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PUBLIC INTEREST COMMENT

HARMONIZING PRIVATE SECURITIES OFFERING EXEMPTIONS

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Concept Release on Harmonization of Securities Offering Exemptions
Agency: Securities and Exchange Commission
Comment Period Opens: June 26, 2019
Comment Period Closes: September 24, 2019
Submitted: September 24, 2019
Docket No. S7-08-19
RIN: 3235-AM27

Thank you for the opportunity to comment on the Concept Release on Harmonization of Securities Offering Exemptions issued by the Securities and Exchange Commission (SEC).[1] I am a senior affiliated scholar with the Mercatus Center at George Mason University and formerly taught securities regulation at the University of Virginia School of Law. From 2006 to early 2009, I served as deputy general counsel at the SEC. The Mercatus Center is dedicated to bridging the gap between academic ideas and real-world problems and to advancing knowledge about the effects of regulation on society. Its interest and my interest in providing this comment is to assist the SEC in identifying ways to improve the regulatory process for raising capital while preserving investor protections. The comment is not submitted on behalf of any other person or group.

This comment proposes a new exemption from the section 5 registration requirements. The proposed approach would simplify and harmonize several of the current exemptions with the aim of further promoting capital formation for startup companies and small to mid-sized companies. It would combine features from Rules 506(b) and (c) of Regulation D and eliminate costly and cumbersome limitations and restrictions that are part of current exemptions for smaller companies, particularly Regulation A, Regulation CF, and Rule 504 of Regulation D. The approach here also would broaden the base for sources of capital by eliminating the accredited investor restriction but preserving the fundamental investor protection of extensive disclosure.

The method to achieve these goals is to return to the emphasis on disclosure that is the premise for the private offering exemption under section 4(a)(2). The settled judicial construction of the exemption is a transaction in which offerees receive or have access to the information that

[1] Concept Release on Harmonization of Securities Offering Exemptions, 84 Fed. Reg. 30,460 (June 26, 2019) ("Concept Release").

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would have been in a registration statement, but Rules 506(b) and (c) have only a distant connection to that construction. The new exemption would mandate disclosures, unlike current Rule 506 for accredited investors, and this change would make the accredited investor category unnecessary. The required disclosures would be sturdy but significantly more efficient than the burdensome set of mandatory disclosure items for registered offerings, Regulation A transactions, and nonaccredited investors. The new exemption would streamline disclosure of core company information to a prospective buyer, and that disclosure would both satisfy the private offering exemption and dispense with the need for an accredited investor limitation.

This comment will proceed in the following way:

- *Basis for a new exemption.* The first part of this comment reviews the data and information from several SEC sources that provide the reasons for a new exemption. The information demonstrates the popularity of the Rule 506(b) exemption; the relative lack of demand for Rule 504, Regulation A, and Regulation CF transactions; and the problems with the definition of "accredited investor."
- *Role of mandatory disclosure.* The next part reexamines the section 4(a)(2) private offering exemption and shows that its basis is adequate disclosure and not traits that have crept into the definition of accredited investor. The objective of the Securities Act was to transmit sufficient accurate information to allow investors to make their own choices and protect themselves. It was not to categorize investors into favored and disfavored classes based on income, wealth, or sophistication and was not to protect investors from investments that failed on the merits.
- *Proposed new exemption.* The comment then describes the features of the new exemption beginning with disclosure and delivery requirements.
- *Comparison with current offering methods.* For an appropriate understanding of the proposed exemption, it is compared to and contrasted with the section 5 registered offer and the exemptions from section 5 in Rule 506.
- *Preference for legislation.* The final part recommends that the SEC proceed by proposing legislation to Congress rather than by rulemaking, although the SEC has authority to make many, but not all, the changes proposed here by notice-and-comment rulemaking. Congress is the appropriate institution to decide on significant policy adjustments to the offering exemptions. As a result, even though this comment occasionally speaks in terms of the SEC adopting specific changes, ultimately the better course would be for the SEC to decide on appropriate reforms of the offering exemptions and submit a comprehensive legislative proposal to Congress.

I. REASONS FOR A NEW EXEMPTION

Data and information in the Concept Release and other SEC studies support the need for an exemption of the type proposed in this comment. The relevant propositions are these:

First, the exemptions from the registration requirement overlap and are confusing and inconsistent. They evolved over time from legislation and agency rulemaking and not from a rational, coherent plan.[2]

Second, the most favored form of exempt transaction is a Rule 506(b) offering sold only to accredited investors and not to any nonaccredited investors. Firms have shown a decided preference for Rule 506 transactions over Rule 504, Regulation A, or Regulation CF transactions. In 2018, the amount raised using Rule 506(b) was $1.5 trillion. The amount from using Rule 506(c) was $211 billion. The amount raised using Rule 504 was $2 billion, the amount from Regulation A was $736 million, and the amount from Regulation CF was $55 million. Together, Rule 504, Regulation A, and Regulation CF offerings raised approximately 0.16 percent of the amount raised through Rule 506.[3]

Rule 504 and Regulations A and CF have dollar limits on the amount that can be raised, but those dollar limits do not explain the difference in total amounts raised. In the years 2009 through 2017, the median amount raised by nonfinancial issuers under Rule 506 was less than $1 million.[4] In new offerings up to $5 million in those years, 98 percent of the capital was raised through Rule 506 offerings and 2 percent through other Regulation D exemptions.[5]

These data tell us that Rule 504 and Regulations A and CF have not been significant contributors to capital formation. Many reasons for this exist, no doubt, and perhaps over time those exemptions will become much more widely used. Issuers are possibly still becoming familiar with Regulation A and Regulation CF, but regulatory requirements undoubtedly play a role. Rule 504 has incentives to comply with state registration laws, and Regulation A incorporates many features of a public offer, has high compliance costs, and has only tepid public support.[6] Regulation CF has a shorter set of mandatory disclosures but imposes a series of other onerous obligations on issuers, such as restrictions on the amounts that may be sold and the need to use an intermediary, which has its own long list of obligations to satisfy, making it an expensive and burdensome method of raising capital for a startup enterprise.[7] Given the large dollar amounts raised under Rule 506, this comment will mainly address the exemptions in that rule.

Third, Rule 506 transactions frequently did not include nonaccredited investors even when the law permitted them to buy. Up to 35 nonaccredited investors may buy in a Rule 506(b)

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[2] Concept Release, 30,461, 30,468.

[3] Concept Release, 30,466; see also Manning G. Warren, "The Regulatory Vortex for Private Placements," *Securities Regulation Law Journal* 45, no. 1 (2017): 9 (discussing preference for Rule 506(b)).

[4] Scott Bauguess, Rachita Gullapalli, and Vladimir Ivanov, "Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017" (white paper, Division of Economic and Risk Analysis, Securities and Exchange Commission, August 2018), 2.

[5] Bauguess, Gullapalli, and Ivanov, "Capital Raising in the U.S.," 20.

[6] See Usha R. Rodrigues, "Financial Contracting with the Crowd" (Legal Studies Research Paper No. 2019-21, University of Georgia School of Law, Athens, GA, July 26, 2019), 18–19, 64; Rutherford B. Campbell Jr., "The SEC's Regulation A+: Small Business Goes under the Bus Again," *Kentucky Law Journal* 104, no. 2 (2015–2016): 330, 335–37.

[7] See SEC, "Regulation Crowdfunding" (staff report, Securities and Exchange Commission, Washington, DC, June 18, 2019), https://www.sec.gov/files/regulation-crowdfunding-2019_0.pdf; see also Rodrigues, "Financial Contracting with the Crowd," 5, 19–24, 51 ("equity crowdfunding . . . is widely regarded as not being worth the effort"; crowdfunding "is broken"); Qing Burke, "Determinants of Securities Crowdfunding Success under SEC Regulation Crowdfunding" (working paper, Miami University, July 30, 2019), https://ssrn.com/abstract=3425853 (finding that 63 percent of companies conducting securities crowdfunding campaigns from 2016 to 2018 successfully raised capital and that ventures that have higher revenue and larger management teams, are older in firm age, and are located in California or New York are more likely to receive funds from crowdfunding investors); Stuart R. Cohn, "The New Crowdfunding Registration Exemption: Good Idea, Bad Execution," *Florida Law Review* 64, no. 5 (September 2012): 1433.

transaction, although each must be sophisticated or have a sophisticated representative. The Concept Release said that "issuers reported non-accredited investors as participating in only six percent of Rule 506(b) offerings in each of 2015, 2016, 2017, and 2018."[8] One study found that 88 percent of Rule 506 offerings of $1 million or less were limited to accredited investors.[9]

Fourth, the income and wealth tests for qualifying a natural person as an accredited investor in Regulation D have been criticized for a wide variety of reasons.[10] Income and wealth are not effective ways of identifying the persons who understand the risks of buying securities and are not even effective ways of defining a population of persons sufficiently sophisticated to request relevant disclosures. Recently, the objection has been that nonaccredited investors have been excluded from attractive investment opportunities in growing private companies.[11] The exclusion has chafed more as high-growth companies have remained private much longer.

The information from the Concept Release and other SEC studies indicates that the SEC should reduce and simplify the number of exemptions for small and medium-sized companies, should preserve features from Rule 506 that the market finds attractive, and should reconsider everything about the definition of an accredited investor, including the advisability of having such a category at all. The question is how to accomplish these goals, and the proposal in this comment is a new exemption that would supplant Rule 504 and Regulations A and CF and, over time, could come to supersede the need for the Rules 506(b) and (c) exemptions.

II. THE ROLE OF MANDATORY DISCLOSURE

The principal difference between the new exemption proposed here and the current exemptions in Rules 506(b) and (c) is the requirement for a disclosure document in every case. The reason for a disclosure document is that the justification for the private offering exemption in section 4(a)(2) is proper disclosure. The definition of "accredited investor" was originally developed to implement that exemption but over time has moved further and further away from the original conception. That evolution has led to a definition prompting many criticisms. The next sections of this comment review these developments and the essential role of mandatory disclosure.

A. The Securities Act

Congress enacted the Securities Act in 1933 mainly because it and the president concluded that voluntary disclosure of information at the time an issuer sold securities was not adequate and that a system of mandatory disclosure was needed. Congress and President Roosevelt deliberately eschewed government selection of meritorious securities offerings or limitations on the nature of persons who could invest.[12] The fundamental reform of the Securities Act was the registered offering with mandatory disclosure items listed in Schedule A or B.

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[8] Concept Release, 30,467n47.

[9] Rutherford B. Campbell Jr., "The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions," *Business Lawyer* 66 (2011): 919, 930 table VII.

[10] Concept Release, 30,473–77; Thaya Brook Knight, "Your Money's No Good Here: How Restrictions on Private Securities Offerings Harm Investors" (Policy Analysis No. 833, Cato Institute, Washington, DC, February 9, 2018), 13–14 (describing criticisms of the accredited investor definition).

[11] Concept Release, 30,467.

[12] Comm. on Interstate and Foreign Commerce, Federal Supervision of Traffic in Investment Securities in Interstate Commerce, H.R. Rep. No. 73-85, at 1–5 (1933).

Underlying those choices was respect for the personal autonomy and liberty of investors. Under the Securities Act, the legal obligation of the issuer was to provide truthful and complete disclosure. If investors had true information about a company and its securities, they could make up their own minds about whether to buy. The Securities Act allowed any person to buy a security in a registered offering and allowed any person other than an issuer, underwriter, or dealer freely to resell securities. The law did not limit the amount of money a person could invest. The law did not limit potential investors to landowners, financial institutions, or natural persons with a large net worth or with the ability to sustain the loss of the investment.[13]

The federal securities laws were meant to increase the flow of accurate information and not to protect investors in a paternalistic way from potentially bad investments. Investors were free to put resources at risk. They could buy securities in a company that looked risky or that proved to be successful or not successful. Investor protection was the spirit of the federal securities laws, but it was protection consistent with the country's history and tradition of freedom and self-reliance.[14]

The disclosure approach is not perfect. It has flaws and weaknesses. Prospectuses in public offers and annual reports from public companies are constantly criticized for prolixity, complexity, obfuscation, and repetitiveness.[15] Congress and the SEC regularly attempt to reform and improve the disclosure system,[16] but some of the flaws have been intractable. Mandatory disclosure has nonetheless remained the centerpiece of the federal securities laws.

B. The Private Offering Exemption

According to the leading judicial decisions, the private offering exemption in section 4(a)(2) was tied to the registration process of the Securities Act by allowing unregistered offers to be made to offerees with knowledge of or access to the information that would be in a registration statement. Information and disclosure are the foundations for the exemption.

The Securities Act exempted certain transactions from the registration requirement. The House report accompanying one of the main predecessors of the act said the bill "carefully exempts from its application certain types of securities and securities transactions where there is

[13] Knight, "Your Money's No Good Here," 1–4 (the accredited investor category denies individuals the choice to take certain financial risks).

[14] See Acting SEC Chairman Michael Piwowar, "Remembering the Forgotten Investor" (Remarks at SEC Speaks 2017, Washington, DC, February 24, 2017) ("Unlike merit-based regimes, our system of disclosure comports well with American traditions of self-reliance, pioneering spirit, and rugged individualism. By arming investors with information, they can evaluate and make investment decisions that support more accurate valuations of securities and a more efficient allocation of capital.").

[15] Lisa M. Fairfax, "The Securities Law Implications of Financial Illiteracy," *Virginia Law Review* 104, no. 6 (October 2018): 1086–96 (citing authorities); Lauren Cohen, Christopher Malloy, and Quoc Nguyen, "Lazy Prices" (NBER Working Paper 25084, National Bureau of Economic Research, Cambridge, MA, 2018); Troy A. Parades, "Blinded by the Light: Information Overload and Its Consequences for Securities Regulation," *Washington University Law Review* 81, no. 2 (2003): 432; KPMG, *Disclosure Overload and Complexity: Hidden in Plain Sight*, 2011, 10; Susanna Kim Ripken, "The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation," *Baylor Law Review* 58, no. 1 (2006): 139, 146–47, 162, 181, 185.

[16] See, e.g., Fixing America's Surface Transportation Act, Pub. L. No. 114-94, § 72002, 129 Stat. 1784 (December 4, 2015); Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 108, 126 Stat. 306 (2012); FAST Act Modernization and Simplification of Regulation S-K, Final rule, 84 Fed. Reg. 12,674 (April 2, 2019); Modernization of Regulation S-K Items 101, 103, and 105, Release No. 33-10668 (August 8, 2019) (proposing rule amendments to modernize the description of business, legal proceedings, and risk factor disclosures that registrants are required to make pursuant to Regulation S-K).

no practical need for its application or where the public benefits are too remote."[17] The registration process in what became section 5 was to be the typical method of selling securities.[18]

One of the exemptions, now in section 4(a)(2), was for "transactions by an issuer not involving any public offering." Two main judicial decisions interpreted the exemption.

The leading authority is *SEC v. Ralston Purina*.[19] The Supreme Court began by saying that 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."[20] The Court then concluded that "the exemption question turns on the knowledge of the offerees" and that the "focus of inquiry should be on the need of the offerees for the protections afforded by registration. The employees here were not shown to have access to the kind of information which registration would disclose."[21]

The opinion also said that an "offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering,'"[22] but that phrase has been misconstrued and taken out of context over the years. The question was whether a person needed the protections of the act, and the protections of the act were the disclosures in a registration statement. People able to fend for themselves were those possessing or having access to the information that would be in a registration statement. Being able to fend for yourself did not mean wealth, sophistication, or the ability to sustain a loss.

More than 20 years later, the Fifth Circuit in *Doran v. Petroleum Management Corp.*[23] considered the private offering exemption and *Ralston Purina*. The *Doran* decision has become a leading authority and is featured in several securities regulation casebooks.[24] The court decided that the private offering exemption did not apply unless "each offeree had been furnished information about the issuer that a registration statement would have disclosed or . . . each offeree had effective access to such information."[25]

The Fifth Circuit drew a distinction between offerees who were furnished with the information a registration statement would provide and offerees who had access to that information. All offerees must have the information available in one of the two ways "as a necessary condition of gaining the private offering exemption."[26]

A high degree of business or legal sophistication of all offerees was not sufficient to qualify for the private offering exemption. "Sophistication is not a substitute of access to the information

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[17] Comm. on Interstate and Foreign Commerce, Federal Supervision of Traffic in Investment Securities in Interstate Commerce, at 5.
[18] Comm. on Interstate and Foreign Commerce, Federal Supervision of Traffic in Investment Securities in Interstate Commerce, at 6–7.
[19] SEC v. Ralston Purina Co., 346 U.S. 119 (1953).
[20] *Ralston Purina*, 346 U.S. at 124–25 (footnote omitted).
[21] 346 U.S. at 126, 127.
[22] 346 U.S. at 125.
[23] Doran v. Petroleum Management Corp., 545 F.2d 893 (5th Cir. 1977).
[24] Stephen J. Choi and A. C. Pritchard, *Securities Regulation: Cases and Analysis*, 5th ed. (St. Paul, MN: West Academic, 2019), 668; John C. Coffee Jr., Hillary A. Sale, and M. Todd Henderson, *Securities Regulation: Cases and Materials*, 13th ed. (St. Paul, MN: West Academic, 2015), 353.
[25] *Doran*, 545 F.2d at 897; see also Gilligan, Will & Co. v. SEC, 267 F.2d 461, 466 (2d Cir. 1959).
[26] 545 F.2d at 903.

that registration would disclose."[27] There "must be sufficient basis of accurate information upon which the sophisticated investor may exercise his skills."[28]

Sophistication of an offeree matters when an offeree is provided access to information but does not receive actual disclosure of information. The "investment sophistication of the offeree assumes added importance [when offered access], for it is important that he could have been expected to ask the right questions and seek out the relevant information."[29]

The two cases established the principle that the private offering exemption applies when all offerees either have the information that would be in a registration statement or have access to that information. They can then fend for themselves. Investor sophistication is a consideration when an offeree has access to but has not actually received the relevant information. As interpreted in these cases, the section 4(a)(2) exemption was about offers to persons with the relevant disclosures and was not about special opportunities for the wealthy or financially sophisticated. It was not about excluding broad swaths of the population from investment opportunities.[30]

III. PROBLEMS WITH THE ACCREDITED INVESTOR CATEGORY

Judicial constructions of the private offering exemption in section 4(a)(2) did not provide the marketplace with the definiteness and certainty it demanded. The SEC addressed this problem with a series of rules leading to Regulation D and the concept of the accredited investor. As that category evolved, it grew further apart from appropriate disclosure and the court interpretations in *Ralston Purina* and *Doran*.

Early SEC efforts to bring more certainty to the private offering exemption hewed closely to the *Ralston Purina* principle of disclosure or access to the information that would have been in a registration statement. That was true for a 1962 interpretation and for Rule 146, which was adopted in 1974.[31]

The SEC and Congress moved toward the current definition of accredited investor with developments in 1979 and 1980.[32] The SEC then proposed Regulation D in 1981 and adopted it in 1982.[33] Regulation D defined a category of accredited investors that included institutional investors

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[27] 545 F.2d at 902.

[28] 545 F.2d at 903.

[29] 545 F.2d at 905.

[30] The Concept Release estimated that 16 million US households, about 13 percent, qualified as accredited investors under the existing criteria. See Concept Release, 30,471.

[31] Non-Public Offering Exemption, 27 Fed. Reg. 11,316 (Nov. 16, 1962) (interpretation of private offering exemption, which depended mainly on "full disclosure of information" necessary to an informed investment decision); 17 C.F.R. § 230.146(e) (1979) (each offeree [or offeree representative] needed access to or receipt of the information that would be in a registration statement).

[32] The SEC proposed Rule 242 in 1979 and adopted it in 1980. See Exemption of Limited Offers and Sales by Qualified Issuers, Adoption of rules, rule amendments, and forms, 45 Fed. Reg. 6,362 (January 28, 1980). The rule had a category of accredited person, which included institutional investors and buyers of $100,000 or more of the offered securities. No disclosure document was needed if sales were made only to accredited persons. The SEC relied "on the ability of such persons to ask for and obtain the information they feel is necessary to their making an informed investment decision." See Exemption of Limiting Offers and Sales by Corporate Issuers, Proposed amendments to rules and forms, 44 Fed. Reg. 54,258, 54,259 (September 18, 1979). Also in 1980, Congress passed the Small Business Investment Incentive Act, which exempted offers and sales solely to accredited investors and defined accredited investors as one of five types of institutional entities or any person who—on the basis of factors such as financial sophistication, net worth, knowledge and experience in financial matters, or amount of assets under management—qualified as accredited under SEC rules. See Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980).

[33] Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Adoption of final rules, rule amendments, and forms, and rescission of rules and forms, 47 Fed. Reg. 11,251 (March 16, 1982).

and otherwise depended on net income, net worth, or a purchase of $150,000 of the securities so long as the purchase did not exceed 20 percent of the person's net worth. The regulation also required that a nonaccredited investor be sophisticated or have a sophisticated representative.

As originally proposed and to this day, sales made only to accredited investors under Regulation D do not need a disclosure document. See Rule 502(b)(1). Issuers may use Rule 506(c) to sell an unlimited dollar amount of securities to an unlimited number of accredited investors identified by a general solicitation, and they have no legal obligation to disclose anything. In some circumstances, sales to accredited investors occur with no disclosures, but the standard practice when selling only to accredited investors is to use a disclosure document of some kind. The disclosures might be in the form of a slide presentation or an abbreviated private placement memorandum, but disclosures of some sort are usually made,[34] generally because the buyers demand information and the issuers want to avoid liability for false or misleading statements. In addition, prospective investors often negotiate terms for the investment and conduct due diligence on the books and records of the issuer.

Over time, the definition of an accredited investor expanded and changed and now is not closely correlated with a person who has knowledge of the information that would be in a registration statement or access to that information. A natural person is an accredited investor based on net worth or net income, but those criteria do not provide a rational connection to an investor's ability to fend for him- or herself by having knowledge of information in a registration statement or having an ability to ask for and obtain the information felt necessary to making an informed investment decision.[35] The definition therefore has lost its relationship to the private offering exemption in section 4(a)(2).

The accredited investor category has come under attack for this and other reasons.[36] The chairman of the SEC and others have objected to the accredited investor concept because it limits the ability of the bulk of retail investors to invest in startups during their high-growth phase. In June 2018 testimony before the House Financial Services Committee, Chairman Clayton said, "Because it is generally difficult and expensive for Main Street investors to invest in private companies, they will not have the opportunity to participate in the growth phase of these companies to the extent they choose not to enter our public markets or do so only later in their life cycle."[37] The Treasury Department raised similar concerns in an October 2017 report: "To the extent that companies decide not to go public due to anticipated regulatory burdens, regulatory

[34] Knight, "Your Money's No Good Here," 12; Ashley J. Hersutamto, "A Fundamentally Different Regulatory Calculus: The Advent of Regulation D, 506(c)," *Florida International University Law Review* 10, no. 1 (Fall 2014): 259; Thomson Reuters Practical Law, "Startup Seed Financing Process: Convertible Notes and SAFEs," Westlaw, resource ID W-000-6519, accessed on August 22, 2019, https://content.next.westlaw.com/Document/Ic72c249d6d5311e598dc8b09b4f043e0/View/FullText.html?contextData=(sc.Default)&transitionType=Default&firstPage=true&bhcp=1.

[35] Concept Release, 30,475.

[36] See *supra* notes 10–11 and accompanying text.

[37] Oversight of the U.S. Securities and Exchange Commission, Hearing Before the House Financial Services Committee, 115th Cong. 3 (2018) (statement of Jay Clayton, Chairman, Securities and Exchange Commission); see also Piwowar, "Remembering the Forgotten Investor" ("prohibiting non-accredited investors from investing in high-risk securities amounts to a blanket prohibition on their earning the very highest expected returns."); Usha Rodrigues, "Securities Law's Dirty Little Secret," *Fordham Law Review* 81, no. 6 (May 2013): 3389.

policy may be unintentionally exacerbating wealth inequality in the United States by restricting certain investment opportunities to high income and high net worth investors."[38]

Commentators have suggested addressing the problem by redefining accredited investors in a variety of different ways.[39] Many comments have proposed expansion of accredited investor status based on various types of sophistication or use of advisers who are sophisticated. Some have proposed requiring investors to pass a test to demonstrate sophistication.

My view is that tinkering with the definition of accredited investors is the wrong approach. Many criticisms of the proposals to amend the definition exist,[40] but two are particularly important. First is that the proposals do not circle back closely enough to the fundamental disclosure basis for the private offering exemption. Second, many of the suggestions for amendments to the definition of an accredited investor heighten government intrusion into and control of private decisions and capital allocation. Definitions based on sophistication, financial acumen, testing, wealth, ability to bear a loss, limitation on investment amount, or discretionary income are all over- and under-inclusive, pry into personal privacy, require problematic line-drawing and verification procedures, increase compliance and enforcement costs, and reduce the personal liberty of investors. In the end, they all involve governmental classifications of the investing public, embracing some and excluding others. These consequences are not consistent with legislation aimed at transmitting enough information to allow investors to make their own choices and protect themselves.

The new exemption proposed here offers a way out of the difficulty with the definition of accredited investors and the perceived unfairness of offering investments to the wealthy but denying them to ordinary retail investors. Private offerings may be opened to all who take delivery of a solid disclosure document. Information is what matters.

IV. THE PROPOSED EXEMPTION: MANDATORY DISCLOSURE AND DELIVERY

The central element of the new exemption proposed here is preparation and delivery of a document with certain mandatory disclosures. The new exemption therefore would rely on the actual disclosure or furnishing of the required information and would not rely on a person's access to the information or a person's sophistication and ability to request the necessary information. It would return to the central idea of the private offering exemption in *Ralston Purina* and *Doran*.

The new exemption would differ from a registered offer and from transactions under Rule 506 in ways that will be discussed below, but the main difference would be that the extent of the mandatory disclosures would be much reduced from those required for a registered offer or a transaction under Rule 506(b) for nonaccredited investors or Regulation A. The model for the disclosure would be Regulation CF, and the aim would be to avoid the significant and off-putting expense associated with more extensive disclosure obligations.

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[38] Steven T. Mnuchin and Craig S. Phillips, A Financial System That Creates Economic Opportunities: Capital Markets (Report to President Donald J. Trump, Executive Order 13772 on Core Principles for Regulating the United States Financial System, United States Department of the Treasury, 2017), 27.
[39] See Concept Release, 30,475–77.
[40] See Knight, "Your Money's No Good Here," 17–20, 22.

A. Current Disclosure Obligations

Current law has many different approaches to mandatory disclosure. Some laws make extensive disclosures obligatory, such as those for an initial public offer, but others require minimal or no disclosures. Preparing a disclosure document involves costs, and the more elaborate disclosure documents involve higher costs.

The most detailed and costly disclosure document is the registration statement used in registered offerings under section 5. The preparation costs are high enough to deter companies from using registered offerings.

Preparation of a registration statement is a daunting task. Some allowances are made for smaller companies, but an issuer must hire legal and accounting experts and navigate SEC forms for public offers, such as Form S-1, and the lengthy and detailed mandatory disclosure obligations in Regulations S-K and S-X. PwC found that the average legal and accounting costs for initial public offerings of companies with a wide range of revenue from early 2015 to mid-2017 were $3 million. The average cost for companies with less than $100 million in revenue was $2.34 million.[41] Few startups or small companies can afford that outlay.

Those costs are just part of the costs of using a registered offer. A registered offer has other direct costs, such as the underwriting discount, and consequential indirect costs. Selling securities in a registered offering leads to continuing high costs because the company becomes a reporting company under section 12 or 15 of the Exchange Act. A company must file annual, quarterly, and current public reports, and section 12 public companies must comply with a variety of additional obligations in the federal securities laws, such as the proxy rules, tender offer regulation, and reports on internal controls. One commentator found that initial public offerings "cost too much to do and, once done, a company has much higher ongoing costs. The higher ongoing costs are a significant bone of contention, particularly with the implementation of Section 404 of the Sarbanes-Oxley Act of 2002."[42]

The disclosures for Regulation A also are significant. "Regulation A is a mini-public offering" and is structured much like a registered offering.[43] The required disclosures for a Regulation A offer are extremely long and detailed. An issuer must comply with Form 1-A, which on the SEC website is 29 pages long.[44] An SEC staff report found that the average legal and accounting costs of a Regulation A filing were approximately $110,000.[45]

A sale under Rule 506(b) to a nonaccredited investor requires disclosures. One set of obligations applies to reporting companies. For an issuer that is not a reporting company, the textual disclosures are those required in a part of Form 1-A for a Regulation A offering or a form for a registered offering. The required financial statement information varies with the amount of the

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[41] PwC, *Considering an IPO to Fuel Your Company's Future? Insight into the Costs of Going Public and Being Public*, 2017, 6, 8–9, https://www.pwc.com/us/en/deals/publications/assets/cost-of-an-ipo.pdf.

[42] Dale A. Oesterle, "The High Cost of IPOs Depresses Venture Capital in the United States," *Entrepreneurial Business Law Journal* 1 (2006): 369; see also David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth" (Heritage Foundation Backgrounder 11-12, Washington, DC, February 14, 2017); Ivy Xiying Zhang, "Economic Consequences of the Sarbanes-Oxley Act of 2002," *Journal of Accounting & Economics* 44 (2007): 110.

[43] Choi and Pritchard, *Securities Regulation*, 707.

[44] 17 C.F.R. §§ 230.252(a), 239.90; SEC, "Form 1-A, Regulation A Offering Statement under the Securities Act of 1933," https://www.sec.gov/files/form1-a.pdf.

[45] See Anzhela Knyazeva, "Regulation A+: What Do We Know So Far?" (white paper, Division of Economic and Risk Analysis, SEC, December 2016), 14.

offering. See Rule 502(b)(2). As a result, a nonreporting company using Rule 506(b) to sell to both nonaccredited and accredited investors faces substantial costs to make the necessary disclosures.

As mentioned above, Regulation D does not require any disclosure when sales are solely to accredited investors, although some disclosures are usually made. That practice shows that the expense of preparing a disclosure document in some form is acceptable in Rule 506 transactions with accredited investors.

The statute and rule creating the crowdfunding exemption specify disclosures that are more limited than those for other exemptions.[46] The mandatory disclosures cover only basic information such as the background of officers and directors, the business of the issuer, the material risk factors, a description of the intended use of proceeds, and the terms of the securities being offered.

B. Disclosure for the Proposed Exemption

The disclosure obligations of the new exemption should provide essential company and security information to buyers but avoid the high costs associated with more extensive disclosures. The test should be the basic information that any investor would require before investing. As with other exemptions, the disclosures should be different for reporting and nonreporting companies.

A reporting company would need to be current with its reporting obligations. It would need to provide a potential buyer with the Forms 10-K and 10-Q and a proxy statement filed within the past 12 months.

The disclosures for a nonreporting company would be similar to those for a crowdfunding offer, although the additional restrictions for such an offer would not apply. With some deletions and modifications, the crowdfunding disclosures are a reasonable model for a new private offering exemption because crowdfunding is open to all investors and is aimed at very small startup companies, which are not able to afford the preparation of more extensive disclosures. Some of the obligatory disclosures for a crowdfunding offer are irrelevant or too burdensome, such as disclosures related to the target amount of the offering and the need for audited financial statements from companies not able to afford them, and the new exemption should delete them or scale them back.

Other models for the disclosures required of a nonreporting company exist. The mandatory disclosures for the new exemption could be limited to those permitted in a notice under Rule 134(a) with appropriate amendments to modify the disclosures for an exempt offer rather than a registered offer. Another model is the required disclosures Congress included in Schedule A of the original Securities Act for registered offerings.

The required disclosures would be a minimum. Investors and issuers would retain the ability to negotiate other aspects of the sale process, such as the terms of the securities, additional disclosures, or access to books and records for due diligence.

An area that could use further study is the extent of disclosures necessary for a simple debt security. Most small companies prefer debt capital and seek loans in relatively modest amounts. "More than 70 percent of small businesses seek loans in amounts under $250,000, and more than

[46] See 15 U.S.C. § 77d-1(b)(1); 17 C.F.R. § 227.201.

60 percent want loans under $100,000."[47] Banks are the key source of this debt capital. Most small businesses apply to small banks for loans; many apply to large banks, and some use online lenders.[48] In one survey, only 7 percent of small businesses sought outside capital by the sale of corporate securities.[49]

This information raises a series of questions about the relationship and differences between the market for loans and the market for securities, particularly fixed income securities, for small business owners. The position of banks as intermediaries that have relationships with small business owners might be entrenched, but Congress and the SEC should consider whether the federal securities laws could be adapted to become a serious alternative to bank loans. One possibility is an exempt offering that is similar to the one proposed here but that is based on even more streamlined and shortened disclosures to parallel the disclosures small business borrowers currently make to lenders. Those disclosures should take into account that a purchase of a debt security differs in many ways from acquisition of a long-term ownership interest in the equity of a company.

The SEC should collect data about the information borrowers usually provide to lenders, through statements or due diligence access, and compare those disclosures to the information small issuers disclose to buyers of basic debt instruments qualifying as securities and to the information they disclose to buyers of common stock. If the information adequate for a typical lender for a small loan (say, under $1 million) is significantly less than the mandatory disclosures for an issuance of debt or equity securities in the same amount, the SEC might be able to reduce the disclosure obligations for certain debt securities. Less burdensome and costly disclosures for plain debt securities would be beneficial for both investors and small business borrowers and would return to Congress's original intent for disclosures in public offers. "The type of information required to be disclosed is of a character comparable to that demanded by competent bankers from their borrowers, and has been worked out in the light of these and other requirements."[50]

C. Delivery of the Disclosure Document

Because disclosure is the key part of the proposed exemption, delivery of the disclosure document is essential. The issuer would need to take steps to provide each potential buyer with a final version of the disclosure document before a purchase contract could be established.

A communication about the securities offering would need to provide a potential buyer with the disclosure document in paper or electronic form before a contract of sale would be valid. The potential buyer could be directed to a link on an internet site. An electronic communication could contain an active hyperlink to the disclosure document. If the issuer received an offer to buy from a person who had not already received a communication with a link to or a copy of the disclosure document, the issuer would not be able to accept the offer to buy until the issuer notified the

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[47] Karen Gordon Mills and Brayden McCarthy, "The State of Small Business Lending: Innovation and Technology and the Implications for Regulation" (working paper 17-042, Harvard Business School, Boston, MA, 2016), 3, 5; see also James R. Booth and Lena Chua, "Structure and Pricing of Large Bank Loans," *Economic Review—Federal Reserve Bank of San Francisco* 3 (1995): 52.

[48] Mills and McCarthy, "The State of Small Business Lending," 27–28.

[49] Brian Knight, "Small Business Capital Access" (Mercatus Survey, Mercatus Center at George Mason University, Arlington, VA, 2018), 7.

[50] Comm. on Interstate and Foreign Commerce, Federal Supervision of Traffic in Investment Securities in Interstate Commerce, at 4.

interested person of the availability of the disclosure document and the person later confirmed the purchase order.

Reliance on electronic delivery would help keep the costs of using the exemption low.

D. Resales and Periodic Disclosures after Issuance

Securities issued through the new exemption would be freely transferable. They would not be restricted securities under Rule 144, and the section 4(a)(1) exemption would be available for resales. The exemption should provide that a control person would not be an issuer under the definition of "underwriter" in section 2(a)(11) of the Securities Act.

Resales are as dependent on disclosures of current company information as the original issuance. Therefore, a company issuing securities under the new exemption should have an obligation to continue providing periodic disclosures to investors and the market for a minimum period of time, such as two years. Regulation CF Rule 202 already has a reasonable model for the mandatory disclosures in periodic reports, although reporting twice a year rather than annually might be worth considering. Alternative models for the content of a periodic report not as elaborate as Form 10-K or Form 10-Q are in sections 4(a)(7), 4(d)(3), Rule 144A(d)(4), or the information required for a nonreporting company in Rule 144(c)(2).

An issuer would have no other obligations as a company with periodic reporting obligations. It would not be a section 12, 13, or 15 reporting company and would not need to comply with the proxy or tender offer rules, section 16, or the various Sarbanes-Oxley requirements such as the report on internal financial controls. The owners of securities issued under the exemption would not count as record owners under section 12(g).

A company could stop making periodic disclosures after two years if it ceased doing business or it had a small number of shareholders, such as fewer than 100. This would be similar to the current approach in sections 12(g) and 15(d) of the Exchange Act with some modifications. If an issuer stopped making periodic disclosures, Rule 144 would need to apply to a resale by any holder, including a natural person.

Requiring an initial and periodic disclosure documents would impose a cost on the use of the new exemption. Three factors justify the cost. First, disclosure is the essence of the approach of the federal securities laws, and Rule 506 has strayed too far from that central value. Second, the proposed disclosures are significantly reduced from current law. They are meant to require core company and security information, but not anything like the disclosures mandated by Regulation S-K, Form S-1, Rule 506(b) for nonaccredited investors, or Regulation A. The cost of preparing the envisioned disclosure document is meant to be manageable for startup and small companies and is not meant to be so sizable that use of the new exemption would be prohibitively expensive. Third, under current law, some form of disclosure document is usually part of a Rule 506 offering to accredited investors.

V. OTHER FEATURES OF THE NEW EXEMPTION

Below are the remaining features of this proposed exemption. In general, the exemption would have very few restrictions and limitations. The intent would be to offer a simple, streamlined, and flexible method of raising capital to a broad range of issuers and all potential investors based on delivery of a reasonable but not unduly costly set of disclosures.

- The basis for the new exemption, at least in part, would be the private offering exemption in section 4(a)(2).
- The exemption would impose no limit on the amount that could be raised.
- With only limited exceptions, any issuer would be able to use the new exemption. At the moment, no limitation on eligible issuers exists for Rule 506(b) or (c). The new exemption has small and medium-sized issuers and nonreporting companies in mind but would not be limited to them. No revenue, market capitalization, or size limitation would exist, but, at least during a trial period, only operating companies would be able to use the exemption. An issuer would not be able to use the exemption if it is an investment company, is not an investment company because of section 3(b) or 3(c) of the Investment Company Act, or is a development stage company that has no specific business plan or purpose or has a business plan to merge with or acquire an unidentified person. The reason for this limitation is that the disclosure obligations in Regulation CF are tailored for an operating company. Different disclosures would be needed for pooled investment vehicles and companies raising money for acquisitions.[51] The exemption might be able to be extended to pooled investment vehicles after the SEC gains further experience with the operation of the exemption.
- Rule 506(d) would apply to disqualify an issuer from using the new exemption.
- As discussed above, any person would be able to buy under the new exemption. The accredited investor category would not apply. Therefore, all natural persons and all institutions, even those not currently within the definition of accredited investor, would be eligible buyers. This would be different from the current Rule 506. No limit on the amount a person could invest would exist. This would be different from Regulation CF and part of Regulation A.
- An issuer would be able to use the new exemption for any type of security. It could issue equity, debt, convertible, or other securities.
- The disclosure obligations and resale rules would be as discussed above.
- The SEC would not have a legal right or obligation to review a disclosure document in advance of delivery of the document or sale of the security to a potential buyer.
- The new exemption would not restrict truthful communications in advance of sales and would not restrict general advertising to and solicitations of the public. The palliative would be the required disclosures and an obligation on the issuer to notify a potential buyer of the availability of the disclosure document before the buyer would be able to enter into a contract to purchase. The obligation to provide a disclosure document before a contract of sale exists would protect investors from the risk of speculative frenzies. This would be a difference from registered offers, which continue to be hemmed in by a variety of restrictions on communications during the registration process until delivery of the final prospectus. For the avoidance of doubt, the new exemption should be added to section 4(b), which currently

[51] See Anne M. Tucker and Yusen Xia, "Investment Company Disclosure: Qualities, Content & Compliance" (working paper, August 1, 2019), https://ssrn.com/abstract=3436952.

provides that offers and sales under Rule 506(c) are not public offerings, although general solicitations may be used.

- The new exemption would preempt state law on registration or qualification. Securities issued under the exemption would be "covered securities" under section 18(b)(4)(F) of the Securities Act, based on the section 4(a)(2) exemption, and would not be subject to any law or legal action of a state or a political subdivision of a state concerning registration or qualification except for a notice filing requirement.
- An issuer would have an obligation to file a short form with the SEC disclosing sales under the new exemption. The form would require minimal information, such as the name of the issuer, the number of securities sold, the amount of the proceeds, and the number of buyers. The purpose of the notice would be solely to provide the SEC with information about use of the exemption.
- Sales under the new exemption would not be integrated with any other sale.
- The civil liability provision in section 12(a)(2) would apply. Proper defendants would include the issuer and any member of the governing body of the issuer or of senior management who significantly participated in the drafting, reviewing, or approving of the disclosure document.

VI. COMPARISON OF THE PROPOSED EXEMPTION TO REGISTERED OFFERS AND OTHER EXEMPT TRANSACTIONS

The new exemption proposed here would have similarities to and differences from registered offers and other exempt transactions.

A. Comparison to Registered Offers

The main difference from the registered offer would be the substantially reduced disclosure obligation. The main reason for that difference is the high cost of preparing a registration statement. The exemption would also differ by not having the SEC staff review a draft of the disclosure document, not restricting the issuer's communications before sale, and not allowing pooled investment vehicles to be issuers. The exemption would be similar by allowing any person to buy and allowing an unlimited offering amount.

If the SEC believes the new exemption would tread too much into the territory of registered offerings, it could consider a limit on the size of the issuers permitted to use the new exemption (emerging growth companies, for example) or on the amount of money that could be raised with the exemption. That would not be preferable, but some might want a distinct separation between exempt private offerings and registered offerings. If a limitation on the offering amount seemed desirable, the exemption then would need offering aggregation or integration rules, which would add to complexity.

B. Comparison to Other Exempt Transactions

The proposed exemption would differ significantly from Regulation A and Regulation CF transactions. The differences are too many to list. The new exemption has more in common with Rules 506(b) and (c) and blends parts of the two, but it also would differ from those exemptions.

The proposed exemption would resemble a transaction under Rule 506(c) with five major differences. First, any person could be a buyer. Sales would not be limited to accredited investors, and that would mean no verification procedures would be necessary. Second, a disclosure document would be required. Under current law, no disclosure to an accredited investor is necessary, and Rule 506(c) is limited to accredited investors. Third, only operating companies would be able to use the new exemption. Current Rule 506(c) does not limit eligible issuers other than for disqualifications. Fourth, the new exemption would not need the integration rule that applies to Rules 506(b) and (c). Fifth, resales would not need to comply with Rule 144 as long as an issuer publicized current information periodically. Otherwise, the new exemption, like Rule 506(c), would be for an unlimited amount to an unlimited number of investors and would permit a general solicitation.

The new exemption would have several differences from Rule 506(b). The new exemption would not be limited to 35 sophisticated, nonaccredited investors and therefore would not need verification procedures. The new exemption would require a disclosure document delivered to all prospective buyers even if all sales were to accredited investors. The new exemption would be able to use general solicitation, which is not permitted under Rule 506(b).

The Investor Advocate already commented that an important question is whether opening exempt offers to nonaccredited investors would produce greater benefits than costs.[52] He raised questions such as whether a significant number of nonaccredited investors would invest in transactions under the proposed exemption, whether the amount they would invest is material compared to the amounts already invested in private offerings, and whether the amount of misconduct in private offerings would spike if nonaccredited investors could invest.

Those are useful questions, but the proposed exemption provides some responses. The concept of accredited investors has come under heavy fire, and the SEC, the courts, and the federal securities laws have a great deal of experience with a mandatory disclosure system and methods of policing the completeness and accuracy of disclosures. As long as each potential investor receives adequate disclosures before investing, the securities laws should not deny investment opportunities to nonaccredited investors. Investors should not face a legal disability on buying a security when they are properly informed; investors should have freedom to choose to invest whether they have a lot of money or a little and whether a government official believes that the security is risky, high or low quality, or not suitable for a particular investor.

A question about the proposed exemption is whether the need to prepare the disclosure document would deter its broad utility. That does not seem likely given that, as a practical matter, accredited investors typically demand basic information about a securities offering and issuers typically volunteer disclosures. As a result, the difference between current Rule 506 offerings and the new exemption would be the extent of the disclosures and the extent of the extra cost. The proposed exemption attempts to take this issue into account by striking a balance between providing essential issuer and security information and drastically cutting back on mandatory disclosures under other parts of the federal securities laws. The disclosures under the

[52] Rick A. Fleming, "Re: Concept Release on Harmonization of Securities Offering Exemptions File No. S7-08-19" (Public Interest Comment, Office of the Investor Advocate, Securities and Exchange Commission, Washington, DC, July 11, 2019), 2.

new exemption must remain limited and must not approach those needed for a registered offering or a Regulation A transaction.

VII. SIMPLIFICATION

A primary goal of the new exemption is to supersede the need for other exemptions and to simplify the array of exemptions. Rule 504, Regulation A, and Regulation CF are not used for a substantial amount of capital formation and seem ripe for reconsideration unless their use accelerates. The new exemption could replace those three other exemptions because of the disclosure document and the serious question of whether the restrictions and limitations attached to those exemptions materially advance investor protection beyond appropriate disclosure.

Also worth considering is whether the new exemption should repeal and replace the Rule 506 exemptions. The SEC might wish to adopt the new exemption alongside Rule 506 for a reasonable trial period. The market should determine which exemptions best serve capital formation and produce a good track record of investor protection. Over time, the SEC will be able to monitor the amount of money raised using Rule 506 exemptions or the new exemption, and it will be able to identify problems or practitioner objections to use of the new exemption when compared to alternatives.

Experience should inform next steps. The market might strongly prefer one exemption over another, just as Rule 506(b) with no nonaccredited investors is strongly preferred now. In a few years, Congress and the SEC could be in a position to repeal and rescind Regulation A, Regulation CF, Rule 504, and Rule 506. Alternatively, the market might find a place for the new exemption as well as Rule 506 transactions, or use over time might demonstrate that the right approach is to convert the new exemption into a new type of registered offering with only essential disclosures, shortened staff review and comment, and free communications in the period leading to the first sales.

VIII. LEGISLATION OR RULEMAKING?

A final issue is whether changes in the areas addressed by the Concept Release or these comments should be made by legislation or rulemaking. My recommendation is that Congress should decide on any changes of substance. The congressional lawmaking process is difficult, but it would be the right way to proceed and probably is necessary.

The Concept Release invited comments on significant and wide-ranging changes to the securities offering system. Changes could alter primary behavior in the securities markets, such as the use of registered or exempt offers, the amount of disclosure, and the breadth of eligible investors. These are fundamental social policy choices, and Congress is the appropriate institution to make final determinations on such major contours of the securities laws.[53]

Furthermore, the current system of exemptions is built on a mix of statutes and rules. Congress has actively promoted speedier and simpler small business capital formation for a long time and has embodied different ideas in statutes. The Jobs Act and the Fast Act are just recent examples.[54] New approaches that simplify and harmonize the current system are likely to need statutory changes.

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[53] See Gundy v. United States, 139 S. Ct. 2116 (2019) (Gorsuch, J., dissenting).
[54] See Concept Release, 30,461.

The SEC has broad rulemaking authority and might have the power to make many changes to the exempt offering system without further congressional action. It might decide to proceed incrementally with a limited set of suggestions from these or other comments and conclude that the circumstances warrant the use of rulemaking or staff action. That could be appropriate, but the better course would be for the SEC to decide on appropriate reforms of the offering exemptions and submit a comprehensive legislative proposal to Congress.

IX. CONCLUSION

The Concept Release requested views from the public on a wide range of important questions about exemptions from the public offering requirement. This comment has sought to address some of the anomalies in the current system, restore a manageable disclosure document to a prominent position, and at the same time eliminate perceived difficulties with the accredited investor category. The goals are to enhance capital formation for startup companies and small to medium-sized companies and responsibly expand investment opportunities with adequate protections for persons not currently qualifying as accredited investors.