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September 24, 2019

Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

Re: Concept Release on Harmonization of Securities Offering Exemptions; File Number S7-08-19

Dear Ms. Countryman:

We appreciate the opportunity to comment on the Concept Release on Harmonization of Securities Offering Exemptions (the "Release"). Robert Anderson is a Professor of Law at Pepperdine whose research and teaching focuses on Mergers & Acquisitions, Securities Regulation, and Corporate Law. Samantha Prince is an Associate Professor at Dickinson Law whose teaching focuses on Business Associations and Entrepreneurship Law. John Neil Conkle and Sarah Zomaya, from Pepperdine and Dickinson, respectively, who are both interested in corporate and securities law, assisted the Professors. We write in our personal capacities and our institutional affiliation is for identification purposes only. All will be collectively referred to as the "Commenters."

We applaud the Securities and Exchange Commission's (the "Commission") initiative to simplify, harmonize, and improve the exempt offering framework. We also support reviewing whether certain aspects of the exempt offering framework unduly burden capital formation or investor access to investment opportunities. In particular, we would like to offer a proposal to correct what we perceive as a weakness of Rule 506(b), the most heavily utilized safe harbor of the Securities Act of 1933's registration requirement.

Specifically, our proposal will address "whether it would be consistent with capital formation and investor protection for [the Commission] to consider steps to make a broader range of investment opportunities available to those investors currently considered non-accredited," as queried on page 23 of the Release. We believe the answer—from both perspectives—is yes.

Additionally, regarding the Commission's enumerated requests for comment, this comment is intended to be responsive to the following queries:

- 2. "Are there burdens imposed by the rules that can be lifted while still providing adequate investor protection?" (We believe there are.)
- 10. "Which conditions are most or least effective at protecting investors in exempt offerings." (We believe the information requirements under Rule 502(b) fall in this category.)
- 11. "Should we amend the existing exemptions . . . to accommodate some form of non-accredited investor participation such that these exemptions may be more attractive to, or more widely used by, issuers?" (We believe so.)

We address these points herein.

Rule 506(b)'s Overly Burdensome Information Disclosure Requirements

As mentioned above, our proposal focuses on Regulation D's information disclosure requirements under the Rule 506(b) exemption from registration. Currently, 506(b) permits a maximum of 35 non-accredited investors to participate in an offering under that exemption. But because issuers must provide non-accredited investors with information disclosures pursuant to Rule 502(b), very few non-accredited investors have to the opportunity to participate in Rule 506(b) offerings. This is one reason non-accredited investors lack access to the private markets, even when they are intimately familiar with the issuer offering securities.

We believe issuers exclude non-accredited investors from 506(b) offerings for many reasons, but among the most important are: (1) the issuers' justifiable fear of exposing themselves to the risk of liability if required to provide specific information to purchasers, and (2) the substantial professional service fees related to providing information disclosures.[1] More concerningly, the accredited investors upon whom issuers rely for capital may be inclined to point to these facially legitimate reasons as a pretext to exclude employees and other individual investors who may not be able to provide substantial sums of capital in Rule 506 offerings. The Commenters encountered this dynamic in early-stage venture capital financings, which, perversely, is a context where knowledge of the mechanics and risks of equity investing is widespread even among non-accredited investors. It is also a context where non-accredited investors are most

[1] As an illustration, in an offering that exceeds $7.5 million, Rule 502(b)(2)(i)(A)-(B) requires companies to provide non-accredited investors the same financial and non-financial information that would be contained in a registration statement. 17 C.F.R. § 230.502(b)(2)(i). Gathering the information contained in a registration statement is one reason going public is so costly for companies. One technology startup counsel the Commenters spoke to estimates these disclosures cost a minimum of $15,000-$20,000 in fees, generally borne by the issuer.

likely to be familiar with the issuer's business, often as employees in a startup. As a result, even investors who have financial expertise, an ability to understand the risks, and who perhaps work for the issuer are effectively barred by Rule 502(b) from investment opportunities that accredited investors are able to take advantage of.

Thus, a fresh look at the rules applicable to 506(b) offerings could meaningfully increase non-accredited investors' access to private company investment and promote capital formation. And importantly—as will be further discussed—we believe our proposal to supplement Rule 506(b) is entirely compatible with investor protection.

Our Proposal Will Increase Investor Access While Ensuring Investor Protection

Modest changes to Rule 506(b) would provide a pathway to including non-accredited investors without triggering the disclosure requirements. In particular, we propose that Rule 506(b) permit issuers to offer and sell to non-accredited investors the same class of securities pursuant to the same terms in an aggregate amount that is less than or equal to the amount sold to accredited investors in the offering, subject to limitations on the amount any individual non-accredited investor puts at risk. Crucially, our proposal would ensure investor protection by limiting the amount non-accredited investors may purchase.

In this section we detail our Covered Investor concept. Below, we first provide suggestions for specific rule changes that could implement the proposal. Implementing the proposal would require a new definition of Covered Investor plus two additional alterations to the existing Regulation D text. Our purpose of providing specific language is to make the proposal precise and to illustrate the regulatory feasibility of our proposal. Then, we discuss the reasoning underlying each aspect of our proposal, the intended effects, and make further recommendations.

The Covered Investor Concept, Generally

The Covered Investor concept would consist of a new defined term containing three operative provisions that might apply to Rule 506(b) offerings. A general summary of the three operative provisions follows:

- Covered Investor, a new definition under Rule 501, would identify certain non-accredited investors who could purchase securities under Rule 506(b) without triggering the information disclosure requirements.
- The Aggregate Offering Limitation would ensure the offering continues to constitute a substantial offering to accredited investors and that the Covered Investor concept does not permit issuers to conduct Rule 506 offerings aimed primarily at non-accredited investors. Specifically, the limitation would allow Covered Investors to purchase in Rule

506(b) offerings only up to the amount purchased by accredited investors, reduced by the amount of payments to executive officers, directors, and promoters.

- The Individual Investment Limitation would ensure that Covered Investors are able to bear the risk of loss of any investment. We propose adopting investment limits for Covered Investors that are identical to those that apply to non-accredited investors under Tier 2 of Regulation A. So under our proposal, Covered Investors could only pay up to 10% of the greater of their annual income or net worth for securities in the offering.[2] This would have the added benefit of harmonizing the two frameworks' investor protections for non-accredited investors.

Covered Investor Definition

We propose implementing the Covered Investor concept by adding a new definition to Rule 501 that reads as follows:

> Covered investor. Covered investor shall mean any person, other than an accredited investor, who purchases securities in a transaction under § 230.506(b) and who satisfies all of the following conditions or the issuer reasonably believes satisfies all of the following conditions:
>
> (1) The person has waived, in a signed writing, such person's right to be furnished information pursuant to § 230.502(b)(1) in connection with the sale of securities to that person;
> (2) The aggregate price of the securities purchased by the person plus those securities purchased by other covered investors in the transaction is less than or equal to the price of securities of the same class purchased by accredited investors in the transaction less any payments to executive officers, directors or promoters required to be disclosed in Item 16 of the notice of sales on Form D; and
> (3) The aggregate purchase price paid for the securities by the person is no more than ten percent (10%) of the greater of the person's:
> (i) Annual income or net worth if a natural person (with annual income and net worth for such natural person purchasers determined as provided in Rule 501 (§ 230.501)); or
> (ii) Revenue or net assets for such purchaser's most recently completed fiscal year if a non-natural person.

[2] 17 C.F.R. § 230.251(d)(2)(i).

Easing The Disclosure Requirement and "Sophistication" Inquiry for Covered Investors

With the definition of Covered Investor in place, we propose two changes. First, we propose the operative change to Rule 506(b)'s information disclosure requirement by amending Rule 502(b)(1) to read as follows:

> If the issuer sells securities under § 230.506 to any purchaser who is *neither* an accredited investor *nor a covered investor*, the issuer shall furnish the information specified in paragraph (b)(2) of this section to such purchaser at a reasonable time prior to sale. [emphasis added].

Second, in order to be attractive to issuers as potential investors, Covered Investors would need to be exempt from the "sophistication" requirements of Rule 506(b)(2)(ii). Covered Investors (who are, by definition, non-accredited) in the offering would otherwise trigger a fact-intensive inquiry into their knowledge and experience, which would likely deter issuers from permitting them to participate. Accordingly, we propose amending Rule 506(b)(2)(ii) to read as follows:

> Nature of Purchasers. Each purchaser who is not *(i)* an accredited investor either alone or with his purchaser representative(s) *or (ii) a covered investor* has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description. [emphasis added].

Aggregate Investment Limitation

Our proposed Covered Investor definition, detailed above, imposes an Aggregate Investment Limitation. This limitation requires that the total purchase price paid by Covered Investors not exceed the aggregate price paid by accredited investors, net of any payments to executive officers, directors, or promoters required to be disclosed in Item 16 of Form D. The purpose of this limitation is three-fold. First, the limitation ensures a small investment by an accredited investor not be used as a basis for soliciting or accepting large amounts from non-accredited investors. Second, it provides some measure of validation of the offering that accredited investors' monetary participation in the offering equals or exceeds the Covered Investors'. Third, it prevents executive officers, directors, and promoters from artificially inflating the aggregate investment amount and then distributing the funds to themselves after the offering

If the Commission believes the Aggregate Investment Limitation does not sufficiently protect Covered Investors, the Aggregate Investment Limitation could be limited further to the amounts invested by accredited investors with indicia of accredited investor sophistication, such as only counting the aggregate investment of accredited investors such as those in §230.501(a)(4) ("any

director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer").

Individual Investment Limitation

The proposed Individual Investment Limitation is designed to ensure that any Covered Investor participating in the offering without the benefit of the specified information disclosure has the financial resources to bear the risk of any loss. This same limitation currently applies to non-accredited investors participating in Tier 2 Regulation A offerings. The Commenters believe the proposed Individual Investment Limitation would ensure that Covered Investors would not sustain losses that severely strain their financial resources.

Elimination of the "Sophistication" Requirement for Covered Investors

The elimination of the "sophistication" requirement in Rule 506(b)(ii)(2) for Covered Investors is likely necessary to induce issuers to use this new pathway. The fact-intensive nature of any sophistication inquiry would expose issuers to risk and provide a pretext to exclude non-accredited investors. We believe the Aggregate Offering Limitation and the Individual Offering Limitation, working in tandem, adequately protects Covered Investors without the need for a sophistication inquiry.

Subsequent Benefits for Business Combinations and Recapitalizations

We believe our proposal would ameliorate problems that arise in business combinations or recapitalizations when non-accredited investors are already present as stockholders (for example, as a result of employee stock grants or options). When such transactions take place and constitute sales of securities under Rule 145, issuers often need to deal with non-accredited investors separately, such as through reverse stock splits or having accredited investors buy the shares. Our proposal will allow all investors to be treated equally in these transactions.

Increase Form D Filing Incentives

There is widespread anecdotal evidence that the apparent absence of consequences for failing to file Form D has led to noncompliance in some cases. In order to better track Regulation D offerings and ensure the valuable data arising from Form D is more representative, we propose the Commission consider some consequence for willful failure to file Form D as required. This would permit the Commission to monitor the operation of these rule changes and to particularly gather more reliable evidence on the effect of these changes on non-accredited investors.

Conclusion: Our Proposal Ensures Investors Access to Rule 506(b) Offerings via Choice of Information Disclosure

Increasing investors' choice and access to investment opportunities is an important priority. Rule 506(b) is not formally limited to accredited investors. But the information disclosure requirements under Rule 502 too-often prevent "Main Street" investors from participating in Rule 506 offerings, even when they are intimately familiar with the business of the issuer. We hope our proposal would, if implemented, contribute to the overall mission of increasing investor access to private markets by permitting them to exercise choice as to which disclosures they receive. And, as previously discussed, we believe the confluence of investors' business expertise, particularly in the venture capital context, with the proposal's imposition of Aggregate and Individual Investment Limitations on Covered Investors, would ensure adequate investor protection to those who exercise their choice.

Our proposal also protects against the risk of widespread recruitment of non-accredited investors in exempt offerings. Because our proposal would only apply to Rule 506(b) offerings, it would be inapplicable to offerings using general solicitation and advertising. As a result, the non-accredited investors participating in the offering would be those closely associated with the company, such as consultants, advisors, contractors, or employees.[3]

For all these reasons, we hope the Commission will consider allowing non-accredited investors access to Rule 506(b) offerings via regulatory changes resembling our proposal.

We thank the Commission, again, for the opportunity to comment. The Commenters stand ready to provide additional information and assistance to the Commission or any interested parties as needed.

Sincerely,

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[3] Although Rule 701 provides employees with the opportunity to invest, the exemption is not available in capital-raising transactions. 17 C.F.R. § 230.701(c)(iii).