980.[17] At the time Rule 242 was proposed, Congress had proposed to amend the Securities Act similar to Rule 242 to authorize issuers to sell to "accredited investors," and included in the definition "any person who, on the basis of such factors as financial sophistication, net worth, knowledge and experience in financial and business matters, or amount of assets under management, qualifies as an accredited investor under rules and regulations the Commission shall prescribe, and [] any other person who does not qualify as an accredited investor under such rules and regulations but who relies upon the investment advice of a person who does so qualify."[18] The Commission did not apply this definition, but instead, defined an accredited investor as a person purchasing $100,000 or more of the issuer's securities, a director or officer of the issuer, or specified entities.[19] With the adoption of Regulation D in 1982, the accredited investor definition included persons who purchased at least $150,000 of securities where the total purchase price did not exceed 20% of the person's net worth (thus, a $150,000 investment would require a net worth of at least $750,000). This was based on the assumption that individuals investing large amounts should have adequate bargaining power with the issuer and could request relevant materials.[20] The Commission

16 This section is most pointedly addressing paragraphs 27, 28, and 29 in the Concept Release.

17 U.S. Sec. & Exch. Comm'n, *Exemption of Limited Offers and Sales by Qualified Issuers*, Rel. No. 33-6180 (Jan. 17, 1980), 45 Fed. Reg. 6362.

18 The Small Business Investment Incentive Act of 1979, H.R. 3991, 96th Cong., 1st Sess. (1979) (quoted in U.S. Sec. & Exch. Comm'n, *Proposing Release Exemption of Limiting Offers and Sales by Corporate Issuers*, Rel. No. 33-6121, File No. S7-800, 44 Fed. Reg. 182 (Sept. 18, 1979), 17 CFR 230 & 239 ("Proposing Release Rule 242")).

19 *Id*.

20 U.S. Sec. & Exch. Comm'n, *Proposed Revision of Certain Exemptions From The Registration Provisions of the Securities Act of 1933 For Transactions Involving Limited Offers and Sales*, Rel. No. 33-6339, 23 SEC Docket 446 (Aug. 7, 1981) ("Regulation D Proposing Release"); U.S. Sec. & Exch. Comm'n, *Revision of Certain*

rescinded this provision in 1988, concluding that the large purchase size did not guarantee sophistication or access to information, as well as the irrational result that someone with a lower income of $750,000 had to invest at least $150,000, while an income of $1,000,000 was required to accredit someone with a much lower purchase amount.[21]

Notwithstanding many commentators and even Congress and the SEC Staff proposing changes to the definition of an accredited investor, the definition has remained unchanged since 1988. As explained below, income and net worth are not accurate proxies for investor sophistication or being able to bear economic loss.

We recommend that the definition of an accredited investor be expanded and the age-based risk model be considered in the reassessment. The limitation of offers that are not subject to the full registration disclosure regime has historically been limited to those individuals who the issuer reasonably believes have the requisite knowledge and experience in financial matters to evaluate the risks and merits of the prospective investment, or who could bear the economic risks of the investment.[22] This context clarifies the Commission's broad authority to adopt additional categories of persons to the definition of "accredited investor" in § 2(a)(15)(i) based on "such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management."[23]

As to the type of sophistication and knowledge in financial matters, it seems incontrovertible that registered financial professionals, who are licensed and registered to provide investment advice, indeed possess the type of knowledge and experience to evaluate the risks and merits of a prospective investment. Accordingly, those individuals should be included as a category of accredited investors. Indeed, the SEC Staff and the U.S. Department of Treasury ("U.S. Treasury") have made this same recommendation. The SEC Staff Report on the Review of the Definition of "Accredited Investor" recommended that individuals with certain professional credentials, such as having passed the Series 7 examination, Series 65 examination, or Series 82 examination, demonstrate a level of investor sophistication to qualify as an

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*Exemptions From Registration for Transactions Involving Limited Offers and Sales*, Rel. No. 33-6389, 17 CFR 230 & 239, 47 Fed. Reg. 11251-01 ("Regulation D Adopting Release").

21 SEC Staff, *Report the Review of the Definition of "Accredited Investor*," at 17-18 (Dec. 18, 2015) ("Report on Accredited Investor") (citing Regulation D Adopting Release). Section 413(b)(2)(A) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), Pub. L. No. 111-203, 124 Stat. 1376 (2010), directs the Commission to review the accredited investor definition of natural persons every four years to determine whether the definition should be modified or adjusted for the protection of investors, the public interest, and in consideration of the economy. Accordingly, the SEC Staff conducted a review and drafted the Report on the Review of the Definition of "Accredited Investor," available at https://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf.

22 Securities Act Rule 146 adopted by the Commission in 1974. *See* U.S. Sec. & Exch. Comm'n, *Transactions By an Issuer Deemed Not To Involve Any Public Offering*, Rel. No. 33-5487 (Apr. 23, 1974), 39 Fed. Reg. 15261. Rule 242 permitted certain domestic and Canadian issuers to sell their securities to unlimited accredited investors and up to 35 nonaccredited investors.

23 Securities Act § 2(a)(15)(ii).

accredited investor.[24] The U.S. Treasury recommended that "financial professionals, such as registered representatives and investment adviser representatives, who are considered qualified to recommend Regulation D investments to others, could also be included in the definition of 'accredited investors.'"[25]

In addition, those persons who are being advised by a registered financial professional should be deemed to have the requisite knowledge and experience in financial matters by virtue of their advisor who assists them and evaluates the risks and merits of the prospective investment. It seems groundless to aver that someone's access to private or public markets should be restricted or even prohibited based on the failure to have the ability to adequately evaluate the merits and risks of an investment decision when that person is being advised by a registered financial professional who evaluates the risks for them. Accordingly, we recommend that an accredited investor should also include anyone who is advised by a registered financial professional, provided that the financial professional is not being compensated based on the transaction (i.e., to avoid conflicts of interest and to better align the interests of the advisor and the investor). Indeed, the U.S. Treasury further recommended the definition of an accredited investor should include "any investor who is advised on the merits of making a Regulation D investment by a fiduciary, such as an SEC- or state-registered investment adviser."[26]

The SEC Staff has stated that "[r]evising the accredited investor definition to include individuals advised by professionals appears to run counter to the Commission's prior determination to allow persons who are unable to evaluate the merits and risks of private offerings only if the issuer provides them with additional information about the issuer."[27] This concern is misplaced because the information requirement is to ensure that persons who cannot fend for themselves are given substantial information required in a registration statement so they can evaluate the merits and risks. A person who is being advised by an investment professional has hired someone to fend for them, and thus, the rationale of the information disclosure does not apply. The SEC Staff has also implied that nonaccredited investors do not hire registered investment professionals when it indicated that there may be "significant overlap between individuals who receive advice from professionals and those who meet the existing financial standards in the accredited investor definition."[28] But, this is circular reasoning as nonaccredited investors are excluded from most private offerings and do not receive as many benefits from investment professionals. Therefore, if nonaccredited investors can gain accredited status by hiring an investment professional, there may well be an increase in unaccredited investors' use of investment professionals.

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24 Report on Accredited Investor, at 44-45.

25 U.S. Dept. of the Treasury, *A Financial System That Creates Economic Opportunities Capital Markets*, (Oct. 2017) ("2017 Treasury Report") at 44, available at https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

26 *Id*.

27 Report on Accredited Investor, at 62.

28 *Id*.

The SEC, since its inception, has grappled with to whom disclosure should be aimed—the "unsophisticated," the "assiduous student of finance who searches for every clue to the intrinsic value of securities," or a "hypothetical 'reasonable' investor of 'reasonable' sophistication."[29] A report dating back to 1969 which reassessed the policies underlying the Securities Act and Exchange Act (the "Wheat Report") concluded that "[a] balance must be struck which reflects, to the extent possible, the needs of all who have a stake in the securities markets."[30] In creating the disclosure regime, the Commission attempts to be pragmatic, and thus, when there are unusual speculative elements of a securities investment, special efforts are made to call these factors to the attention of the ordinary investor by way of the introductory statement, and detailed financial information was intended for the skillful analyst. The Commission recognized that "complicated business facts [] have little meaning for the average investor[, but that] disclosures reach average investors through a process of filtration in which intermediaries (brokers, bankers, investment advisers, publishers of investment advisory literature, and occasionally lawyers) play a vital role."[31] This recognizes the critical role that registered financial professionals play in assisting the "average investor" in evaluating investments and making investment decisions—in all securities offerings, even those provided by full reporting companies. Accordingly, even in registered offerings, the Commission recognized that investors without knowledge and experience to evaluate an offering would likely depend on registered securities professionals to assist them. These intermediaries are core to the registered offering process, and their utility should not be limited in the private markets. Investors relying on the advice of such a financial professional in registered offerings, should equally be afforded the opportunity to invest with that same advice in private offerings.

Similarly, private investment funds should also be considered accredited even when total assets are less than $5 million if a registered investment advisor advises the fund. Just as a registered investment advisor should be an accredited investor, anyone who is advised by a registered investment advisor should also be deemed accredited—whether the advisee is a person or a fund. A fund advised by a registered investment adviser is being advised by someone with the requisite knowledge and experience to evaluate the merit and risks of investment decisions who has a fiduciary relationship with the advisee.

As to the assumption that accredited investors are those who can bear the economic risks of the investment, it is necessary to reevaluate the reliance on income and net-worth based tests. These metrics tend to be skewed towards older investors, particularly the net-worth based test. But, this is the opposite approach of traditional investment recommendations, which generally guide that individuals should reduce their investment risk as they age, particularly as they near retirement.[32] We recommend that the Commission reassess its metrics regarding who is able to

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29 Commissioner Francis M. Wheat, *Disclosure to Investors - A Reappraisal of Federal Administrative Policies under the '33 and '34 Acts*, at 51 (Mar. 1969) (often referred to as the "Wheat Report"), available at http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1960/1969_Wheat_CH02.pdf.

30 *Id*. at 52.

31 *Id*.

32 For example, the basic stock allocation rules provide that a rule of thumb has typically been to hold a percentage of stock equal to 100 minus the individual's age, such that a 70-year-old should hold only 30% of their

bear the economic risks of the investments. Younger individuals, advised by a registered finance professional, may be better suited to bear economic losses, given they have a materially longer timeframe before they may need the funds, and longer to recoup any losses.

The definition of an accredited investor has more far reaching implications, particularly in light of Section 12(g) of the Exchange Act.[33] This section limits the number of investors to 2,000 and the number of nonaccredited investors to 500 for issuers that are neither banks nor bank holding companies. Companies that exceed these limits trigger the registration requirements under the Exchange Act. We encourage the Commission to consider the additional implications of the accredited investors definition and whether those regulations and the underlying assumptions thereto, such as Section 12(g) should be reconsidered as well.

### 2. Private Placement Exemption and Rule 506 of Regulation D[34]

In assessing Regulation D, it is useful to review its history, predecessor rules, and the reasons and underlying assumptions therein. Regulation D was prompted by the Consideration of the Impact of the Small Business Investment Incentive Act of 1980 on Certain Exemptions From the Registration Provisions of the Securities Act of 1933, ("Small Business Investment Act Impact Release").[35] Regulation D, at the time of adoption, was a simplification of then-existing rules and regulations, particularly focused on small business capital formation while maintaining investor protection. Specifically, it replaced the exemptions under then-existing Rules 146, 240, and 242. These rules were each created to provide more certainty in the application of the now-Section 4(a)(2) exemption, and what was deemed to be a private offering.

Rule 146, which the Commission adopted in 1974, permitted unlimited capital raises with the conditions: (1) offers and sales could be made only to persons the issuer reasonably believed had the requisite knowledge and experience in financial matters to evaluate the risks and merits of the prospective investment or who could bear the economic risks of the investment; (2) issuers had to provide offerees with access to information comparable to what a registration statement would contain; (3) no more than 35 purchasers could participate in the offering; and (4) general advertising and general solicitation was prohibited.

Rule 240, which the Commission adopted in 1975, limited the beneficial owners before and after the offering to 100, limited the amount of securities sold in a twelve-month period to $100,000, and prohibited general advertising and general solicitation.

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investments in equity. *See, e.g.*, https://www.investopedia.com/articles/investing/062714/100-minus-your-age-outdated.asp. There are alternative recommendations that at a certain age, a higher percentage of one's investment portfolio should be in equity; yet, if the individual does not meet the accredited investor definition, this closes off the private markets and relegates the investor to the public markets. Further, in general, all nonaccredited investors are relegated mainly to the public markets rather than private companies and lose the opportunity to invest early in successful companies or even unicorns.

[33] 15 U.S.C. 781(g).

[34] This section is most notably addressing paragraphs 33, 35, and 44 in the Concept Release.

[35] Rel. No. 33-6274 (Dec. 23, 1980), 46 Fed. Reg. 2631.

Rule 242, which the Commission adopted in 1980, allowed limited offerings up to $2 million, allowed unlimited accredited investors and up to 35 nonaccredited investors, offerings with only accredited investor participation did not require any specific information disclosure, and prohibited general advertising and general solicitation. The lack of information requirements was based on the assumption that accredited persons are in a position to ask for and obtain information they believe is relevant. Notably, Rule 242, by the terms of the Proposing Release "would be in the nature of an experiment," and "[t]he Commission would monitor closely the use of Rule 242 for an appropriate period to determine whether the Rule has functioned as an effective means for issuers, particularly small issuers, to raise limited amounts of capital through unregistered offerings to the public consistent with the protection of investors."[36] At the time Rules 146, 240, and 242 were promulgated, and their successor, Regulation D, in the 1980's, no one fathomed how our capital markets and society would evolve, and how the speed of change would become exponentially fast. Therefore, these rules remain experiments that need to be constantly monitored, reviewed, and updated.

The rules regarding private placements and Regulation D have again become unwieldly and need to be streamlined and simplified for today's issuers, investors, and markets. Rule 506 is particularly a place in which the exempt offering framework is inconsistent, inaccessible, and ineffective for both companies and investors, and the Commission should simplify, improve, and harmonize these exemptions. Notably, the distinction between accredited investors, on the one hand, and nonaccredited investors who alone or with a purchaser representative possess sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the prospective investment, on the other hand, seems to improperly bifurcate what was intended as two alternative requirements to qualify as an accredited investor: either the ability to evaluate risks *or* the ability to bear the economic loss. It appears that the Commission's current rules assume being able to bear the economic risk in terms of what that means to the Commission is more important than being able to evaluate the risks and merit of an investment decision. This is seemingly in stark contradiction to the purpose underlying the securities laws; that being, a disclosure regime such that investors can adequately evaluate investments.[37]

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[36] Proposing Release Rule 242.

[37] This section is also applicable to the discussion of the appropriate definition of an accredited investor, discussed *infra*. It is noteworthy in considering the assumptions underlying our securities laws to recall that,

> Shortly after the [Securities] Act went into effect, a commentator who was later to be the Chairman of the Commission observed:
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> The truth about securities having been told, the matter is left to the investor. The Act presupposes that the glaring light of publicity will give the investors needed protection. But those needing investment guidance will receive small comfort from the balance sheets, contracts, or compilation of other data revealed in the registration statement. They either lack the training or intelligence to assimilate them and find them useful or are so concerned with a speculative profit as to consider them irrelevant. And wise and conservative investors will find the Securities Act useful but not necessary and from it will gain but little real protection against an occasional Kreuger or Insull. This means that the results of the Act so far as investors are concerned are primarily two-fold: (1) the requirement that the truth about securities be told will in and of itself prevent some fraudulent transactions which cannot stand the scrutiny of publicity[;] (2) even though an investor has neither

As an initial matter, the inclusion of nonaccredited investors in Rule 506 offerings under the current framework is not particularly practical without a better understanding of the level of sophistication required to qualify for the exemption. For example, under Rule 506(b)(2)(ii), a nonaccredited investor must "either alone or with his purchaser representative(s) [have] such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment." Determining who has, and who does not have, the requisite "knowledge and experience" is a gray area that necessarily presents confusion, especially in a litigation, when the burden rests heavily on the issuer to prove the conditions for the exemption are met. Typically, however, this condition is met if the issuer reasonably believes that the nonaccredited investor meets this standard; but this subjective determination is ripe for disagreement, including by the Commission. And, although it is generally recommended that the issuer—at its own expense—provide a purchaser representative to represent the entire class of nonaccredited investors to ensure the sophistication requirements are met, doing so can be costly to the issuer. This often results in a cost-benefit analysis, the outcome of which is often the exclusion of nonaccredited investors entirely.

Even if nonaccredited investors are included in the offering, the usefulness of Rule 506(b) of Regulation D is severely limited by the restriction to only 35 nonaccredited investors, the burdensome information disclosure to nonaccredited investors required under Rule 502(b),[38] and the prohibition on general solicitation. While it is difficult to balance the Commission's tri-part mission, here, the protection of nonaccredited investors—whether the definition is appropriate or not—has improperly overridden the interests of capital formation and fair, efficient, and orderly markets. Rather than this one-size-fits-all approach, we recommend a percentage restriction of nonaccredited investors rather than a defined number, as well as exemption from heightened disclosure requirements for certain issuers.

As the Concept Release itself states, Rule 506(b) is not very useful, as nonaccredited investors participate in a mere six percent of all 506(b) offerings.[39] Most nonaccredited investors are unable to make larger investments, thus, a combined capital raise from 35 investors is simply not worth the extensive effort and costs associated with heightened disclosure obligations. Moreover, after extensive research, the number 35 as a limit of nonaccredited investors appears to be an arbitrary selection that resembles the discussion of what constitutes an offering to the "public" dating back to 1933, and prior to the Supreme Court's *Ralston Purina* decision, in which it abandoned a numerical investor standard of what constitutes a "public" offering, in favor of the approach of protecting those who are unable to fend for themselves. It is understandable why the Commission applied a specific number, such as 35, due to its ease of application and being an easily definable measure. The number 35 from Regulation D comes

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> the time, money, nor intelligence to assimilate the mass of information in the registration statement, there will be those who can and who will do so, whenever there is a broad market. The judgment of those experts will be reflected in the market price. Through them investors who seek advice will be able to obtain it.

Wheat Report at 53 (quoting H. R. Rep. No. 85, 73d Cong. 1st Sess. 8 (1933)) (internal quotation marks omitted).

[38] *See* 17 CFR 230.502(b)(2)(i)-(vii).

[39] Concept Release.

from the predecessor Rule 146, which permitted 35 nonaccredited investors. Rule 146 appears to have relied on a Federal Securities Code written by Professor Louis Loss, in which a "distribution" was defined as 35 investors.[40] Prior to that, and dating back as early as 1935, the Commission's General Counsel, in a letter, had referred to 25 as the number of persons to whom an issuer could offer securities that would not be considered a substantial number and "presumably does not involve a public offering."[41] The General Counsel's letter set forth numerous factors to be considered in what was a public offering, including (i) the number of offerees and their relationship to each other and to the issuer, (ii) the number of units offered, (iii) the size of the offering, and (iv) the manner of offering. This appears to have been an attempt to clarify what "substantial" meant in a letter from the Federal Trade Commission ("FTC") in 1933, which administered the securities laws before the SEC was created. Specifically, the FTC letter states that "[i]f the group of security holders includes a substantial number of persons, the offering should be considered a 'public' one."[42] The Commission, years later, stated that it "has rarely acquiesced in a claim for exemption where as many as a hundred offerees have been involved and then only in circumstances where for special reasons the protections of the Act appear not to be necessary."[43] It appears then that the arbitrary number of 35 nonaccredited investors comes from the lineage of securities interpretations beginning in 1933 that a private offering should be limited to 25-100 persons who need the protections of the federal securities laws. Significantly, in 1953, the Supreme Court wholly rejected the notion that a specific number of persons was a proxy for a private offering, and instead focused on who needs the protection of the securities laws. Specifically, in *Ralston Purina*, the Court, in rejecting a quantity limit on the construction of the statute, set out the following test:

> Exemption from the registration requirements of the Securities Act is the question. The design of the statute is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions. The natural way to interpret the private offering exemption is in light of the statutory purpose. Since exempt transactions are those as to which "there is no practical need for . . . [the bill's] application,' the applicability of [§ 4(a)(2)] should turn on whether the particular class of persons affected need the protection of the Act. An offering to

40 Fed. Sec. Code Draft, Definitions, Tentative Draft 11 (25), Section 277(b) (stating that "[a] limited offering is one in which the following conditions are satisfied: (A) the initial buyers of the securities are institutional investors and not more than thirty-five other persons."); *see also* Section 202(41)(B)(i) of the American Law Institute, Fed. Sec. Code (1980).

41 U.S. Sec. & Exch. Comm'n, *Letter of General Counsel Discussing the Factors To Be Considered In Determining The Availability Of The Exemption From Registration Provided By the Second Clause of Section 4(1) [Now 4(a)(2)]*, Securities Act Rel. No. 285 (Jan. 24, 1935), 17 CFR Part 231, 11 Fed. Reg. 10952 (1946).

42 U.S. Fed. Trade Comm'n, *Extracts From Letters Of The Federal Trade Commission Relating To The Application Of Various Sections of the Act*, Securities Act Rel. No. 97 (Dec. 28, 1933), 17 CFR 231, 11 Fed. Reg. 10949 (1946).

43 *SEC v. Ralston Purina Co.*, Brief for the Appellant SEC, No. 512 (Apr. 9, 1953), 1953 WL 78401, at *20-21 (1953).

> those who are shown to be able to fend for themselves is a transaction "not involving any public offering."[44]

The Court further explained that "the statute would seem to apply to a 'public offering' whether to a few or many," and stated that the Commission could use a numerical test as a proxy for investigating particular exemption claims, "[b]ut there is no warrant for superimposing a quantity limit on private offerings as a matter of statutory interpretation."[45] The Court also cited with approval dictum from *Nash v. Lynde*, that "'[t]he public' . . . is, of course, a general word. No particular numbers are prescribed. Anything from two to infinity may serve: perhaps even one."[46]

After courts flatly rejected the notion of a numerical limit on the number of investors for the purposes of defining a private offering, the Commission still applies an arbitrary 35 investor limit on nonaccredited investor participation (even though the investor alone or with a purchaser representative must have an adequate level of sophistication to evaluate the merits and risks of the investment). Even if a numerical limit is applied, as a trigger for investigation or as a limit to a safe harbor, the numerical range of 25-100 from 1935-1953 should be reassessed in light of today's markets, society, and technological advancements.

Remaining loyal to the purpose of § 4(a)(2), the safe harbor should be based on whether the particular class of persons affected needs the protection of the Securities Act. The SEC's distinction between accredited and nonaccredited investors implies that nonaccredited investors need the protection of the Act. Limiting the number of them to 35 does not appear to protect them. Using the SEC's rationale, a more logical limitation on the investment of nonaccredited investors would be based on a percentage of the offering's total amount raised from nonaccredited investors—e.g., 20% of the total amount raised could come from nonaccredited investors, investing as individuals or through an SPV. An additional safeguard could be that the offering to nonaccredited investors is contingent on this 20% limitation, and nonaccredited investor funds would be held in escrow until the offering has been adequately subscribed by accredited investors. This same limit should be applied to offerings conducted pursuant to Rule 506(c).

Additionally, once an issuer includes nonaccredited investors in an offering, the issuer is limited in its ability to later change its offering exemption. In other words, by including nonaccredited investors, the issuer is prohibited from later changing its exemption from Rule 506(b), which prohibits general solicitation, to Rule 506(c), which permits general solicitation. This results in issuers having less flexibility in their ability to raise capital if circumstances change during the capital raising period.

It is therefore critical to allow nonaccredited investors to participate in a meaningful way in offerings under 506(b), and Rule 506(c) should be amended to likewise permit nonaccredited

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44 *Ralston Purina*, 346 U.S. at 124-25 (footnotes omitted).

45 *Id.*, at 125.

46 *Id.*, at 125 n.11 (quoting *Nash v. Lynde*, [1929] A.C. 158, 169).

investor participation. As stated above, the costs associated with the significantly increased information disclosures make including nonaccredited investors an unattractive option. Because the process is often cost-prohibitive (particularly for smaller issuers) and the potential participation is so limited (35 nonaccredited investors), the usefulness and effectiveness of the exemption is not significant. While it is important to protect nonaccredited investors, it seems unlikely that the additional information is generally of the type that nonaccredited investors find helpful.[47] Issuers should be able to avail themselves of this additional costly disclosure if they have substantial institutional ownership or good governance. It is significant that institutions are not historically or generally seen as needing the protection provided by registration under the Securities Act.[48] Indeed, the Commission has noted that individuals, not institutions were the "investing public" that Congress intended to protect by registration requirements:

> References to investors in the legislative history of the Securities Act are to "the poor women who ha[d] a little money to invest," "poor men and women who turned over their life savings," and "widows who owned Liberty bonds, having invested the accumulations of a lifetime," not to sophisticated institutions. Speaking to the "rank and file of the people" who "possess stock and bonds," Representative Rayburn concluded that "[m]illions of citizens" had been "swindled into exchanging their savings for worthless stocks." Ferdinand Pecora's account of the exhaustive hearings conducted by the Senate Committee on Banking and Currency dealt solely with the abuses suffered by individual investors."[49]

Furthermore, James Landis, who was a principle draftsman of the Securities Act and who later became an SEC Chairman stated that "[t]he sale of an issue of securities to insurance companies or to a limited group of experienced investors, was certainly not a matter of concern to the federal government."[50] An institution is often assumed to be able to fend for itself because, *inter alia*, (i) institutions generally have access to information by virtue of their economic bargaining power; (ii) if adequate information is not obtained, the institution may decline to buy a large amount of securities; and (iii) institutions are better situated to analyze information and make informed investment decision based on their resources.[51] In addition, institutional investors "play a crucial role in monitoring companies and encouraging better disclosure and governance practices."[52] In stocks that are predominately owned by individual investors, such as OTC stocks, studies indicate that these stocks are "predominately illiquid, generate negative and volatile returns, are frequently targeted by alleged market manipulation schemes, and rarely

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47 *See e.g.,* Wheat Report at 51-52.

48 *Chop Suey* at 322-330.

49 U.S. Sec. & Exch. Comm'n, *Proposing Release 144A*, Securities Act Rel. No. 33-6806, 53 Fed. Reg 44,016 at n.101 (1988) (cited in *Chop Suey*).

50 James Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash, L. Rev. 29, 37 (1959) (cited in *Chop Suey*).

51 *Chop Suey* at 325-26 (citations omitted; collecting sources).

52 Joshua White, *Outcomes of Investing in OTC Stocks*, at 1, SEC DERA (Dec. 16, 2016), available at https://www.sec.gov/files/White_OutcomesOTCinvesting.pdf.

transition to an exchange."[53] It seems that a key to investor protection is participation by institutional investors. Accordingly, issuers with significant institutional ownership provide some level of protection to those less able to "fend for themselves." A proposed metric could be 80% ownership by, or 80% external investment from, institutional or otherwise accredited investors, which would provide a level of protection for nonaccredited investors. Alternatively, a certain level of governance could provide a similar safeguard. An issuer with a Board of Directors with at least three independent directors who must participate in the offering and sign offering materials, would also provide a level of protection for investors. The key is to ensure that the issuer has a board of directors with significant membership who are independent, with significant power and incentive to protect investors.

Finally, nonaccredited investors should be permitted to participate in offerings that allow general solicitation, provided there is some safeguard of protection; for example, (i) at least 50% (or some other material percentage) of the offering is subscribed to by institutional investors; (ii) nonaccredited investors receive the same terms as the institutional investors; and (iii) the offering is conducted though a registered intermediary who can confirm that the same terms are offered to all investors. Indeed, institutional investors, typical venture capital firms, do not generally participate in Rule 506(c) offerings. One goal is to encourage broader institutional participation in these types of offerings.

As for the ban on general solicitation, the rationale again dates back to the assumptions underlying a private offering from the 1930's. Similar to the arbitrary limit of 35 nonaccredited investors, the assumptions underlying the prohibition of general solicitation to render an offering "private" does not apply today. In adopting the Nonpublic Offering Exemption in 1962, the Commission stated that "[n]egotiations or conversations with or general solicitations of an unrestricted and unrelated group of prospective purchasers for the purpose of ascertaining who would be willing to accept an offer of securities is inconsistent with a claim that the transaction does not involve a public offering even though ultimately there may only be a few knowledgeable purchasers."[54] The SEC's ban on general advertisement and general solicitation relates to this view of what constitutes a public versus private offering pre-*Ralston Purina*. After *Ralston Purina*, this rationale does not seem to apply to the analysis of whether an offering is private. Particularly given that our society has significantly advanced technologically, and our networks of people through social media and electronic communications generally are so expanded, many of our everyday communications with our networks would be considered general solicitations under the securities laws. The ban on general solicitation does not identify, much less protect, those who cannot fend for themselves. Beyond that, the breadth of "general solicitation" to include social media and the like is an outdated prohibition in light of our technological society. These bans on solicitation, and what constitutes solicitation, date back to the anachronistic era of the Great Depression, before the Internet and email, before smartphones, and before Facebook, LinkedIn, Twitter, and other similar platforms.

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[53] *Outcomes of Investing in OTC Stocks* at 26.

[54] U.S. Sec. & Exch. Comm'n Final Rule, *Nonpublic Offering Exemption*, Rel. No. 33-4552 (Nov. 6, 1962).

### 3. Limited Offerings—Rule 504 of Regulation D[55]

Rule 504 of Regulation D should be eliminated, as it is not actively used; specifically, according to the Commission, from 2018-2019, only two percent of capital raised in Reg. D offerings under $5 million by non-investment companies was offered under Rule 504.[56] As a consequence, this exemption mainly creates confusion for issuers, especially if the offering limits are increased. Rule 506 should be amended to better serve all issuers; those issuers who would rely on Rule 504 should be able to rely on a revised Rule 506. This goes to the overarching goal of creating a simple path for a private company to conduct an offering under Rule 506, then a listed company status, relying on Regulation A+ or full registration.

Rule 504 became more beneficial when, in 2016, the aggregate amount of securities offered and sold in any twelve-month period increased from $1 million to $5 million.[57] The higher ceiling under Rule 504 was adopted as (i) "more reflective of contemporary seed-capital needs of early stage companies"; and (ii) "to facilitate the development of regional offerings, and intrastate crowdfunding offerings."[58] Where Rule 504 diverges from its sister exemption, Rule 506, is that Rule 504 does not preempt state blue sky laws. Therefore, issuers using Rule 504 have needed to ensure that appropriate state securities law exemptions are available. Preemption under Rule 506 provides a significant advantage and eliminates often onerous requirements in exchange for state notice and filing fees.

Despite the 2016 amendment, Rule 504 offerings have substantially declined.[59] The limited use of the exemption, with the addition of the complications arising from the lack of federal preemption, significantly limits the Rule's practicality, particularly given the complexity and costs associated with complying with all of the different state laws. It is telling that among Regulation D offerings under $5 million—for which Rule 504 offerings are currently available—Rule 506 accounts for almost 98% of the capital raised.[60] This suggests that the more restrictive provisions of Rule 506 are less important than state securities law preemption.[61] Accordingly, those issuers who choose Rule 504 would be best served by amending Rule 506 to allow for

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55 This section is most notably addressing paragraph 65 in the Concept Release.

56 Concept Release at p. 116.

57 U.S. Sec. & Exch. Comm'n, *Exemptions to Facilitate Intrastate and Regional Securities Offerings*, 17 CFR Parts 200, 230, 239, 240, 249, 270 and 275, Rel Nos. 33-10238 and 34-79161, available at https://www.sec.gov/rules/final/2016/33-10238.pdf.

58 Scott Bauguess, Rachita Gullapalli, And Vladimir Ivanov, *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings*, 2009-2017 (Aug. 2018) ("DERA Analysis") at 10, available at https://www.sec.gov/files/DERA%20white%20paper_Regulation%20D_082018.pdf.

59 As noted by the Commission, these offerings declined by 16% from 2016 to 2017 and by 4% from 2015 to 2016. *See* Concept Release *supra* p. 116 n. 372.

60 DERA Analysis at 14.

61 *Id.*

more meaningful non-accredited investor participation and less burdensome disclosure requirements when non-accredited investors participate.

### 4. Regulation Crowdfunding[62]

Issuers considering crowdfunding have several disadvantages because of the unintended consequences of a significant number of nonaccredited investors possessing an equity stake in their company. Because no pooling vehicle can be used, the nonaccredited investors all hold the securities in their own name, as opposed to a broker, for example, holding stock for investors in street name. One consequence is that the capitalization table become unwieldly, and issuers can have difficulty finding a venture capital or angel investor willing to invest with so many individual investors. A second consequence is that if the company is successful, this may cause it to become a public reporting company earlier than it would have preferred. Section 12(g) of the Exchange Act is an often the trigger for registration. Section 12(g) requires an issuer to register a class of equity securities when they have 2,000 holders of record, or 500 nonaccredited investors (among other triggers).[63] As part of Title III of the JOBS Act, equity crowdfunding investors are excluded from the shareholders of record for Section 12(g) purposes, provided that the following three conditions are met: (i) issuers are current on their ongoing reporting obligations; (ii) issuers do not have assets exceeding $25 million; and (iii) issuers engage a registered transfer agent.[64] Successful companies may quickly exceed the $25 million in assets—sooner than anticipated—and the number of investors may easily surpass 2,000, or 500 nonaccredited investors, triggering registration—sooner than the company was prepared. Accordingly, Regulation Crowdfunding should be amended to provide for investments by pooled crowdfunding vehicles advised by registered investment advisors.

The disadvantages described above suggest that although Regulation Crowdfunding is still a relatively new concept, it has not attracted interest because it not of much use to investors seeking to contribute substantial amounts to startups and other early stage companies. Currently, crowdfunding allows for securities to be sold to a large number of small investors with less disclosure than public offerings require. However, this could result in a large number of unsophisticated, and uninformed investors, which is antithetical to promoting the growth of emerging companies. A hybrid mix of professional insight with smaller investors provides an alternative to increasing the profile of Regulation Crowdfunding, while maintaining some

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62 This section is most notably addressing paragraph 85 in the Concept Release.

63 The JOBS Act amended Section 12(g) of the Exchange Act to adjust the thresholds for registration. Final Rules were adopted by the Commission in May 2016. Section 12(g) establishes thresholds at which an issuer is required to register a class of securities with the Commission. Aside from the registration requirement noted above, the JOBS Act established a separate registration threshold for banks and bank holding companies pursuant to which an issuer must register a class of equity securities within 120 days after the last day of its fiscal year end if, on the last day, the issuer has total assets of more than $10 million and a class of equity securities is "held of record" by 2,000 or more persons without regard to accredited investor status. *See* Sec. & Exch. Comm'n, *Changes to Exchange Act Registration Requirements to Implement Title V and Title VI of the JOBS Act* (May 24, 2016), available at https://www.sec.gov/info/smallbus/secg/jobs-act-section-12g-small-business-compliance-guide.htm.

64 U.S. Sec. & Exch. Comm'n, *Regulation Crowdfunding: A Small Entity Compliance Guide for Insurers* (May 13, 2016, with Apr. 5, 2017 updates), available at https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm.

semblance of organization and control of cashflow. Specifically, the removal of the ban on investors from forming special purpose vehicles ("SPVs") to pool investments in crowdfunding campaigns presents a number of benefits, namely that small, inexperienced investors will be able to ride the proverbial coattails of sophisticated lead investors, who can provide certain guidance and expertise.[65]

Introducing SPVs in crowdfunding is not a new concept. In fact, it has been actively pursued through legislative efforts with strong support. In 2016, the Subcommittee on Capital Markets, a subcommittee of the House of Representatives' Financial Services Committee, introduced the Fix Crowdfunding Act to increase the potential to turn Regulation Crowdfunding into a more powerful tool by increasing investor protection and providing further opportunities for smaller investors.[66] Importantly, this bill allows SPVs or "crowdfunding vehicles" to engage in crowdfunding and make investments in a crowdfunding issuer, subject to certain limitations. These include that the issuer (1) is limited to one class of securities; (2) receives no compensation in connection with such acquisition, holding, or disposition of securities; (3) prevents associated persons of the company receiving compensation in connection with such acquisition, holding, or disposition of securities unless acting on behalf of a registered investment adviser; (4) ensures that the securities are issued pursuant to Section 4(a)(6) of the Securities Act; (5) remains current in its ongoing disclosure obligations of Rule 202 of Regulation Crowdfunding; (6) ensures the company whose securities the issuer holds is current in its ongoing disclosure obligations of Rule 202 of Regulation Crowdfunding; and (7) is advised by a registered investment adviser in the state in which the investment adviser is registered, or registers as an investment adviser who maintains its principal office and place of business in the state.[67] In the 115th Congress, the House passed S. 488, the JOBS and Investor Confidence Act of 2018. Included in the JOBS and Investor Confidence Act as Title XXXII was "Crowdfunding Amendments," which was based on bipartisan and bicameral legislation introduced on July 16, 2018. This title would have allowed crowdfunding investors to pool their money together into a fund that is advised by a registered investment advisor.[68]

The $1.07 million annual threshold under Regulation Crowdfunding[69] substantially limits an entity or individual from raising money in the way the Rule was designed. Many platforms—

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65 Tom Zanki, *Scaled-Down Crowdfunding Bill Disappoints, Attys Say*, LAW360 (June 16, 2016), available at https://www.mccarter.com/files/Uploads/Documents/Law360%20Scaled-Down%20Crowdfunding%20Bill%20Disappoints,%20Attys%20Say%20Hron.pdf.

66 H.R. 4855, 114th Congress (2016).

67 *Id.*

68 H.R. 6830 and S. 3213, 115th Congress (2018).

69 Title III of the JOBS Act added Section 4(a)(6) to the Securities Act to provide an exemption from registration for certain crowdfunding transactions. Pub. L. No. 112-106, April 5, 2012, 126 Stat 306. In 2015, the Commission adopted Regulation Crowdfunding to implement these requirements. Under these rules, eligible companies are exempted from registration for Internet-based securities offerings of up to $1.07 million over a 12-month period. U.S. Sec. & Exch. Comm'n, Vladimir Ivanov and Anzhela Knyazeva, *U.S. Securities-based Crowdfunding Under Title III of the JOBS Act* (Feb. 28, 2017), available at https://www.sec.gov/dera/staff-papers/white-papers/28feb17_ivanov-knyazeva_crowdfunding-under-titleiii-jobs-act.html.

namely larger entities—have created workarounds to bypass the Rule regarding investment caps and limitations. For example, issuers have run concurrent offerings under Regulation Crowdfunding and Reg D side by side for accredited investors, with an option to send accredited investors into the Reg D offering. This enables issuers to raise an unlimited amount from accredited investors and reserve the $1.07m maximum capital raise for nonaccredited investors. In addition, accredited investors under Regulation Crowdfunding are prevented from investing discretionary amounts and thus can invest more money in a Reg D offering.

Although the $1.07 million cap could be increased to provide balance to the number of disclosure and other requirements under Regulation Crowdfunding, many Regulation Crowdfunding offerings do not reach the existing cap. This may be due to the exclusion of certain investment vehicles. Many accredited investment crowdfunding platforms operate on the investment fund model by recruiting investors to invest in an SPV. Traditionally, angel investors operate in groups and follow a lead investor, which allows all investors to exist on an equal playing field. An additional benefit to this model is that the company ends up with one additional investor on its cap table, as opposed to the hundreds that result under the current rule.

Additionally, Regulation Crowdfunding could raise the investment caps for investors. Currently, the rule caps investors based on their income or net worth, with a separate hard cap regardless of these factors. At a minimum, there could be no hard cap for accredited investors: the $107,000 cap on high net worth individuals who have the capacity to participate in a Regulation Crowdfunding offering is too restrictive.

Finally, Regulation Crowdfunding funded companies that cross the $25 million asset threshold are required to register with the Commission. This may prevent companies from growing, which seems antithetical to the spirit of the Regulation. Regulation Crowdfunding was intended to democratize the startup investment space by enabling those shut out from private offerings from their lack of accredited investor status participate in deals for the first time. Improving upon these rules and allowing for greater participation will allow the market to better tap the potential of the regulation.

### 5. Pooled Investment Funds[70]

Certain restrictions on pooled investment funds unreasonably inhibit their access to capital and hinder investors' ability to participate in pooled investment funds.

Section 205(a)(1) of the Advisers Act prohibits an investment adviser (whether SEC-registered or not, unless exempt from registration under Section 203(b)) from receiving any type of performance-based advisory fee, calculated as a percentage of capital gains or appreciation in the client's account. The Investment Advisers Act also contains exceptions from this prohibition for contracts with: (1) registered investment companies and clients having more than $1 million in managed assets, if specific conditions are met; (2) private investment companies excepted from the Investment Company Act under Section 3(c)(7) of that Act; and (3) clients that are not U.S. residents. In addition, Rule 205-3 under the Advisers Act permits investment advisers to charge performance fees to: (1) clients with at least $750,000 under management with the

[70] This section is most notably addressing paragraph 123 in the Concept Release.

adviser or more than $1,500,000 of net worth; (2) clients who are "qualified purchasers" under Section 2(a)(51)(A) of the Investment Company Act; and (3) certain knowledgeable employees of the investment adviser. But, performance related fees can be an important incentive for registered investment advisors to facilitate investments in private companies, thus they should be permitted to charge performance fees—on exit from the investment—to all clients. There should be no restrictions on an advisor's ability to charge performance-based fees. Equally important, investors should have the ability to hire advisors who are incentivized by a performance-based fee. Some investors are limited in the advisors who will accept them as clients because they do not have the net worth that enables a performance-based fee. As a consequence, these investors are disqualified to be certain advisors' clients based purely on their net worth.

In addition, while the Concept Release does not specifically raise the following issues, we recommend that they be considered as part of the comprehensive review.

First, private funds face two different limits on the number of investors—100 under one exemption[71] and fewer than 2,000 under a different exemption.[72] This causes confusion, and should be normalized making both exemptions available for less than 2,000 accredited investors.[73] Simplifying and harmonizing these rules will increase opportunities for investors and make it easier to maneuver through the regulatory landscape. We recommend that both (c)(1) and (c)(7) funds should be available to accredited investors, and SPVs should be counted as one entry on the cap table and one beneficial owner. Here again, we encourage the Commission to consider the fundamental purposes of the federal securities laws and jettison arbitrary limitations on investor participation, particularly when those investors can fend for themselves.

Section 3(c)(1)[74] excludes funds beneficially owned by not more than 100 persons that are not making and, do not propose to make, a public offering of their securities. The Economic Growth Act amended this section to increase the limit to 250 persons in the case of a qualifying venture capital fund, which is a venture capital fund with not more than $10 million in aggregate capital contributions and uncalled committed capital. Conversely, Section 3(c)(7)[75] exempts from the definition of an investment company, any fund the outstanding securities of which are owned exclusively by persons who at the time of acquisition are "qualified purchasers."

71 Investment Company Act § 3(c)(1).

72 *Id.* § 3(c)(7).

73 Once the number of holders of record of an equity security reaches 2,000, or other thresholds are met, the Exchange Act § 12(g) requires the issuer is required to register the class of equity securities.

74 15 U.S.C. 80a-3(c)(1); The Economic Growth Act clarified the number of investors could be increased to 250 individuals provided that certain conditions are met, including that the fund (i) has at all times less than $10 million in aggregate capital contributions and uncalled committed capital; and (ii) meets the definition of a "venture capital fund," which is defined through a cross reference to Rule 203(l)-1 under the Investment Advisers Act.

75 15 U.S.C. 80a-3(c)(7).

Second, funds relying on the "Venture Capital Exemption"[76] should be allowed to purchase securities in the secondary market in excess of the 20% limit. We propose a limit up to 49.9%, which would leave at least 50.1% to remain in primary investments. This percentage would still provide balance to portfolios. However, secondary offering restrictions should only apply to issuers' securities that have not been registered. We believe that this approach may lead to a more vibrant secondary market for VC-backed issuers' securities. According to the Commission at the time of the Rule's adoption, no empirical evidence was provided showing that the venture capital industry helped determine the appropriate size of the basket, although it relied on certain anecdotal evidence from advisers' experiences with non-qualifying investments.[77] After reviewing these comment letters, and "after giving due consideration" to approaches suggested by comment letters at the time, the Commission adopted a limit of 20% of a qualifying fund's capital commitments for non-qualifying investments.[78] Indeed, it even appears that 20% was the bare minimum certain commentators—relied on by the Commission—would accept.[79]

In the ensuing eight years since the Rule's adoption, it has become clear that increasing this limit now may provide even better flexibility for venture capital fund managers to structure portfolio company investments during changes in the market. This is especially crucial, as venture capital funds look toward investing in digital currencies. Under Rule 203(1)-1, venture capital funds are limited in the amount they can invest in digital investments vis-à-vis the capacity of the 20% basket. For that same reason, venture capital funds focused solely on digital investments are not feasible. This is because many of these investments are not considered "equity securities," as the term is defined under the Rule. Consequently, those investments are limited to the remaining capacity of the venture capital fund's 20% basket.

This, in turn, raises the notion that Rule 203(1)-1 may be considered for revision, too, particularly where emerging growth companies are not considered a qualifying portfolio company under the Rule. The change would allow venture capital funds to better support start-ups and other similar firms, although they are similarly constrained by Rule 203(1)-1. For example, and as stated above, Section 504 of the Economic Growth Act permits venture capital funds with 250 investors to qualify for an exemption under Section 3(c)(1) so long as, among other things, it has less than $10 million in aggregate capital contributions and uncalled committed capital. Generally, the $10 million cap is too low for many venture capital funds to qualify, and those that do, will eventually exceed that cap.

Indeed, under Rule 203(1)-1, "qualifying investments" are limited to, as mentioned above, investments in equity securities. Although Chairman Clayton has noted that most initial coin offerings are securities offerings that should be registered with the Commission, many of

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76 Investment Advisers Act § 203(l).

77 U.S. Sec. & Exch. Comm'n, *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less than $150 Million in Assets Under Management, and Foreign Private Advisers*, 17 CFR Part 275, Rel. No. IA-3222, at 17, available at https://www.sec.gov/rules/final/2011/ia-3222.pdf.

78 *Id.*

79 *Id.* at 18 fn. 72 (quoting the Charles Rivers letter) ("anything less than 20% would be inadequate").

them are not necessarily equity securities offerings. Therefore, when it comes to digital investments, it is not feasible to continue to view venture capital funds as distinguished from private equity and other funds.

Third, private funds should be able to facilitate secondary trading on their own securities between investors to allow for liquidity. Historically, venture capital has been too small within the alternative assets class to support a robust secondary market; however, recent years have shown the significant growth in the amount of money allocated to venture capital investments. There exists, however, a disparity between venture capital investments and venture-backed companies. As a result, the secondary market has served as an alternative liquidity vehicle for investors in venture-backed companies. Indeed, there are numerous reasons why a venture investor may consider a secondary transaction. These include facilitating a return of cash to venture capital firms' limited partners, the age of the firm, or the changing direction of the firm.

### 6. Exempt Offering Framework—Stimulating Independent Investment Research[80]

In considering the exempt framework overall, it would be significantly improved and facilitate the flow of capital if there was more information sharing, particularly, from independent research analysts. This consistent communication with investors about the performance of the issuer and the market would considerably improve capital formation, investor protection with added information, and the fairness, orderliness, and efficiency of the private markets. Issuers may be well-served if they can retain and pay research analysts to provide coverage subject to appropriate compliance measures to mitigate conflicts of interest. And while research cannot solve all small issuer challenges, more research on more issuers can certainly contribute to improved liquidity and more continuous trading for smaller issuers.

The volatility of today's markets requires an explanation of its direct relationship with various geopolitical factors in order for investors to make informed decisions and meet their financial objectives. Equity research is, therefore, the cornerstone of a healthy market; it provides the necessary tools to all market participants—from large institutional investors, to small individual investors—to best observe growth patterns in a particular company. This is particularly important for smaller buy-side shops that lack the resources to monitor entire sectors for certain important trends.

Here, as the definition of accredited investor comes into view—and the proficiency and sophistication of investors as a whole—the value of research is all the more important. Because investors vary in sophistication, equity research is all the more valuable because it provides a resource that is typically only available to institutional investors. We believe it is therefore crucial to the Commission's analysis, to consider the importance of investment research, noting just how much research can supplement deficiencies on even the most basic level, helping investors frame their investment narrative.

[80] This section is most notably addressing paragraph 7 in the Concept Release.

The influence of equity research is most tangible when examining the aftermath of the revised Markets in Financial Instruments Directive, MiFID II,[81] which saw a dramatic decline in research budgets across Europe and crystallized a longstanding crisis for equity research. Under MiFID II, providers of research are now required to set prices and charge for research separately from trading costs (i.e., commissions and spreads), which has resulted in investment management firms deciding whether to absorb the cost of research or pass it on to clients. Although the intent of these rules was to reduce potential conflicts of interest between investment managers and their clients, it has resulted in higher (bundled) transaction costs. Indeed, in December 2018, Chairman Clayton noted MiFID II's impact by highlighting concerns that "the broad availability of research may be reduced." In 2018, European equity research declined by $300 million in the wake of MiFID II's rules on unbundling payments for investment research.[82]

MiFID II has not only impacted the number of analysts, but the type of companies covered. Since its enactment, there has been an upswing in the number of larger companies at the expense of smaller players,[83] whose exclusion may ultimately result in a lack of diversity and choice in investment options.

In the U.S., there has also been a decline in research coverage of equities, particularly for small cap companies. A 2017 report indicates that 61% of U.S. companies with less than a $100 million market cap had no research coverage.[84] This is alarming, particularly where small-cap companies are illiquid by nature. According to former NASDAQ Vice Chairman David Weild, without equity analysts as "intermediaries to provide research, marketing, and capital commitment to support liquidity, small-cap markets deteriorate."[85] The result is what has been seen in Europe: the shifting of capital allocations away from smaller companies. The Commission has received testimony directly on the adverse effects that smaller companies face without research. During the Commission's April 23, 2018 Roundtable on market structure for thinly traded securities, Adam Epstein of Third Creek Advisors noted, "[t]rading illiquidity gravely impacts the ability for small cap companies to garner and retain research coverage. Trading illiquidity gravely impacts mergers and acquisitions in the small cap ecosystem. Trading illiquidity gravely impacts the ability for small cap companies to hire and actually retain

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81 The Markets in Financial Instruments Directive is EU legislation that regulates firms who provide services to clients related to financial instruments and the venues where those instruments are traded. *See* Financial Conduct Authority website, available at https://www.fca.org.uk/markets/mifid-ii.

82 Hayley McDowell, THE TRADE, *MiFID II sees $300 million decline of equity research industry* (Jan. 10, 2018), available at https://www.thetradenews.com/mifid-ii-sees-300-million-decline-of-equity-research-industry/.

83 Sanford Bragg, INTEGRITY, *MiFID II Isn't Working as Intended and Investors are Losing as a Result* (Dec. 6, 2018), available at http://www.integrity-research.com/mifid-ii-isnt-working-intended-investors-losing-result/.

84 CapitalIQ as of June 9, 2017.

85 Testimony of David Weild before the U.S. House of Representatives Financial Services Committee, *Capital Markets and Government Sponsored Enterprises Subcommittee*, May 13, 2015, available at https://financialservices.house.gov/uploadedfiles/05.13.2015_david_weild_testimony.pdf.

great employees."[86] Even the U.S. Treasury noted that a "lack of research coverage for smaller public companies" was contributing to fewer IPOs. In outreach meetings with the U.S. Treasury, smaller public companies asserted that sell-side research coverage of their firms has become sparse, or has even been discontinued, due in part to the increase in regulation and compliance costs caused by the Global Settlement of Conflicts of Interest Between Research and Investment Banking ("Global Settlement").[87] The U.S. Treasury recommends a holistic review of the Global Settlement and the research analyst rules to determine which provisions should be retained, amended, or removed, with the objective of harmonizing a single set of rules for financial institutions.[88]

## Conclusion

We commend the Commission for issuing the Concept Release and examining the multifaceted private offering regulatory regime. Issuers, investors, and entrepreneurs will all benefit from the Commission's commitment to facilitating capital formation and promoting efficient private markets. Our capital markets are dynamic and must meet the needs of all market participants. Companies must have access to sources of equity capital at each stage in their development. Regulation should not drive companies to seek an initial public offering as the only option. Healthy private markets with increased investor participation can provide investors with more opportunities and not lose the protections afforded by the securities laws. We encourage the Commission to remain mindful of the fundamental purposes underlying the creation of the federal securities laws and the assumptions on which the current rules are based, and examine whether our current regulatory regime achieves those purposes and is in fact based on accurate assumptions representative of our current society, markets, issuers, and investors.

Thank you for your consideration of our comments. We welcome the opportunity to discuss our observations and comments with the Commission and its Staff.

Rashad Kurbanov, CEO
Iownit Capital and Markets, Inc

86 Transcript of Roundtable on Market Structure for Thinly-Traded Securities, (Apr. 23, 2018) (the "Roundtable Transcript"), at 21-22 https://www.sec.gov/spotlight/equity-market-structure-roundtables/thinly-traded-securities-rountable-042318-transcript.txt.

87 *See generally*, U.S. Sec. & Exch. Comm'n, Press Rel., *Federal Court Approves Settlement of SEC Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking*, (Oct. 31, 2003), available at https://www.sec.gov/news/press/2003-144.htm.

88 U.S. Department of the Treasury, *A Financial System That Creates Economic Opportunities: Capital Markets*, (Oct. 2017), available at https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.