Committee on Securities Law of the Business Law Section of the Maryland State Bar Association

March 16, 2020

VIA EMAIL TO RULE-COMMENTS@SEC.GOV

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

Re: Proposed Amendments to the "Accredited Investor" Definition, File No. S7-25-19

Ladies and Gentlemen:

This letter expresses the views of the Committee on Securities Laws (the "Committee") of the Business Law Section of the Maryland State Bar Association ("MSBA"), with respect to the above-referenced proposing release, SEC Release Nos. 33-10734; 34-87784; File No. S7-25-19 (sometimes referred to herein as the "release") relating to the Securities and Exchange Commission's (the "Commission") proposed amendments to the definition of "accredited investor." The membership of the Committee consists of securities practitioners who are members of the MSBA and includes lawyers in private practice, business, and government. The Business Law Section and the Board of Governors of the MSBA have not taken a position on the matters discussed herein, and individual members of the MSBA and the Committee, and their associated firms or companies, may not necessarily concur with the views expressed in this letter.

The Committee wishes to express its support for the majority of the proposed amendments to the "accredited investor" definition. In particular, we agree that it is appropriate to incorporate into the definition provisions that expand the concept of financial sophistication beyond measures of wealth and income. We also believe, however, that as the Commission continues to be pressured (both in connection with the current proposal and otherwise) to expand the definition of "accredited investor" even further or to eliminate it altogether, and to all but abandon its investor protection mandate, a measure of temperance is advisable. We are aware of opinions voiced both inside and outside the Commission advocating for "Main Street" investors to have the

"opportunity" to invest in private placements given that much of a company's growth and opportunity for a return on investment happens while a company is still privately-held; such persons contend, among other things, that by limiting such investment opportunities to accredited investors, average investors are excluded from the opportunities that make the rich richer, further contributing to economic inequality.

What is often left out of this narrative, however, are a number of important realities that make the situation far more nuanced and warrant caution in considering further expansions of, or eliminating, the accredited investor definition: For one, that most offerings in the private capital marketplace are risky and will not, in fact, be the next Microsoft or Google; rather, many if not most investors, even financially sophisticated ones, will lose money in these types of investments. Further, investing in private placements is risky and most average investors are unlikely to appreciate the risks they are taking when they invest in private placement offerings;[1] And, finally, that the federal securities laws do not actually mandate that private placements be limited to accredited investors, but instead that issuers choose to limit their offerings in such manner for a variety of reasons (including not wanting to provide Form 1-A or registration statement-level disclosure or have non-sophisticated persons as stockholders).

To illustrate the point, consider venture capital funds. It is their *business* to invest in start-up companies. They are (generally) run by financially sophisticated people who make decisions about investing in private companies *for a living*. And yet they are wrong most of the time. That is, only about two out of every ten investments wind up paying off.[2] To believe that more than a tiny fraction (if any) of the universe of average investors are going to beat these odds is ludicrous. Instead, opening up private placements to "Main Street" investors would result in almost all of them losing a significant portion, if not all, of their invested money and, potentially, life savings. We are gratified that the

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[1]For example, one committee member recalls: reading statements by persons demanding a "refund" of their "order" after making a donation to a start-up company on a non-security-based crowdfunding web site; a reader-letter in a newsmagazine demanding that the federal government reimburse the writer for losses in his retirement accounts during the stock market crash in connection with the 2007-2009 recession; and even a lawyer (though thankfully not a securities lawyer) insisting that there was securities fraud "all over" an offering in which the attorney purchased common stock merely because the attorney lost money on his investment.
[2]*See, e.g.*, Tomer Dean, *The meeting that showed me the truth about VCs*, TechCrunch (June 1, 2017), available at https://techcrunch.com/2017/06/01/the-meeting-that-showed-me-the-truth-about-vcs/.

Commission, at least in respect of the proposed amendments to the definition of accredited investor, is not being so reckless, and we applaud it for doing so.

We have some specific comments regarding certain elements of the proposal, which we discuss below.

Entities

We strongly support the proposed amendment to Rule 501(a)(3) to include limited liability companies as being able to qualify as accredited investors if they have total assets in excess of $5,000,000 and were not formed for the specific purpose of acquiring the securities offered. This is consistent with existing Commission staff guidance, and proposed new Rule 501(a)(9) to extend the definition such that any entity that meets this criteria but is not otherwise a type of entity listed in paragraphs (1)-(8) of Rule 501(a) may qualify as an accredited investor. We agree that there is no logical reason to treat entities differently when it comes to qualifying as an accredited investor based solely on their form. Some of us have encountered situations where an entity did not qualify for participation in a private placement limited to accredited investors solely as a result of the potential investor's form, which was frustrating to both the issuer and the potential investor.

Professional Certifications, Designations, and Credentials

We also support the Commission's proposal to add persons that hold certain professional certifications or designations, and other credentials, "that demonstrate an individual's background and understanding in the area of securities and investing," as set forth in proposed Rule 501(a)(10). We agree that natural persons who have demonstrated through one or more examinations that they have a "comprehension and sophistication in the areas of securities and investing" and as a result of holding such a certification, designation, or other credential "can reasonably be expected to have sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of a prospective investment," will be able to understand the risks of investing in exempt private offerings and "do not need the additional protections of registration under the Securities Act of 1933." Requiring such persons to additionally meet the wealth or income tests of current Rule 501(a), therefore, does not further investor protection and serves no useful purpose. Further, there is a strange inconsistency in the current version of Rule 501(a) that permits persons who have obtained certain of these credentials, such as a licensed

investment adviser, to advise regarding investments using other people's money but deems them not sufficiently knowledgeable or sophisticated enough in this area to make such decisions with respect to their own money.

We also believe that the professional certifications and designations the Commission preliminarily expects to designate as qualifying credentials in an initial Commission order accompanying a final rule to amend the accredited investor definition, as set forth in the release, is appropriate.

The release also asks several questions in the nature of expanding the referenced initial order or whether additional considerations should be included in connection with this part of the proposal. We address a number of these below.

Educational Degrees

The release asks whether the Commission "[s]hould ... include a credential from an accredited educational institution, such as [a Masters of Business Administration ("MBA") degree], in such initial order" or "consider educational backgrounds more generally, such as advanced degrees in certain areas such as law, accounting, business, or finance, as a means for qualifying as an accredited investor." We also note with some trepidation the reference in the release that "[s]everal commenters stated that qualifying credentials should include ... having been in the securities industry as a broker, lawyer, or accountant."

We strongly advise against expanding the definition of "accredited investor" in this manner. Every member of the Committee has a law degree and works in the securities industry; at least one of us has an MBAs and several of us have undergraduate degrees in business as well. And we can tell you without hesitation that a formal education or degree, even an advanced degree, does not endow one with any degree of financial sophistication or "sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of a prospective investment." Even a thorough understanding of the federal securities laws and how they operate in practice does **not** provide a person with such sophistication and knowledge when applied to evaluating "the merits and risks of a prospective investment." The Committee's Chair and Vice Chair each spent the first few years of their career as attorneys with the Commission, in the Divisions of Corporation Finance and Enforcement, respectively. We each believe that we left the Commission with a comprehensive understanding of the federal

securities laws and how they work in practice. And each of us is confident stating that after obtaining a law degree and working several years at the Commission, there is no way we should have been considered an "accredited investor" on the basis of sophistication and knowledge when we left the Commission, despite law degrees and several years of *practicing securities law at the Commission*. After approximately a quarter of a century practicing securities law, we believe we might now be getting to that point. But certainly education and even several years of experience in the securities field should not be considered sufficient to qualify *anyone* as an accredited investor.

Similarly, we don't believe that an accounting degree, or even being a Certificated Public Accountant, should qualify an individual as an accredited investor. We do not believe that even the most thorough understanding of accounting and auditing standards provides the individual who possesses such knowledge with any degree of financial sophistication in the sense of being able to make knowledgeable investment decisions.

With respect to persons who believe that they have the requisite sophistication, knowledge, and experience such that they should qualify as accredited investors, we believe that an accredited investor examination to determine investor sophistication, which the release asks whether the Commission should consider developing, would be a much better way to address this issue.

Self-Certification

The release also asks whether the Commission "[s]hould ... consider permitting individuals to self-certify that they have the requisite financial sophistication to be an accredited investor as another means for determining investor sophistication.

On the off chance that the Commission is seriously considering this, we thought it prudent to respond: No.

It's one thing to have potential investors self-certify as to their accredited investor status when they are certifying as to objective measures such as their net worth, their income, whether they are an officer or director of the issuer or, if the amendments are adopted, that they have certain licenses or other credentials. Asking a person to self-certify as to their level of financial sophistication is an entirely different matter. People are often poor judges of their own intelligence

and abilities and will often over-estimate their level of knowledge about certain matters; the average investor will be in no position to make unbiased determinations regarding their own financial sophistication. We believe that even a modicum of investor protection considerations requires that self-certification with respect to matters of financial sophistication not be adopted, and we urge the Commission to abandon its consideration of this idea.

Spousal Equivalents

The proposed amendments would permit "spousal equivalents" to pool their finances for the purpose of qualifying as accredited investors. As proposed, a "spousal equivalent" would be defined as "a cohabitant occupying a relationship generally equivalent to that of a spouse." We urge the Commission not to adopt this part of the proposal.

The members of the Committee have had some spirited discussions over the last few years as to whether adding the concept of spousal equivalents to the accredited investor definition was appropriate and whether the reasons persons in a long-term romantic relationship decide not to get married should be relevant in determining whether pooling their resources for this purpose was appropriate.[3] Some members insisted that the reasons people choose not to get married was often directly related to whether it was appropriate to pool their income and assets in determining accredited investor status.[4] Others insisted that we shouldn't be delving into the reasons people choose not to get married at all. In the end, however, it became clear that we didn't need to resolve this debate because we believe this is a bad idea based on investor protection considerations alone.

The Committee believes that this part of the proposal is contrary to the Commission's investor protection mandate because it lets a person who really cannot afford the loss of his or her investment, and does not have sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of a prospective investment, to invest in risky private placements based solely on wealth or income that legally is not theirs and to which they have no right. This part of the proposal is also contrary to the

[3]This, of course, led to a discussion as to whether a relationship could be considered the equivalent of a marriage if the relationship was still "romantic."

[4]For example, if a couple's main reason for not getting married is to keep their assets separate to preserve such assets for their children, common among older adults, does it really make sense to pool such assets to determine whether both members of the couple can qualify as accredited investors?

investor protection mandate because it seems to be based on the potentially erroneous assumption that an unmarried partner would be the beneficiary of the sophisticated partner's knowledge and expertise to the same extent that a married partner would. As noted in the release, "the current accredited investor definition uses wealth—in the form of a certain level of income, net worth, or assets—as a proxy for financial sophistication." Income, net worth, and assets, it is generally acknowledged, are an imperfect proxy for financial sophistication. That being the case, surely wealth and income that doesn't legally belong to the person in question and was accumulated (possibly before they even met) or was or is earned by a romantic partner with whom the person in question has no legal relationship and for whom they have no legal responsibility or obligation, is an even worse proxy for financial sophistication. We are uncomfortable with the concept of opening up the risky private markets to individuals who may have limited assets, income, and financial sophistication solely on the basis that they are in a "marriage-like" relationship with someone who does have these things.

In addition, we believe that there is some comfort in the idea of allowing accredited investors to invest in riskier offerings because they generally have sufficient income and assets to absorb a loss of their investment. This would not be true of someone that relies on the assets and income of someone with whom he or she is involved but to whom he or she has no legal connection. The proposed amendments, however, would let such a person invest a significant portion, or all, of their perhaps limited assets in risky private investments.

Legally, a "spousal equivalent" is not the equivalent of a spouse, as marriage entails certain legal protections and obligations that make it reasonable to consider a married couple's income and net worth jointly in a manner that is just not true in other long-term relationships. As noted above, a "spousal equivalent" is not legally responsible for or to the other person in the relationship; if their money is kept separately such that losses by the non-qualifying spousal equivalent would not impact the financial situation of the qualifying spousal equivalent, the non-qualifying spousal equivalent may not receive the benefit of the qualifying spousal equivalent's supposed financial sophistication in matters of investing. Further, the qualifying spousal equivalent could leave the relationship for any reason at any time, leaving the non-qualifying spousal equivalent entirely without the assets and income that he or she relied on to qualify as an accredited investor, putting him or her in a risky financial situation that may be exacerbated by his or her investments in riskier private offerings. In a marriage, that is not legally possible.

Prior to the June 2015 Supreme Court decision in *Obergefell v. Hodges*, 576 U.S. ___ (2015), the Committee generally agreed with the concept of including references to a "spousal equivalent" in the definition of accredited investor; this made sense when same-sex couples were legally barred from getting married in the United States. When couples who would otherwise get married were prohibited from doing so, we believed fairness dictated including spousal equivalents for purposes of determining accredited investor status, and that the benefits of doing so outweighed the investor protection risks discussed above. Now that same-sex couples can marry in the United States, there is insufficient justification for expanding the accredited investor definition in this manner given the attendant investor protection concerns. We see no compelling reason to extend any benefit of marriage to persons who can get married but for whatever reason choose not to do so, and we believe that the lack of legal protection regarding an individual's access to the income and assets of a spousal equivalent is a good reason to distinguish between married and unmarried relationships for the purpose of the accredited investor definition. In this case, investor protection concerns should outweigh the positive capital-raising benefit of increasing the pool of potential investors.

Further, as a practical matter, we are concerned about how an issuer conducting a Rule 506(c) offering would "verify" that two people are spousal equivalents as opposed to, for example, roommates. Is the issuer expected to verify a couple's status through a series of intrusive questions into the nature and status of a couple's relationship or will the issuer be able to rely on the couple self-certification to that effect? What if a couple cohabitates the majority of the time, but one spouse maintains their former "home" and the couple takes occasional breaks from such cohabitation? Does a couple have to be having sex regularly or, conversely, *not* having sex regularly, to be considered "spousal equivalents?" The members of the Committee cringe at even the prospect that these very private and personal matters would become relevant inquiries for advising clients in participating in capital-raising activities.

While "spousal equivalent" is used in the definition of Family Office[5] and in Regulation Crowdfunding[6], its use is in each of those rules does not raise the same investor protection concerns as the proposed amendment to the definition of accredited investor given the different nature of these rules compared to the accredited investor definition. Further, the use of the term "spousal equivalent"

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[5]Rule 202(a)(11)(G)-1(d)(9).
[6]17 CFR 227.501(c)

in these rules do not implicate the verification concerns we discussed above. In the Family Office context, the family members and the family office are in a position to verify the spousal equivalent relationship with ease, since all of the members of the Family Office presumably have access to and knowledge of the individuals asserting they are "spousal equivalents," which allows the family members, in most cases, to easily confirm their status. The use of "spousal equivalent" in Regulation Crowdfunding is also easily differentiated from the proposed use in the definition of accredited investor in that under Regulation Crowdfunding the person asserting "spousal equivalent" is allowed to purchase securities issued under Regulation Crowdfunding in a secondary market from a family member less than a year after such securities were issued. Similar to the Family Office exemption, the Regulation Crowdfunding exemption places the onus on an individual who is in the same family as the person asserting "spousal equivalent" to confirm that such individual falls within the definition of "spousal equivalent," and neither involves verification of "spousal equivalent" status by a third party. As previously noted, asking a third-party issuer to verify the status of some unknown persons as "spousal equivalents" will be a difficult, thorny inquiry for issuers and raise a variety of other concerns to an issuer, such as privacy issues, that issuers would likely be unwilling to voluntarily confront.

Given the concerns outlined above, we suggest that a better alternative is for the Commission to include the proposed reference to "spousal equivalent" in the accredited investor definition as proposed, but limit the term such that it applies solely to persons in other legally-recognized relationships besides marriage, including domestic partnerships and civil unions, that provide legal rights to the participants in such an arrangement that are similar to those accorded to legal spouses (at least with respect to financial matters).

Adjusting for Inflation

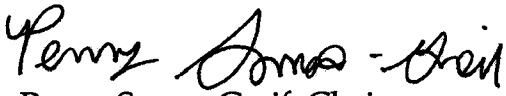
Finally, the release requests comment on whether the financial thresholds included in the accredited investor definition should be adjusted to account for inflation. For the reasons discussed in the release, we agree with the Commission's conclusion therein that "[n]otwithstanding the significant increase in the number of investors that qualify as accredited investors since 1982, we do not believe it necessary or appropriate to modify the definition's financial thresholds at this time." In particular, when considering whether any inflation adjustments to these thresholds are appropriate, we agree that it is most important to consider the increased role that private placements have in capital-raising today compared to 1982, and the devasting impact on this market that

would follow adjusting these figures for inflation since that time. Raising capital in the public markets and the resulting reporting requirements under the Securities Exchange Act of 1934 is exponentially more difficult today than it would have been in 1982. The imposition of reporting and other requirements heaped on Exchange Act reporting companies following stock market crashes and recessions and to address a variety of social ills unrelated to investor protection and market function, including economic inequality, terrorism financing, and war in the Congo, have made raising capital publicly a much more difficult endeavor than it was 38 years ago before, just to name a few items, issuers had to deal with detailed compensation disclosure, a compensation discussion and analysis, and disclosure controls and procedures and internal control over financial reporting and their attendant certifications. Many companies that could have easily raised capital publicly in 1982 would not be able to do so today for many reasons, including the ones we discuss here. Decreasing the relative percentage of accredited investors to 1982 levels would have devasting effects on our private markets and the companies that rely on them to raise capital. We appreciate the Commission's acknowledgement of these concerns and its cautious approach in this regard, and we urge restraint as it continues to consider this matter.

We appreciate the Commission's consideration of the foregoing comments.

Very truly yours,

Committee on Securities Law of the Business Law Section of the Maryland State Bar Association



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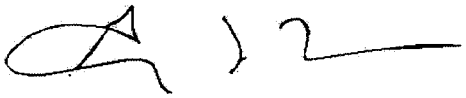

Gregory T. Lawrence, Vice-Chair