



Consumer Federation of America

October 1, 2019

Vanessa Countryman, Director
Office of the Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

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

Dear Ms. Countryman,

We are writing on behalf of the Consumer Federation of America (CFA)¹ to discuss our grave concerns regarding the recently published Concept Release on Harmonization of Securities Offering Exemptions.² While few could object to the stated purpose of the Release -- to conduct a "comprehensive review of the design and scope of our framework for offerings that are exempt from registration" -- many of the concepts discussed are clearly designed to expand, rather than "harmonize," the existing private offering exemptions. The Commission proposes these concepts for consideration without apparently having conducted any serious analysis of the impact that the proliferation and expansion of private offering exemptions has had on the health and vitality of our public markets. Similarly, the Concept Release fails to assess the impact of that decades-long expansion of private markets, and the associated contraction of the number of public companies, on investor protection, market integrity, or capital formation. Decisions about whether or how to adjust the private offering exemption framework, particularly those that would further expand private markets, cannot reasonably be divorced from these critical considerations.

Throughout the Concept Release, the Commission acknowledges that it lacks critical data needed to assess these fundamental matters. But the issues discussed in this Concept Release are far too important to be addressed in a haphazard and cursory manner. Instead of rushing forward to consider a raft of possible policy changes for which there is no supporting evidence, the Commission should start by identifying the additional data and analysis that would be needed to adequately weigh its options. Only then would the Commission have an adequate knowledge base on which to develop an appropriate framework for our private *and public* markets -- one

¹ Consumer Federation of America is a nonprofit association of more than 250 national, state, and local consumer groups that was established in 1968 to advance the consumer interest through research, advocacy, and education.

² Concept Release on Harmonization of Securities Offering Exemptions, Release Nos. 33-10649; 34-86129; IA-5256; IC-33512; File No. S7-08-19, <http://bit.ly/2msMUjT>.

that is based on facts, rather than the mix of anecdote and ideology that currently seems to frame the debate. Where the Commission finds that it needs additional resources or authority to obtain the necessary data, it should ask Congress for the additional authority or resources it needs to full its existing statutory obligations to engage in informed decision-making.³

To move forward with rulemaking *without* additional data, and without more serious attention to concerns about the potential impact on the health of our public markets, would be irresponsible. After all, as the U.S. Department of the Treasury stated in its 2017 report on the topic, the U.S. capital markets are “of critical importance in supporting the U.S. economy.”⁴ Mounting evidence suggests that those markets are at risk. By favoring private markets over public markets, a number of the proposals under consideration here threaten to make that problem worse, with potentially dire consequences for both individual investors and the health of the overall economy.

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³ Should the Commission choose to adopt this approach, CFA would strongly support legislation to provide the Commission with the authority and resources needed to collect data on the private markets necessary to support informed decision-making.

⁴ Steven T. Mnuchin, Secretary, and Craig S. Phillips, Counselor to the Secretary, *A Financial System that Creates Economic Opportunities: Capital Markets*, U.S. Department of the Treasury (October 2017), <https://bit.ly/2fPPMR3>.

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I. Our Current Regulatory Framework is Out of Balance, Putting Investors, Public Markets, and the Economy at Risk.

One of the signal achievements of the 20th Century was the restoration of trust and confidence in the U.S. capital markets after the cataclysmic events triggered by the 1929 stock market crash. Between September of 1929 and July of 1932, the value of all stocks listed on the New York Stock Exchange plummeted from nearly \$90 billion to just under \$16 billion, a loss of 83 percent.⁵ Roughly half of the \$50 billion of new securities sold in the post-World War I decade ultimately proved to be either nearly or totally valueless. Even leading “blue chip” securities, such as General Electric, Sears, Roebuck, and U.S. Steel common stock, lost over 90 percent of their value between selected dates in 1929 and 1932.⁶ As the Senate Banking Committee later wrote, “The annals of finance present no counterpart to this enormous decline in security prices.”⁷

Happily, that remains true to this day, in no small part because of the actions that Congress took during the early days of the Roosevelt Administration, first by enacting the Securities Act of 1933 and then by following up with passage of the Securities Exchange Act of 1934. These foundational federal securities laws are based on a principle that is elegant in its simplicity -- that “all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it.”⁸ Adherence to that principle helped to build capital markets that were the envy of the world, engines of a vibrant and growing U.S. economy.

Over the last four decades, however, Congress and the SEC have repeatedly chipped away at that basic principle. Through a series of new rules and legislation, they have allowed more and more securities to be offered and traded without providing the “basic facts” necessary to support an informed investment decision, to the point where the full and fair disclosure upon which our markets were built is the exception, rather than the rule. Today, we see mounting evidence that this four decades-long deregulatory crusade has gone too far, putting investors, our capital markets, and our economy at risk.

This section of our comment letter discusses: how the early securities laws succeeded in creating the deepest, most liquid, most vibrant capital markets the world has ever seen; how the basic principles of transparency and accountability on which those laws are based have been undermined over the last several decades; and how both investors and public markets are harmed as a result.⁹ Based on this analysis, we call for a return to the basic principles of transparency and accountability on which our markets were built. Specifically, we call on the Commission to immediately halt any and all proposals to expand existing private offering exemptions at least

⁵ Joel Seligman, *The Transformation of Wall Street (Third Edition)*, Wolters Kluwer Law & Business, at 1.

⁶ *Id.* at 2.

⁷ *Id.* at 1.

⁸ U.S. Securities and Exchange Commission, About the SEC, What We Do, <http://bit.ly/2MngEXy> (last accessed August 16, 2019).

⁹ We focus in particular in this section on the Securities Act of 1933, because of its direct relevance to the discussion of private offering exemptions covered by this Concept Release. However, as we discuss later in this letter, these issues also directly implicate transparency in the trading of securities and, thus, the Securities Exchange Act of 1934.

until it can more carefully consider these proposals' likely effects on the health and vitality of our public markets, investor protection, and sustainable economic growth and job creation.

A. Early Securities Laws Created a Legal Framework Based on Transparency and Accountability.

The Securities Act of 1933 was drafted amidst the economic wreckage of the Great Depression. Its authors were acutely aware of the tragedy that had befallen “thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities,” as well as the “wastage” that industry had suffered.¹⁰ And they were unambiguous about its cause: “The flotation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest, and prudent dealing that should be basic to the encouragement of investment in any enterprise. Alluring promises of easy wealth were freely made with little or no attempt to bring to the investor’s attention those facts essential to estimating the worth of any security.”¹¹ In the years leading up to the crash, securities had been developed to satisfy investor demand, rather than to provide needed capital or support productive ventures, according to the ‘33 Act’s authors, resulting “in the imposition of unnecessary fixed charges upon industry and in the creation of false and unbalanced values for properties whose earnings cannot conceivably support them. Whatever may be the full catalogue of the forces that brought to pass the present depression,” they wrote, “not least among these has been this wanton misdirection of the capital resources of the Nation.”¹²

As documented in a 2017 study by Fordham University Gabelli School of Business Professor Brent J. Horton, Congress was responding to a very real problem with the “spotty and unreliable” quality of corporate disclosure provided at the time.¹³ The Horton study examines 25 stock prospectuses pre-dating the ‘33 Act from firms that include both well-known companies -- such as Aluminum Company of America (“ALCOA”), Coca-Cola Company (“Coca-Cola”), and United Cigar Stores Company of America (“United Cigar”) -- as well as many smaller ventures. Based on that analysis, Horton found that “even the best pre-Act prospectuses were deficient, often failing to provide adequate financial statements, information about capital structure and voting rights, and information about compensation of executives and underwriters. Further, they overly hyped the securities being offered at the expense of a sober assessment of risk.”¹⁴

Looking at prospectus disclosures in five key areas, the report finds: With regard to financial statements, “there was a wide range of quality, from none, to rudimentary, to barely adequate” among the 25 prospectuses examined.¹⁵ “While there was generally good disclosure in pre-Act prospectuses as to capitalization itself (i.e., the amount of common stock, preferred stock, bonds), there was often inadequate disclosure regarding the voting rights (which are

¹⁰ H.R. Rep. No. 73-85 at 2.

¹¹ *Id.*

¹² *Id.* at 2-3.

¹³ Brent J. Horton, *In Defense of a Federally Mandated Disclosure System: Observing Pre-Securities Act Prospectuses*, 54 Am. Bus. L. J. 743 (2017), <http://bit.ly/2lehDkt>.

¹⁴ *Id.* at 23.

¹⁵ *Id.* at 28.

necessary to defend the economic rights that accompany the given investment).”¹⁶ Only 12 of the 25 prospectuses examined provided a list of corporate executives, and only two provided information on executive compensation,¹⁷ and information on underwriter compensation also “appears to have been a closely guarded secret.”¹⁸ Also absent from most pre-Act prospectuses were risk factors. Among the 25 prospectuses examined, only Coca-Cola included a discussion of risks.¹⁹ In short, companies large and small were failing to provide the basic facts necessary for investors to make informed investment decisions.²⁰

To counteract this problem, the authors of the ‘33 Act sought to develop legislation that embodied the principles outlined by President Franklin Delano Roosevelt in his March 1933 message to Congress, delivered just weeks into his presidency. What was needed, according to the new president, was a combination of transparency and accountability. “Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit,” the president wrote.²¹ “There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.”²²

In keeping with those basic principles, the ‘33 Act “closes the channels” of interstate commerce “to security issues unless and until a full disclosure of the character of such securities has been made.”²³ The Act sets forth in detail the items that were required to be disclosed, including “essential facts” concerning: 1) the property in which the investor “is invited to acquire an interest”; 2) the “identity and the interests of the persons with whom he is dealing or to whom the management of his investment is entrusted”; and 3) “the price and cost of the security he is buying and its relation to the price and cost of earlier offerings.”²⁴ According to the bill’s authors, these items were comparable to the information “demanded by competent bankers from their borrowers” and were “indispensable to any accurate judgment upon the value of the security.”²⁵ They warned that, “To require anything else would permit evasions, but to require these disclosures fulfills the President’s demand that ‘there is an obligation upon us to insist ... that no essentially important element attending the issue shall be concealed from the buying public.’”²⁶

¹⁶ *Id.* at 31. (“Specifically, of the twenty-five prospectuses that I examined, twenty-three provided adequate information regarding capitalization. However, only seven provided adequate information regarding voting rights.”)

¹⁷ *Id.* at 31-32.

¹⁸ *Id.* at 33.

¹⁹ *Id.* at 35-36.

²⁰ The pre-Securities Act market operated much the same way the “private” markets operate today, with even so-called “sophisticated” investors receiving insufficient information to make reasoned judgments about the values of their security holdings.

²¹ H.R. Rep. No. 73-85 at 2.

²² *Id.*

²³ *Id.* at 3.

²⁴ *Id.* at 18.

²⁵ *Id.* at 3-4

²⁶ *Id.* at 3-4.

The '33 Act required for the first time that this information be included in a registration statement filed with the Commission and provided to investors in the form of a prospectus. It imposed a waiting period after the registration was filed before the securities could be sold, the purpose of which was: 1) to “slow up the procedure of selling securities and the consequent pressures that the underwriters could exert upon their selling group or other dealers to take sight unseen an allotment of the issue” and 2) to “give an opportunity for the financial world to acquaint itself with the basic data underlying a security issue and through that acquaintance to circulate among the buying public as well as independent dealers some intimation of its quality.”²⁷ In a contemporary law review article, William O. Douglas and George E. Bates elaborated on the benefits of the '33 Act's disclosure-based approach, which they said “are chiefly of two kinds: (1) prevention of excesses and fraudulent transactions, which will be hampered and deterred merely by the requirement that their details be revealed; and (2) placing in the market during the early stages of the life of a security a body of facts which, operating indirectly through investment services and expert investors, will tend to produce more accurate appraisal of the worth of the security if it commands a broad enough market.”²⁸

In order to better ensure the accuracy of information provided, the Securities Act also included strong civil liability provisions, entitling “the buyer of securities sold upon a registration statement including an untrue statement or omission of material fact, to sue for recovery of his purchase price, or for damages not exceeding such price, those who have participated in such distribution either knowing of such untrue statement or omission or having failed to take due care in discovering it.”²⁹ As President Roosevelt stated in his message to Congress: “This proposal adds to the ancient rule of caveat emptor, the further doctrine ‘let the seller also beware.’ It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.”³⁰

While the Securities Act of 1933 dealt exclusively with the offer of securities, the Securities Exchange Act of 1934 brought those same principles of transparency to the trading of securities. In doing so, it helped to ensure that investors' ability to get complete and accurate information about a company whose shares they own or are considering buying doesn't end at the point of issuance. As the SEC has stated: “This provides a common pool of knowledge for all investors to use to judge for themselves whether to buy, sell, or hold a particular security. Only through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions. The result of this information flow is a far more active, efficient, and transparent capital market that facilitates the capital formation so important to our nation's economy.”³¹

The '33 Act's authors confidently declared that, “No honestly conceived and intelligently worked out offering, floated at a fair but not exorbitant profit, will be injured by the revelation of

²⁷ James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29 (1959).

²⁸ William O. Douglas and George E. Bates, *The Federal Securities Act of 1933*, 43 Yale L.J. (1933), <https://bit.ly/2KEJKmO>.

²⁹ H.R. Rep. No. 73-85 at 9.

³⁰ *Id.*

³¹ U.S. Securities and Exchange Commission, *About the Sec, What We Do*, <http://bit.ly/2MngEXy> (last accessed August 16, 2019).

the whole truth which these requirements seek to elicit.”³² However, the new law was the source of great consternation in certain quarters. In particular, some in the corporate community viewed its disclosure obligations, and the increased liability that accompanied its enhanced disclosures, as “an unhealthy deterrent to legitimate business.”³³ Among them were those who thought they saw a way around the law’s requirements in its exemption from registration for “transactions by an issuer not involving any public offering.”³⁴ Although the fear that the securities laws would prove to be a deterrent to legitimate business was quickly revealed to be misplaced, efforts to evade the law persisted.

B. The Private Offering Exemption was Intended to be Narrow and Tightly Limited.

Despite its intentionally broad scope, the Securities Act does include exemptions for certain classes of securities as well as for certain types of transactions. Exempt securities are not only exempt from the registration requirement, they may also be resold without being registered.³⁵ Transaction exemptions, on the other hand, provide an exemption only from the Act’s registration requirements. The securities in question remain subject to both the ‘33 Act and the ‘34 Act and cannot be resold unless they are registered or another exemption is available.³⁶ The most significant of the transaction exemptions, in the current context, is the exemption for “transactions by issuers not involving any public offering.”³⁷

According to J.M. Landis, who took a lead role in drafting the ‘33 Act, this focus on public versus private offerings was foremost in the authors’ minds in determining the appropriate scope of the legislation.³⁸ Although the legislative history does not provide details on the intended scope of the exemption, the legislative record, the early opinions of the SEC, and subsequent court interpretations all make clear that the non-public offering exemption was intended to be extremely narrow and limited in scope. According to the House Committee Report, for example, the exemption was designed “to permit an issuer to make a specific or an isolated sale of its securities to a particular person.”³⁹ The Conference Committee similarly stated that, “Sales of stock to stockholders become subject to the act unless the stockholders are so small in number that the sale to them does not constitute a public offering.”⁴⁰

³² H.R. Rep. No. 73-85 at 7.

³³ William O. Douglas and George E. Bates, *The Federal Securities Act of 1933*, 43 Yale L.J. 173 (1933), <https://bit.ly/2KEJKmO>.

³⁴ See, e.g., Letter of General Counsel discussing factors to be considered in determining the availability of the exemption from registration provided by the second clause of section 4(1), Securities and Exchange Commission, Securities Act of 1933 Release No. 285, January 24, 1935 11 FR 10952. The opinion by SEC General Counsel John J. Burns, not his first on the topic, was aimed at “the present tendency of large issuers to resort to so-called ‘private financing’ may in many instances be at variance with the law.”

³⁵ James D. Cox, Robert W. Hillman, Donald C. Langevoort, Ann M. Lipton, William K. Sjostrom, *Securities Regulation: Cases and Materials*, Wolters Kluwer (Ninth Ed. forthcoming).

³⁶ *Id.*

³⁷ 15 U.S.C. 77d(a)(2). Exempted transactions. [Section 4(a)(2) of the Securities Act.]

³⁸ James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29, 37 (1959) (“The sale of an issue of securities to insurance companies or to a limited group of experienced investors, was certainly not a matter of concern to the federal government.”).

³⁹ H.R. Rep. No. 73-85 at 15-16.

⁴⁰ H.R. Rep. No. 152, 73d Cong., 1st Sess. (1933). (Conference Committee Report) at 25.

The notion that Congress intended to tightly constrain the availability of the exemption gets additional support from language in the Committee Report regarding a separate but related matter -- the Commission's authority to exempt additional classes of securities from the requirements of the Act. As the Committee Report makes clear, this authority was strictly limited, applying only to securities that "because of the small amount involved or the limited character of the public offering should properly be excluded from the provisions of the act."⁴¹ The report authors went on to explain their reasoning: "This general power of the Commission ... is closely limited by the requirement that it shall not extend to any issue whose aggregate amount exceeds \$100,000. The Commission is thus safeguarded against any untoward pressure to exempt issues whose distribution may carry all the unfortunate consequences that the act is designed to prevent."⁴²

C. For Decades, the SEC Combated Efforts to Evade the Act's Requirements.

From the outset, the SEC faced efforts by some in the corporate community to evade the Act's requirements by relying on the non-public offering exemption. In a series of early opinions, SEC General Counsel John J. Burns laid the foundation for an approach to combating these efforts that relied on a narrow interpretation of the exemption. Writing in 1935, Burns stated that, "The purpose of the exemption of non-public offerings would appear to have been to make registration unnecessary in these relatively few cases where an issuer desires to consummate a transaction or a few transactions and where the transaction or transactions are of such a nature that the securities in question are not likely to come into the hands of the general public."⁴³ Burns went on to outline a facts-and-circumstances based approach to determining whether a public offering occurred based on such factors as: the number of offerees and their relationship to each other and to the issuer; the number of units offered; the size of the offering; and the manner of the offering.⁴⁴

That early analysis appears to have guided SEC policy for several decades. In 1962, for example, the Commission reinterpreted this guidance in light of the subsequent Supreme Court decision in *S.E.C. v. Ralston Purina Co.*⁴⁵ The new guidance was needed, according to the Commission, because of "an increasing tendency to rely upon the exemption for offerings of speculative issues to unrelated and uninformed persons."⁴⁶ Here again, the guidance emphasized the narrow availability of the exemption, noting for example that simply limiting the offering to a small number of individuals would not be sufficient absent "the requisite association with and knowledge of the issuer which make the exemption available."⁴⁷ Another important factor was "whether the securities offered have come to rest in the hands of the initial informed group or whether the purchasers are merely conduits for a wider distribution."⁴⁸

⁴¹ H.R. Rep. No. 73-85 at 15.

⁴² *Id.*

⁴³ Securities Act of 1933 Release No. 285, January 24, 1935 11 FR 10952.

⁴⁴ *Id.*

⁴⁵ *S.E.C. v. Ralston Purina Co.*, 346 U.S. 119 (1953).

⁴⁶ Nonpublic Offering Exemption, Securities Act of 1933, Release 33-4552 (Nov. 6, 1962).

⁴⁷ *Id.*

⁴⁸ *Id.*

Even Rule 146, adopted in 1974 by a more conservative administration to provide “more objective standards” for determining when transactions do not involve a public offering, adhered to these basic principles.⁴⁹ The Rule Release stated, for example, that: “[I]t is frequently asserted that wealthy persons and certain other persons such as lawyers, accountants and businessmen are ‘sophisticated’ investors who do not need the protections afforded by the Act. It is the Commission’s view that ‘sophistication’ is not a substitute for access to the same type of information that registration would provide, and that a person’s financial resources or sophistication are not, without more, sufficient to establish the availability of the exemption.”⁵⁰ The Rule Release went on to note that, “In view of the legislative history, statutory language, judicial decisions, and the Commission’s reexamination of its interpretations of section 4(2) of the Act, the Commission is of the view that the significant concepts in determining when transactions are deemed not to involve any public offering are access to the same kind of information that registration would disclose and the ability of offerees to fend for themselves so as not to need the protections afforded by registration.”⁵¹

D. Courts Have Upheld a Narrow Interpretation of the Private Offering Exemption.

That focus on access to information in the *Ralston Purina* decision often gets lost in modern day discussions of this pivotal decision, which tend to focus instead on the characteristics of the investors to whom the security is offered or sold. This arises from a too narrow reading of the most often cited sentence from the Court’s decision, that: “An offering to those who are shown to be able to fend for themselves is a transaction ‘not involving any public offering.’”⁵² *Ralston Purina* had argued that its offering of company stock to certain select employees was not a public offering. The Court rejected that argument, and its reasoning helps to clarify that what it meant when it referred to those “who are able to fend for themselves” was very different from how that term is typically used today.

In contrast to the current accredited investor definition, the Court was focused not simply on the investors’ wealth or financial sophistication, but on their access to the kind of information that registration under the Act would provide. The Court noted, for example, that an employee offering “made to executive personnel who because of their position have access to the same kind of information that the Act would make available in the form of a registration statement” might qualify for the exemption. “The focus of inquiry should be on the need of the offerees for the protections afforded by registration,” the court explained. “The employees here were not shown to have access to the kind of information which registration would disclose. The obvious opportunities for pressure and imposition make it advisable that they be entitled to compliance” with the Act’s disclosure requirements.⁵³

Since the *Ralston* decision, much of the litigation around the non-public offering exemption has centered around “identifying the types of persons in need of the protections

⁴⁹ Transactions By an Issuer Deemed Not To Involve Any Public Offering, Securities Act of 1933 Release No. 33-5487 (Apr. 23, 1974).

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *S.E.C. v. Ralston Purina Co.*, 346 U.S. 119, 123-24 (1953).

⁵³ *Id.*

afforded by registration and therefore ineligible subjects of private offerings.”⁵⁴ While upholding the Court’s emphasis in *Ralston* on access to information as a key factor in the exemption’s availability, courts have held that other factors, including the nature of information provided and the sophistication of investors, also must be weighed. For example:

- The United States District Court for the District of Colorado held that, “Mere acknowledgement by [investors] that they had the opportunity to ask questions and evaluate the merits and risks of the investment is not sufficient to demonstrate that they had access to the information that would be disclosed in a registration statement.”⁵⁵
- In a case involving the offering of securities to an undetermined number of sophisticated investors, none of whom had a prior relationship with the issuer and 13 of whom ended up purchasing the securities, the Fifth Circuit concluded that “the relationship of the offerees to each other and the issuer was not sufficient to justify treating this offering as private rather than public in scope.” The decision turned, in part, on the court’s determination that the offerees “lacked a *privileged relationship* with the issuer.” The fact that the investors were sophisticated was not viewed as a substitute for access to information.⁵⁶
- The Fifth Circuit reaffirmed this position that sophistication alone is not sufficient to satisfy the exemption in a later decision. The court ruled that “there must be a sufficient basis of accurate information upon which the sophisticated investor must be able to exercise his skills. Just as a scientist cannot be without his specimens, so the shrewdest investor’s acuity will be blunted without specifications about the issuer. For an investor to be invested with exemptive status he must have the required data for judgment.”⁵⁷
- In this same decision, the court held that the information standard could be satisfied either through disclosure or through effective access to the relevant information. Where disclosure is relied on, no relationship between the issuer and offeree would be necessary, but where “*access to information is the measure*” both the relationship between the issuer and the offeree and the sophistication of the offeree take on added importance. Key questions, according to the court, are whether “the offeree could realistically have been expected to take advantage of his access to ascertain the relevant information” and whether “he could have been expected to ask the right questions and seek out the relevant information.”⁵⁸
- The U.S. District Court for the District of Columbia took the same position in a 1998 decision, “holding that an engineering degree, investment experience, and large net worth were insufficient to show a private offering exemption absent a ‘sufficient basis of accurate information upon which the sophisticated investor may exercise his skills.’” The decision states, “Absent any evidence that Defendants provided sophisticated investors with meaningful access to information equivalent to that which would have been

⁵⁴ James D. Cox, Robert W. Hillman, Donald C. Langevoort, Ann M. Lipton, William K. Sjoström, *Securities Regulation: Cases and Materials*, Wolters Kluwer (Ninth Ed. forthcoming).

⁵⁵ *Id.*, referencing *SEC v. Trujillo*, 2010 U.S. Dist. LEXIS 99208, 18-19 (D. Colo. Sept. 22, 2010).

⁵⁶ *Id.*, referencing *Hill York Corp. v. American International Franchises, Inc.*, 448 F.2d 680 (5th Cir. 1971). Cox goes on to cite the decision in *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 761 F. Supp. 2d 504, 551 (S.D. Tex. 2011) (the *Ralston* standard “is based more on access to information than a party’s sophistication and wealth. Where a party has no ability to obtain the vital, material information about the investment, the exemption should not apply.”).

⁵⁷ *Id.*, referencing *Doran v. Petroleum Management Corp.*, 545 F.2d 893 (5th Cir. 1977).

⁵⁸ *Id.*

provided in a registration statement, the court concludes that Defendants do not qualify for an exemption from section 5's registration requirements."⁵⁹

- Courts have divided over the weight that should be given to the sophistication of offerees in determining whether the exemption would apply and how to define sophistication. But only the Eighth Circuit appears to have taken the position that sophistication may not be required at all where the offerees have access to information and the "economic bargaining power to demand any information necessary to make an informed investment decision."⁶⁰
- Outside the context of Rule 506, courts have generally not looked at offerees' ability to withstand financial losses as a factor in determining their ability to " fend for themselves without the protections afforded in a public offering."⁶¹

In short, courts, like the early SEC, construed the exemption for non-public offerings as strictly limited -- nothing that could reasonably be used to create "private markets" where individuals with no particular financial sophistication could be sold securities through sometimes very public means based on little or no information.

E. Congress and the SEC have Turned a Narrow Exemption into a Gaping Loophole.

When examining how we got from a world where "every issue of new securities to be sold in interstate commerce" was to be accompanied by full disclosure to one in which thousands of offerings are made each year to individual investors based on little meaningful information, it should perhaps come as little surprise that the roots of the transition are to be found in the late 1970s. By that time, memories of the Great Depression had faded and deregulatory fervor was on the rise, leaving policymakers increasingly willing to dismantle the regulatory framework on which the recovery and growth of our capital markets had been based. Moreover, the country was experiencing challenging economic times. Amid the plunging stock prices, sky-rocketing interest rates, and weak economic growth of the 1970s, it is easy to believe that small start-up companies were finding it difficult to obtain affordable financing to grow and expand.

Small wonder then that policymakers' focus began to shift away from ensuring that investors receive adequate information about their investments and toward easing restrictions on companies seeking to raise capital. As the SEC wrote in 1979: "The study of the problems confronting small businesses, while a topic of longstanding interest, has recently become the focus of considerable public attention. The wealth of concern for the well-being of that sector stems from the pivotal role it plays in the vitality of the general economy. The contribution of small businesses in supplying jobs, technical innovation, and generally in keeping our system competitive requires that unnecessary obstacles to their formation and growth be removed."⁶² With that in mind, the Commission had undertaken a study, including extensive public hearings, "regarding the effects of its rules and regulations on the ability of small businesses to raise capital and the impact on small businesses of the disclosure requirements under the Securities

⁵⁹ *Id.*, referencing *Securities and Exchange Commission v. Kenton Capital, Ltd.* 69 F. Supp. 2d 1 (D.D.C. 1998).

⁶⁰ *Id.*, referencing *Van Dyke v. Coburn Enters., Inc.*, 873 F.2d 1094, 1098 (8th Cir. 1989).

⁶¹ *Id.*

⁶² Simplified Registration and Reporting Requirements for Small Issuers, Federal Register, Release No. 33-6049, Vol. 44, No. 70 (April 10, 1979).

Acts.”⁶³ Although the hearing record ultimately “indicated that most of the problems faced by small businesses result from factors outside the scope of the federal securities laws,”⁶⁴ the die was cast.

In October 1980, Congress adopted the Small Business Investment Incentive Act of 1980, laying the foundation for the first major breach of the strict public-private divide established by the Securities Act. Among other things, the Small Business Investment Incentive Act created a new exemption from the ‘33 Act’s registration requirements for certain offers and sales of securities by an issuer solely to “accredited investors.” And it defined the term, with regard to natural persons, as “any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under the rules and regulations which the Commission shall prescribe.”⁶⁵ It simultaneously authorized the Commission to work with state securities regulators “in effectuating greater uniformity in Federal-State securities matters, including development of a uniform exemption from registration for small issuers.”⁶⁶ It is this legislation which prompted the development of Regulation D, which abandoned for the first time the principle that even sophisticated investors need access to complete and accurate information in order to make sound investment decisions.

Rule 506 under Reg D made it possible for issuers to raise unlimited amounts of money from unlimited numbers of “accredited” investors without requiring the securities to be registered.⁶⁷ As discussed below, private offerings immediately took off after its adoption. But the securities were restricted, meaning they had to be held for a certain time period before they could be resold. Over the years, however, the SEC has adopted a series of rule changes to ease those trading restrictions.⁶⁸ In 1972, the Commission adopted Rule 144 creating a non-exclusive safe harbor for the resale of restricted securities by non-affiliates.⁶⁹ The original rule allowed resale after two years if certain conditions were met and unconditional resale after three years. In 1997, the holding periods under Rule 144 were shortened to one year, if certain conditions were met, with unconditional resales after two years. The holding period was shortened again in 2007 to one year with no conditions.⁷⁰ And, in 2015, Congress adopted the FAST Act, which included a provision allowing immediate resale of restricted securities to accredited investors. These changes made it much easier for investors and employees seeking liquidity to sell their shares, including through online trading platforms that have emerged in the past decade to facilitate such trades.⁷¹

⁶³ *Id.*

⁶⁴ Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, Release No. 33-6339; File No. S7-891, Federal Register, Vol. 46, No. 159 (Aug. 18, 1981).

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ It also permitted sales to a limited number of sophisticated non-accredited investors.

⁶⁸ These included the adoption of Rule 144A in 1989 allowing immediate resale to very large institutional investors, or “qualified institutional buyers.”

⁶⁹ *See, e.g.*, Letter from Keith F. Higgins, Chair, Committee on Federal Regulation of Securities, American Bar Association, to John White, Dir. Div. of Corp. Fin., March 22, 2007, <http://bit.ly/2lqX97W>.

⁷⁰ Renee M. Jones, *The Unicorn Governance Trap*, 66 U. Pa. L. Rev. Online 165 (2017), <http://bit.ly/2msD01w>.

⁷¹ *Id.*

Between them, Reg D and the amendments to Rule 144 abandoned the central principles of the '33 Act. Reg D allowed securities to be sold to certain members of the general public, accredited investors, without providing them with, or assuring that they had access to, the essential facts needed to make an informed investment decision. In doing so, it dramatically reduced issuers' need to turn to public markets to raise large amounts of capital. The shortened time periods adopted under Rule 144 beginning in 1997 virtually eliminated restrictions designed to ensure that the private offering exemption wasn't used to provide an end-run around the registration requirement for securities that would ultimately end up being distributed to members of the general public. It dramatically reduced issuers' need to turn to public markets "to provide liquidity for founders, early investors, and employees."⁷²

A third change, this time to the requirements under the Securities Exchange Act of 1934, delivered what could end up being the fatal blow to our public markets. A provision in the Jumpstart Our Business Startups Act (JOBS Act) increased from 500 to 2,000 the number of shareholders a company can have without being required to become a reporting company under the '34 Act. Moreover, because the threshold is based on shareholders of record rather than beneficial owners and because there are exclusions from even that generous threshold, the actual number of investors may be much higher than the 2,000 limit. In the past, "Start-ups facing the prospect of Exchange Act registration almost always chose to pursue an IPO to create a public trading market for their shares."⁷³ This change to Exchange Act reporting requirements has made it possible for even very large companies, with a widely dispersed shareholder base, to remain private virtually indefinitely.

These three changes were the most significant, but certainly not the only, changes adopted by Congress and the SEC to promote private securities markets at the expense of public markets. Others include: passage in 1996 of the National Securities Markets Improvement Act (NSMIA) giving the SEC broad new exemptive authority under the '33 Act (and removing from regulation under state blue sky laws offers made pursuant to Rule 506), and adoption of provisions in the JOBS Act to create a new crowdfunding exemption, to greatly expand the amount of capital that can be raised under Regulation A, and to allow general solicitation in Reg D offerings.

Almost without exception, these changes were adopted in the name of promoting small company capital formation. But, as far as we can determine, neither Congress nor the SEC has ever seriously examined whether providing broad new exemptions to enable capital raising based on minimal disclosures actually leads to sustainable job creation and economic growth. Moreover, even in the wake of a financial crisis that saw, in the sale of mortgage-backed securities to large institutional investors, many of the same types of abuses that led to the stock market crash of 1929, neither Congress nor the SEC appears to have seriously questioned the assumption that institutional investors can always "fend for themselves without the protections afforded in the public markets." Similarly, when the Madoff scandal highlighted the vulnerability of even very wealthy individuals to fraud, neither Congress nor the SEC seriously questioned the wisdom of an accredited investor definition based on financial thresholds that bear no meaningful relation to financial sophistication, let alone access to information. And, even as

⁷² *Id.*

⁷³ *Id.*

policymakers decried the declining numbers of IPOs and public companies, the pressure to expand private offerings has continued unabated -- as evidenced by both the Treasury Department's Capital Markets report and this Concept Release.

Clearly, the drafters of the '33 Act were justified in fearing that, if broad exemptive authority were granted to the Commission, it would lead to "untoward pressure to exempt issues whose distribution may carry all the unfortunate consequences that the act is designed to prevent."⁷⁴

F. After Decades of Policies Favoring Private Markets, Public Markets Are In Decline.

The original federal securities laws created capital markets that were the envy of the world, engines of economic growth and innovation. Recently, however, concerns over the continued health and vitality of U.S. public markets have grown. Although the argument that public markets are failing is often trotted out as a cynical prop for proposals to roll back "burdensome" regulations (those designed to ensure the accuracy and reliability of public company disclosures, for example),⁷⁵ there appears to be genuine cause for concern. Whether you measure by the number of initial public offerings (IPOs) or the number or percentage of U.S. companies that are listed on a major securities exchange, the downward trend is inescapable. Our public markets, once the envy of the world, are in decline.

1. The Number of IPOs is Well Below Long-Term Norms.

IPOs are considered by many to be a key measure of the state of the public markets, "because they are typically companies' only bite at the apple when it comes to raising equity capital from the general public."⁷⁶ While the various researchers who have analyzed this issue use different definitions (including or excluding certain categories of companies) and examine different time periods, and thus arrive at different raw numbers, their general conclusions are remarkably consistent: the number of IPOs peaked in the late 1990s and has been well below long-term norms in recent years. For example:

- One analysis, by Duke University School of Law Professor Elisabeth de Fontenay, found that there was an average of just 99 IPOs per year from 2001 through 2012, compared with an average of 310 IPOs per year between 1980 and 2000. De Fontenay noted that, because "the total number of U.S. startups grew overall during the same period, the proportion of U.S. firms undergoing an IPO fell even more dramatically."⁷⁷
- Another analysis, by Ohio State University Professor Paul Rose and Berkeley Law Professor Steven Davidoff Soloman, found that "the number of IPOs peaked at 821 in

⁷⁴ H.R. Rep. No. 73-85 at 15.

⁷⁵ See, e.g., Steven T. Mnuchin, Secretary, and Craig S. Phillips, Counselor to the Secretary, *A Financial System that Creates Economic Opportunities: Capital Markets*, U.S. Department of the Treasury (Oct. 2017), at 19-46, <https://bit.ly/2fPPMR3>.

⁷⁶ Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 *Hastings Law Journal* 445-502 (2017), <http://bit.ly/2mRoPmP>. ("Subsequent attempts to raise new equity capital from the public are relatively rare, as most corporations prefer to fund their operations with retained profits or by issuing debt.")

⁷⁷ *Id.*

1996 and fell to 119 by 2016.” Since the financial crisis, according to this study, the annual number of IPOs has averaged 188, “far less than the average of 325 during the period before.”⁷⁸

- Looking behind these broader trends, analysts at Ernst & Young found that the number of IPOs peaked at 460 in 1999, then experienced a sharp decline “after the implosion of the technology bubble,” dropping to 335 in 2000 and to 68 in 2003. Just as the IPO numbers were starting to recover (to 199 in 2007), the financial crisis struck. While IPO activity increased after the 2008 recession, the number of public offerings has remained well below mid-1990s levels, according to the E&Y analysis.⁷⁹

Table 1: The Decline in U.S. IPOs Since 2000

	Average No. IPOs per Year	Percentage of IPOs		Total Proceeds (\$ billions)
		Small Firms	Large Firms	
1980–2000	310	53%	47%	\$28.3
2001–2012	99	28%	72%	\$28.0

Source: Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company* (April 11, 2017).

There also appears to be broad agreement that the decline in IPOs has been particularly marked among small companies, with Rose and Davidoff Solomon declaring that, “The small company initial public offering (IPO) is dead.”⁸⁰ Their analysis found that the number of IPOs for companies with an initial market capitalization of less than \$75 million has dropped from 168 in 1997 to just seven in both 2008 and 2012.⁸¹ Similarly, de Fontenay reports that, while 53 percent of IPOs between 1980 and 2000 were by small firms, from 2001 through 2012 just 28 percent of IPOs were by small firms.⁸² (See Table 1 above.) And, in a widely-cited paper on listing trends, Craig Doidge, G. Andrew Karolyi, and René M. Stulz report that “there were many fewer firms listed in 2012 that were comparable in size to the smallest firms listed in 1996.”⁸³ In general, listed firms became larger, so that the entire size distribution for listed firms shifted to the right.⁸⁴ This shift toward larger company IPOs is reflected in the fact that, despite the dramatic decline in the overall number of IPOs, total proceeds from those IPOs has continued

⁷⁸ Paul Rose and Steven Davidoff Solomon, *Where Have All the IPOs Gone? The Hard Life of the Small IPO*, 6 *Harv. Bus. L. Rev.* 83 (2016), <https://bit.ly/31NAIte>.

⁷⁹ Les Brorsen, EY, *Looking Behind the Declining Number of Public Companies*, Harvard Law School Forum on Corporate Governance and Financial Regulation, May 18, 2017, <https://bit.ly/2HoP5cU>.

⁸⁰ Paul Rose and Steven Davidoff Solomon, *Where Have All the IPOs Gone? The Hard Life of the Small IPO*, 6 *Harv. Bus. L. Rev.* 83 (2016), <https://bit.ly/31NAIte>.

⁸¹ *Id.*

⁸² Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 *Hastings Law Journal* 445-502 (2017), <http://bit.ly/2mRoPmP>.

⁸³ Craig Doidge, G. Andrew Karolyi, and René M. Stulz, *The U.S. Listing Gap*, National Bureau of Economic Research, Working Paper 21181 (May 2015), <https://www.nber.org/papers/w21181.pdf>.

⁸⁴ *Id.* (They go on to explain that, “While these results seem at first supportive of the hypothesis that listing became less attractive for smaller firms, our tests show that listing became less attractive for firms of all sizes. Therefore, the listing gap cannot simply be due to the fact that small firms in particular are no longer choosing to be listed and/or are delisting from the exchanges.”)

to climb. As Ernst & Young stated in its analysis, “companies conducting a US IPO today are raising more money than ever before.”⁸⁵

2. The Number of Public Companies Has Plummeted.

Another commonly cited metric for measuring the health of our public markets is the number of U.S. public companies listed on a major securities exchange.⁸⁶ While companies do not technically raise money on exchanges, “exchange listings are intimately tied to public capital raising because they represent a promise of liquidity to investors, which is a crucial inducement for them to invest in the first place.”⁸⁷ Here again, the trends are disturbing. According to de Fontenay, for example, “the number and relative share of exchange-listed companies has plummeted over the last four decades, suggesting a stark decline in public equity.”⁸⁸

- Citing statistics from Doidge, Karolyi, and Stulz, de Fontenay notes that, between 1977 and 2012, the number of U.S. exchange-listed firms fell in absolute terms from 4,710 to 4,102 firms, representing a decline of almost thirteen percent.⁸⁹ During the same period, both the ratio of U.S. listed firms to all U.S. firms and the number of U.S. listed firms per capita plunged by roughly 40 percent each.⁹⁰ By the end of 2017, the number of publicly listed companies had dropped even further, to roughly 3,600.⁹¹
- That decline is even more pronounced when you consider the large increase in publicly listed companies that occurred between the late 1970s and the peak in 1996, at the height of the tech stock bubble, when there were 8,025 publicly listed companies in the United States.⁹² (See Table 2 below.)
- Doidge, Karolyi, and Stulz find that both unusually high rates of delistings and unusually low rates of IPOs post-1996 contributed to the decline.⁹³ More specifically, according to the E&Y analysis, a significant portion of the post-1996 decline came as a result of the 2,800 delistings that occurred between 1996 and 2003, largely as a result of the bursting of the tech stock bubble.⁹⁴ Indeed, according to E&Y, “the loss of domestic US-listed

⁸⁵ Les Brorsen, EY, *Looking Behind the Declining Number of Public Companies*, Harvard Law School Forum on Corporate Governance and Financial Regulation, May 18, 2017, <https://bit.ly/2HoP5cU>.

⁸⁶ See, e.g., Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 *Hastings Law Journal* 445-502 (2017), <http://bit.ly/2mRoPmP>. (“As a technical matter, firms do not generally raise capital on the stock exchanges. . . . Nonetheless, exchange listings are intimately tied to public capital raising because they represent a promise of liquidity to investors, which is a crucial inducement for them to invest in the first place.”).

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ Editorial Board, *Where Have All the Public Companies Gone?*, Bloomberg Opinion (April 9, 2018), <https://bloom.bg/2RwuEBE> (citing statistics from Jay R. Ritter, Warrington College of Business Administration, University of Florida and University of Chicago Center for Research in Security Prices.).

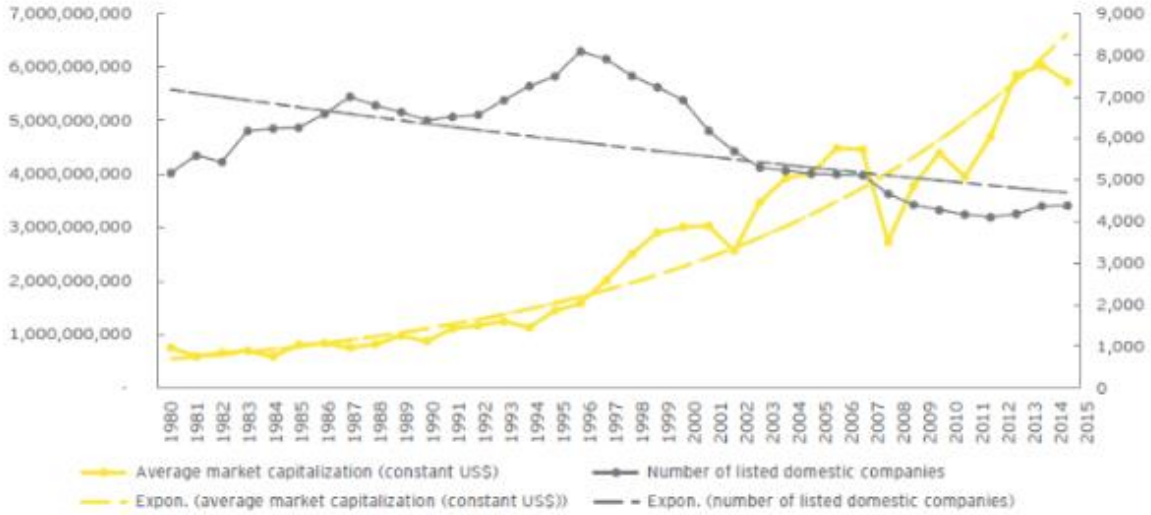
⁹² Andrew Ross Sorkin, *C.E.O.s Meet in Secret over the Sorry State of Public Companies*, N.Y. Times, July 21, 2016, <https://nyti.ms/31TcHRD>.

⁹³ Craig Doidge, G. Andrew Karolyi, and René M. Stulz, *The U.S. Listing Gap*, National Bureau of Economic Research, Working Paper 21181 (May 2015), <https://www.nber.org/papers/w21181.pdf>.

⁹⁴ Les Brorsen, EY, *Looking Behind the Declining Number of Public Companies*, Harvard Law School Forum on Corporate Governance and Financial Regulation, May 18, 2017, <https://bit.ly/2HoP5cU>.

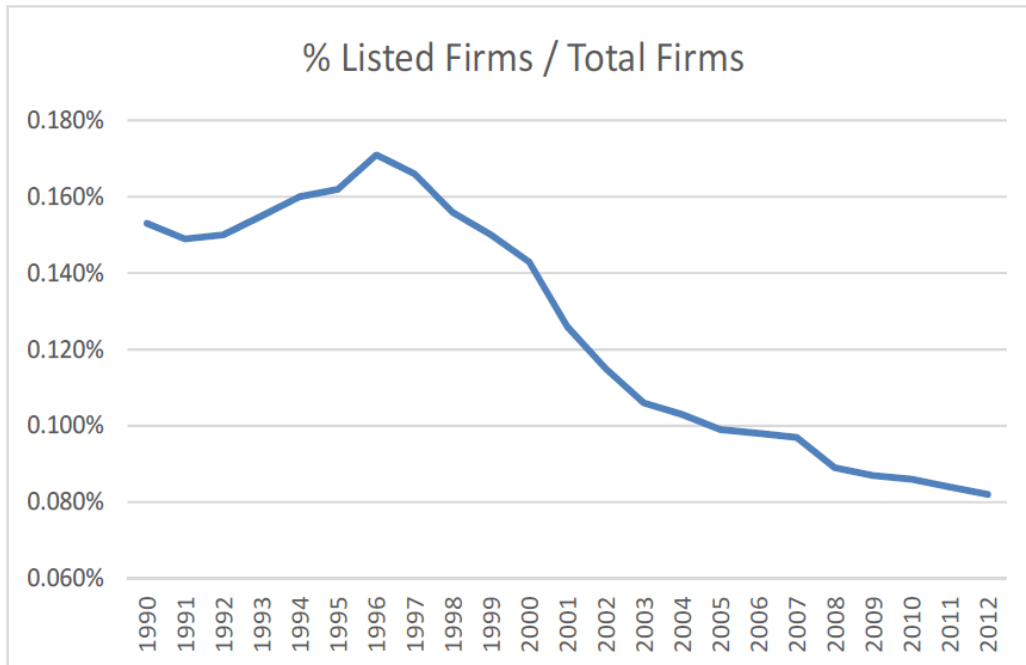
companies in 1996–2003 represents 74% of the loss from 1996 to date.”⁹⁵ (See Table 3 below.)

Table 2: Number of Domestic-listed Companies and Average Market Capitalization



Source: World Bank, excluding investment funds and trusts.

Table 3: U.S. Exchange-Listed Firms as a Percentage of All U.S. Firms (1990-2012)



Source: Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company* (April 11, 2017)

⁹⁵ *Id.* (finding that, since the 2008 financial crisis, “the total number of domestic US-listed companies has largely stabilized again, ranging between 4,100 and 4,400. During this same period, foreign companies listed on US exchanges have steadily increased in number.”).

Here again, evidence suggests that remaining publicly listed companies are bigger than ever. For example, E&Y cited a recent analysis which found that, as of early 2017, the average market capitalization of a U.S.-listed public company was \$7.3 billion compared to an average of \$1.8 billion in 1996.⁹⁶ The analysis further noted that approximately 140 companies with more than \$50 billion in market capitalization constituted more than half of the total U.S. market capitalization.⁹⁷

While the decline in IPOs appears to be an international phenomenon, the decline in the number of publicly listed companies appears, in the words of de Fontenay, to be “truly unique to the United States. Peer countries with developed national stock exchanges did not experience a similar decline in listings.”⁹⁸ Similarly, Ernst & Young researchers report that, “The trends in the United States toward fewer public listings are unusual compared to the trends in other developed countries with similar institutions and economic development.”⁹⁹ The E&Y analysis cites one study that found that, while U.S. listings dropped by about half since 1996, listings in a sample of developed countries increased by 48 percent.¹⁰⁰ On the other hand, according to the E&Y analysis, the United States remains the favorite location for foreign countries that conduct a cross-border listing.¹⁰¹

G. Private Markets Have Experienced Explosive Growth.

At the same time that U.S. public markets have experienced a decline, our private markets have enjoyed explosive growth. The result is that the amount of capital raised today in private offerings dwarfs the amount raised in public markets. The Commission acknowledges this phenomenon in the Concept Release, which states: “As the regulatory and operational framework for exempt offerings has evolved, the amount raised in exempt markets has increased both absolutely and relative to the public registered markets.”¹⁰² As a result, in 2018, “registered offerings accounted for \$1.4 trillion of new capital compared to approximately \$2.9 trillion that we estimate was raised through exempt offering channels.”¹⁰³ (See Table 4 below.) The Treasury Department Capital Markets report states that, “Amounts raised through private offerings of debt and equity for 2012 through 2016 combined exceeded amounts raised through public offerings of

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 *Hastings Law Journal* 445-502 (2017), <http://bit.ly/2mRoPmP>; See also, Doidge, Karolyi, and Stulz, *The U.S. Listing Gap*, attributing the decline to a combination of a high number of delists (accounting for roughly 46 percent of the listing gap) and low new lists (accounting for roughly 54 percent of the listing gap). (“After 1996, we find that the new list rate was low and the delist rate was high by historical standards. We also find that the U.S. new list rate was low and the delist rate was high compared to other countries over that same period.” Also, “What we do find is that the U.S. had an unusually high number of merger delists after 1996. The number of mergers is high compared to both U.S. history and to other countries.” “In our analysis, we find that mergers play a critical role for the decrease in U.S. listings.”)

⁹⁹ Les Brorsen, EY, *Looking Behind the Declining Number of Public Companies*, Harvard Law School Forum on Corporate Governance and Financial Regulation, May 18, 2017, <https://bit.ly/2HoP5cU>.

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² Concept Release at 16.

¹⁰³ *Id.*

debt and equity over the same time period by approximately 26%.¹⁰⁴ Moreover, as Commission economists reported in a 2018 White Paper on Capital Raising in the United States, the \$1.8 trillion raised just through Reg D offerings in 2017 “is considerably larger than the amount of public debt (straight and convertible debt) and public equity (common and preferred) offerings over the same time.”¹⁰⁵

Table 4: Number of Offerings by Type of Offering and Year

Year	Public Offerings		Private Offerings		
	Public equity	Public debt	Regulation D	Rule 144A	Other private*
2009	942	1,445	18,295	1,661	942
2010	1,072	1,930	25,993	1,958	930
2011	863	1,465	27,336	1,388	960
2012	954	1,473	28,184	1,558	531
2013	1,250	1,510	30,429	1,896	841
2014	1,176	1,576	33,429	1,813	674
2015	985	1,565	34,877	1,761	287
2016	821	1,636	35,793	1,500	450
2017	976	1,846	37,785	2,099	1,217

*Includes offerings conducted under Regulation S, qualified Regulation A, Regulation Crowdfunding, and Section 4(a)(2).

Source: Concept Release

While the Commission’s recent analysis focuses primarily on the last decade, the rapid growth of the private markets can be traced back to the 1980s, when Reg D was adopted to “simplify and clarify existing [registration] exemptions, to expand their availability, and to achieve uniformity between Federal and state exemptions in order to facilitate capital formation consistent with the protection of investors.”¹⁰⁶ Writing in the winter of 1990, shortly after SEC adopted Rule 144A easing restrictions on trading of unregistered securities, Indiana University School of Law Professor Kellye Testy observed that “the private placement market, the premier institutional investor playground, is challenging the public market’s share of total corporate financings.”¹⁰⁷ Testy noted that “the total amount of securities privately placed in the United States exploded” from \$18 billion in 1981, to \$70 billion in 1985, and to \$202 billion in 1988.¹⁰⁸ Private placements already accounted for 43 percent of total corporate financings by 1988, according to Testy, who added that, “the percentage of equity now privately placed has grown to twelve percent of corporate financings in 1987.”¹⁰⁹ “In the wake of this explosive growth in the

¹⁰⁴ Steven T. Mnuchin, Secretary, and Craig S. Phillips, Counselor to the Secretary, *A Financial System that Creates Economic Opportunities: Capital Markets*, U.S. Department of the Treasury (Oct. 2017), at 24, <https://bit.ly/2fPPMR3>.

¹⁰⁵ Scott Bauguess, Rachita Gullapalli, and Vladimir Ivanov, *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017*, Division of Economic and Risk Analysis (DERA) U.S. Securities and Exchange Commission (Aug. 2018), <https://bit.ly/2WJXofd>.

¹⁰⁶ Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, Securities and Exchange Commission, Release No. 33-6389 (FR Vol. 47, No. 51) (March 16, 1982).

¹⁰⁷ Kellye Y. Testy, *The Capital Markets in Transition: A Response to New SEC Rule 144A*, 66 *Indiana Law Journal* 233 (1990), <https://bit.ly/2KE2ItK>.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

institutional and private placement markets, the SEC has fanned the flame with Rule 144A,” Testy wrote.¹¹⁰

Because 144A made it easier for institutional investors, including mutual funds, to invest in private securities, Testy predicted (correctly) that the explosive growth of the private placement market during the 1980s would only accelerate in the 1990s. In her article, Testy quoted a tongue-in-cheek contemporary prediction intended to highlight the pace of that change that, “If current trends persist, [t]he last share of publicly traded common stock owned by an individual will be sold in the year 2003.”¹¹¹ However, Testy herself expressed confidence that public listings were here to stay. “The value of the public market, even to investors having access to relatively liquid private markets, has been proven empirically,” she wrote.¹¹² “Entrepreneurs turn to the public market for a source of capital, partly because of its efficiency as a provider, but also because of the perceived status of having a corporation listed on the national exchanges, thereby giving the public market a degree of inelasticity. This inelasticity allows Rule 144A to operate successfully ... without the private market totally eclipsing the public one.”¹¹³

H. Policies Promoting Private Markets are the Primary Driver of Public Markets’ Decline.

While Testy’s optimism may have made sense in 1990, there are reasons to be considerably less sanguine today about the continued relevance of U.S. public markets under our current regulatory framework. Shockingly, however, those who profess great concern about our public markets’ decline largely ignore the role that policies promoting private markets have played in spurring that decline. Specifically, those whose goal is to push a deregulatory agenda -- whether by rolling back public market regulations or by expanding private market exemptions -- prefer to blame the high and rising costs of being a public company.¹¹⁴ But, as de Fontenay argues persuasively in her paper, *The Deregulation of Private Capital and the Decline of the Public Company*, they get the argument backward.¹¹⁵

The gist of de Fontenay’s argument is this: Federal securities laws imposed a significant cost on public companies, primarily in the form of increased disclosure obligations.¹¹⁶ But going public also came with a significant benefit -- the right to raise money from the “largest (and therefore cheapest) source of capital: the general public.” For many decades, but no longer, private companies “were restricted to raising capital primarily from insiders and financial

¹¹⁰ *Id.*

¹¹¹ *Id.*, citing Light, *The Privatization of Equity*, reprinted in Jensen, *Eclipse of the Public Corporation*, Harv. Bus. Rev., Sept.-Oct. 1989, at 61-62. (Light admits that this forecast may be fanciful, noting that “short-term trends never persist” but that “the basic direction [decreasing public stock ownership in the United States] is clear.”).

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ See, e.g., Steven T. Mnuchin, Secretary, and Craig S. Phillips, Counselor to the Secretary, *A Financial System that Creates Economic Opportunities: Capital Markets*, U.S. Department of the Treasury (Oct. 2017), <https://bit.ly/2fPPMR3>.

¹¹⁵ Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 *Hastings Law Journal* 445-502 (2017), <http://bit.ly/2mRoPmP>.

¹¹⁶ *Id.* The costs of enhanced disclosure include, not just the cost of preparing and auditing the disclosures, but also the increased liability that accompanies those disclosures and the ability of competitors to gain insights into the company’s operations that they can use to their advantage.

institutions, without publicity and subject to severe limitations on subsequent transfers of their securities.” In that environment, companies “seeking to raise large amounts of capital gladly took up the public side bargain precisely because there was a plausible, direct connection between the cost (information disclosure) and the benefit (the broad investor base).”¹¹⁷

Over the past several decades, however, policymakers have “repeatedly loosen[ed] the restrictions on capital raising and trading on the private side ... giv[ing] birth to a contradiction in terms: private securities markets.” When private companies “can raise ample, cheap capital with relative ease,” public companies “benefit significantly less from their disclosure obligations.” “Thus, while critics blame the increase in regulation for the decline of public equity,” de Fontenay writes, “the ongoing deregulation of private capital raising arguably played the greater role. That is, even if public company disclosure requirements had remained constant over the last three decades, there would likely still be a dearth of public companies today, due to the increasing ease of raising capital privately.”¹¹⁸

Public companies have been disadvantaged by the expansion of the private markets in other ways as well, de Fontenay argues. For example, because the aggregate supply of capital for investment is limited, much of the surge of investment in private companies and privately offered securities has been at the expense of the public markets. Moreover, she argues, with “issuers and investors increasingly free to cross the public-private divide, public and private companies now compete more directly for both investors and customers. The result is that the mandatory disclosure regime is no longer a closed system for the benefit of public companies: The third-party effects of disclosure amount to a penalty on public companies and a subsidy to private companies.”¹¹⁹ When going public is no longer necessary to raise large amounts of capital from a large number of shareholders, companies will inevitably weigh the costs and benefits of that decision very differently. An Ernst & Young executive expressed the same concept more succinctly. Companies are staying private longer today, he said, “Because they can.”¹²⁰

In addition to the direct and indirect costs of disclosure, there are other effects of going public that may weigh against the decision. These include: the loss of control that results from having a broad, diverse, and sometimes activist shareholder base; increased liability exposure; a perceived need to manage the company to meet analysts’ expectations, and the related problem of “short-termism” in the market’s judgements. When access to capital is no longer a determining factor, any perceived disadvantages must be weighed against a more limited set of potential benefits, such as: the expanded research coverage, publicity, and reputational advantages that can come with an exchange listing; “a simpler capital structure (typically); and more uniform shareholder rights -- as compared to, for example, multiple rounds of venture capital financing, each associated with potentially differing cash flow and other rights.”¹²¹ In

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ Testimony from Glen Giovannetti, EY Global Biotechnology Leader, before the Securities and Exchange Commission’s Advisory Committee on Small and Emerging Companies, “Private market trends: multiple options for growing companies,” February 15, 2017, <https://bit.ly/2ZaXXzS>.

¹²¹ De Fontenay, *The Deregulation of Private Capital*.

addition, public markets (at least for now) retain a distinct liquidity advantage over private markets.

Indeed, that added liquidity appears to be a key reason that going public is now viewed primarily, not as a way to gain access to capital, but “as a mechanism for founders, employees, and early investors to cash out their relatively illiquid stakes in the firm,” according to de Fontenay.¹²² She sums it up this way: “Today, then, ‘going public’ is no longer the unavoidable stepping stone to raising large amounts of capital -- far from it. Weighing the costs and benefits, firms are increasingly declining whatever it is that the public side still has to offer them. Those that do go public appear to be motivated primarily by the need to allow insiders to cash out some of their investment in the business or by the fear of running afoul of the securities law provisions based on size or trading in their securities. Retrenchments of the securities laws are increasingly helpful in alleviating those fears and thus delay firms’ entry into the public side even further.”¹²³

In her paper, *The Unicorn Governance Trap*, Boston College Law Professor Renee M. Jones, argues that two other recent policy changes have significantly undercut the liquidity advantage that public markets once had.¹²⁴ By repeatedly reducing the required holding period for restricted securities, the SEC has dramatically reduced public companies’ need to go public in order to provide liquidity for founders, early investors, and employees, according to Jones. Meanwhile, by dramatically increasing the number of shareholders a company can have without becoming a reporting company under the ‘34 Act, Congress has eliminated a key incentive large companies with a dispersed shareholder base formerly had to go public once they were required to become reporting companies under the ‘34 Act.¹²⁵

One effect of all this is that young start-up companies increasingly choose to stay private “for years on end,” often waiting to enter the public markets until “long after they have achieved scale,” de Fontenay writes.¹²⁶ The embodiment of this phenomenon are the “unicorns” -- companies that achieve valuations of \$1 billion or more while remaining private. Rare creatures as recently as a decade ago, unicorns are increasingly common today. Jones noted, for example, that the number of unicorns had increased dramatically, “from a mere 40 in 2013 to a reported 267” in 2017.¹²⁷ As of August 30 of this year, the same database cited by Jones in her 2017 paper put the number at 496, including 21 companies valued at \$10 billion or more.¹²⁸

Jones summarizes the reasons for the explosive growth of very large private companies this way: “[E]xpanded liquidity in markets for private securities reduced pressure on companies to race toward an exit through a sale of the company or an IPO. These market shifts were facilitated by a series of deregulatory reforms, including amendments to Rule 144 and Regulation D. The JOBS Act amendments to Section 12(g) struck a final blow to the system of discipline that encouraged start-ups to mature as they grew. The result of these regulatory and market changes has been a proliferation of Unicorns that linger for extended periods in an ill-

¹²² *Id.*

¹²³ *Id.*

¹²⁴ Renee M. Jones, *The Unicorn Governance Trap*, 66 U. Pa. L. Rev. Online 165 (2017), <http://bit.ly/2msD01w>.

¹²⁵ *Id.* at 174-177.

¹²⁶ De Fontenay, *The Deregulation of Private Capital*.

¹²⁷ Jones, *The Unicorn Governance Trap*, at 178.

¹²⁸ CrunchBase Unicorn Leaderboards, TechCrunch, <https://tcrn.ch/2mwtdHG>.

defined space between public and private status.”¹²⁹ “If the trend continues,” de Fontenay writes, “the typical U.S. public company will be a corporate behemoth that is no longer growing meaningfully” and our public markets, “no longer the promised land for companies poised to grow” will be little more than “a holding pen for massive, sleepy corporations.”¹³⁰

While it may have been perfectly reasonable in 1990 to predict, as Professor Testy did, that public and private markets could exist in harmony, the evidence today that the growth of private capital raising is threatening our public markets is unavoidable. Instead of seriously considering what all of this means for our current system of private offering exemptions, however, the Commission dismisses the question with barely a mention. The Concept Release states merely that, “There are many possible reasons why the amount of capital raised in exempt offerings exceeds the amount raised in registered offerings. However, the focus of this concept release is to seek input on whether, in light of the increased activity in the exempt markets, the current exempt offering framework is working effectively to provide access to capital for a variety of issuers, particularly smaller issuers, and access to investment opportunities for a variety of investors while maintaining investor protections.”¹³¹ Worse, concern that investors are being denied an opportunity to invest in companies while they are still growing is used to justify further policy changes to expand investor access to private offerings -- policy changes that, if adopted, could well end up being the final nail in the coffin for our public markets.

I. The Decline of Public Markets is Damaging to Investors.

Some might ask why policymakers should care if capital raising is shifting from public to private markets, as long as issuers of all sizes have access to capital on affordable terms. That appears to be the assumption behind the Concept Release. This attitude not only ignores the lessons of history, however, it fails to take account of the very real and concrete advantages investors enjoy when securities are offered and trade in public, rather than private, markets. These start, of course, with the far greater transparency that exists in public markets and the attendant benefits that transparency brings. But the benefits of public markets for investors extend well beyond transparency.¹³² They include greater liquidity, more accurate valuations, higher quality third-party research, lower trading costs,¹³³ stronger legal protections, and better

¹²⁹ Jones, *The Unicorn Governance Trap*, at 177.

¹³⁰ De Fontenay, *The Deregulation of Private Capital*.

¹³¹ Concept Release at 21.

¹³² See, e.g., Testimony of Tyler Gellasch, Executive Director of the Healthy Markets Association, “Legislative Proposals to Help Fuel Capital and Growth on Main Street,” before the House Financial Services Committee, Subcommittee on Capital Markets, Securities and Investment, May 23, 2018, <https://bit.ly/2lWt4gt>. (“When compared to private securities, public securities typically offer a number of significant advantages for investors, including: Public securities often are accompanied by more robust accounting and business disclosure practices. Information about public companies, including third party research, is much more readily available and fairly distributed (as required by SEC rules). Public securities are far more easily and reliably valued. Public securities offer a transparent and efficient method to liquidate shares of common stock. Liquidity risks and trading costs for public securities are often significantly lower than for similarly-situated private securities. Public securities are much more easily benchmarked, such as against the S&P 500. These factors play a paramount role in pension plans’ and investment advisers’ abilities to fulfill their respective fiduciary duties.”).

¹³³ *Id.* at 7. (“One major difference between public and private markets is trading cost. ... So-called “effective spreads” in the largest companies are less than a penny per share. For less-liquid public companies, these spreads may be pennies per share. By the time you get to the OTC markets, these trading costs may be quite large. And by

regulatory oversight. Among the most important benefits of public markets for retail investors are a set of regulatory protections designed to ensure that even the smallest of investors trade on equal terms with the largest of institutional investors. Those same protections simply do not apply in the private markets. As a result, policies to expand retail investors' access to private offerings threaten to expose them, not just to the risks inherent in investing in early stage start-up companies, but to the risk that they will do so based on inadequate or unreliable information and at a distinct disadvantage to other more sophisticated participants in that market.

1. Private Markets Lack the Transparency Needed to Support Informed Investment Decisions.

As discussed above, a central purpose of both the '33 Act and the '34 Act is to ensure that investors have full access to the “essential facts” that are “indispensable to any accurate judgment upon the value of the security.”¹³⁴ As the SEC states on its website, these disclosures provide “a common pool of knowledge for all investors to use to judge for themselves whether to buy, sell, or hold a particular security.”¹³⁵ For decades after the passage of the '33 Act, availability of the private offering exemption turned on whether offerees were provided or had access to the same type of information as would be available through registration. But that is no longer the case. Instead, under the most commonly relied upon private offering exemption, Rule 506 of Regulation D, the issuer has full discretion to decide what information to give to accredited investors, so long as that information does not violate the anti-fraud provisions of the federal securities laws and the company makes itself available to answer questions from prospective purchasers.¹³⁶ Only if the company offers the securities to non-accredited investors, which most apparently do not, is the issuer required to provide those investors with disclosure documents, including financial statements, that are generally the same as those used in either a registered offering or an offering under Regulation A.¹³⁷

The result is that hundreds of billions of dollars' worth of securities may be sold each year without investors' receiving the “essential facts” needed to support an informed investment decision. As a result, investors may find it difficult to value the company conducting a Reg D offering or determine a fair price for its stock. Even where valuations are provided publicly, as they often are for the largest private companies, the “lack of reliable information about [their]

the time you get to private securities, trading costs may total many, many times those of trades in public securities.”).

¹³⁴ H.R. Rep. No. 73-85 at 18, 3.

¹³⁵ U.S. Securities and Exchange Commission, About the Sec, What We Do, <http://bit.ly/2MngEXy> (last accessed August 16, 2019).

¹³⁶ Securities and Exchange Commission, “Fast Answers: Rule 506 of Regulation D,” <http://bit.ly/2mRsOzM>. Moreover, these disclosures are not required to be filed with the SEC. Instead, companies must file a brief form (Form D) with the Commission after they first sell their securities that “includes the names and addresses of the company's promoters, executive officers and directors, and some details about the offering, but contains little other information about the company.” By the Commission's own admission and discussed below, a significant but unknown percentage of issuers fail to file Form D as required.

¹³⁷ However, as the Commission notes in the Concept Release, participation of non-accredited investors is the rare exception, rather than the rule. *See, e.g.*, Concept Release at 22 (“The current framework permits non-accredited investors some limited access to unregistered offerings. ... In 2018, however, aggregate investments in exempt offerings in which non-accredited investors participated represented less than one percent of investment in all exempt offerings, and approximately two percent of all exempt offerings, excluding other exempt offerings.”).

financial performance means publicly disclosed valuations ... are likely unreliable.”¹³⁸ At the same time, private companies may find it easier than public companies to keep information about such matters as business risks or inappropriate corporate conduct under wraps.¹³⁹ And, because private market disclosures may not be vetted by third parties, such as underwriters, auditors, attorneys, and analysts, and aren’t subject to the same tough liability standards that apply in public markets, the information that is provided may be less reliable than disclosures provided by public companies.

A recent *Wall Street Journal* article examined this in the context of unicorns contemplating IPOs, such as Peloton Interactive Inc., WeWork parent We Co., and Lyft Inc., stating: “While they were private, these companies could easily paint rosy pictures of their finances. But going public means they have to report numbers based on standard accounting rules, which often reveal losses, sometimes huge ones.”¹⁴⁰ One problem, according to experts quoted in the article, is that private companies often rely on non-standard metrics or use terms, such as profitability, in ways that “contaminate” the accepted meaning of those terms.¹⁴¹ Bad as that problem is at the offering stage, those who purchase restricted securities in secondary markets face even more difficulty assessing the value of their shares, in part because they may lack direct access to the company.¹⁴² As a result, something as basic as the price others are paying for the company’s shares may be difficult to ascertain in private markets. Moreover, the absence of both public information and a public market for shares of private companies eliminates the market discipline provided by investor arbitrage activity, for example, through short selling.

Problems with private company valuations were recently illustrated by two high-profile examples -- Uber and WeWork.¹⁴³ Just a few months before it went public in May of this year, press reports suggested that Uber Technologies could be valued as high as \$120 billion.¹⁴⁴ By the time it conducted its IPO, however, its value was placed at a more modest \$82 billion. Since that time, when it was forced to begin providing more robust public disclosures, Uber’s stock has continued its steady decline. In a development reminiscent of the Uber IPO, reports emerged earlier this month that WeWork may go public at less than half the valuation it secured from its biggest backer just a few months ago.¹⁴⁵ Subsequently, as the estimated value continued to

¹³⁸ Jones, *The Unicorn Governance Trap*, at 182-183.

¹³⁹ See, e.g., Jones, *The Unicorn Governance Trap*. Jones cites the high-profile example of Uber, where corporate managers were able to keep serious problems with both the corporate culture and the company’s business model from investors that, Jones argues, would almost certainly have come to light much sooner, or might in some cases have been prevented altogether, if the companies had been subject to discipline and disclosure obligations that apply to public companies.

¹⁴⁰ Jean Eaglesham, *Unicorns’ Pre-IPO Profit Claims Get Scrutinized*, *The Wall Street Journal*, September 22, 2019, <https://on.wsj.com/2kXYTFD>.

¹⁴¹ For example, private companies are not required to reconcile non-GAAP numbers, such as EBITDA, to Generally Accepted Accounting Principles.

¹⁴² Jones, *The Unicorn Governance Trap*, at 182-183.

¹⁴³ Jason Zweig, *How We Should Bust an Investing Myth*, *Wall Street Journal*, September 24, 2019, <https://on.wsj.com/2m3Rrck>.

¹⁴⁴ Trefis Team, *How Uber Could Justify A \$120 Billion Valuation*, *Forbes*, December 3, 2018, <http://bit.ly/2kSVGqL>.

¹⁴⁵ See, e.g., Michelle Davis, Giles Turner, and Gillian Tan, *WeWork Targets \$20 Billion to \$30 Billion IPO Value*, *Bloomberg*, September 5, 2019, <https://bloom.bg/2k32XUv>.

drop¹⁴⁶ and concerns about management increased,¹⁴⁷ that backer reportedly began urging the company to shelve its IPO.¹⁴⁸ By late September, the CEO had been forced out and the valuation of the company had dropped further still.¹⁴⁹ If sophisticated investors with extensive insider access to information can't reliably value private companies, what chance do individual accredited investors have?

These examples perfectly illustrate one reason the transparency provided in public markets is so important. As Donald C. Langevoort, Thomas Aquinas Reynolds Professor of Law at Georgetown University Law Center, explains in his chapter of *Securities Market Issues for the 21st Century*, the '33 Act's disclosure requirements "reflect some mix of (1) doubts about the opportunity to bargain and enforce effectively when offerees are unsophisticated and/or widely dispersed; (2) agency costs that arise when there are conflicting interests on the part of those in control of the issuer; (3) a desire to promote uniformity and comparability in presentation and content so as to facilitate comparison shopping; and (4) a recognition that disclosure generates positive externalities by enriching that capital-raising environment generally—offering information that aids in the valuation of other issuers beside the one making the disclosure ... and facilitating other healthy economic activity. There are many such positive externalities beyond the immediate value of the information for trading purposes, including better corporate governance."¹⁵⁰ Those benefits are lost in private markets.

In other words, the lack of transparency in private markets has implications not only for individual investors, who can't bargain effectively and risk making decisions based on incomplete or inaccurate information, but also for the broader economy. After all, for the original drafters of the '33 Act, a key reason for improving disclosure was to help ensure that capital flows to its best uses.¹⁵¹ They had seen firsthand the economic damage that can result when, in the absence of full disclosure, capital is misallocated to fraudulent investments or squandered on enterprises with little realistic prospect for success. The Commission acknowledges this critical role of transparency in promoting our nation's economic well-being on its website. Referring to the initial and continuing reporting requirements under the '33 Act and '34 Act, the website

¹⁴⁶ Joshua Franklin and Anirban Sen, *WeWork is now considering an IPO valuation as low as \$10 billion, down from \$47 billion*, Reuters, September 13, 2019, <https://bit.ly/2ISmsjq>.

¹⁴⁷ Michael J. de la Merced, Andrew Ross Sorkin and David Gelles, *WeWork C.E.O.'s Ouster Is Weighed in Bid to Salvage I.P.O.*, The New York Times, September 22, 2019, <https://nyti.ms/2moIQRr>.

¹⁴⁸ Ryan Duffy, *WeWork and Uber Deal Blows to SoftBank's Vision Fund*, Morning Brew, September 11, 2019, <http://bit.ly/2mYzlca>.

¹⁴⁹ David Gelles, Michael J. de la Merced, Peter Eavis and Andrew Ross Sorkin, *WeWork C.E.O. Adam Neumann Steps Down Under Pressure*, The New York Times, September 24, 2019, <https://nyti.ms/2mWWBHD>.

¹⁵⁰ Donald C. Langevoort, *The Regulation of Primary Markets*, in *Securities Markets Issues for the 21st Century*, 101 (Merritt B. Fox, Lawrence R. Glosten, Edward F. Greene & Menesh S. Patel, ed., 2018), <https://bit.ly/2JUm0ZD>.

¹⁵¹ See H.R. Rep. No. 73-85 at 2-3 ("Whatever may be the full catalogue of the forces that brought to pass the present depression, not least among these has been this wanton misdirection of the capital resources of the Nation."); See also Alan R. Palmiter, *Securities Regulation: Examples & Explanations* 1 (2nd ed. 2002) ("[S]ecurities regulation...proceeds from the premise that mandatory disclosure (with antifraud liability) will equip securities investors and markets with the information to move capital to its optimal uses. That is, investor protection is a means to healthy and vigorous capital markets, which in turn are the lifeblood of a robust economy.").

states, “The result of this information flow is a far more active, efficient, and transparent capital market that facilitates the capital formation so important to our nation’s economy.”¹⁵²

By increasingly shifting capital raising into private markets, which lack that transparency, policymakers risk recreating the conditions that led to the Crash of ‘29. Indeed, the recent financial crisis exhibited many of these same characteristics. Specifically, investors in mortgage-backed securities that were a root cause of the crisis were typically forced to make their investment decisions without basic information or time to assess and correctly price the securities.¹⁵³ When the securities proved to be much riskier than their AAA ratings suggested, that had catastrophic results not just for those who invested in mortgage-backed securities, but for the broader investing public and the economy as a whole. In response, some experts called for certain exemptions, such as Rule 144A, to be scaled back or eliminated as part of the Dodd-Frank Act.¹⁵⁴ More recently, leveraged loans sold through private offering exemptions have begun to raise similar safety and soundness concerns.¹⁵⁵ As Healthy Markets Executive Director Tyler Gellasch asked in a recent letter to the House Investor Protections, Entrepreneurship, and Capital Markets Subcommittee, “if these products were sold with the same types of disclosures that accompany registered offerings, would they be giving rise to the same risks? Put another way, if all of the relevant details are adequately disclosed, would investors still be willing to purchase them in the same amounts, or on the same general terms?”¹⁵⁶

Instead of expanding the population of investors who have the “privilege” of investing in private offerings based on non-existent or inadequate information, policymakers should consider restoring restrictions on the availability of the private offering exemption to situations in which investors have access to the same type of information as would be available if the securities were registered. That would be better for investors and better for the economy.

2. Retail Investors Operate at a Distinct Disadvantage in Private Markets.

Public markets are fundamentally egalitarian in a way that private markets are not. This is particularly important for retail investors, who do not have the same ability as other, more sophisticated participants in this market, such as large financial institutions and venture capital funds, to protect their own interests. The following are among the most important of these public market regulatory protections designed to help ensure a level playing field for all market participants:

- No matter how small the investment, retail investors are assured of getting the best available price when they trade on a national exchange.

¹⁵² U.S. Securities and Exchange Commission, About the Sec, What We Do, <http://bit.ly/2MngEXy> (last accessed August 16, 2019).

¹⁵³ See, e.g., Statement of Commissioner Luis A. Aguilar, Correcting Some of the Flaws in the ABS Market, August 27, 2014, <http://bit.ly/2lvsCpJ>.

¹⁵⁴ See, e.g., Jeff Madrick and Stephen Diamond, *A “Modest Proposal” for Capital Market Reform: Close Down Rule 144A*, HuffingtonPost, May 25, 2011, <http://bit.ly/2linIMR>.

¹⁵⁵ Statement for the record from Tyler Gellasch on behalf of Healthy Markets Association, “Examining Private Market Exemptions as a Barrier to IPOs and Retail Investment,” Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets, Committee on Financial Services, U.S. House of Representatives, September 10, 2019, at 12-13, <http://bit.ly/2mXaGVf>.

¹⁵⁶ *Id.*

- They get timely updates regarding important developments through the periodic disclosures required under the '34 Act.
- Regulation Fair Disclosure ensures that material information is shared equally with all investors and can't be selectively disclosed to a favored few.¹⁵⁷
- Retail investors who purchase stock in public companies typically have the same rights of ownership as large institutional players.¹⁵⁸

None of these protections apply in the private markets, where early investors and large investors can, and often do, receive more favorable terms. That is because, in private offerings, the issuer gets to decide who to sell to and on what terms. One result is that the best deals may only be made available to the largest investors.¹⁵⁹ Moreover, early investors, such as venture capital firms (VCs) that provide initial funding to start-up companies, may negotiate to receive preferred stock, contractual protection against dilution of their shares in future funding rounds, and representation on the board along with other benefits not available even to wealthy individuals investing in the same company.¹⁶⁰ Meanwhile, large institutional investors may be able to use their market power to get a better price than individual investors who purchase or sell the same security.¹⁶¹ And, particularly when trading in secondary markets, those large institutional investors may also have access to information that isn't generally made available to retail investors.¹⁶²

Those whose answer to the decline in public markets is to advocate expanded retail investor access to private offerings miss this basic point. Such policies force retail investors who want to invest in companies while they are still growing out of a market where they operate on a relatively level playing field and into one where they operate at a distinct disadvantage to larger,

¹⁵⁷ See, e.g., Michael D. Guttentag, *Protection from What? Investor Protection and the JOBS Act*, 13 UC Davis Business Law Journal 207 (2013), <http://bit.ly/2kU1ws5>. (“A second harm that federal securities regulations are intended to protect investors from is the risk that some investors might have unfair access to information that is not readily available to all. ... Frankfurter applauded the adoption of a disclosure-based securities regulation regime, because ‘[t]hus will be exposed distribution profits, watered values, hidden interests, and preferred lists that too frequently have been regarded as the secret prerequisites of insiders.’”).

¹⁵⁸ Recent IPOs that come with very limited investor rights, such as heavily diluted or no voting rights, threaten to undermine this traditional advantage of public markets. See, e.g., Gellasch Testimony at 12; See also, Council of Institutional Investors, Dual Class Companies List, <http://bit.ly/2n61n5l> (last viewed September 26, 2019) (listing U.S.-incorporated, Russell 3000 companies that have at least two outstanding classes of common stock with unequal voting rights.).

¹⁵⁹ See, e.g., Javier Espinoza, *Private equity funds target the wealthy as the hunt for yield continues*, The Financial Times, Sept. 2, 2019, <https://on.ft.com/2myEGXd> (“Axel Geuer wanted to invest in big private equity funds but could not get past the door. The German entrepreneur had wealth but lacked the hundreds of millions required to gain access to the largest buyouts, through funds such as KKR and Carlyle in the US and CVC and EQT in Europe. ... ‘Big names are not really accessible to investors with a couple of thousand dollars or [even] low single-digit millions,’ says Geuer, who used to work at consultancy Bain & Co. ‘It’s not easy, because these funds don’t want a fragmented portfolio of investors.’”).

¹⁶⁰ See, e.g., Jones, *The Unicorn Governance Trap*, at 172-173. Smaller individual investors typically do not have this same power to negotiate favorable terms.

¹⁶¹ Although these large investors would likely expend significant search and bargaining costs along the way.

¹⁶² See, e.g., Testimony of Michael S. Pieciak, NASAA Past-President and Vermont Commissioner of Financial Regulation, on behalf of the North American Securities Administrators Association, before the Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets, Committee on Financial Services, U.S. House of Representatives, “Examining Private Market Exemptions as a Barrier to IPOs and Retail Investment,” at 8, September 11, 2019, <http://bit.ly/2lff1Ox>.

more sophisticated institutional players. The “opportunities” made available to small retail investors in private markets are all too likely to be those that can’t attract funding from larger, more sophisticated market participants. Even if they are fortunate enough to get in on the ground floor of a company that ends up taking off, they may see the value of their investment diluted in future funding rounds, so that they fail to participate in the stock’s rise. None of the policies under consideration in this Concept Release would help to redress that imbalance.

Instead of promoting policies that further stack the odds against retail investors, policies should be focused on reining in private offering exemptions and restoring the incentives companies have to trade publicly or, at the very least, become publicly reporting companies.

3. Private Companies Operate Without Sufficient Control Mechanisms.

Private companies generally operate with less scrutiny from third parties, including regulators and gatekeepers, and without the same control mechanisms that public companies operate under. Among the important differences is the lower liability standard that applies to private offerings, which both weakens deterrence and increases the risk that defrauded investors won’t be able to recover their losses. First, private companies can and do place limits on shareholders’ rights to access the courts to pursue legal claims, something that public companies have so far generally not been permitted to do. Second, private placements are held only to a fraud standard, rather than the easier to prove strict liability standard that applies to registration statements. (Moreover, as discussed below, given the opacity of these markets, it is all too likely that even fraud will go undetected.) Finally, basic due diligence obligations are weaker as a result of the Supreme Court’s 1995 decision in *Gustafson v. Alloyd Corp*, holding that the due diligence obligation does not apply outside the context of a public offering.¹⁶³ With that decision, “another restraint on aggressiveness in the sales and marketing of unregistered securities disappeared,” according to Professors Robert B. Thompson and Donald C. Langevoort.¹⁶⁴ As a result, “far more aggressive advertising and marketing is permitted” in private placements than would be permitted in public offerings, “as issuers and their agents prospect for accredited investors without the due diligence requirements that exists elsewhere in the ’33 Act space.”¹⁶⁵ According to Thompson and Langevoort, “this occurs without any regulatory oversight at all.”¹⁶⁶

As Professor Jones writes in her paper, *The Unicorn Governance Trap*, the lower standards that apply to private offerings undermine investors’ ability to hold private companies accountable. “The securities laws’ disclosure rules seek to shine light on corporate activities that pose risks to investors and other stakeholders,” she writes.¹⁶⁷ “These laws create remedies for investors when managers fail to disclose required information on conflicts of interest and other corporate misconduct. Because Unicorns are free from public disclosure requirements, they can engage in questionable activities with less fear of exposure, and do not face the same threat of

¹⁶³ Robert B. Thompson and Donald C. Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital-Raising*, 98 Cornell L. Rev. 1573 (2013), <https://bit.ly/2lzjUq3>.

¹⁶⁴ *Id.* at 1614. Thompson and Langevoort note that brokers have due diligence obligations under FINRA rules when they are involved in a private placement.

¹⁶⁵ *Id.* at 1586-1587.

¹⁶⁶ *Id.* at 1587.

¹⁶⁷ Jones, *The Unicorn Governance Trap*, at 179.

securities fraud claims that helps discipline managers of public companies.”¹⁶⁸ Jones further notes that, “in the absence of an impending IPO, Unicorn managers and investors lack sufficient incentives to develop governance structures and practices appropriate for enterprises of their scale.”¹⁶⁹ While Jones’ analysis is focused on unicorns, because of the significant influence they have on our economy, the same lack of accountability holds true for other private companies. Indeed, the size of unicorns brings a degree of public scrutiny that other smaller private companies lack.

Traditionally, venture capital investors were able to provide that discipline.¹⁷⁰ But their influence has waned, according to Jones, as VCs have agreed to “founder-friendly financing” deals that give founders “voting power to control the board of directors. This new financing model allow[s] founders to entrench their control with little investor oversight of their activities.”¹⁷¹ This has hampered VCs’ ability “to step in and prevent or correct misconduct.”¹⁷² Ironically, one reason VCs may have been willing to cede that control, according to Jones, is the influx of vast amounts of new capital into private markets beginning in the 1990s. “These new sources of funding compete with conventional VCs for deal flow, but take a more passive approach to monitoring their investments. As VCs vied with other powerful players for access to promising start-ups, they began to offer financing on terms more friendly to founders.”¹⁷³

The lack of accountability at the offering stage is exacerbated when securities of a private company trade in secondary markets without providing the ongoing reporting required under the ‘34 Act. For example, those who purchase private securities in secondary markets not only lack direct access to the company, they also “lack access to the traditional governance tools -- periodic disclosure, proxy statements, and monitoring by the plaintiffs’ bar -- that could help them protect their financial interests,” Jones writes. “When compared to the process for listing shares on a stock exchange, Unicorn founders face little threat to their secrecy and control when they allow their company’s shares to trade in private secondary markets. No gatekeepers or analysts are involved in vetting the company. Founders need not worry as much about a shareholder revolt, since many have already locked down control over the board.”¹⁷⁴

In short, regulatory policies that promote private markets -- including, in particular, expansion of Reg D, shortened holding periods for restricted securities under Rule 144, and the dramatic relaxing of 12(g) requirements for companies to become publicly reporting companies - - “have contributed to a new governance problem by creating a class of unaccountable Unicorns, insulated both from the investor control that typifies private company governance and the public scrutiny and oversight that accompanies an IPO,” according to Jones.¹⁷⁵ Again, this lack of accountability is likely to be even more of a problem outside the world of very large private companies that is the focus of Professor Jones’ analysis. While the implications for the economy may be greatest with regard to the largest private companies, which have an out-sized influence

¹⁶⁸ *Id.*

¹⁶⁹ *Id.* at 167-168.

¹⁷⁰ *Id.* at 172-173.

¹⁷¹ *Id.* at 167.

¹⁷² *Id.* at 168.

¹⁷³ *Id.* at 173.

¹⁷⁴ *Id.* at 182-183.

¹⁷⁵ *Id.* at 170.

on the broader economy, the implications for investor protection when companies are able to operate without appropriate discipline and accountability are market-wide.

4. Private Markets May Impose High Costs on Issuers.

Lack of transparency and insufficient control mechanisms in private markets are also likely to create problems for issuers. First, they create the lemons problem.¹⁷⁶ If investors can't distinguish high quality private investments -- to the extent they are allowed to participate in them at all -- from poor quality private investments, investors are likely to demand a premium to invest in any private investment, raising the cost of capital for all private businesses, including high quality businesses. If investors require a poor quality premium for all private investments, this increases the risk that poor quality investments will saturate the market. As Professor Langevoort has explained, "The cost of capital goes up for all ventures, perhaps prohibitively, unless the investors have some reliable mechanism for telling the difference between the sour lemons and the sweeter fruit...the Securities Act tries to solve this problem in public offerings via mandatory, credible disclosure."¹⁷⁷ Unfortunately, the opacity of private markets makes it difficult, if not impossible, to draw such distinctions.

Relatedly, private markets are likely to create allocative inefficiency problems. Healthy capital markets operate on the idea that, with limited capital to invest, investors will spot and invest in the best businesses. As a result, according to this theory, the best businesses that most deserve to be funded will receive the money that allows them to be productive, while inferior businesses that do not deserve funding won't receive funding that would be wasted.¹⁷⁸ In other words, enabling the efficient allocation of capital to its most promising and beneficial uses fosters a productive economy.¹⁷⁹ However, in a market where investors can't distinguish high quality investments from low quality investments, it's likely that undeserving companies will receive funding that should have gone to deserving companies. This misallocation of capital undermines the capital formation goals on which these deregulatory proposals are being advanced and contributes to the churn and burn of job creation and destruction associated with small companies.

¹⁷⁶ See George A. Akerlof, *The Market for "Lemons": Qualitative Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970) (In the context of buying and selling used cars, because consumers couldn't distinguish high quality used cars from low quality used cars, consumers priced a premium in all cars to account for the possibility that the car they purchased was low quality. Because consumers were only willing to pay for low quality cars, the used car market was overrun with poor quality cars.).

¹⁷⁷ Donald C. Langevoort, *The Regulation of Primary Markets*, in *Securities Markets Issues for the 21st Century*, 101 (Merritt B. Fox, Lawrence R. Glosten, Edward F. Greene & Menesh S. Patel, ed., 2018), <https://bit.ly/2JU0ZD>.

¹⁷⁸ See de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company* ("With scarce capital to go around, an ideal disclosure regime would enable us to collectively value projects more accurately and thus to identify and invest in the ones producing the highest risk adjusted returns.").

¹⁷⁹ See Alan R. Palmiter, *Securities Regulation: Examples & Explanations* 1 (2nd ed. 2002). ("[S]ecurities regulation...proceeds from the premise that mandatory disclosure (with antifraud liability) will equip securities investors and markets with the information to move capital to its optimal uses. That is, investor protection is a means to healthy and vigorous capital markets, which in turn are the lifeblood of a robust economy.").

5. Private Markets Appear to be More Prone to Fraud and Other Predatory Practices.

Lack of transparency, limited regulatory oversight, and weaker control mechanisms combine to make private markets more prone to fraud and other predatory practices than public markets. This is not merely theoretical. State regulators have for years raised serious concerns about investors' being preyed upon in private markets. In addition, FINRA has raised concerns about broker-dealers' role in private markets and has brought numerous enforcement actions against broker-dealers for selling unsuitable private placements. The following specific examples of private placement fraud and other predatory practices highlight how investors can be harmed in loosely regulated private markets.

For many years, abuses associated with private offerings have been at the top of state securities regulators' list of concerns. According to recent Congressional testimony by Alabama Securities Commissioner Joseph Borg on behalf of the North American Securities Administrators Association (NASAA), private offerings "routinely rank among the most common products or schemes leading to enforcement actions in surveys of state securities regulators ...As the regulators closest to hard-working Americans, state securities regulators frequently receive complaints from those who are victimized in offerings conducted under Rule 506, and private placements are commonly listed on NASAA's annual list of top investor traps."¹⁸⁰ "The biggest area of fraud has always been in these private offerings," Denise Voigt Crawford, a former Texas securities regulator, told the *Wall Street Journal*. "Now you've got more people that are eligible to be the victims of fraud," Crawford continued.¹⁸¹

Most troublingly, the brunt of the harm often falls on the elderly, according to NASAA enforcement reports. For example, NASAA members specifically "identified the offer and sales of unregistered securities offerings as the scheme used most often to victimize seniors and other vulnerable adults," according to NASAA's 2018 Enforcement Report.¹⁸² According to NASAA's 2017 report, "Investigations of senior financial exploitation most often involve unregistered securities offerings."¹⁸³ Similarly, both the 2013 and 2014 reports found that "unregistered securities, in the form of promissory notes, private offerings or investment contracts, were clearly the most common product involved in senior abuse cases, accounting for more than half of all reported senior-related enforcement actions and outnumbering the reported cases involving 'traditional securities' by more than four to one."¹⁸⁴

The fact that seniors are disproportionately victimized in the private placement market should come as no surprise, considering a recent *Wall Street Journal* analysis found that roughly one-third of the accredited households are retirees. According to the Journal's analysis, over 16%

¹⁸⁰ Written Testimony of Joseph P. Borg, President, North American Securities Administrators Association, Inc. and Director, Alabama Securities Commission, Before the U.S. House Committee on Financial Services, Subcommittee on Capital Markets, Securities, and Investment, "Ensuring Effectiveness, Fairness, and Transparency in Securities Law Enforcement," June 13, 2018, <http://bit.ly/2n6AsX7>.

¹⁸¹ Jean Eaglesham and Coulter Jones, *Opportunities to Invest in Private Companies Grow*, Wall Street Journal, September 23, 2018, <https://on.wsj.com/2mDpCHZ>.

¹⁸² NASAA Enforcement Section, *NASAA 2018 Enforcement Report Based on 2017 Data*, <http://bit.ly/2lHhJRA>.

¹⁸³ NASAA Enforcement Section, *NASAA 2017 Enforcement Report Based on 2016 Data*, <http://bit.ly/2mAziHk>.

¹⁸⁴ NASAA Enforcement Section, *NASAA 2014 Enforcement Report Based On 2013 Data*, <http://bit.ly/2nbJJNQ>.

of U.S. households aged 75-95 years old are accredited investors, second only to the 19% of U.S. households aged 55-64 years old that are accredited investors. In short, retirees and near retirees who are least able to recover when they are victims of fraud are disproportionately represented in the population of accredited investors who may fall victim to the high incidence of fraud in private markets.

In response to concerns regarding abuses in the private placement market, state securities regulators have stepped up their investigation and enforcement efforts. For example, in July 2017, NASAA established a task force with Massachusetts and Alabama as lead states to investigate the failure by LPL, the nation's largest independent broker-dealer, to establish and maintain reasonable policies and procedures to prevent the sale of unregistered, non-exempt securities by LPL to its customers. The task force determined that LPL had been negligent in its duty to supervise its agents and employees and to prevent the sale of unregistered securities to its customers, over the past 12 years.¹⁸⁵ The lead states negotiated a settlement with LPL in May 2018.

In July 2018, Secretary of the Commonwealth of Massachusetts William Galvin launched an investigation into 10 broker-dealer firms' sales practices in connection with private placements.¹⁸⁶ Galvin launched the investigation following a *Wall Street Journal* investigation that found that broker-dealer firms with unusually high numbers of brokers with disciplinary histories are selling tens of billions of dollars a year of these investments, often targeting seniors.¹⁸⁷ A previous *Wall Street Journal* analysis found that one in eight brokers marketing private placements had three or more red flags on their records, such as an investor complaint, regulatory action, criminal charge or firing, based on a review of regulatory filings from September 2008 through 2017.¹⁸⁸ That compares with one in 50 among all active brokers, according to the *Journal's* analysis. In sum, the *Journal* identified over a hundred firms where 10% to 60% of the in-house brokers had three or more investor complaints, regulatory actions, criminal charges or other red flags on their records. These brokerages helped sell more than \$60 billion in private placements to investors, according to the *Journal*.

Galvin previously brought an enforcement against Securities America for its role in selling fraudulent and worthless Medical Capital (MedCap) securities.¹⁸⁹ Between 2003 and 2009, MedCap raised \$1.7 billion by selling private promissory notes, purportedly to buy discounted medical receivables based on the theory that the firm would recover the full price

¹⁸⁵ Press Release, Secretary of the Commonwealth and Massachusetts Director of the Alabama Securities Commission, "Secretary Galvin and Alabama Director Borg Announce 26 Million Dollar Settlement With LPL Financial," (May 2, 2018), <http://bit.ly/2mDTmV9>.

¹⁸⁶ The DI Wire, *Galvin Launches Investigation of Private Placement Sales by "Bad Actors,"* July 6, 2018, <http://bit.ly/2mIAhKx>.

¹⁸⁷ Jean Eaglesham and Coulter Jones, *Firms With Troubled Brokers Are Often Behind Sales of Private Stakes*, Wall Street Journal, June 24, 2018, <https://on.wsj.com/2Mnkf81>; Jean Eaglesham and Coulter Jones, *Regulators Step Up Scrutiny of Sales of Private Stakes*, Wall Street Journal, July 2, 2018, <https://on.wsj.com/2n8uLlg>.

¹⁸⁸ Jean Eaglesham and Coulter Jones, *A Private-Market Deal Gone Bad: Sketchy Brokers, Bilked Seniors and a Cosmetologist*, Wall Street Journal, May 7, 2018, <https://on.wsj.com/2IEZ34Y>.

¹⁸⁹ Administrative Complaint, *In re: Securities America*, No. 2009-0085 (Mass. Sec'y of the Commonwealth, Sec. Div. Jan. 26, 2010), <http://bit.ly/2II6M2a>. See also Second Amended Complaint for Violations of the Federal Securities Laws at 7-24, *SEC v. Med. Capital Holdings, Inc.*, No. SACV 09-818 DOC (RNBx) (C.D. Cal. Mar. 16, 2010).

from insurance companies. Investors were told that they could expect returns of 8.5–10.5% and that their money was safe because it would be in the hands of “trustees” that were national banks...including Wells Fargo and Bank of New York (now BNY Mellon). While many broker-dealers sold MedCap securities, Securities America was by far the largest seller, accounting for 37% of the total MedCap notes issued, which amounted to \$697 million. It received more than \$26 million in compensation. MedCap securities were sold to 20,000 investors in all. Thanks to the enforcement action, investors recovered \$432 million of the \$1 billion they lost, according to the court appointed receiver, making them more fortunate than many other fraud victims, but that still represents only about 40 cents on the dollar.¹⁹⁰ “The notes Securities America sold were sold under a regulation exemption that allows sale to sophisticated and accredited investors, but these were pushed at dinner seminars for as many as 100 people at a time who were never asked if they were sophisticated and accredited investors,” said Secretary Galvin.¹⁹¹ “These were people trying to protect their savings, but were sold high-risk products which garnered high commissions for the broker-dealer,” Galvin continued.¹⁹²

Secretary Galvin has also launched an investigation into broker-dealers’ sales practices of private placements by GPB Capital Holdings. GPB, which was launched in 2013, became a leading seller of high-risk, high commission private placement firms. GPB securities were sold to individual accredited investors through independent broker-dealers. The investigation, which is still ongoing, involves 63 broker-dealer firms which sell GPB sponsored private placements.¹⁹³ It was sparked when GPB missed a deadline to file financial statements with the SEC for two of its largest funds after it crossed the 12(g) reporting threshold and the company suspended redemptions.¹⁹⁴ “While my securities division’s investigation is in the very nascent stages, recent activity within GPB raises red flags of potential problems,” Galvin said. “These red flags, coupled with the fact that sales of private placements by independent broker dealers have been an ongoing source of investor harm, have led to this investigation.”¹⁹⁵ According to press reports, broker-dealers sold \$1.8 billion of GPB private placements in the auto dealership industry and the waste management industry to investors.¹⁹⁶ Following the announcement of Secretary Galvin’s investigation and reports that GPB’s auditor resigned, the SEC, FINRA, and the FBI launched their own investigations.¹⁹⁷

In another national scandal involving private placements, Robert H. Shapiro was found to have conducted a massive Ponzi scheme raising more than \$1.2 billion from over 8,400

¹⁹⁰ Bruce Kelly, *Seven-year MedCap Capital Holdings Ponzi case is over*, InvestmentNews, August 25, 2016, <http://bit.ly/2l0nyt4>.

¹⁹¹ The DI Wire, *Securities America to Pay Additional \$1 Million to Massachusetts MedCap Investors*, March 3, 2017, <http://bit.ly/2mCjFLq>.

¹⁹² *Id.*

¹⁹³ The DI Wire, *Massachusetts Regulator Sweeps 63 Broker-Dealers Selling GPB Private Placements*, September 13, 2018, <http://bit.ly/2mA1eXL>.

¹⁹⁴ Bruce Kelly, *Investors wait for financial statements from leading seller of alternative investments*, InvestmentNews, July 11, 2018, <http://bit.ly/2mBqVHB>.

¹⁹⁵ The DI Wire, *Massachusetts Regulator Sweeps 63 Broker-Dealers Selling GPB Private Placements*, September 13, 2018, <http://bit.ly/2mA1eXL>.

¹⁹⁶ Bruce Kelly, *Is time running out for advisers who sold GPB private placements?*, InvestmentNews, May 2, 2019, <http://bit.ly/2ncTonh>.

¹⁹⁷ Bruce Kelly, *SEC, Finra investigating GPB fund raising: sources*, InvestmentNews, December 18, 2018, <http://bit.ly/2lGf8Yh>.

unsuspecting retail investors nationwide, many of them seniors, through fraudulent unregistered securities offerings.¹⁹⁸ Woodbridge paid agents “substantial commissions,” totaling \$64.5 million, to sell its investments, including seven different private placement fund offerings, according to the SEC complaint. Shapiro promised investors they were investing in “low risk,” “conservative,” “safe” and “secure” Woodbridge investments, which would be repaid from the high rates of interest Shapiro’s companies were earning on loans the companies were purportedly making to third-party borrowers, according to the complaint.¹⁹⁹ However, nearly all the purported third-party borrowers were actually limited liability companies owned and controlled by Shapiro, which had no revenue, no bank accounts, and never paid any interest under the loans, according to the complaint. Without real revenue to pay the monies due to investors, Shapiro resorted to fraud, using new investor money to pay the returns owed to existing investors, according to the complaint.²⁰⁰ Meanwhile Shapiro and his family lived in the lap of luxury and spent exorbitant amounts of investor money on items such as luxury automobiles, jewelry, country club memberships, fine wine, and chartering private planes, according to the complaint.²⁰¹ Ultimately, Shapiro pled guilty to conspiracy and tax evasion charges.²⁰² The more we expand sales of private securities to retail investors, the easier it will be for con artists to perpetrate Ponzi schemes such as this one and the harder it will be for regulators to deter and detect such scams.

While the Commission may be able to detect and bring enforcement actions for billion dollar Ponzi schemes that involve thousands of investors (though often not until after considerable damage has been done), it simply doesn’t have the resources to detect smaller-scale frauds. And some of the changes adopted to exempt offerings in recent years have left state securities regulators hamstrung in their abilities to detect and deter violations of the federal and state securities laws to protect their citizens.²⁰³ Thus, it is impossible to know how many of these frauds occur in private markets. It is certainly plausible, however, that they occur regularly, with the vast majority of the perpetrators experiencing few if any consequences. At the very least, the Commission has an obligation to do more than it has done to date to determine the scale of the fraud problem in private markets that now dwarf our public markets in size.

FINRA has also raised concerns about broker-dealers’ role in private markets and has brought numerous enforcement actions against broker-dealers for selling unsuitable private placements. Specifically, FINRA has raised concerns about firms’ failure to comply with their obligation to conduct a “reasonable investigation of the issuer and the securities.”²⁰⁴ According to FINRA’s 2018 Report on FINRA Examination Findings:

¹⁹⁸ Complaint for Injunctive and Other Relief, *SEC v. Robert H. Shapiro, Woodbridge Group of Companies, et al.*, No. 17-24624 (S.D. Fla. December 20, 2017), <http://bit.ly/2mBRqwy>.

¹⁹⁹ *Id.*

²⁰⁰ *Id.*

²⁰¹ *Id.*

²⁰² Bob Van Voris, *Ex-Woodbridge Group CEO Robert Shapiro pleads guilty in \$1.3 billion Ponzi scheme*, Bloomberg, August 8, 2019, <https://bloom.bg/211jSau>.

²⁰³ For example, the failure to impose meaningful sanctions for Form D filing violations limits the information state securities regulators receive about these offerings, and the rules allowing general solicitation in Reg D offerings eliminated one of the red flags states used to rely on to identify fraudulent offerings.

²⁰⁴ FINRA, Report on FINRA Examination Findings, December 2018, <http://bit.ly/215hCPz>.

- “No Reasonable Diligence -- Some firms failed to perform reasonable diligence on private placement offerings prior to recommending the offerings to retail investors. In some instances, firms performed no additional research about new offerings because they relied on their experience with the same issuer in previous offerings. In other instances, some firms reviewed the offering memorandum and other relevant offering documentation, but did not discuss the offering in greater detail with the issuer or independently verify, research or analyze material aspects of the offerings. FINRA also observed that some firms did not investigate red flags identified during the reasonable diligence process.”²⁰⁵
- “Overreliance on Third Parties – Where some firms obtained and reviewed due diligence reports provided by due diligence consultants, experts or other third-party vendors, they sometimes did not independently evaluate the third parties’ conclusions, respond to red flags or significant concerns noted in the reports, or address concerns regarding the issuer or the offering that were apparent outside the context of the report.”²⁰⁶
- “Potentially Conflicted Third-Party Due Diligence – Some firms used third-party due diligence reports that issuers paid for or provided in their due diligence analysis. While some of these reports provided valuable and relatively objective information, in some cases, firms did not consider the related conflicts of interest in their evaluation and assessment of the reports’ conclusions and recommendations.”²⁰⁷

These examination findings come almost a decade after FINRA issued Regulatory Notice 10-22, “remind[ing] broker-dealers of their obligation to conduct a reasonable investigation of the issuer and the securities they recommend in offerings made under the Securities and Exchange Commission’s Regulation D under the Securities Act of 1933—also known as private placements.”²⁰⁸ FINRA routinely brings enforcement actions against broker-dealers and registered representatives for violations of the securities laws related to private placement sales.²⁰⁹ We have no way of measuring, however, what percentage of abuses are captured in these actions.

The Commission cannot reasonably take steps to expand retail investor access to private offerings without first conducting a thorough study of the likely impact on investor protection. Given the high percentage of accredited investors who are either retirees or pre-retirees, the Commission should pay particularly close attention to the harmful impact on these most vulnerable investors.

II. The Commission is Largely Operating in the Dark When it Comes to Regulating Private Markets.

One of the most shocking aspects of the Concept Release is what it reveals about the level of ignorance at the Commission regarding crucial aspects of the private markets. This is a side effect of the opacity of private markets, in which the Commission fails to collect even the

²⁰⁵ *Id.* at 8.

²⁰⁶ *Id.*

²⁰⁷ *Id.*

²⁰⁸ FINRA Regulatory Notice 10-22, Regulation D Offerings: Obligations of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings, April 2010, <http://bit.ly/2ndIgGO>.

²⁰⁹ See FINRA, FINRA Disciplinary Actions Online, <http://bit.ly/2lxtNoN>.

most basic information needed to assess the impact of its policies on investor protection, capital formation, and competition. Rectifying that information gap should therefore be a top priority. Because that lack of data is the direct result of the natural opacity of private markets, we believe this is best achieved by reining in private offering exemptions so that more activity occurs in transparent public markets that supply the Commission with the data it needs for effective oversight. Short of that, however, the Commission should at least determine what changes to the exemptions would be needed to enable it to collect the data necessary to support informed policymaking regarding private markets. Before moving forward with additional proposals to further expand exemptions, as outlined in the Concept Release, the Commission should use its existing authority and, if necessary, request additional authority from Congress to collect the data and conduct the analysis necessary to adequately assess its policy options.

A. The Commission Is Ignorant about Critical Features of the Reg D Market.

The Commission's experience with Regulation D provides a useful case study of how the Commission has allowed private markets to balloon in size and economic importance without collecting the basic data necessary to provide proper oversight, let alone support informed policy-making. When the Commission adopted Reg D in 1982, the Form D filing requirement was intended to serve an important data collection function, including, among other things, to support the Commission's rulemaking efforts.²¹⁰ Specifically, Form D was intended to enable the Commission "to collect empirical data which will provide a basis for further action by the Commission either in terms of amending existing rules and regulations or proposing new ones."²¹¹ Further, Form D was intended to "allow the Commission to elicit information necessary in assessing the effectiveness of Regulation D as a capital raising device for small businesses."²¹²

Unfortunately, the Form D filing requirement has failed to effectively fulfill this function for many years. This is in part because the Commission has failed to adopt adequate filing requirements for Reg D offerings and in part because it has failed to enforce compliance with the existing Form D filing requirement. As a result, the Commission can't answer the most basic questions about a market that is significantly larger than our public markets, such as:

- Who is raising money in this market?
- How successful are they?
- How do those companies fare over time?
- Are they part of the churn and burn of job creation and destruction all too common among small companies, or do they contribute to sustainable job creation and lasting economic growth?
- Who invests in Reg D offerings?
- Does that differ based on the type of offering (e.g., operating company or pooled investment)? If so, how?
- What type of information do they receive about the companies they invest in?

²¹⁰ Proposed Amendments to Regulation D, Form D and Rule 156, Release No. 33-9416; Release No. 34-69960; Release No. IC-30595; File No. S7-06-13 (July 10, 2013), at 17, <http://bit.ly/2mJ8gcE>.

²¹¹ *Id.*, citing Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, Release No. 33-6339 (Aug. 7, 1981) [46 FR 41791, 41799 (Aug. 18, 1981)].

²¹² *Id.*

- How have those investments performed?

Over and over again, throughout the Release, the Commission’s response to questions such as this is, “We don’t know,” or in economist parlance, “Due to data limitations, it is difficult to draw rigorous conclusions ...”²¹³ “We don’t know” is not a good enough answer when it comes to issues of such critical importance, particularly when it is well within the Commission’s power to rectify the problem, as is the case here.

B. The Commission’s Blatant Disregard for Form D Compliance Incentivizes Noncompliance.

Form D is designed to collect basic information about those seeking to raise funds through a Reg D offering. The information collected includes: the identity, size, principal place of business, entity type, and industry group of the issuer; the identities of the key officers, directors, and promoters associated with the offering; information about the offering itself, such as the exemptions claimed, the expected duration of the offering, the type of securities offered, the minimum investment accepted; the total offering amount, the total amount sold, and the total remaining amount; the number of existing investors, and whether any of them are non-accredited investors; sales compensation, sales commissions, and finders fee expenses; and how the proceeds will be used. While far short of the information an investor would need to make a truly informed investment decision, and not enough for the Commission to determine how those offerings fared, it would be enough to give the Commission at least a basic understanding of the Reg D market *if* the information were reliably being reported. But, as the Commission itself acknowledges, it is not.

The Commission has known for well over a decade that issuer noncompliance with regard to filing Form D is a serious problem. The primary reason is that failure to file Form D is unlikely to result in serious repercussions. As the Commission and its staff have repeatedly acknowledged, “[F]iling Form D is not a condition to claiming a Regulation D safe harbor or exemption. We understand that some issuers do not file Form Ds for offerings intended to be eligible for relief under Regulation D.”²¹⁴ The issue was brought to the attention of the Commission in 2009, when the SEC Inspector General (IG) issued a report highly critical of the agency’s oversight of the Reg D market, including its failure to enforce filing requirements.

²¹³ See, e.g., Concept Release at 23 (“Due to data limitations, it is difficult to draw rigorous conclusions about the extent of fraud in exempt securities offerings.”); at 24 (“Due to data limitations, it is also difficult to draw rigorous conclusions about the average magnitude of investor gains and losses in exempt securities offerings.”); at 36 (“We estimate households and not individuals due to data limitations because the database underlying our analysis measures wealth and income at the household level.”).

²¹⁴ See, e.g., Vlad Ivanov and Scott Baugess, *Capital Raising in the U.S. The Significance of Unregistered Offerings Using the Regulation D Exemption*, SEC Staff Report, February 2012, <http://bit.ly/2IIHzVw>; See also Concept Release at 16. (“[A] failure to file the notice does not invalidate the exemption. Accordingly, it is possible that some issuers do not file Forms D for offerings relying on Regulation D.”) See also Proposed Amendments to Regulation D, Form D and Rule 156 at 18 (“We understand that some issuers are not making a Form D filing for Rule 506 offerings because the filing of Form D is not a condition of Rule 506.”).

The IG report described how the SEC relies upon the “honor system” for filers to fill out Form D.²¹⁵ While Rule 507 disqualifies an issuer from using a Reg D exemption in the future if the issuer has been enjoined by a court for failure to file Form D information with the Commission, according to the IG report the SEC never brought a single action against a company for violating Rule 503 by not filing a Form D. Also, according to the report, no court has ever enjoined a company for its failure to comply with Rule 503, as contemplated by Rule 507.²¹⁶ As a result, the IG concluded, “there are simply no tangible consequences when a company fails to file a Form D.”²¹⁷ We are not aware that anything has changed in the ten years since the IG report was issued,²¹⁸ although investor groups and state securities regulators urged the Commission to beef up its enforcement at the time of the Reg D general solicitation rulemaking.²¹⁹

The IG also criticized the SEC’s oversight of the Reg D market more generally. The report found, for example, that the Commission’s Corporate Finance (CF) staff “does not substantively review Form D filings, determine whether issuers appropriately use the Regulation D exemptions, and generally does not take action when CF staff learn that issuers are non-compliant with the rules of Regulation D.” It further found that, “There are many different types of abuses and non-compliance issues involving Regulation D, including illegal securities offerings, which could be addressed by appropriate CF or Commission action.”²²⁰

By taking a hands-off approach to compliance and enforcement, the Commission has sent a signal to issuers, good and bad actors²²¹ alike, that it is perfectly acceptable for them not to file. Issuers understand that they won’t be penalized for failing to file, and issuers have incentives not to file. Massachusetts Secretary of the Commonwealth William Galvin tried to draw the Commission’s attention to the issue in a 2013 comment letter, stating: “[W]e are concerned that a culture of non-compliance is developing with respect to filing Form D for Rule 506 offerings. It is easy to foresee that a widespread attitude among issuers will be that: ‘The SEC says you are

²¹⁵ SEC Office of Inspector General, *Regulation D Exemption Process*, Report No. 459 (March 31, 2009), <http://bit.ly/2mCJ5sv>.

²¹⁶ We were able to find only one case since 2009 where the defendant was charged with violating Rule 503. In that case, the defendant engaged in a massive Ponzi scheme. Failing to file Form D was just one of many violations that he engaged in. *SEC v. Alfred Clay Ludlum III, Printz Capital Management, LLC, Printz Financial Group, Inc., and PCM Global Holdings, LLC*, Civil Action No. 10-7379 (E.D. Pa., December 20, 2010), <http://bit.ly/2mJc7q8>. We are aware of no other cases in which a violation of Rule 503 has been alleged, either exclusively or as part of a broader set of claims.

²¹⁷ *Id.*

²¹⁸ The IG report stated that the Division of Corporate Finance “does not substantively review the more than 20,000 Form D filings that it receives annually, which in 2008, identified total estimated offerings of \$609 billion dollars.” The number of Reg D offerings and amounts raised have only grown since.

²¹⁹ *See, e.g.*, Recommendations of the Investor Advisory Committee Regarding SEC Rulemaking to Lift the Ban on General Solicitation and Advertising in Rule 506 Offerings: Efficiently Balancing Investor Protection, Capital Formation and Market Integrity, adopted unanimously by the IAC on Oct. 12, 2012, <https://bit.ly/2m6h9gl>. (Recommendation 4 states: “The filing of Form D should be made a condition for relying on the Regulation D exemption. In implementing this recommendation, which is intended to encourage broad compliance with the filing requirement, the Committee encourages the Commission also to consider incorporating measures to ensure that it does not impose undue penalties for inadvertent violations by small, unsophisticated issuers.”).

²²⁰ *Id.*

²²¹ Bad actors have a particularly strong incentive not to file a Form D because filing a Form D would increase the likelihood that a state securities regulator would discover the fraudulent activity.

supposed to file Form D, but you really don't need to file it.' Current SEC rule enforcement relating to Form D fosters such an attitude. The non-enforcement of the filing requirement may signal to some issuers that the regulators are not serious about enforcing even basic rules relating to the exemptions. This is dangerous to the continued vitality of the Form D filing requirement and is also dangerous to other important elements of securities law compliance.”²²²

According to a 2018 *TechCrunch* article, noncompliance has become widespread, leading to the “Disappearing Form D,” whereby “startups are increasingly foregoing Form D disclosure.”²²³ The article quotes a startup lawyer who provided several “reasons why management, the board of directors, or even investors may be sensitive to fundraising disclosures and why, as a result, issuers may forego filing a Form D:

- “The company doesn’t want the increased scrutiny internally that comes along with a new funding round. This can come from employees demanding different levels of compensation.
- “The company doesn’t want increased regulatory scrutiny. Many startups operate in regulatory gray areas, and increased attention from regulators before they are ready can be a Bad Thing.
- “The company has security concerns. For startups that operate in certain environments internationally, raising a monster round can place a target on the backs of its employees. This has been an issue in Latin America from time to time.
- “The company has competitive concerns. Raising a big round may attract new entrants to the market or heighten attention from existing competitors before a startup has solidified its position in the market.
- “Investors don’t want disclosure. Some investors want to disclose new investments on their own timeframe, and they make this a condition of their investment. Publicly-traded investors or sovereign wealth funds may only want to disclose at the time of their quarterly reports.
- “Flat rounds or down rounds can suck away any positive momentum. When founders are trying to convince customers and employees to join the rocket ship that is their company, a flatlining fundraise can look like... well, a flatlining company.
- “The round may not be closed yet. Companies sometimes have optimistic goals about the size of a round (“We’re raising \$4 million!”), but only have a smaller amount committed at the outset of the round. Sometimes a single round can take 18+ months to close, even though a sizable (or not so sizable) percentage closed at the outset.”²²⁴

Also, we have been given to understand that counsel at at least one of the largest international law firms recently have been counseling their clients not to file a Form D, likely for the reasons discussed above.

The Commission itself has acknowledged that there’s an incentive for issuers not to disclose certain information about themselves and their activities. It has stated, for example, that

²²² Letter from William Francis Galvin, Secretary of the Commonwealth of Massachusetts, to the SEC, September 23, 2013, <http://bit.ly/2mCRufx>.

²²³ Danny Crichton and Arman Tabatabai, *The Disappearing Form D*, TechCrunch, November 7, 2018, <https://tcrn.ch/2IH8HnG>.

²²⁴ *Id.*

“issuers may not wish to reveal certain information such as the timing of amounts offered and raised, including whether an offering was successfully completed, which could inform other market participants, including competitors, about the issuers’ ability to finance investments.”²²⁵ It has further acknowledged “that the incentives for compliance with these [Rule 503 Form D filing requirements] requirements must be strengthened.”²²⁶ But it has failed to act on proposals to strengthen those requirements.

Troublingly, the Commission doesn’t even know what the rate of noncompliance is with regard to the filing of Form D and doesn’t appear to have taken any serious steps to rectify that knowledge gap. The Commission has stated, for example, that its “analysis by DERA staff of Form D filings by funds advised by registered investment advisers and broker-dealer members of FINRA suggests that Form D filings are not made for as much as 10% of unregistered offerings eligible for relief under Regulation D.” Actual, overall non-compliance is likely to be significantly higher than 10% for two reasons.

First, having a registered entity who understands his or her legal obligations and has an independent incentive to comply increases the likelihood that there will be higher rates of compliance. Indeed, as the Commission has conceded, “Our estimates of compliance for issuers that use a registered investment adviser or broker-dealer also may not reflect the rate of compliance among issuers that do not. To the extent that Forms D are more likely to be filed when a registered entity is involved, there could be a greater rate of non-compliance among the remaining Rule 506 offerings that do not involve a registered investment adviser or broker-dealer.”²²⁷ The Commission further stated that, “Although we cannot estimate the rate of compliance among the issuers of the remaining 89% of Rule 506 offerings that do not use a registered investment adviser or broker-dealer, it may be reasonable to assume that they are no more likely to file a Form D, particularly to the extent that they undertake an offering without the assistance of a regulated entity. This evidence suggests that many private issuers are failing to file a Form D even though this is a requirement under Regulation D.”²²⁸

Second, based on DERA’s analysis of the companies that do file Form D, it appears that the vast majority of offerings by operating companies under Reg D do not involve the use of a broker-dealer or investment adviser. According to a DERA, “[O]nly 20% of new Regulation D offerings since 2009 report using a financial intermediary.”²²⁹ Moreover, according to the DERA analysis, “Both fund and non-fund issuers experienced a decrease in the use of intermediaries from 2009 to 2017. For example, the use of intermediaries by non-fund issuers declined from approximately 23% in 2009 to approximately 19% in 2017.”²³⁰ Among non-filers, the percentage that do not use an intermediary may be even higher, for the reasons noted above. Thus, the Commission only has evidence of compliance based on a small segment of the market. Non-

²²⁵ Proposed Amendments to Regulation D, Form D and Rule 156 proposal at 137, footnote 221.

²²⁶ *Id.* at 70.

²²⁷ *Id.* at 127-128.

²²⁸ *Id.* at 146 (bolded for emphasis).

²²⁹ Scott Baugess, Rachita Gullapalli, and Vladimir Ivanov, *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017*, Division of Economic and Risk Analysis (DERA) U.S. Securities and Exchange Commission, August 2018, <http://bit.ly/2mE7b62>.

²³⁰ *Id.*

compliance is likely to be much higher for the remaining 80 percent or more of the Reg D offerings that do not use a registered entity.

Form D is often the only public record that a Reg D offering has taken place. Noncompliance therefore raises several serious concerns. First, without this information, state securities regulators are unable to adequately protect their citizens from being harmed. According to Secretary Galvin, “The state securities agencies are often the first regulators that investors turn to when they want information about an investment or a sponsor, or when they believe they are victims of investment fraud. When an issuer has no Form D on file with either a state or federal agency, the states often will not have even the most basic information about the offering or the people behind it. We need the information Form D filings provide to inform ourselves and investors about these offerings. Moreover, these filings provide information that helps states start investigations when fraud or other violations of the law are suspected.”²³¹ Next, to the extent Form D constitutes the only public information about an offering, failure to file the form deprives investors of important information that would help them make an informed investment decision.

Finally, noncompliance hampers the Commission’s ability to engage in the most basic analysis of what’s going on in the Reg D market, impairs the reliability of the analysis and conclusions that the Commission may draw from the data that it does present, and creates serious questions about whether the Commission is pursuing the appropriate regulatory framework for Reg D offerings. This is particularly troubling in the context of this Concept Release, since it reveals the extent to which the Commission is operating in the dark when it comes to a market that is already larger than our public markets and continuing to grow in size and importance. However, the Concept Release, which would have been a natural place to raise this issue, asks only the most general questions about the Form D filing requirement and includes no concrete suggestions to strengthen those requirements.

C. The Current Form D Filing Requirement Doesn’t Provide Adequate Data to Support Informed Policymaking.

Even if companies consistently complied with the existing Form D filing requirement, serious gaps in the Commission’s knowledge of the Reg D market would remain as a result of inadequacies in the filing requirements themselves. The Commission has previously admitted that, because of these information gaps, it doesn’t have complete or conclusive data about Reg D offerings’ critical characteristics or the associated risks that Reg D offerings present to investors and markets. In 2013, for example, the Commission documented extensively how its ability to understand and analyze Reg D markets was limited due to the fact that the existing Form D disclosure does not require issuers to provide information that would enable the Commission to properly understand and analyze Reg D markets. This lack of data about Reg D markets concerned the Commission, particularly in light of the “magnitude of the change that the elimination of the prohibition against general solicitation represents to the Rule 506 market.”²³² The Commission stated that, “To review and analyze these changes more effectively, and to

²³¹ Letter from William Francis Galvin, Secretary of the Commonwealth of Massachusetts, to the SEC, September 23, 2013, <http://bit.ly/2mCRufx>.

²³² Proposed Amendments to Regulation D, Form D and Rule 156 at 10.

facilitate the assessment of the effects of such changes on investor protection and capital formation, the Commission staff will need better tools to evaluate this changing market than are currently provided.”²³³

Accordingly, the Commission proposed a series of changes to Form D designed to enable the Commission and staff to understand and analyze Reg D markets.²³⁴ In particular, the Commission proposed to require the filing of a closing amendment to Form D after the termination of any Rule 506 offering. As the Commission noted in the proposing Release, Reg D originally included a requirement to amend the Form D filing every six months during the course of an ongoing offering and to make a final Form D filing within 30 days of the final sale of securities in the offering. However, that requirement was eliminated in 1986, depriving the Commission of vital data just as the Reg D market was starting to heat up. In commenting on the Commission’s general solicitation proposal, a number of investor groups and state securities regulators urged the Commission to restore the requirement to file a closing amendment to Form D.²³⁵ Commenters noted that adopting such a requirement would enable the Commission to collect more complete information about the size and characteristics of the Rule 506 offering market, including who invests and how those offerings fare for issuers and investors alike.²³⁶

Unfortunately, the Commission never took action on this proposal. That failure, combined with the Commission’s lax approach to Form D filing compliance, means the Commission is flying blind when it comes to policy in this area. For example:

- The Commission has admitted it doesn’t know the total amount of capital raised in Reg D markets.

The Commission admitted in the 2013 proposing release that, “the Commission does not have a complete picture of Rule 506 offerings, such as the total amount of capital actually raised in these offerings.”²³⁷ The Commission explained that, “Since issuers are not required to submit a filing when an offering is completed, and submit amendments only under certain circumstances, we have no definitive information on the final amounts raised.”²³⁸ Thus, even if issuers comply with their Form D filing requirement, and there is compelling evidence that many do not, the Commission’s estimates of capital raised in Reg D markets are likely to be inherently unreliable.

- The Commission has admitted it doesn’t have even a basic understanding about who the investors are who buy Reg D offerings.

²³³ *Id.* at 10-11.

²³⁴ The proposal also would have strengthened the penalties for failing to file Form D, by disqualifying an issuer from relying on Rule 506 for one year for future offerings if the issuer, or any predecessor or affiliate of the issuer, did not comply, within the last five years, with Form D filing requirements in a Rule 506 offering.

²³⁵ *See, e.g.*, Letter from Barbara Roper, CFA, to the SEC, September 23, 2013, <http://bit.ly/2IH7nkP>; Letter from Dennis M. Keller, Better Markets, to the SEC, September 23, 2013, <http://bit.ly/2mINlqs>; Letter from A. Heath Abshire, NASAA, to the SEC, September 27, 2013, <http://bit.ly/2mCYysz>.

²³⁶ Proposed Amendments to Regulation D, Form D and Rule 156 at 27.

²³⁷ *Id.* at 19.

²³⁸ *Id.* at 113.

The Commission admitted in the 2013 proposing release that, “We have relatively little information on the types and numbers of investors in Rule 506 offerings. Form D currently requires issuers in Rule 506 offerings to provide information about the total number of investors who have already invested in the offering and the number of persons who do not qualify as accredited investors. ... [However, w]e do not know what fraction of these investors are natural persons or entities because Form D does not require any other information on the types of investors.”²³⁹

The result of this reporting gap can be seen in DERA’s 2018 white paper on unregistered securities offerings. According to DERA’s analysis, “Aggregated Form D information...reveals that during the period 2009-2017 on average approximately 316,288 investors participated in Regulation D offerings.”²⁴⁰ The Commission can’t say, however, how many of these investors were natural persons and how many were entities, let alone how many different individuals are represented among the natural persons who invest. Instead, the Commission is left to speculate based on the limited information at its disposal: “The presence of so many relatively small offerings suggests that a sizable number of current investors in Rule 506 offerings are natural persons or legal entities in which all equity owners are natural persons. This is because smaller offerings may not provide sufficient scale for institutional investors to earn a sizable return. Institutional investors typically have a larger investable capital base and more formal screening procedures compared to investors who are natural persons, and the associated costs of identifying potential investments and monitoring their investment portfolio lead them to make larger investments than natural persons.”²⁴¹ While this analysis seems plausible, if vague, the question of who is investing in Reg D offerings is too important to issues under active consideration by the Commission, such as possible changes to the definition of accredited investor, to rely on speculation, however logical, as the basis for its policy proposals.

The Commission has previously acknowledged that knowing this information would be critical for investor protection purposes, as well. According to the 2013 proposing release, “Understanding the composition of investors in Rule 506 offerings as between natural persons and legal entities would also be important for risk assessment purposes...To the extent that natural persons are less sophisticated and more prone to be targets of fraud than institutional investors, understanding how many natural persons are participating in Rule 506(c) offerings could help identify those Rule 506(c) offerings that raise greater investor protection concerns. This information could also help the Commission better understand how general solicitation is used with respect to the types of investors. Additionally, concerns about verification methods to assess accredited investor status are greatest as it relates to natural persons. Having a better understanding of the involvement of natural persons in Rule 506(c) offerings would assist the Commission in its assessment of the efficacy of the verification provisions.”²⁴²

The Commission also has admitted it doesn’t know how many accredited investors, either individuals or institutions, actually participate in Reg D offerings. With regard to individuals, the

²³⁹ *Id.* at 118.

²⁴⁰ Scott Baugess, Rachita Gullapalli, and Vladimir Ivanov, *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017*, Division of Economic and Risk Analysis (DERA) U.S. Securities and Exchange Commission, August 2018, <http://bit.ly/2mE7b62>.

²⁴¹ Proposed Amendments to Regulation D, Form D and Rule 156 at 119-120.

²⁴² *Id.* at 138-139.

Commission conceded that the data it relies on “provides an estimate of the overall pool of qualifying households in the United States. It does not, however, represent the actual number of accredited investors that do or would invest in the Regulation D market or in other exempt offerings.”²⁴³ The Commission further explained in a footnote that, “Form D data and other data available to us on private placements do not allow us to estimate the number of unique accredited investors participating in the exempt offerings.”²⁴⁴ With regard to institutions, the Commission has further admitted that, “We lack data to generate a comprehensive estimate of the overall number of institutional accredited investors because disclosure of accredited investor status across all institutional investors is not required and because, while we have information to estimate the number of some categories of institutional accredited investors, we lack comprehensive data that will allow us to estimate the unique number of investors across all categories of institutional accredited investors under Rule 501.”²⁴⁵

In addition to these fundamental questions, which the Commission can’t answer, the Commission can’t tell us anything meaningful about the characteristics of the investors who actually participate in Reg D offerings or what their experience is when investing in Reg D offerings. It can’t, for example, say anything meaningful about these investors’ net worth, their income, or their level of sophistication. It can’t tell us how much of their net worth individual investors typically invest in these markets (either as a percentage or on an absolute basis), what type of information they are able to secure when deciding whether to invest,²⁴⁶ or the extent to which they rely on financial professionals’ advice. Nor can it tell us how they fare generally when investing in Reg D offerings, or how that may differ for different types of Reg D securities (including whether they obtain any valuable diversification benefits, how the investments perform net of any fees, and whether that differs between equity and debt, individual securities and pooled investments, etc.). It would be irresponsible for the Commission to move forward with proposals that would have the effect of expanding the pool of eligible investors without a better understanding of these critical issues.

- The Commission has admitted it doesn’t have even a basic knowledge of Reg D issuer characteristics.

Inadequate Form D filing requirements and the Commission’s failure to enforce even those requirements have also left it woefully ignorant with regard to the basic characteristics of issuers who raise capital through Reg D offerings. The Commission admitted in its 2013 proposing release, for example, that it does not know much about issuers’ revenue or net asset value. According to the release, “At present, a majority of Form D filings do not provide information on the size of the issuer’s revenue (if the issuer is an operating company) or net asset value (if the issuer is a hedge fund or other investment fund). It is likely that some issuers keep

²⁴³ Concept Release at 37.

²⁴⁴ *Id.* at footnote 83.

²⁴⁵ *Id.* at 38.

²⁴⁶ Unlike in the public markets, where all investors are entitled to receive the same material information, different investors in Reg D offerings may receive different materials. For example, some investors may receive a one-page term sheet, others may receive a more detailed offering memorandum, and still others may receive audited financials and a detailed business plan.

this information private for competitive purposes and therefore do not make this information widely available.”²⁴⁷

Disturbingly, “a significant number of [non-fund] issuers decline to disclose their revenues (71%),” according to a DERA analysis.²⁴⁸ Similarly, according to the DERA analysis, “more than three-quarters of [fund] issuers have declined to disclose NAV.”²⁴⁹ Without this information, the Commission doesn’t have a complete picture of the Rule 506 market and isn’t able to accurately assess the impact of allowing general solicitation on capital formation across issuer sizes. As the Commission has previously acknowledged, “[t]his information would be particularly useful in better understanding the effects of general solicitation on capital formation by small businesses, a set of issuers that otherwise face significantly greater challenges than larger issuers in finding investors.”²⁵⁰ In other words, the Commission doesn’t have the data necessary to measure the impact of recent changes to Rule 506 offerings that fundamentally altered the nature of this market.

- The Commission has admitted it doesn’t know how issuers intend to use proceeds of capital raised under Reg D.

The Commission admitted in its 2013 proposing release that it does not know how issuers intend to use proceeds of Reg D offerings,²⁵¹ although that information is crucial to determine whether the offerings actually promote true small company capital formation. For example, the Commission doesn’t know whether the proceeds are being used to acquire assets or for working capital, which would be consistent with capital formation purposes, or whether they are being used to repurchase or retire the issuer’s existing securities, which would likely have no direct effect on capital formation.²⁵² Similarly, the Commission doesn’t know whether offerings are being used to allow insiders and/or incumbent shareholders a partial or full exit, which again would likely have no direct effect on capital formation.²⁵³ Without this information, the Commission doesn’t have any meaningful understanding about why issuers are seeking to raise capital under Reg D or whether the proceeds are actually being used to promote capital formation, which was the justification on which the exemption was based.

- The Commission has admitted that it doesn’t know what the market for general solicitation and advertising looks like, including what methods of general solicitation are being used or what types of investors are being solicited.

Under Rule 506(c), issuers are allowed to engage in general solicitation and advertising when conducting an offering. This fundamentally changed the nature of Reg D offerings. However, the Commission failed to adopt changes to Form D to reflect this policy changes. As a

²⁴⁷ Proposed Amendments to Regulation D, Form D and Rule 156 at 139.

²⁴⁸ Scott Baugess, Rachita Gullapalli, and Vladimir Ivanov, *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017*, Division of Economic and Risk Analysis (DERA) U.S. Securities and Exchange Commission, August 2018, at 30, <http://bit.ly/2mE7b62>.

²⁴⁹ *Id.*

²⁵⁰ Proposed Amendments to Regulation D, Form D and Rule 156 at 139-140.

²⁵¹ *Id.* at 41-42, 99, 143-144.

²⁵² *Id.* at 99.

²⁵³ *Id.* at 143.

result, Form D does not collect information specific to Rule 506(c) offerings, including information about the issuer’s plan to engage in general solicitation.²⁵⁴ The Commission acknowledged in its 2013 proposing release that this lack of information posed a significant limitation and that it would “need to understand developments in...the market practices through which issuers solicit potential purchasers of securities offered in reliance on Rule 506(c).”²⁵⁵ The Commission stated that, “Having this information would help the Commission perform reviews of the Rule 506 market to better understand how the different methods of solicitation correspond to issuer behavior, including potentially fraudulent activity....”²⁵⁶ Unfortunately, this proposal languished along with the other proposed changes to Form D.

This information is of particular concern regarding the private funds market. First, private funds account for more than 80 percent of the money raised through Rule 506 offerings.²⁵⁷ Moreover, private funds’ reliance on 506(c) appears to be increasing substantially relative to non-funds’ reliance on the rule.²⁵⁸ In addition, private funds’ advertising practices have attracted heightened scrutiny for being misleading and deceptive, particularly around reporting investment returns.²⁵⁹ This is partly because there are no standards for reporting returns, which allows private funds to present returns in various ways. Inevitably, some use this flexibility to report performance in misleading and deceptive ways. The Commission has acknowledged this concern, stating in its 2013 proposing release that, “Based on enforcement and regulatory experience regarding private funds, we believe that the areas identified in Rule 156 as being vulnerable to misleading statements in investment company sales literature are similarly vulnerable with respect to private fund sales literature.”²⁶⁰ The Commission went on to note that it “has brought enforcement actions against private fund advisers and others for material misrepresentations to investors and prospective investors regarding past or future investment performance and characteristics or attributes of the private fund.”²⁶¹

The Commission also raised concerns that investors who are solicited to invest in a private fund may not understand critical differences between private funds and registered investment companies. The Commission highlighted, for example, how the Investment Company Act “provides important protections that are not applicable to private funds or their investors. For example, the Investment Company Act includes limitations on self-dealing, affiliated

²⁵⁴ *Id.* at 19.

²⁵⁵ *Id.* at 88.

²⁵⁶ *Id.* at 145.

²⁵⁷ Scott Baugess, Rachita Gullapalli, and Vladimir Ivanov, *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017*, Division of Economic and Risk Analysis (DERA) U.S. Securities and Exchange Commission, August 2018, at 22, <http://bit.ly/2mE7b62>. (“Since the inception of the electronic Form D filings in 2009, pooled investment funds have accounted for \$8.9 trillion of new capital raised through Regulation D offerings and reported on Form D, compared to \$1.42 trillion raised by non-funds.”).

²⁵⁸ *Id.* According to DERA analysis, “Total capital reported to be raised (Forms D and D/A) and initial amounts reported to be raised (Form D) by fund issuers relying on Rule 506(c) exemption increased by 378% and 969% respectively during 2017, relative to the previous year.” In contrast, total capital raised (Forms D and D/A) and initial amounts reported to be raised (Form) by non-fund issuers relying on Rule 506(c) exemption increased by 148% and 337%, respectively, during 2017.”

²⁵⁹ See, e.g., Mary Childs, *How Private-Equity Funds Can Artificially Boost Their Returns*, Barron’s, August 22, 2019, <http://bit.ly/219IUph>; Don A. Steinbrugge, Agecroft Partners, *What aren’t you telling me? Major discrepancies in hedge fund performance reporting*, hedgeweek, June 27, 2019, <http://bit.ly/2mJG7SM>.

²⁶⁰ Proposed Amendments to Regulation D, Form D and Rule 156 at 80-81.

²⁶¹ Proposed Amendments to Regulation D, Form D and Rule 156 at 81.

transactions and leverage and requirements regarding independent board members, none of which apply to private funds...”²⁶² The Commission expressed concern that investors may get a “misimpression regarding the level of statutory and regulatory protections that apply to investors in a private fund,” as a result.²⁶³

The Commission has nonetheless failed to take the steps necessary to ensure that it has a good understanding of general solicitation and advertising practices in the Reg D market. Without a thorough understanding of what the market for general solicitation and advertising looks like, the Commission won’t be able to adequately assess whether Reg D issuers, including those issuers that are likely to pose the greatest risk to investors, are selling their securities in fraudulent or misleading ways. Similarly, it won’t be able to adequately assess whether certain vulnerable investors are being targeted in ways that lead to their being harmed. That is critical information for the Commission to have before proceeding with proposals to expand the definition of accredited investor or otherwise expand retail investor access to private offerings.

- The Commission has admitted that it doesn’t know what verification methods issuers use for 506(c) offerings or whether, as a result of inadequate verification practices, issuers are selling 506(c) offerings to non-accredited investors.

Under Rule 506(c), participating investors must be accredited investors, and Rule 506(c) requires issuers to take reasonable steps to verify that such persons are accredited investors. However, Form D does not require firms to file information specific to Rule 506(c) offerings, including information relating to practices used to satisfy the verification requirement in Rule 506(c) and the types of investors participating in Rule 506(c) offerings.²⁶⁴ As a result, the Commission doesn’t know what verification methods issuers are using for 506(c) offerings, whether issuers are in fact taking reasonable steps to verify accredited investor status, or whether they are selling 506(c) offerings to non-accredited investors in violation of the rule requirement.

The Commission acknowledged in its 2013 proposing release that “it is possible that some verification methods could lead to participation by non-accredited investors.”²⁶⁵ The Commission explained that, “Non-accredited investors who are not detected by reasonable verification methods could then participate in Rule 506(c) offerings for which they may not be well suited.”²⁶⁶ The Commission also expressed the concern that, “There is also an increased likelihood of non-accredited investor participation in Rule 506(c) offerings if verification methods are deficient.”²⁶⁷ Finally, the Commission acknowledged that, “Both of these likelihoods increase with issuers’ ability to generally solicit their offers to an audience of potential investors through broader communication and advertising channels.”²⁶⁸

In the absence of information on issuers’ verification practices, the Commission can’t assess in any meaningful way what the impacts of Rule 506(c) have been, including the extent to

²⁶² *Id.* at 66-67.

²⁶³ *Id.* at 67.

²⁶⁴ *Id.* at 19.

²⁶⁵ *Id.* at 109.

²⁶⁶ *Id.*

²⁶⁷ *Id.*

²⁶⁸ *Id.*

which issuers are fulfilling their regulatory obligations under the Rule or, alternatively, the extent to which non-accredited investors are being sold 506(c) offerings and being harmed as a result. Among other things, this information gap makes it impossible for the Commission to determine whether certain verification methods are correlated with higher incidence of fraud in these markets and, if necessary, to take appropriate corrective action.²⁶⁹

- The Commission has admitted that it doesn't know how much fraud occurs in Reg D markets.

On an issue of central importance to the Commission's investor protection mission, the extent of fraud in the Reg D market, the Commission does not collect the data necessary to provide a credible estimate. The Concept Release states that, "Due to data limitations, it is difficult to draw rigorous conclusions about the extent of fraud in exempt securities offerings."²⁷⁰ Breaking this down, the Commission doesn't know, among other things, the incidence of fraud with regard to:

- Reg D markets generally;
- 506(b) offerings as compared with 506(c) offerings;
- different types of securities offered (equity vs. debt vs. other);
- operating company issuers as compared with non-operating company (private fund) issuers;²⁷¹
- different segments of investors, particularly unsophisticated retail investors and near-retirees, retirees, and the elderly;
- offerings in which intermediaries are involved as compared with offerings that do not include the involvement of an intermediary; and
- the verification methods used.

Yet the Commission has acknowledged that, "While we cannot estimate the extent of fraud in the market for privately offered securities, we do know, based upon our own experience enforcing the federal securities laws and the enforcement efforts of criminal authorities and state securities regulators, that fraud exists in this market."²⁷²

The Commission has known for some time that it did not collect adequate data relating to the incidence of fraud in Reg D markets, but it has failed to act to correct the deficiency. The 2013 proposing release stated that "one of the primary objectives" of the proposed amendments to Regulation D and Form D was "to increase the information available to the Commission about the Rule 506 market so that we can better assess, and, if necessary, take steps to respond to, fraudulent practices in the market for privately offered securities."²⁷³ By failing to finalize that rule, the Commission has adopted a see-no-evil approach, remaining willfully ignorant on this

²⁶⁹ *Id.* at 145

²⁷⁰ Concept Release at 23.

²⁷¹ *Id.* at 125. The Commission acknowledged that, "Empirical evidence on the extent of fraud involving private funds is not readily available. While a few economic studies suggest that certain hedge funds engage in various types of misreporting, such as misrepresenting past performance, delaying disclosure of returns and inflating returns at the end of the fiscal year in order to earn higher fees, these studies do not provide information about the extent or magnitude of any such misreporting activities."

²⁷² Proposed Amendments to Regulation D, Form D and Rule 156 at 126.

²⁷³ *Id.* at 126-127.

critically important topic. The Commission can't reasonably blame "data limitations" when it had the opportunity to address those limitations but chose not to.

- The Commission has admitted that it knows little about intermediaries' involvement in Reg D markets.

Among the approaches the Commission is considering to expand retail investor "access" to private offerings is conditioning that participation on reliance on a recommendation or advice from a registered investment professional. According to DERA, however, "While financial intermediaries commonly underwrite public offerings, there is relatively little information about intermediary participation in private markets."²⁷⁴ As a result, the Commission doesn't currently have the data that would enable it to assess the likely impact of its policy proposals.

The data the Commission does collect suggests that the use of intermediaries varies significantly by issuer type. For example, venture capital funds and non-financial operating companies use intermediaries the least, according to the Commission's limited data, while the real estate industry uses intermediaries the most. However, the Commission doesn't appear to know why intermediary participation varies significantly by issuer. One possibility is that the usage of an intermediary may reflect an issuer's inability to sell private securities based purely on their merit. Conversely, the decision not to use an intermediary may reflect an investor's ability to bargain directly for favorable terms. In other words, increased usage of an intermediary may reflect that the sale occurred based on inverse market competition, where the security was sold rather than bought. Or, it may reflect something entirely different.

The use or non-use of intermediaries raises other questions, as well. For example, given that private markets are supposed to function based on investors' ability to bargain for the same type of information that they would receive from a registration statement, does the use of an intermediary create barriers for investors to access that necessary information, make it easier to access that information, or not impact the result? To what extent do investor outcomes differ when an intermediary is used? And to what extent do investor outcomes differ based on the different types of intermediaries that are used? These are all important questions that the Commission doesn't appear to be able to answer as a result of self-imposed limitations on its data collection. It is imperative that the Commission have a better understanding of these issues before pushing proposals to increase the role of intermediaries in the sale of private offerings.

- The Commission has admitted it doesn't know how Reg D issuers perform.

A claim that is often made about privately offered securities is that they provide enhanced returns and diversification benefits, as compared with publicly offered securities. This claim is often used, including by some Commission officials, as a justification for expanding retail investors' access to these investment "opportunities."²⁷⁵ Yet, the Commission offers no evidence

²⁷⁴ Scott Baugess, Rachita Gullapalli, and Vladimir Ivanov, *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017*, Division of Economic and Risk Analysis (DERA) U.S. Securities and Exchange Commission, August 2018, at 36, <http://bit.ly/2mE7b62>.

²⁷⁵ See, e.g., Chairman Jay Clayton, Remarks to the Economic Club of New York, September 9, 2019, <http://bit.ly/2lJTrq8> ("We should...increase the type and quality of opportunities for our Main Street investors in our private markets."); Julie Segal, *The SEC Wants to Democratize Private Investments*, Institutional Investor,

that this claim is true generally. Indeed, the Commission acknowledges in the Concept Release that, “Due to data limitations, it is also difficult to draw rigorous conclusions about the average magnitude of investor gains and losses in exempt securities offerings.”²⁷⁶ The Commission is even less able to analyze the likely gains and losses for individual retail investors, in light of adverse selection that is likely to occur in the distribution of investment opportunities. For example, it’s virtually certain that a VC firm will get much better opportunities, and be offered better terms, than an individual accredited investor with a few thousand to invest. Even among individual investors, it is highly likely that the wealthiest individuals will be offered better opportunities than “Mr. and Mrs. 401(k).” Without analyzing these differences, the Commission cannot reasonably proceed with proposals to expand retail access to private offerings based on the unproven assumption that they will benefit from that access.

- The Commission has admitted that it doesn’t know whether Rule 506(c) is working as intended.

When the Commission adopted amendments to Rule 506 as required under the JOBS Act, it acknowledged that Form D did not provide the necessary information that would enable the Commission to properly evaluate whether and to what extent the rule was delivering on its capital formation goals and doing so without undermining investor protection or market integrity. The Commission stated, “Currently, Form D is required to be filed only after the first sale of securities, which means that issuers that offered securities, but did not complete a sale, are not required to file a Form D, thereby limiting the Commission’s ability to determine which issuers are facing challenges raising capital under Rule 506(c) and whether further steps by the Commission are needed to facilitate issuers’ ability to raise capital under Rule 506(c).”²⁷⁷ Similarly, the Commission acknowledged that its ability to assess the effectiveness and efficiency of the private offering market and the impact of the elimination of the prohibition against general solicitation was limited.

The Commission properly understood that, “Without a closing Form D amendment requirement...any analysis of the information in Form D filings would be based on incomplete data, which may limit the intended benefits of collecting the Form D information.”²⁷⁸ Accordingly, the Commission recognized the need for “[u]pdated and more conclusive data on Rule 506 offerings from closing Form D amendments” which would “provide the Commission with a more complete account of the flow of capital in the Rule 506 market, how the flow relates to offering characteristics and the potential associated risks and would assist the Commission in evaluating whether further regulatory action is necessary.”²⁷⁹ But here again, the Commission failed to make the necessary changes to the filing requirements to deliver those benefits.

September 19, 2019, <http://bit.ly/2ncmxPj> (“If growth opportunities have shifted — not all the way, but to a substantial extent — into private markets and ordinary investors don’t have access to them, that’s not good,” said Clayton, speaking at CNBC and *Institutional Investor*’s Delivering Alpha conference on Thursday.); *Also*, the Concept Release refers to, “A significant number of attractive investment opportunities in the exempt market, including access to many growth-stage issuers...” Concept Release at 22.

²⁷⁶ Concept Release at 24.

²⁷⁷ Proposed Amendments to Regulation D, Form D and Rule 156 at 132.

²⁷⁸ *Id.* at 134.

²⁷⁹ *Id.* at 135.

In sum, the Commission has chosen to bury its head in the sand, failing to require information to be filed that would allow it to accurately evaluate the effectiveness of Regulation D. As a result, the Commission does not have the data that would enable it to assess the impact of the existing rules, let alone the impact of its proposed policy changes, on investor protection, capital formation, and competition. Nor can it properly assess risks in these markets in order to make informed and strategic decisions about where to focus agency resources, particularly enforcement resources.

D. What happened with the Rule 506 Work Plan?

When the Commission adopted amendments to Rule 506 permitting general solicitation in Reg D offerings, the Commission directed the staff to execute a comprehensive work plan to review and analyze the use of the new exemption.²⁸⁰ The 2013 proposing release stated, “We also appreciate the need to undertake a broader effort to review and analyze the market impact and developing market practices resulting from permitting general solicitation in connection with offerings relying on new Rule 506(c).” Accordingly, the Commission indicated that it would “evaluate the use of Rule 506(c) by issuers and market participants, and, in particular, the steps they take to verify that the purchasers of the offered securities are accredited investors” and that it had, toward that end, “directed the Commission staff to execute a comprehensive work plan upon the effectiveness of Rule 506(c) to review and analyze the use of Rule 506(c).” The “Rule 506(c) Work Plan” would involve a coordinated effort of staff from DERA, the Division of Investment Management, the Division of Trading and Markets, the Office of Compliance Inspections and Examinations, and the Division of Enforcement.

In announcing the launch of this inter-departmental effort, the Commission indicated that the staff would, among other things:

- evaluate the range of purchaser verification practices used by issuers and other participants in these offerings, including whether these verification practices are excluding or identifying non-accredited investors;
- evaluate whether the elimination of the prohibition against general solicitation has been accompanied by an increase in sales to non-accredited investors;
- assess whether the availability of Rule 506(c) has facilitated new capital formation or has shifted capital formation from registered offerings and unregistered non-Rule 506(c) offerings to Rule 506(c) offerings;
- examine the information submitted or available to the Commission on Rule 506(c) offerings, including the information in Form D filings and the form and content of written general solicitation materials submitted to the Commission;
- monitor the market for Rule 506(c) offerings for increased incidence of fraud and develop risk characteristics regarding the types of issuers and market participants that conduct or participate in Rule 506(c) offerings and the types of investors targeted in these offerings to assist with this effort;
- incorporate an evaluation of the practices in Rule 506(c) offerings in the staff’s examinations of registered broker-dealers and registered investment advisers; and

²⁸⁰ *Id.* at 13-15.

- coordinate with state securities regulators on sharing information about Rule 506(c) offerings.

While the Concept Release and the DERA white paper address a few of these topics, at least superficially, there is no indication in the Concept Release that the Commission has pursued this work plan. If it has, we urge the Commission to publish the results of staff’s analysis and findings immediately. Doing so would allow interested parties to better understand the development of the Rule 506 market. If it has not implemented this work plan, we urge the Commission to do so without further delay and to halt any changes to the Reg D market until it has completed this task and published the results. If, as we suspect, the Commission’s self-imposed data limitations have limited its ability to perform the promised analysis, we urge the Commission to take the steps necessary to correct these shortcomings in the Reg D filing requirements and their enforcement.

E. The Commission has not Compiled Data Regarding other Exemptions that Would Enable Informed Decision-Making.

The lack of data regarding Regulation D is particularly troubling, given the size and importance of the Reg D market. Similar data gaps are available for other exempt offerings. For example, the Concept Release states:

- “We do not have data available on, and are unable to estimate, amounts raised under the intrastate exemptions under Securities Act Section 3(a)(11) or Rule 147 or 147A.”²⁸¹
- “A portion of these Regulation A issuers may have, or may be approaching, the number of holders of record that would require registration under the Exchange Act, and a portion of the Tier 2 issuers may be relying on the conditional exemption in Rule 12g5-1. However, we do not have sufficient data available to estimate the number of holders of record or the public float for these issuers, so we cannot provide a more accurate estimate of the number of Tier 2 issuers that may be using the conditional exemption from Section 12(g).”²⁸²
- “[W]e are not able to observe if these Regulation Crowdfunding issuers used other offering exemptions for which we do not have data, such as Section 4(a)(2), Rule 147, or Rule 147A.”²⁸³

Meanwhile, significant changes have been made to the offering exemptions in the last decade, including changes to Reg A, changes to Rule 504 of Reg D, the repeal of Rule 505 of Reg D, the creation of Rule 506(c) of Reg D, new crowdfunding provisions, and changes to the intrastate offering exemption, to name just a few. It is doubtless the case that these regulatory changes have affected issuers’ capital raising decisions, with regard to whether to conduct an exempt offering and, if so, which exemption to use. That has profound implications for investors, both those who participate in private offerings and those who do not. Even as it proposes additional sweeping changes to the exempt offerings, however, the Commission staff has acknowledged that it is flying blind with regard to the effect on investors, issuers, and markets of

²⁸¹ Concept Release at 17.

²⁸² Concept Release at 107.

²⁸³ Concept Release at 149.

the latest round of revisions.²⁸⁴ Instead of making enormously consequential regulatory decisions that are not based in evidence, we urge the Commission to do its homework and gather the data necessary to enable informed regulatory decision-making on these critical issues.

F. Available Data Regarding Regulation A and Crowdfunding Raises Red Flags.

Somewhat more, though still limited, data is available with regard to two of the newer exemptions, Regulation A+ and Regulation Crowdfunding, than is currently available for Regulation D offerings. While both exemptions were promoted as facilitating small company capital formation without sacrificing investor protection, the available data about both raises serious red flags.

1. Expansion of Regulation A Has Been Bad for Investors and Markets.

Since the JOBS Act dramatically increased the amount of money that companies can raise each year through a Reg A offering, the experience has been an unmitigated disaster for investors. As the *Wall Street Journal* reported earlier this year, “Intended to create jobs and reinvigorate public U.S. capital markets, Reg A+ has instead been tainted by poor post-IPO performance and concerns about fraud.”²⁸⁵ Examples abound.

A July 2019 post by Renaissance Capital on its IPO Pro website, in which it referred to Reg A+ as “the wild west of IPOs,” described an SEC filing from Huixinjia Capital Group “laying out its plan to raise \$700 million in a Nasdaq Reg A+ IPO that would value the company at \$7 billion.”²⁸⁶ The article described several aspects of the filing as “suspect,” including: the fact that Reg A+ imposes a \$50 million maximum deal size; the auditor’s opinion for the fiscal year ended 12/31/18 was dated 12/14/18 and purported to come from Ernst & Young’s office in “New York, CA”; much of the prospectus “is plagiarized whole cloth from Ares Management’s (ARES) 2014 IPO prospectus, except with Ares’ name replaced with Huixinjia; George Soros is listed as co-founder, Secretary and Director; and more. According to the article, Huixinjia Capital Group had issued a press release earlier in the year trying “to hype the deal, saying that the company planned to offer shares at \$3.50, but ‘according to Chinese reports... massive interest in China could drive Huixinjia’s share price beyond the top of its intended price range’ and that it would help ‘China in its race to overtake the US as a world leader in AI technology.’”

²⁸⁴ Scott Baugess, Rachita Gullapalli, and Vladimir Ivanov, *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017*, Division of Economic and Risk Analysis (DERA) U.S. Securities and Exchange Commission, August 2018, at 6, <http://bit.ly/2mE7b62> (“[W]e do not have enough information to determine the extent to which some of these newer rules and the amendments to Regulation D that became effective in 2017 (amended Rule 504 and repeal of Rule 505) will affect the importance of Rule 506(b) and 506(c) of Regulation D or serve as alternatives to registered offerings.”).

²⁸⁵ Alexander Osipovich, *Exchanges Shy Away From Mini-IPOs After Fraud Concerns*, Wall Street Journal, June 10, 2019, <https://on.wsj.com/2lrPWET>.

²⁸⁶ Renaissance Capital, Reg A+ is the wild west of IPOs and here’s the latest example, July 10, 2019, <http://bit.ly/2m4WyJr> (describing a Chinese company that announced plans to raise \$700 million, despite Reg A’s offering limit of \$50 million, the company listed its auditor’s office in New York, CA, it listed George Soros as a cofounder, secretary and director, and much of it appeared to be “plagiarized whole cloth” from Ares Management Corp’s 2014 IPO prospectus.).

In a November 2018 article titled, “How (Not) to Market Your Regulation A+ Mini-IPO offering,” *Crowdfund Insider*’s Samuel Guzik described a Reg A+ offering by XYO Network that was apparently being aggressively advertised online. Its message: “11,000% BIGGER THAN BTC? -- Meet the company taking on an \$11.2 trillion market. Don’t miss this one.”²⁸⁷ The company testimonial included a “celebrity endorsement” by “tech pioneer” Charlie Shrem, who turned out to be a convicted felon. And the article notes a number of other abusive sales practices associated with the offering, including a misleading claim that “100% of the funds go directly towards developing the XYO Team and Technology,” when in fact 11% of the shares being sold were owned by founder, CEO, CFO and principal shareholder, Arie Trouw.

The company sales practices replicated other characteristics associated with a “high pressure, boiler room,” according to Guzik, including “countdown clocks,” “popup messages three or four times per minute indicating that buyers are out there snapping up shares,” and only a limited time offered to read the company’s mandatory SEC disclosures – “well under an hour to go through a nearly 40 page single spaced offering document. Not nearly enough time to read and digest these disclosures for the average investor, in my opinion, let alone ask questions of the company’s management.” As Guzik noted, “One of the disclosures you might have missed if you rushed to get in on the next big thing before carefully reading the Offering Circular is the massive dilution resulting from more than 20 million options issued to insiders and consultants in March 2018 at \$1.00 per share, well below the offering price set on March 19, 2018 of \$8.00 per share – a hefty bump in share price from the \$1.00 offering price set in 2016.”

Meanwhile, a recent *Barron’s* article described how “[M]ost Reg A+ businesses haven’t gotten beyond the startup phase known as the pipedream.”²⁸⁸ Examples cited in the article include businesses seeking capital for cannabis paraphernalia, flying cars, and to study UFOs, telepathy, and light-speed travel. And while Regulation A’s supporters have touted Regulation A’s job creating potential, the *Barron’s* article states that the only people Regulation A clearly has created jobs for are Regulation A underwriters and promoters on Wall Street, many of whom have “checkered stock market histories.” Indeed, it would be difficult to find a better illustration of the distinction between capital raising and true capital formation than that provided by the Reg A market.

Reg A has been particularly problematic for those companies that listed on an exchange. As the *Wall Street Journal* reported in February 2018, the handful of Reg A companies that listed on U.S. exchanges in 2017 were trading about 40% below their offer price during a period in which the S&P 500 had risen 18% and the average IPO listed on a major U.S. exchange had climbed 22%.²⁸⁹ Similarly, the *Barron’s* article described the “woeful performance” of the few

²⁸⁷ Samuel Guzik, *How (Not) to Market Your Regulation A+ Mini-IPO Offering*, *Crowdfund Insider*, November 14, 2018, <http://bit.ly/2mVrJaq>.

²⁸⁸ Bill Alpert, Brett Arends, and Ben Walsh, *Most Mini-IPOs Fail the Market Test*, *BARRON’S*, February 13, 2018, <http://bit.ly/2FwKPw5>.

²⁸⁹ Corrie Driebusch and Juliet Chung, *IPO Shortcuts Put Burden on Investors to Identify Risk*, *Wall Street Journal*, February 6, 2018, <http://on.wsj.com/2p4n8kf> (stating that the handful of Reg A companies that listed on U.S. exchanges in 2017 were trading about 40% below their offer price. Meanwhile, the S&P 500 had risen 18% since the start of 2017 and the average traditional IPO listed on the major U.S. exchanges in 2017 had climbed roughly 22%). See also Bill Alpert, Brett Arends, and Ben Walsh, *Most Mini-IPOs Fail the Market Test*, *BARRON’S*, February 13, 2018, <http://bit.ly/2FwKPw5> (describing the “woeful performance” of the few dozen companies that

dozen companies that are currently exchange-listed as well as the difficulty of trading or getting a price quote for the vast majority of companies that aren't exchange listed. The one company that early on appeared to be the exception to this rule, Longfin, turned out to be a total fraud and was subsequently shut down by the Commission.²⁹⁰

Legitimate issuers trying to raise money through a Reg A IPO have been affected as well, as Royalty Flow founder Matthew Smith described in an April 2018 article titled, "Reg A+ has failed both investors and startups: one founder's experience."²⁹¹ "Reg A+ was supposed to break the cycle of IPOs that served only to enrich founders, venture capital, and private equity. It was meant to give investors of all stripes access to early-stage investment opportunities," Smith wrote. "But as stated in the *Barron's* article *Most Mini IPOs Fail The Market Test*: 'Instead, we've gotten GoFundMe-style websites hawking penny stocks and professional wrestlers shilling shares on TV.'" Smith blamed the lower disclosure and accounting standards that apply to Reg A+ offerings, along with the fact that companies are permitted to market directly to retail investors. "So unsophisticated investors might buy into a company long on advertising hype but short on fundamentals, only to be disappointed when (in the very rare case) the stock ever becomes tradable."

The major exchanges have learned from this experience. Rather than weaken requirements further, they have gone in the opposite direction, tightening listing requirements in order to better ensure that only legitimate businesses list.²⁹² Before moving forward with plans to further expand exempt offerings, including by allowing Reg A securities to trade on venture exchanges (see below), the Commission should first conduct a careful review to determine whether and to what extent Reg A is contributing to true capital formation, and to what extent it is instead diverting capital into questionable companies engaged in even more suspect sales practices to the detriment of investors, legitimate issuers, and capital formation.

2. What We Know about Crowdfunding is Deeply Troubling.

When Congress was considering the crowdfunding provisions in the JOBS Act, we expressed serious concerns about the concept. Specifically, we expressed deep concerns about creating an experimental online marketplace that, by its very nature, would bring together inexperienced issuers with unsophisticated investors and harness the power of the Internet to hype stocks. We also expressed skepticism that the "wisdom of the crowd" would substitute for traditional securities law requirements to protect investors. And when the Commission promulgated the crowdfunding provisions, we argued that the Commission had chosen a

are currently exchange-listed and the difficulty trading or getting a price quote for the vast majority of companies that aren't exchange listed. The Barron's article further described how "[M]ost Reg A+ businesses haven't gotten beyond the startup phase known as the pipedream.").

²⁹⁰ Press Release, SEC, "SEC Obtains Emergency Freeze of \$27 Million in Stock Sales of Purported Cryptocurrency Company Longfin," April 6, 2018, <http://bit.ly/2lp0bts>; Jean Eaglesham and Aaron Back, *Longfin Collapse Puts Focus on Lax IPO Rules*, Wall Street Journal, April 3, 2018, <https://on.wsj.com/2lnkKGE>.

²⁹¹ Matthew Smith, *Reg A+ has failed both investors and startups: one founder's experience*, Medium, April 9, 2018, <http://bit.ly/2lQFUNP>.

²⁹² Alexander Osipovich, *Exchanges Shy Away From Mini-IPOs After Fraud Concerns*, Wall Street Journal, June 10, 2019, <https://on.wsj.com/2lrPWET>.

regulatory approach that undermined investor protections to a greater degree than Congress intended.

Since those rules have been implemented and the crowdfunding market has developed, our fears have been borne out by real world evidence. First, FINRA has had to shut down several crowdfunding portals for violating the law. For example, FINRA shut down uFundingPortal (UFP) shortly after the crowdfunding provisions took effect for violating a host of regulatory requirements.²⁹³ According to FINRA, UFP lacked a reasonable basis for believing that certain companies offering securities through its online crowdfunding portal had complied with applicable regulatory requirements. In fact, according to FINRA, UFP:

- reviewed and in some cases assisted in the preparation of required paperwork filed with the SEC by 16 different issuers that offered securities through UFP’s platform;
- knew that none of the 16 issuers had filed a number of required disclosures with the SEC;
- had reason to believe the companies listed on their site had the potential for fraud or other investor protection concerns;
- included on its website issuer communications that it knew or had reason to know contained untrue statements of material facts or were otherwise false or misleading; and
- did not reasonably supervise the activities of its online crowdfunding portal.

In fact, according to Sara Hanks of CrowdCheck, uFundingportal demonstrated “an almost complete failure to follow disclosure and filing requirements.”²⁹⁴

More recently, FINRA also shut down DreamFunded Marketplace.²⁹⁵ According to a FINRA hearing panel ruling, DreamFunded and its CEO “committed multiple violations” of both the SEC’s Regulation Crowdfunding Rules and FINRA’s Funding Portal Rules. Among the violations, according to the ruling, DreamFunded made false and misleading statements regarding a purported investment in an issuer, either with intent to mislead investors or in reckless disregard of the likelihood of misleading them. In addition, DreamFunded made false and misleading statements on its website regarding the due diligence that it conducted on issuers before allowing issuers to make crowdfunding offerings on the platform, either with intent to mislead investors or in reckless disregard of the likelihood of misleading them. As a result, FINRA expelled DreamFunded as a funding portal and barred its CEO from association with any FINRA funding portal member.

These violations do not appear to be unique or limited. Rather, recent research by University of Mississippi School of Law Professor Mercer Bullard shows that problems in crowdfunding markets are much more extensive, including widespread non-compliance by issuers and portals.²⁹⁶ Bullard analyzed a sample of 362 crowdfunding offerings and evaluated

²⁹³ UFP, LLC, Letter of Acceptance, Waiver and Consent, No. 201651563901 (Nov. 25, 2016), <http://bit.ly/2nfKm8Z>.

²⁹⁴ JD Alois, *FINRA Action on uFundingportal: Potential for Fraud Found on Crowdfunding Platform*, Crowdfund Insider, December 13, 2016, <http://bit.ly/2mI4d0i>.

²⁹⁵ *Department of Enforcement v. Dreamfunded*, FINRA Office of Hearing Officers, Extended Hearing Panel Decision, No. 2017053428201 (June 5, 2019), <http://bit.ly/2181qwX>.

²⁹⁶ Mercer Bullard, *Crowdfunding's Culture of Noncompliance: An Empirical Analysis*, 24 Lewis & Clark L. Rev. ___ (forthcoming 2020), <http://bit.ly/218Upfv>.

compliance with some of Reg CF’s most basic requirements.²⁹⁷ He found that, during the first 13 months of crowdfunding, almost half of issuers failed to file complete financial statements that met the applicable standard of review, barely one-quarter of issuers that were required to file two annual reports did so, less than 15 percent of issuers timely filed the final amount raised in their offering, and the only data point on Form C that was reviewed was, far more often than not, substantially inaccurate. Finally, Bullard found that the third largest crowdfunding funding portal may be violating the prohibition against a funding portal’s giving advice.²⁹⁸

“In short, crowdfunding appears to have become the regulatory mess than many predicted, with issuers and intermediaries routinely failing to comply with the simplest, most fundamental requirements of crowdfunding regulation,” Bullard concluded.²⁹⁹ “[T]hese findings reveal a deeply embedded culture of noncompliance.”³⁰⁰ Juxtaposed against Bullard’s empirical research and analysis, the recent crowdfunding report recently issued by the Commission staff is, “strangely devoid of actual data or other information on whether issuers or intermediaries are actually complying with the law,” according to Bullard.

Before making any changes to crowdfunding regulation designed to further expand this market or encourage greater investor participation, the Commission has a responsibility to examine non-compliance in crowdfunding markets and remedy those deficiencies. To do otherwise would be irresponsible. Like the Commission’s failure to impose sanctions for noncompliance with the Form D filing requirement, it would send a disturbing message that the Commission is perfectly content to tolerate rampant noncompliance in this market. That, in turn, would only reinforce the crowdfunding “culture of noncompliance.”³⁰¹

G. The Commission Hasn’t Seriously Analyzed Whether Exempt Offerings Promote, or Undermine, Sustainable Job Creation and Economic Growth.

Proponents of policies to expand exemptions from the ’33 Act and ’34 Act have typically justified those policies as needed to promote small company capital formation. In making this argument, they inevitably cite the conventional wisdom that small businesses are the engines of job creation and thus critical to the overall health of the economy.³⁰² But the data on the job-creating prowess of small businesses is mixed, and the issue is more nuanced than the proponents of private markets would have us believe. As John Haltiwanger, Ron S. Jarmin, and Javier Miranda wrote in a 2013 article in the Massachusetts Institute of Technology (MIT) journal, *Review of Economics and Statistics*, the “perception . . . that small businesses create the most private sector jobs,” while “popular among politicians of different political persuasions, small

²⁹⁷ *Id.*

²⁹⁸ *Id.* at 1.

²⁹⁹ *Id.* at 4.

³⁰⁰ *Id.* at 1.

³⁰¹ *Id.*

³⁰² See, e.g., Securities and Exchange Commission, Simplified Registration and Reporting Requirements for Small Issuers, Federal Register, Vol. 44, No. 70 (April 10, 1979); Martha Miller, SEC Advocate for Small Business Capital Formation, *Long Title. Big Mission.*, Remarks to Maha Discovery Festival Entrepreneurs, August 15, 2019, <http://bit.ly/2naKdnd>. (“Small businesses are big business: they create a majority of net new jobs in the country.”).

business advocates, and the business press,” is based on evidence that suffers from “statistical and measurement pitfalls.”³⁰³

One of the most common of these pitfalls is a tendency to focus on gross job creation, while ignoring small companies’ role in job destruction. Analysis that focuses on *net* job creation (jobs created minus jobs lost) leads to somewhat different conclusions. For example:

- A 2018 analysis of Bureau of Labor Statistics data found that, over the past decade, large firms (defined as those with more than 250 employees) created 3.4 million of the 7.1 million net jobs created (48%), while small firms (those with fewer than 50 employees) created just 1.6 million, or 22% of net new jobs.³⁰⁴
- A 2007 paper from the Bureau of Labor Statistics found that, from June 1990 to September 2005, “[f]irms with fewer than 100 employees contributed an average of 61.4 percent of gross job gains.”³⁰⁵ When you focus on net job gains, however, firms with fewer than 100 employees contributed a somewhat more modest 45.0 percent of the average quarterly net growth. That is because, over the same period, firms in this category “had a 62.3-percent share” of gross job losses.³⁰⁶
- And, even within the small company category, relative size matters. A 2019 Congressional Research Service report found that the smallest firms (startups with fewer than 20 employees) “tend to have a negligible effect on net job creation over time whereas startups with 20-499 employees tend to have a positive employment effect.”³⁰⁷

While they analyze the data somewhat differently and draw different lines between large and small firms, researchers seem to agree that the “high rates of gross job gains and losses are evidence of more turnover and volatility in small firms.”³⁰⁸ In contrast, larger firms have a higher survival rate and the jobs they create are more likely to persist.³⁰⁹

When it comes to job creation, firm age appears to be a more important factor than firm size. Specifically, the role of small companies in job creation is largely attributable to “firm birth,” according to the MIT study. Put simply, jobs at newly created firms are, by definition, new jobs. “[B]ecause new firms tend to be small, the finding of a systematic inverse relationship between firm size and net growth rates in prior analyses is entirely attributable to most new firms

³⁰³ John Haltiwanger, Ron Jarmin, and Javier Miranda, *Who Creates Jobs? Small Versus Large Versus Young*, The Review of Economics and Statistics, Vol. XCV, No. 2 (May 2013), <http://bit.ly/2mIqR8P>.

³⁰⁴ U.S. Bureau of Labor Statistics, TED: The Economics Daily, *Over the last decade, large firms responsible for 48 percent of net job growth*, May 1, 2018, <http://bit.ly/2mGM8zM>.

³⁰⁵ Jessica Helfand, Akbar Sadeghi, and David Talan, *Employment dynamics: small and large firms over the business cycle*, Monthly Labor Review (March 2007), <http://bit.ly/2IbG7L9>.

³⁰⁶ *Id.*

³⁰⁷ Robert Jay Dilger, *Small Business Administration and Job Creation*, CRS Report, Updated September 11, 2019, <http://bit.ly/2lOq06v>.

³⁰⁸ U.S. Bureau of Labor Statistics, TED: The Economics Daily, *Firm Size and Employment Growth, 1992-2016*, May 4, 2017, <http://bit.ly/2nhjUfk>.

³⁰⁹ Steven Davis, John Haltiwanger, and Scott Schuh, *Small Business and Job Creation: Dissecting the Myth and Reassessing the Facts*, NBER Working Paper (October 1993), <http://bit.ly/2njpyxx> (“[T]he one-year survival rate at the biggest firms is 92 percent, as compared to only 81 percent at the smallest firms. The one-year survival rate for newly-created jobs at the biggest firms is 76 percent, as compared to only 65 percent at the smallest firms.”); also, U.S. Bureau of Labor Statistics, TED: The Economics Daily, *Firm Size and Employment Growth, 1992-2016*, May 4, 2017, <http://bit.ly/2nhjUfk>.

being classified in small size classes.”³¹⁰ In contrast, the MIT study finds that “small, mature businesses have negative net job creation.”³¹¹ This leads them to “emphasize the critical role start-ups play in U.S. employment growth dynamics.”³¹² Specifically, they “document a rich up-or-out dynamic of young firms in the United States. That is, conditional on survival, young firms grow more rapidly than their more mature counterparts.”³¹³

This issue of start-up survivability is critical to the question of the sustainability of small company job creation. According to the MIT study, young firms (like small companies more generally) “have a much higher likelihood of exit, so job destruction from exit is also disproportionately high among them. More generally, young firms are more volatile and exhibit higher rates of gross job creation and destruction than their older counterparts.”³¹⁴ As a result, the MIT study finds “that net job creation is concentrated among a relatively small group of surviving ‘high-impact’ businesses that are younger and smaller than the typical business, but also have, on average, been in operation for 25 years.”³¹⁵

Staying power, or net job creation over time, is an especially important consideration since SBA statistics indicate that “the majority of small companies actually shed jobs after their first year,” according to Robert D. Atkinson and Michael Lind, authors of *Big is Beautiful: Debunking the Myth of Small Business*.³¹⁶ Atkinson and Lind cite one study which found that, “among small companies in their second, third, fourth, and fifth years of business, more jobs were lost to bankruptcy than were added by those still operating... or, as the [Small Business Administration] puts it, ‘employment gains from growing businesses are less than employment declines from shrinking and closing businesses.’”³¹⁷ Similarly, the CRS study found that, while business startups play an important role in job creation, they “have a more limited effect on net job creation over time because fewer than half of all startups are still in business after five years.”³¹⁸

In short, the research suggests that it is not enough to indiscriminately promote small company capital raising. If the goal is to promote sustainable job growth, a more thoughtful approach is needed. As the MIT study stated, “the formation and execution of effective policies intended to increase net job creation require a rich and nuanced understanding of these processes. A natural conclusion from our findings on the role of firm size and age is that policies that target businesses of a certain size, while ignoring the role of age, will likely have limited success in

³¹⁰ John Haltiwanger, Ron Jarmin, and Javier Miranda, *Who Creates Jobs? Small Versus Large Versus Young*, The Review of Economics and Statistics, Vol. XCV, No. 2 (May 2013), <http://bit.ly/2mIqR8P>.

³¹¹ *Id.*

³¹² *Id.*

³¹³ *Id.*

³¹⁴ *Id.*

³¹⁵ *Id.*

³¹⁶ Robert Atkinson and Michael Lind, *Debunking the Myth of Small Business Job Creation*, The MIT Press Reader (adapted from “Big is Beautiful: Debunking the Myth of Small Business”), <http://bit.ly/2ni12Nd>.

³¹⁷ *Id.*

³¹⁸ Robert Jay Dilger, *Small Business Administration and Job Creation*, CRS Report, Updated September 11, 2019, <http://bit.ly/2lOq06v>. (The study adds, however, that “Larger startups, and startups that survive past the five year threshold, tend to have a positive effect on net job growth in part due to young firms growing faster than their mature counterparts.”).

improving net job creation.”³¹⁹ As former SEC Commissioner Luis Aguilar put it, there is a difference between policies that promote capital raising and those that promote true capital formation. “Capital formation is much more than just capital raising. By itself, selling a bond or a share of stock doesn’t add a thing to the real economy, no matter how quickly or cheaply you do it. True capital formation requires that the capital raised be invested in productive assets – like a factory, store, or new technology – or otherwise used to make a business more productive. The more productive those assets are, the greater the capital formation from the investment – and, importantly, the more jobs created.”³²⁰

This distinction between capital formation and mere capital raising is directly relevant to the issues before the Commission in this Concept Release. A crucial question for the Commission to ask before proceeding with its planned “harmonization” and expansion of exempt offerings is whether capital raising through exempt offerings is effective in promoting sustained capital formation and net job creation. Or does it, in the absence of detailed and reliable disclosures, divert resources to less meritorious start-ups, promoting gross job creation followed quickly by gross job destruction? Alternatively, is the capital raised simply used to enrich founders, company executives, and intermediaries at the expense of everyone else? And does that differ among the various exemptions? Put another way, what percentage of money raised through exempt offerings over the years has gone to fund companies that were able to use that funding to create lasting job growth and what percentage has gone to fund companies whose contribution to job creation was more ephemeral? In keeping with the premise that transparency promotes efficient allocation of capital, would that record of success and failure have been different if more information had been available about the companies in question? Like much else of importance to this Concept Release, it is a question that the Commission has not answered, or even seriously sought to analyze.

That is a serious oversight. After all, the success of our public markets as engines of job growth is clear. The early securities laws played a critical role in rescuing the country from the depths of the Great Depression, and our public markets have been engines of economic growth ever since. According to a 2017 NASDAQ whitepaper, for example, “since 1970, 92% of job creation has come from public companies.”³²¹ Policies that favor private markets over public markets put that record of success at risk. It is far from clear that, in the absence of complete and reliable disclosure, capital is efficiently allocated to its best uses, funding the companies that are best able to provide the sustainable job creation and growth critical to a healthy economy.

If, instead, private markets fail to distinguish between companies with bright prospects and those that are doomed to failure or if they otherwise undermine the efficiency of the capital formation process, that would call into question the basis for four decades of policies designed to promote private offerings as a mechanism for healthy small company capital formation. At the very least, given the growing dominance of private markets and the precarious state of our public

³¹⁹ John Haltiwanger, Ron Jarmin, and Javier Miranda, *Who Creates Jobs? Small Versus Large Versus Young*, The Review of Economics and Statistics, Vol. XCV, No. 2 (May 2013), <http://bit.ly/2mIqR8P>.

³²⁰ SEC Commissioner Luis Aguilar, “Capital Formation from the Investor’s Perspective,” December 3, 2012, <http://bit.ly/2IB97MF>.

³²¹ Laura Anthony, *NASDAQ Issues Report Advocating for The U.S. Public Markets*, Anthony L.G. PLLC, October 24, 2017, <http://bit.ly/2mluPhT>.

markets, the Commission has an obligation to conduct a serious analysis of the issue before doubling down on a strategy of promoting private capital raising. The Commission could, for example, look at a random sample of companies that raised money through private offerings over the years to determine how those companies, and their investors, ultimately fared. That sort of analysis is critical before undertaking an expansion of private offering exemptions. Even the more modest goal of harmonizing the existing exemptions would benefit from such an approach.

H. It Would Be Irresponsible for the Commission to Proceed Without Collecting More Data and Conducting More Analysis.

As discussed above, the Commission is proposing to further expand private offerings and retail investor access to those offerings without first answering the most basic questions that should govern policymaking in this area. Instead, on question after question, the Commission's response is, "We don't know" -- or, in economist parlance, "Due to data limitations, it is difficult to draw rigorous conclusions about..."³²² But "We don't know" is not an adequate excuse, particularly when it comes to issues of such importance and when the agency's ignorance is the result of its own inaction. The Commission has had years to address concerns about a lack of data on these markets, and it failed to act. It cannot reasonably move forward with new proposals to expand retail access to private offerings without first collecting that data. Indeed, it cannot reasonably move forward with proposals to "harmonize" the existing offerings without first analyzing whether some or all of those exemptions should be repealed, curtailed, or otherwise revised. Instead, the Commission should use this Concept Release to gain renewed insight into the gaping holes in its knowledge of private markets and adopt a new work plan to eliminate those gaps. Should the Commission need additional congressional authority or resources to implement the necessary data gathering and analysis, CFA would strongly support the necessary legislation and appropriations.

III. Certain Proposals under Consideration would Further Undermine Public Markets and Put Investors at Risk.

While the Concept Release is supposedly focused on harmonizing the existing exemptions, a number of the proposals discussed in the Release would significantly expand those exemptions -- or expand retail investor access to exempt offerings -- further threatening the health of our public markets and putting vulnerable investors at risk. Among these are proposals to expand the definition of accredited investor, to allow non-accredited investors to access private offerings when they rely on recommendations from investment advisers or broker-dealers, to lift limits on the amounts that registered funds can invest in private securities, to allow non-accredited investors to invest directly in private funds, to expand secondary trading of exempt offerings, and to allow exempt securities to trade on venture exchanges. The Commission should not proceed with these proposals both for reasons of substance (discussed

³²² See, e.g., Concept Release at 23 ("Due to data limitations, it is difficult to draw rigorous conclusions about the extent of fraud in exempt securities offerings."); Concept Release at 24 ("Due to data limitations, it is also difficult to draw rigorous conclusions about the average magnitude of investor gains and losses in exempt securities offerings."); Concept Release at 36 ("We estimate households and not individuals due to data limitations because the database underlying our analysis measures wealth and income at the household level.").

below) and because it has not yet collected the data or conducted the analysis that would support their adoption (as discussed above).

A. The Commission Should Be Looking to Narrow, Not Expand the Definition of Accredited Investor.

Despite the Commission's claim that the primary purpose of the Concept Release is to "harmonize" existing offering exemptions, the bulk of the discussion regarding the accredited investor definition is devoted to proposals to further expand the pool of investors issuers can sell to without adhering to the basic standards of transparency and accountability applicable in the public markets. As the Commission has itself acknowledged, however, it must consider both the impact on investors and the impact on the supply of capital to the Reg D market when considering revisions to the definition.³²³ To date, the Commission has not even conducted that analysis with regard to the existing accredited investor definition, despite having been directed by Congress to do so,³²⁴ let alone analyzed the potential impact of the proposals put forward here. One reason may be that it doesn't currently collect the data necessary to conduct a thorough analysis, as discussed above -- a deficiency it should quickly address. Meanwhile, the evidence that does exist suggests that the policy proposals under consideration by the Commission are, for the most part, headed in exactly the wrong direction.

1. The Current Definition of Accredited Investor is Vastly Over-Inclusive.

The accredited investor definition set forth in Rule 501(a) of Regulation D plays a critical role in determining what investors issuers can sell to when making a private offering -- i.e., one that does not comply with the '33 Act requirement to provide potential investors all the "essential facts" necessary for an informed investment decision. The Concept Release states that the definition is "intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary."³²⁵ Although this characterization of the definition, which treats access to information and ability to fend for themselves as separate concepts, has become commonplace, it represents a serious misreading of the Supreme Court decision in *SEC v. Ralston Purina*. In fact, as discussed further above, the Court clearly intended that investors' ability to "fend for themselves" turn not on their sophistication or ability to sustain investment losses, but rather on their ability to gain access to the kind of information that

³²³ See, e.g., Concept Release at 42.

³²⁴ The SEC's 2015 staff study of the accredited investor definition did a good job of describing the various proposals put forward to adjust the definition but, as we noted at the time, in our comment letter on the study, it did not attempt to analyze the effectiveness of the current definition. See Letter from Barbara Roper, CFA, and Lisa Donner, Americans for Financial Reform, to SEC, "Report on the Review of the Definition of 'Accredited Investor,'" April 27, 2016, <https://bit.ly/2mpe9vK> ("The report reflects a reasonably thorough review of the various approaches that could be adopted to update the definition, including options to strengthen the definition's investor protections without unnecessarily sacrificing capital formation. On the other hand, the study suffers from two major shortcomings that seriously undermine its usefulness in providing the basis for further regulatory action. First and foremost, it does not carefully assess the effectiveness of the current accredited investor definition in identifying a population of investors who are able to fend for themselves without the protections afforded in the public markets. Nor does it include a meaningful assessment of the likely impact of the various alternatives that have been put forward.").

³²⁵ Concept Release at 32.

would be provided through registration. As the Fifth Circuit subsequently explained, “Just as a scientist cannot be without his specimens, so the shrewdest investor’s acuity will be blunted without specifications about the issuer. For an investor to be invested with exemptive status he must have the required data for judgment.”³²⁶

The vast majority of individuals who qualify as accredited investors under the current definition have no such access to the kind of information about Reg D issuers that would be provided in a registration statement. Instead, under the terms of Regulation D, issuers are able to determine what information will be provided and to whom when selling exclusively to accredited investors. There is no evidence that individual accredited investors are routinely able to gain access to such information. Worse, they may operate at a distinct information disadvantage relative to large institutional investors who do have the market power to demand information from issuers. As such, the current definition clearly fails to fulfill the regulatory purpose intended by the Court when it limited the private offering exemption to those made exclusively to investors who are able to fend for themselves -- i.e., could gain access to the type of information provided through registration -- without relying on the regulatory requirements of the ‘33 Act.

But even on its own terms -- as a measure of financial sophistication or ability to withstand losses -- the current definition as it relates to natural persons is vastly over-inclusive. As the SEC Investor Advisory Committee stated in its recommendation that the Commission revise the definition of accredited investor, financial thresholds in the definition serve as an imperfect proxy not only for access to information, but also for financial sophistication and ability to withstand investment losses. With regard to financial sophistication, for example, the IAC stated: “It is true that some individuals who meet the income and net worth criteria of the definition will also be financially sophisticated, ... [h]owever, there is nothing in the definition itself that guarantees that this will be the case. Indeed, the limited data that exists suggests that, though there is a correlation between income and financial literacy, a significant percentage of even the wealthiest investors score poorly on tests of basic financial literacy. Such tests don’t begin to measure the type or level of financial sophistication needed to evaluate the potential risks and benefits of private offerings.”³²⁷

The IAC also questioned the validity of the financial thresholds as a reliable proxy for ability to withstand losses. First, those thresholds have been significantly eroded by inflation since being set in the early 1980s.³²⁸ Second, as the IAC noted, the income test by itself does not provide an effective measure of ability to withstand losses, stating: “The ability to withstand potential risks of private offerings among individuals who qualify as accredited investors based exclusively on income will vary greatly based on a number of factors, including whether they also have substantial assets, albeit less than the \$1 million in net worth required to qualify as

³²⁶ *Doran v. Petroleum Management Corp.*, 545 F.2d 893 (5th Cir. 1977).

³²⁷ Recommendation of the SEC Investment Advisory Committee, Accredited Investor Definition, adopted Oct. 9, 2014, <https://bit.ly/22HoUHW>. (FN 4 states: “For example, high income individuals got an average score of 3.42 on the FINRA Investor Education Foundation’s 2009 National Survey of Financial Capability in the United States, which uses a 5-point scale, compared with an overall average of 2.72. However, the survey tests knowledge of such basic concepts as the effect of inflation, compound interest, diversification, mortgages, and the correlation between interest rates and bond prices; it does not measure financial sophistication at a level relevant to this issue.”).

³²⁸ Adjusted for inflation, \$1 million in 1982 would be worth more than \$2.65 million today. Similarly, \$200,000 would be worth approximately \$530,000 today, and \$300,000 would be worth almost \$800,000.

accredited, how heavily invested they are in private offerings, and how many working years they have left to recover financially if they suffer a substantial loss.”³²⁹ None of that nuance is reflected in the current definition.

The IAC expressed particularly grave concerns regarding inadequacies in the net worth threshold. It noted, for example, that with the exception of the primary residence, non-financial assets had not been excluded from the net worth calculation. “As a result, the current definition of net worth does not guarantee that the individual accredited investor will in fact have sufficient liquid financial assets to ensure either that they can hold the securities indefinitely or that they can withstand a significant loss on those investments.”³³⁰ Second, the IAC voiced concern that “many individuals who meet the net worth threshold will do so based on a retirement nest egg that they rely on to provide regular income that will need to last them throughout their remaining years...While some of those retirees and near retirees will be easily able to absorb the potential losses associated with private offerings, others who comfortably meet the threshold would nonetheless see their retirement security put at risk as a result of such losses. The illiquidity of private offerings also poses a particular challenge for those who are relying on their investments as a source of regular income to meet monthly living expenses.”³³¹ Indeed, we suspect that a thorough analysis of the characteristics of the individual accredited investor population would show that the percentage who cannot afford to withstand significant investment losses or accept the lack of liquidity typically associated with private offerings greatly exceeds the percentage who can.

2. There Is No Evidence of Investor Demand to Expand the Definition.

Whether you measure by access to information, sophistication, or ability to withstand private offering risks, the current definition does not effectively identify a pool of investors who are capable of fending for themselves without the protections afforded in the public markets. This may help to explain why, according to the SEC’s own analysis, such a small percentage of those who qualify as accredited investors under the current definition choose to invest in private offerings. According to the Concept Release, roughly 16 million U.S. households (or 13%) qualify as accredited investors.³³² In contrast, DERA has estimated that on average only approximately 316,288 investors participated in Regulation D offerings each year between 2009 and 2017, an unknown percentage of whom are individual investors.³³³ Even if you assume that a large percentage of these are individual investors and that there is a limited number of repeat players reflected in the total, that still suggests that only a tiny fraction (on the order of 1.5% to 1.75%) of all those who qualify as individual accredited investors actually choose to invest in private offerings in any given year. In light of that fact, it is hard to imagine that proposals to expand the pool of accredited investors of the type presented in the Concept Release would actually deliver a significant increase in capital for private offerings. At the very least, it

³²⁹ *Id.* at 4.

³³⁰ *Id.* at 3.

³³¹ *Id.* at 3-4.

³³² Concept Release at 36.

³³³ Scott Baugess, Rachita Gullapalli, and Vladimir Ivanov, *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017*, Division of Economic and Risk Analysis (DERA) U.S. Securities and Exchange Commission, August 2018, <http://bit.ly/2mE7b62>.

highlights the need for the Commission to conduct far more in-depth analysis than it has conducted to date of the likely impact of its proposed changes.

The low percentage of accredited investors who choose to invest in private offerings also calls into question the assumption underlying this Concept Release that there is pent up demand to participate in private offerings among those who do not currently qualify as accredited. This point is reinforced by the analysis contained in the comment letter from SEC Investor Advocate Rick Fleming.³³⁴ Fleming notes that, when you look at the individuals who fall just below the current thresholds (those in the 75th to 90th percentiles in terms of net worth), the bulk of their assets are held in retirement accounts, and relatively few (one in four households) hold stocks directly.³³⁵ If a majority of the wealthiest non-accredited investors don't routinely invest in individual stocks of publicly traded companies, it hardly seems likely that they are chomping at the bit for an opportunity to buy shares in private companies. This is not to suggest that unsuspecting retail investors couldn't be sold private offerings by an enterprising broker or adviser looking to cash in on the high compensation that typically comes with selling private offerings, but that is a very different thing from actual investor demand. In reality, this issue is being driven by those who want to expand the pool of eligible investors to sell to, and not the other way around.

Nor are these individual investors likely to have access to the best deals available among either the operating companies or the pooled investments that rely on Reg D to raise capital. As a group of the nation's leading securities law professors argue persuasively in their comment letter on the Concept Release, there is currently "vigorous competition for investments and a growing sense of overcrowding" in the private markets.³³⁶ "In this highly competitive environment, capital is far from scarce. The notion that institutional investors may have passed over a large set of attractive private investments is therefore implausible...Therefore, the private issuers that seek out direct investment from small-dollar retail investors are likely to be the smallest issuers with the worst prospects—the product of severe adverse selection, if not outright fraud."³³⁷

Given the evidence that there is little investor demand to access private offerings, even among those who already qualify as accredited investors, the strong likelihood that small dollar investors would be targeted with the worst of the available private offerings, and the evidence that even many existing accredited investors are ill-equipped to withstand the risks of private offerings, the existing evidence strongly suggests that the potential harm to investors of expanding the definition would greatly outweigh any benefits to issuers or to small company capital formation.

3. The Commission Should Fundamentally Reconsider Its Approach to the Accredited Investor Definition.

Measured against its intended regulatory function, the current definition of accredited investor is a complete failure. It does not identify a pool of investors who can readily access

³³⁴ Letter from SEC Investor Advocate Rick Fleming to the SEC, July 11, 2019, <https://bit.ly/2mQXBgi>.

³³⁵ *Id.*

³³⁶ Letter from Elisabeth D. de Fontenay, Erik F. Gerding et. al., to the SEC, September 24, 2019, <http://bit.ly/2ombQKO>.

³³⁷ *Id.*

complete and reliable information on which to base their investment decisions. It does not identify a pool of financially sophisticated investors who will readily understand the particular risks they face when investing in private offerings. And it does not identify a pool of investors whose wealth insures that they can readily withstand both the liquidity risks and heightened risks of investment loss presented by private offerings. In response, the Commission should be considering a fundamental revision to the definition -- not one that simply tinkers with the definition and certainly not one that expands the pool of accredited investors to include even more individuals who are not able to fend for themselves without the protections afforded in the public markets.

To do that, however, the Commission would need to know far more than it currently does about the characteristics of accredited investors, including with regard to differences between those who do invest in private offerings and the vast majority who do not. For example, while we continue to believe that access to information is critical, in theory we might support an approach that focused on investor sophistication as a qualification for accredited investor status, but only if the Commission were able to devise a reliable measure of sophistication that could be readily implemented.³³⁸ It has so far failed to indicate that it can. The proposals that have been put forward in this regard range from the inoffensive but insignificant, such as permitting licensed securities professionals to automatically qualify regardless of income or net worth, to the downright reckless, such as expanding the definition to take into account measures of non-financial sophistication, regardless of income or net worth, or permitting individuals, after receiving disclosure about the risks, to opt into being accredited investors.

One proposal that seems to have gained considerable traction is the proposal to include licensed securities professionals in the definition, without regard to income or net worth. While we don't object to this proposal, we doubt it would have a meaningful impact on the supply of capital for private offerings, since many if not most such professionals will already qualify based on income or net worth. We would be concerned, however, if this concession became the thin end of the wedge to allow others with less claim to true investment knowledge to qualify as accredited investors based on their supposed sophistication. In this regard, we note that the Chartered Financial Analyst certification has been suggested as a possible qualifying credential. While that proposal seems defensible, adopting this approach of relying on private certification poses significant challenges for the Commission. Specifically, it would place the agency in the role of deciding which voluntary certifications adequately measure investment sophistication, and which do not. As the IAC noted in its recommendation on the topic, "The risk to the Commission of pursuing this approach is that many other credentials with less claim to measure relevant expertise are likely to seek inclusion on a list of qualifying credentials."³³⁹ To the degree that this approach was used to open up a loophole that includes individuals with no particular investment expertise, such as attorneys or insurance agents, in the definition, we would strongly oppose it.

³³⁸ We believe access to information remains the critical component of an exemption that is supposed to turn on the ability of the buyers to fend for themselves. However, a truly sophisticated investor should understand the importance of information and make access to information a condition of investing. Only a very rigorous sophistication measure would serve this function, which is a key reason we remain skeptical of this approach.

³³⁹ IAC Accredited Investor Recommendation at 7.

Proposals to expand the definition to include individuals with specific industry or issuer knowledge or expertise raise similar concerns. First, while useful, knowledge and experience alone cannot substitute for access to information. Second, such expertise is likely to be even more difficult to reliably identify than investment expertise, and the pressure to rely on inadequate measures is likely to be intense. After all, this approach is being pushed by the same entities -- such as the Advisory Committee on Small and Emerging Companies -- that have consistently resisted any meaningful revisions to the financial thresholds, despite their obvious inadequacies in identifying a pool of investors capable of fending for themselves. That suggests a willingness to expand the pool of eligible investors at any cost, regardless of the impact on investor protection, an attitude that should not guide Commission policy decisions.

Other proposals, such as the proposal to permit individuals who pass an accredited investor examination to qualify as accredited investors, would hinge on the Commission's ability to develop an effective measure of sophistication. Before going down that route, however, the Commission would need to determine whether there is sufficient investor demand to justify the costs of developing and administering such a test. We are skeptical. Certainly, there is currently no evidence to support the viability of this approach.

Finally, while a well-designed sophistication requirement could benefit investors as a replacement for the existing financial thresholds, that does not appear to be what advocates of this approach have in mind. Instead, the goal appears to be to use sophistication measures to further expand the existing pool of eligible investors while continuing to include unsophisticated investors in the pool who meet the financial thresholds. Currently, however, the Commission does not even collect the data that would enable it to adequately analyze what the effect would be of revisions to the definition based on various different purported measures of investment sophistication. The Commission should therefore start by collecting the data and performing the analysis necessary to determine what impact such an approach would have on both investors and the flow of capital for private offerings.

In the interim, to the degree that the Commission considers revising the definition, it should focus on proposals that would narrow the definition so that it would at least minimize the risks to investors who do not have the ability to readily withstand risks associated with private offerings, particularly the substandard offerings likely to be marketed to small dollar investors. To the degree that a narrower definition forced issuers to look to the public markets to gain access to a broad pool of capital or forced private companies to become reporting companies earlier because they triggered the Section 12(g) reporting thresholds, narrowing the definition could also benefit the public markets. Possible approaches would be to adjust the financial thresholds upwards to reflect inflation, to remove non-financial assets from the calculation of net worth, to count only investment assets held outside qualified retirement accounts in determining eligibility, and to limit investments in private offerings to a percentage of net worth, along the lines of the crowdfunding rules. These approaches deserve far more serious consideration than they have received from the Commission to date.

B. Don't Expand the Definition to Include Non-Accredited Investors who Rely on Advice or Recommendations from an Investment Adviser or Broker-Dealer.

One idea that gets a lot of attention in the Concept Release is the question of whether to expand the definition of accredited investor, and therefore the pool of potential investors issuers can sell to in exempt offerings, to include otherwise non-accredited investors who retain financial professionals to advise them. The Release cites to the 2017 Treasury Report, which supported the idea of broadening the definition of accredited investor to include “any investor who is advised on the merits of making a Regulation D investment by a fiduciary, such as an SEC- or state-registered investment adviser.”³⁴⁰ The Concept Release has expanded on that idea, asking for comment on whether any natural person or entity that is advised by a “registered financial professional” should be considered an accredited investor.³⁴¹

CFA has in the past been open to the idea of allowing individuals to qualify as accredited investors based on reliance on advice from a fiduciary adviser, but only under tightly limited conditions. Specifically, our support was conditioned on the fiduciary adviser’s having no personal financial stake in the investment being recommended, including not receiving any direct or indirect compensation from the issuer, and being held to a meaningful fiduciary duty to act in the best interest of the investor. Given the SEC’s refusal to adopt a strong uniform fiduciary duty for brokers and advisers under section 913(g) of Dodd-Frank, and its refusal to use its 913(g) authority to rein in widespread, harmful conflicts,³⁴² those safeguards clearly are not satisfied here. Accordingly, and for the reasons discussed above regarding lack of investor demand, we strongly oppose the concept of expanding the definition of accredited investor to allow otherwise non-accredited investors to qualify by virtue of the fact that they rely on advice or recommendations from investment advisers or broker-dealers, as appears to be contemplated here.

1. The Commission’s Enforcement of the Advisers Act Fiduciary Standard Does Not Satisfy Conditions We Previously Identified as Necessary to Protect Investors in Private Offerings.

The unfortunate fact is that the Commission’s interpretation and enforcement of the Investment Advisers Act fiduciary duty does not satisfy the conditions that we previously laid out as necessary to protect investors from conflicted advice with regard to private offerings. According to the Commission’s recent re-interpretation of the Advisers Act fiduciary duty, for example, an adviser can satisfy its duty of loyalty by providing “full and fair disclosure” and obtaining a client’s “informed consent” to any conflicts or limitations on the scope of the engagement.³⁴³ Nothing prevents the adviser from having a personal financial stake in the investment being recommended or from receiving direct or indirect compensation from the issuer, as long as those conflicts are disclosed, and nothing requires advisers to recommend the

³⁴⁰ Concept Release at 44.

³⁴¹ Concept Release at 57.

³⁴² The Commission used this authority to ban certain types of sales contests, but refused to use that same authority to limit or ban other incentives firms create that encourage recommendations that are not in customers’ best interests.

³⁴³ Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248; File No. S7-07-18, June 5, 2019, <http://bit.ly/2lcibr1>.

investments they reasonably believe are the best available option for the investor. As such, getting advice from an investment adviser does not provide sufficient protections from the potentially harmful impact of conflicts to justify basing a registration exemption on that standard.

Traditionally, investment advisers have fulfilled their obligation to provide full and fair disclosure of conflicts by disclosing them in a firm's Form ADV, which can span over 100 pages and be written in dense legalese that make it difficult if not impossible for anyone other than securities lawyers to understand. It is unsurprising, then, that a wealth of evidence shows that retail investors aren't likely to read or understand disclosures of this sort. Unfortunately, with its recently adopted Customer Relationship Summary (CRS), the Commission has over-corrected, requiring advisers to condense key information about the firm, including information about its conflicts of interest, into no more than two pages (four for dual registrant firms).³⁴⁴ This all but guarantees that, absent more meaningful restrictions on conflicts, the CRS disclosures regarding conflicts will be too brief and generic to provide a sufficient warning to investors of the extent to which conflicts could taint the advisers' private securities recommendations.

The Advisers Act re-interpretation does suggest that, "In some cases, conflicts may be of a nature and extent that it would be difficult to provide disclosure to clients that adequately conveys the material facts or the nature, magnitude, and potential effect of the conflict sufficient for a client to consent to or reject it."³⁴⁵ It further states that, "For retail clients in particular, it may be difficult to provide disclosure regarding complex or extensive conflicts that is sufficiently specific, but also understandable."³⁴⁶ However, the Commission provides no meaningful guidance as to what types of conflicts the Commission was contemplating when making these statements.

Recommending private offerings when the advisor has a stake in the offering or receives compensation as a result of their advice to invest in a private offering *ought* to be viewed as creating exactly the type of conflict that is too complex or extensive to address through disclosure alone. This is particularly the case with regard to private pooled investment vehicles, such as hedge funds and private equity. Indeed, the Commission itself has acknowledged that, "private pools have become increasingly complex and involve risks not generally associated with many other issuers of securities. Not only do private pools often use complicated investment strategies, but there is minimal information available about them in the public domain. Accordingly, investors may not have access to the kind of information provided through our system of securities registration and therefore may find it difficult to appreciate the unique risks of these pools, including those with respect to undisclosed conflicts of interest, complex fee structures and the higher risk that may accompany such pools' anticipated returns."³⁴⁷

The Commission has also acknowledged that, "Hedge fund advisers often have substantial conflicts of interest, both with the hedge fund and with other non-hedge fund

³⁴⁴ Form CRS Relationship Summary; Amendments to Form ADV, Release Nos. 34-86032; IA-5247; File No. S7-08-18, June 5, 2019, <http://bit.ly/2oifSUK>.

³⁴⁵ Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248; File No. S7-07-18, June 5, 2019, at 28, <http://bit.ly/2lcibr1>.

³⁴⁶ *Id.*

³⁴⁷ Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, SEC Release Nos. 33-8766 and IA-2576 (Dec. 27, 2006), <http://bit.ly/2lOtYfc>.

investors.”³⁴⁸ Thus, there are likely to be multiple levels of conflicts of interest present in these private offerings, both at the product level and at the advisory level, with significant potential to adversely impact the investor. It is unlikely that an unsophisticated investor who relies on their adviser’s recommendations will understand the nature and extent of these multiple layers of conflicts of interest in order to accept or reject the advice. Certainly, the Commission has provided no evidence to allay that concern. Nor are we aware of any enforcement actions by the Commission in circumstances where the Commission determined the nature and extent of an adviser’s conflicts were so complex and extensive that disclosure would not sufficiently enable the client to consent to or reject it. Given the array of complex conflicts firms are permitted to address through disclosures that few investors will ever read and fewer still will understand, however, there is no reason to believe the Commission now intends to crack down on this practice when it comes to conflicts associated with private offerings.

a. Disclosures that Apparently Satisfy the Commission’s “Full and Fair” Disclosure Requirement Do Not Provide Investors with Useful Information.

Even a cursory review of advisory firms’ Form ADVs shows how unhelpful disclosure of this sort can be. As just one example, Goldman Sachs’ 184-page Form ADV³⁴⁹ is likely to be incomprehensible for the typical retail investor. It’s more likely that only a securities lawyer or investment banker would be able to understand the various complex fee structures and compensation arrangements as well as the various conflicts of interest that result from these compensation arrangements. These vary based on the specific account and whether the account uses different affiliated (Goldman managed) and unaffiliated products, including hedge funds and private equity funds.

The conflict disclosures themselves manage to be both dense and devoid of meaningful content. For example, the Goldman ADV Form states: “These service providers may have business, financial or other relationships with Goldman Sachs (including its personnel), including being a portfolio company of, or otherwise affiliated with, GSAM, Goldman Sachs, or an Advisory Account. These relationships may influence GSAM’s selection of these service providers for Advisory Accounts or their portfolio companies. In such circumstances, there may be a conflict of interest between GSAM, Goldman Sachs, and the Advisory Accounts (or their portfolio companies) or between Advisory Accounts (or their portfolio companies) if the Advisory Accounts (or their portfolio companies) determine not to engage or continue to engage these service providers.”³⁵⁰ Any investor who actually reads this disclosure is unlikely to walk away with a clear understanding of the nature and extent of the conflicts and how they might affect the recommendations they receive. The Goldman ADV Form is far from an isolated example.

³⁴⁸ Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission (September 2003), <http://bit.ly/2niaJHA>. The Commission staff also stated, “We remain concerned that less sophisticated investors, even those meeting the accredited investor standard, may not possess the understanding or market power to engage a hedge fund adviser to provide the necessary information to make an informed investment decision.” Report at 81.

³⁴⁹ Goldman Sachs Asset Management, Form ADV Part 2A, March 28, 2019, <http://bit.ly/2lCZfSz>.

³⁵⁰ *Id.* at 20.

It is true that the Commission has brought enforcement actions where an adviser recommended hedge funds while receiving third-party payments. The classic example is the case against JP Morgan, where the firm failed to disclose its preference for recommending its proprietary hedge funds and third-party-managed hedge funds that made payments to a JP Morgan affiliate even when options with lower costs and better performance were available.³⁵¹ However, this case was not brought on the basis that the nature and extent of these conflicts made it impossible that disclosure would sufficiently enable the client to consent or reject the conflict, much less whether the recommendation was actually in the investor's best interest. On the contrary, the case was brought on the basis that JP Morgan didn't disclose these conflicts in the first place. All JP Morgan had to do to correct the problem was improve its ADV disclosures. That strongly suggests that the Commission believe conflicts such as these *can* adequately be addressed through disclosure, even if those disclosures are unlikely to be read or understood by investors.

Even if the Commission were to decide that disclosure alone is not enough, the Commission provided no meaningful guidance in its Advisers Act fiduciary re-interpretation as to what an adviser must do when he or she determines that a conflict is too complex and extensive to be cured through disclosure alone. Instead, the Commission generically states that, "In all of these cases where an investment adviser cannot fully and fairly disclose a conflict of interest to a client such that the client can provide informed consent, the adviser should either eliminate the conflict or adequately mitigate (i.e. modify practice to reduce) the conflict such that full and fair disclosure and informed consent are possible."³⁵² The Commission does not provide any guidance on what would constitute proper "mitigation."

b. The Commission's Approach Makes a Mockery of the Concept of "Informed Consent."

The Commission's approach makes a mockery of the idea of "informed consent." According to the Commission's perverse interpretation, a client need not actually be informed to be deemed to be "informed," and a client need not actually consent to a disclosed conflict for the client to be deemed to have given "consent." Specifically, the Commission "does not require advisers to make an affirmative determination that a particular client understood the disclosure and that the client's consent to the conflict of interest was informed."³⁵³ In addition, according to the Commission, consent is "generally considered on an objective basis and may be inferred."³⁵⁴ More specifically, "[A] client generally may provide its informed consent implicitly 'by entering into or continuing the investment advisory relationship with the adviser' after disclosure of a conflict of interest."³⁵⁵ In other words, so long as the client doesn't object either by rejecting the advice or terminating the advisory relationship, they will be deemed to have consented to conflicts -- including conflicts most investors will never know existed.

³⁵¹ Press Release, SEC, "J.P. Morgan to Pay \$267 Million for Disclosure Failures," (December 18, 2015), <http://bit.ly/2lcAI6z>.

³⁵² Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248; File No. S7-07-18, June 5, 2019, at 28, <http://bit.ly/2lcibr1>.

³⁵³ *Id.* at 27.

³⁵⁴ *Id.* at 8, footnote 24; at 24, footnote 59.

³⁵⁵ *Id.* at 27, footnote 68; at 32, footnote 81.

In adopting this approach, the Commission rejected our suggestion that they strengthen this interpretation by at least acknowledging that investors do not give “informed consent” to be harmed. In other words, while an investor may reasonably consent to the existence of a conflict, they do not reasonably consent to be harmed as a result of that conflict. That is supposed to be the added layer of protection that a best interest standard provides. But even this modest proposal was a step too far for the Commission, which appears to be content to rely on disclosures to address the vast majority of investment adviser conflicts, even when it knows, or reasonably should know, that those disclosures are completely ineffective in giving typical, unsophisticated retail investors actionable information about the extent of conflicts and the risks they pose.

As a result, the “protections” supposedly afforded by the Advisers Act fiduciary standard would do nothing to safeguard investors against the risks: 1) that they would receive highly conflicted advice from their adviser regarding private offerings; 2) that they would be incapable of assessing the nature and extent of those conflicts; 3) that they would similarly be incapable of assessing the quality of the private offering recommendations they received; and 4) that, as a result, they would receive inferior quality advice that they would unwittingly rely on, to their detriment. For these reasons, we strongly oppose allowing the sale of private offerings to non-accredited investors based on a recommendation from an investment adviser.

2. Reg BI Does Not Satisfy Conditions We Previously Identified as Necessary to Protect Investors in Private Offerings.

In adopting Regulation Best Interest (Reg BI), the Commission flouted clear congressional intent that it promulgate a uniform fiduciary standard for broker-dealers and investment advisers when they provide personalized investment advice to retail customers. Moreover, the Commission ignored congressional intent that the fiduciary standard for brokers and advisers include a requirement to act “without regard to” the financial or other interests of the broker-dealer or investment adviser. Instead, the Commission invented a new “best interest” standard of conduct that isn’t adequate to ensure brokers will provide advice that is of high quality and not tainted by conflicts of interest. This new “best interest” standard is not a true fiduciary duty to act in the best interest of the investor, as any reasonable investor would interpret that term, any more than the Commission’s interpretation of the Advisers Act fiduciary duty embodies such a standard.

On the contrary, Reg BI’s care obligation appears to do little more than codify existing FINRA suitability rules and related case law and guidance, rather than provide the meaningful enhancement in protections that investors desperately need. Among its many deficiencies, Reg BI does not define “best interest.”³⁵⁶ The Commission makes clear, however, that the “best interest” obligation in Reg BI does not require the broker to recommend, from the investments the broker has reasonably available to recommend, the securities that the broker reasonably believes represent the best available match for the investor.³⁵⁷ Furthermore, while a broker is required to “consider” costs in determining what to recommend, the Release focuses more on

³⁵⁶ Regulation Best Interest: The Broker-Dealer Standard of Conduct, Release No. 34-86031; File No. S7-07-18, at 73, <http://bit.ly/2mMO75u> (“we are declining to expressly define “best interest” in the rule text as suggested by some commenters”).

³⁵⁷ *Id.* at 278-291.

what brokers are *not* required to do to meet that obligation than on what the standard *would* require.³⁵⁸ This suggests that the Commission is likely to turn a blind eye to recommendations of high-cost securities that provide much higher compensation to the broker, such as many of those sold through private offerings, as long as the broker can come up with some minimally plausible justification for recommending that security rather than available alternatives that could accomplish the same investment goal at a lower cost to the investor.

While Reg BI also includes a conflict obligation, it does not require a broker's recommendation to be made "without regard to" their own financial or other interest. Moreover, Reg BI relies very heavily on disclosure to address conflicts, despite the fact that a wealth of available evidence shows that disclosures aren't effective in protecting retail investors from the harmful impact of conflicts. Specifically, all firm-level conflicts can be addressed through disclosure alone under Reg BI. As a result, a broker-dealer firm would be free under Reg BI to have a financial stake in the investment being recommended and to receive direct or indirect compensation from the issuer as long as that conflict was disclosed. While Reg BI does require firms to "mitigate" such conflicts at the individual sales rep level, the Release fails to provide any guidance on what would constitute proper "mitigation" of such conflicts. Moreover, except with regard to conflicts associated with limited product menus, Reg BI doesn't even explicitly state that mitigation has to be reasonably designed to prevent the conflict of interest from tainting the broker's recommendations. Given the lack of specificity in the rules, it appears that the Commission may intend to defer to brokerage firms to determine what types of conflicts should be mitigated and what form that mitigation should take, with the predictable result that those policies will not be adequate to protect investors from the harmful impact of conflicts.

This lack of effective restrictions on conflicts of interest is particularly troubling in the context of private placements. Brokers typically receive significantly more compensation for selling private placements than they do for selling other investments typically sold to retail investors, such as mutual funds or ETFs. As Massachusetts Secretary of the Commonwealth William Galvin has stated, "Private placements are risky investments that reward the salesperson handsomely with high commissions."³⁵⁹ To give a sense of the scale of those conflicts, when FINRA proposed an amendment to Rule 5122 in 2011 to limit to 15% the proportion of the proceeds of private placements of the firm's securities that could be used to pay for offering costs, discounts, commissions or any other cash or non-cash sales incentives, brokerage firms objected to the restrictions (although the requirement was ultimately adopted).³⁶⁰

³⁵⁸ *Id.* at 76 ("Regulation Best Interest will not necessarily obligate a broker-dealer to recommend the "least expensive" or the "least remunerative" security or investment strategy, provided the broker-dealer complies with the specific component obligations. In other words, Regulation Best Interest will allow a broker-dealer to recommend products that entail higher costs or risks for the retail customer, or that result in greater compensation to the broker-dealer, or that are more expensive, than other products, provided that the broker-dealer complies with the specific component obligations detailed below...").

³⁵⁹ Jean Eaglesham and Coulter Jones, *Regulators Step Up Scrutiny of Sales of Private Stakes*, Wall Street Journal, July 2, 2018, <https://on.wsj.com/2n8uLIg>.

³⁶⁰ Bruce Kelly, *Securities firms fight commission cap plan for private placements*, InvestmentNews, March 20, 2011 <http://bit.ly/2nkawaN>; FINRA Rules 5122. Private Placements of Securities Issued by Members, <http://bit.ly/2ICsTr6> (use of offering proceeds requiring at least 85% of the offering proceeds raised to be used for business purposes, which shall not include offering costs, discounts, commissions or any other cash or non-cash sales incentives.).

Given the magnitude of the conflicts associated with private offerings, Reg BI does not adequately ensure that harmful conflicts won't taint brokers' recommendations. And, just as in the advisory space, it is highly unlikely that most retail investors would be capable of assessing the nature and extent of those conflicts or of assessing the quality of the private offering recommendation based on the disclosures brokers will be required to provide. As a result, it's likely that investors would receive inferior quality recommendations that they would unwittingly rely on, to their detriment. For these reasons, Reg BI does not provide an adequate basis for an expansion of the accredited investor definition to include otherwise non-accredited investors who invest based on the recommendation of a licensed financial professional.

3. The Commission Should Strengthen Requirements That Apply to Purchaser Representatives.

Instead of expanding the accredited investor definition in this way, the Commission should be looking to strengthen the requirements that apply to purchaser representatives. Currently, non-accredited investors are able to qualify as sophisticated, and invest in Rule 506 offerings that do not involve general solicitation, based on their reliance on a recommendation from a purchaser representative. As the IAC noted in its recommendation, however, the Commission's rules "allow unsophisticated, non-accredited investors to invest in private offerings in reliance on a recommendation from a purchaser representative who may have significant conflicts of interest and who isn't subject to a clear legal obligation to act in the best interests of the investor. While the regulations place some restrictions on purchaser representatives, they still allow them to be paid by the issuer and to have a considerable financial stake in the success of the offering, so long as that financial interest is disclosed to the investor. Such disclosures are notoriously ineffective in protecting investors from harm, as was well documented in the SEC's 2012 financial literacy study."³⁶¹

We agree with the IAC that, "Where a purchaser representative is serving in a professional capacity (and not simply providing uncompensated advice to a friend or family member, for example) ... the appropriate approach is to eliminate financial conflicts of interest to the degree possible" and to apply a strong fiduciary standard to that recommendation. To adequately protect the investor, that would have to include an obligation to act in the best interests of the investor, defined as recommending those investments that the purchaser representative reasonably believes represent the best available options for the investor, and without regard to the purchaser representative's own financial interests. Failure to adopt such a standard would continue to place vulnerable investors at risk.

C. The Commission Should Not Expand Retail Investors' Access to Exempt Offerings through Pooled Investments.

The Concept Release expresses concern that retail investors who are not accredited investors have a limited ability to obtain exposure to exempt offerings through pooled investment funds, such as registered investment companies and BDCs. To remedy this perceived problem, the Concept Release suggests expanding retail investors' access to exempt offerings by loosening the restrictions under current law on the investments registered investment companies

³⁶¹ IAC Accredited Investor Recommendation at 11.

and robo-advisers can make in exempt offerings on retail investors' behalf. The Concept Release also suggests allowing non-accredited retail investors to invest in private funds directly. Both would raise serious investor protection concerns. The Commission should therefore not move forward with either proposal.

1. The Commission Should Not Raise the Limit on Investment Company Holdings of Illiquid Private Securities.

The Investment Company Act is one of the crown jewels of the federal securities laws. It provides strong investor protections by requiring funds to make high-quality disclosures, restricting conflicts of interest, limiting the types of securities that funds can invest in, and requiring daily pricing, among other things. These safeguards were adopted in order to provide meaningful protections to investors, including the least sophisticated investors who rely heavily on mutual funds to provide the benefits of diversification and professional management on affordable terms. As former Chairman Arthur Levitt stated, the Investment Company Act “was designed to protect unsophisticated investors from the risks of investing in unregulated investment pools...”³⁶² According to Paul Schott Stevens, President and CEO of the Investment Company Institute (ICI), “Under the Investment Company Act of 1940 and other securities laws, fund investors enjoy a range of vital protections...Funds have embraced this regulatory regime and they have prospered under it.”³⁶³

In addition to the other protections discussed above, the 1940 Act requires open-end funds to maintain sufficient liquidity to meet daily redemptions at net asset value (NAV).³⁶⁴ According to the Commission, “For decades, the Commission has recognized that because open-end funds hold themselves out at all times as being prepared to meet these statutory redemption requirements, they have a responsibility to manage the liquidity of their investment portfolios in a manner consistent with those obligations and any other related representations. Thus, long-standing Commission guidelines contain a liquidity standard that generally limits an open-end fund’s aggregate holdings of “illiquid assets” to no more than 15% of the fund’s net assets (the “15% guideline”).”³⁶⁵ In 2016, the Commission codified this guidance into Rule 22e-4.³⁶⁶ In

³⁶² Letter from SEC Chairman Arthur Levitt to Rep. Edward J. Markey (D-Mass.), Jan. 29, 2001.

³⁶³ Statement of Paul Schott Stevens, President and Chief Executive Officer, Investment Company Institute, Hearing before the Committee on Banking, Housing, and Urban Affairs, United States Senate, One Hundred Eleventh, Congress, First Session, On “Examining What Went Wrong in the Securities Markets, How We Can Prevent the Practices That Led to Our Financial System Problems, and How to Protect Investors,” March 10, 2009, <http://bit.ly/2nqJtdN>.

³⁶⁴ See Investment Company Liquidity Risk Management Programs, Release Nos. 33- 10233; IC- 32315; File No. S7-16-15, October 13, 2016, at 16-17, <http://bit.ly/2m2NrZJ> (“An open-end fund’s failure to maintain sufficiently liquid assets or otherwise manage liquidity implicates multiple provisions of the Act, as well as other federal securities laws and regulations. Section 2(a)(32) of the Act, when read together with sections 4(2) and 5(a), creates an obligation on open-end funds and UITs to provide shareholders with approximately their proportionate share of NAV upon the presentation of a redemption request. Section 22(e) of the Act provides in turn that the right of redemption may not be suspended and payment of redemption proceeds may not be postponed for more than seven days after tender of a redeemable security absent specified unusual circumstances.”).

³⁶⁵ *Id.* at 17.

³⁶⁶ Under the Rule’s limitation on illiquid investments, a fund is not permitted to purchase additional illiquid investments if more than 15 percent of its net assets are illiquid investments that are assets. An illiquid investment is an investment that the fund reasonably expects cannot be sold in current market conditions in seven calendar days without significantly changing the market value of the investment.

2018, the Commission extended the compliance date for certain requirements of the liquidity risk management rules, while simultaneously reaffirming its commitment to the 15% limit on illiquid securities. In doing so, the Commission stated: “Indeed, two provisions of the rule that are at the heart of the investor protection benefits that the rule seeks to achieve — the requirement that a fund institute a liquidity risk management program and the 15% illiquid investment limit — will go into effect as planned.”³⁶⁷ Any deviation by the Commission from this thoughtful and consistently held position would be a significant and deeply troubling about-face, without any meaningful analysis to justify that change in position.

The 15% limit on illiquid investments already permits open-end funds to invest in illiquid securities, including private securities such as hedge funds, private equity, and other securities issued pursuant to a registration exemption.³⁶⁸ Other registered investment companies have even fewer constraints on their ability to invest in these securities. For example, closed-end funds do not need to maintain liquidity to meet daily redemptions because investor redemption rights are often limited. As a result, closed-end funds have more flexibility than open-end funds to invest in illiquid securities, including private securities.

As explained by University of Mississippi Professor of Law Mercer Bullard, the rules requiring open-end funds to maintain sufficient liquidity to meet daily redemptions at net asset value ensures that funds accurately value themselves and their holdings. As such, it helps to align investor expectations with the investments that they purchase. These features in turn promote confidence and stability in these markets. “Mutual fund investors are confident that they will receive the net asset value of their holdings upon redemption and they appear to believe that the net asset value of those shares—the net asset value will be fair and accurate,” Bullard stated.³⁶⁹ “This confidence in the valuation and redeemability of mutual fund shares reduces the likelihood of the kind of panic selling that creates systemic risk and may provide a useful lesson for the regulation of other financial intermediaries,” Bullard continued.³⁷⁰ Allowing open-end fund investors to invest in higher quantities of illiquid (and difficult-to-value) investments would threaten these valuable benefits.

The suggested approach also appears to be divorced from the reality of how the open-end fund industry operates. Despite the fact that they can invest up to 15% in illiquid securities, the vast majority of funds do not even come close to that limit. According to a Morningstar analysis, for example, few funds invest in private securities at all.³⁷¹ Those funds equate to just 5.8% of the 1,204 large-cap equity funds in Morningstar’s database. Of the funds that do invest in private securities, Morningstar found that 89% of the funds in the study invested less than 3% of assets

³⁶⁷ Investment Company Liquidity Risk Management Programs; Commission Guidance for In-Kind ETFs, Release No. IC-33010; File No. S7-03-18, February 22, 2018, at 18, <http://bit.ly/2mRJh7b>.

³⁶⁸ Investment Company Liquidity Risk Management Programs, Release Nos. 33- 10233; IC- 32315; File No. S7-16-15, October 13, 2016, at 18, <http://bit.ly/2m2NrZJ>.

³⁶⁹ Statement of Mercer E. Bullard, Associate Professor, University of Mississippi School of Law, and President, Fund Democracy, Inc., Hearing before the Committee on Banking, Housing, and Urban Affairs, United States Senate, One Hundred Eleventh, Congress, First Session, On “Examining What Went Wrong in the Securities Markets, How We Can Prevent the Practices That Led to Our Financial System Problems, and How to Protect Investors,” March 10, 2009, <http://bit.ly/2nqJtdN>.

³⁷⁰ *Id.*

³⁷¹ Katie Rushkewicz Reichart, *Unicorn Hunting: Large-Cap Funds That Dabble in Private Companies*, Morningstar, June 4, 2018, <http://bit.ly/2lqbDoM>.

in private-firm equity as of December 2017. Furthermore, the median fund in the study invested in three privately held companies, totaling 0.71% of overall fund assets. Even those funds that do invest in private securities to a much greater degree than other funds are still well below the limit, according to the Morningstar analysis. For example, Fidelity Contrafund invested \$1.67 billion across 18 private companies as of December 2017 -- a bigger investment than the entire asset base of some mutual funds. However, that stake totaled just 1.35% of Fidelity Contrafund's \$123.5 billion asset base.

These findings suggest that funds already invest significantly less in private securities than they are permitted to do under current rules. The Morningstar analysis explains some of the reasons why funds do not invest significant amounts in private securities. Chief among them is the fact that private companies typically have a limited size and liquidity, which means investments in private securities are unlikely to substantially impact fund performance. Moreover, "it can be very time-consuming to monitor dozens of privately held companies where the market is not setting prices and due diligence could take longer."³⁷² Given these facts, raising the limit on how much funds can invest is unlikely to have any meaningful impact either on the capital available for private offerings or on investor exposure to such offerings.

The Morningstar analysis did provide an illustration of what could go wrong if the Commission allowed open-end funds to invest more in private securities and some funds chose to do so. A fund that has invested a certain amount in private securities, when faced with redemptions, might choose to sell its most liquid securities, leaving a greater proportion of illiquid, private securities among the fund's holdings. This happened with Morgan Stanley Institutional Mid Cap Growth, according to the analysis. After the fund experienced a "rough patch of performance between 2014 and 2016, investors yanked billions of dollars from the fund. As a result, its once-reasonably-sized stake in private companies ballooned to 9% of assets by mid-2016. With private-firm holdings lacking liquidity to help meet redemptions, the managers pared back all of the fund's public holdings, further affecting the portfolio."³⁷³ According to the Morningstar article, "This example highlights a risk of private-company ownership in an open-end structure. Investors can be fickle and may not stick around when the fund is going through a rough spell. Managers can be forced to trim or sell publicly traded stocks they may have preferred to keep. Portfolio construction can also appear out of whack, as the private, illiquid holdings soak up more of a fund's assets and drive more of the fund's performance than perhaps was initially intended."³⁷⁴

Some have suggested that target date funds are somehow exempt from this concern because they are designed to be held for the long-term. However, this ignores the extent to which target date funds are sold to the least financially sophisticated, smallest dollar investors -- those who can least afford the risks associated with private investments. It also ignores evidence that such investors often misuse target date funds -- for example, by simultaneously investing in other funds, thus undermining the asset allocation benefits associated with target date funds.³⁷⁵ Finally,

³⁷² *Id.* These are largely the same reasons why institutional investors don't invest in small companies.

³⁷³ *Id.*

³⁷⁴ *Id.*

³⁷⁵ See David Blanchett, *Mixed Target-Date Fund Investors: Is There a Method to the Madness?*, Morningstar, August 20, 2019, <http://bit.ly/2lOu9aF> (finding that there are potentially over 10 million participants in defined contribution plans combining a target-date fund with other plan investments, when target-date funds are best used as

it ignores evidence that the financially unsophisticated investors who are disproportionately represented among the investors in target date funds are least likely to read and understand disclosures regarding risks associated with the fund’s investment in illiquid private securities.

Moreover, the mere fact that a target date fund may have a 2040 date attached to it doesn’t change the fact that investors still expect that they will be able to redeem their shares on a daily basis. Indeed, the small investors of modest means who are major users of target date funds may be the very individuals who are most in need of accessing their funds to make ends meet in a severe downturn. If, as a result of an unhealthy concentration in private securities, target date funds were unable to deliver on their promise to allow daily redemptions at NAV or experienced the kind of extreme fluctuations in share value some experienced during the financial crisis, that could shake retail investor confidence in these funds and the market more generally. Making such significant changes to a product that is relied on heavily by Mr. and Ms. 401(k), without any evidence that doing so would deliver benefits that outweigh the costs, would be foolish and unjustified.

2. The Commission Should Not Permit Non-Accredited Retail Investors to Invest in Private Funds Directly.

The Concept Release also asks for comment on whether non-accredited investors should be permitted to invest in private funds directly. They should not. Private funds are largely unregulated investments that operate without the protections, highlighted above, that the Investment Company Act or other securities laws provide. According to ICI, for example, “Hedge funds are largely unregulated products that may engage in very risky investment strategies, with virtually no required day-to-day safeguards for investors. They are not subject to any substantive regulation and there are no restrictions on who can start a hedge fund. Indeed, with the exception of the antifraud standards – which have been described by a former Commission official as ‘too little, too late’ for defrauded investors – hedge funds are largely free from direct regulation under the federal securities laws. The fact that unregistered hedge funds operate largely outside of regulation designed to protect the markets and the investing public – including but not limited to registration, disclosure, most reporting requirements, specific conflict of interest prohibitions, and investment limitations – makes it imperative that hedge funds continue to be both offered and sold only to investors who are able to ‘fend for themselves.’”³⁷⁶ We agree.

As discussed above, the Commission itself has acknowledged that, “private pools have become increasingly complex and involve risks not generally associated with many other issuers of securities. Not only do private pools often use complicated investment strategies, but there is minimal information available about them in the public domain. Accordingly, investors may not

an “all or none” investment option). *See also* Financial Engines, *Not so simple: Why target-date funds are widely misused by retirement investors*, March 2016, <http://bit.ly/2lpC8uz> (finding that only a fraction—one in four—of total target-date fund users are full-target-date fund users who utilize their target-date fund as intended by holding virtually all (90 percent or more) of their investments in target-date funds).

³⁷⁶ Letter from Paul Schott Stevens, ICI, to the SEC, October 9, 2007, <http://bit.ly/2lSkOi7> (citing Paul Roye, then Director of the Commission’s Division of Investment Management, “By the time we find out about [an instance of hedge fund fraud], it’s too late. The money’s gone.”).

have access to the kind of information provided through our system of securities registration and therefore may find it difficult to appreciate the unique risks of these pools, including those with respect to undisclosed conflicts of interest, complex fee structures and the higher risk that may accompany such pools' anticipated returns."³⁷⁷ The Commission has also acknowledged that, "Hedge fund advisers often have substantial conflicts of interest, both with the hedge fund and with other non-hedge fund investors."³⁷⁸ As a result, the Commission staff has stated, "We remain concerned that less sophisticated investors, even those meeting the accredited investor standard, may not possess the understanding or market power to engage a hedge fund adviser to provide the necessary information to make an informed investment decision."³⁷⁹

Private equity funds pose the same problems, so much so that institutional investors have raised concerns regarding conflicts of interest in the private equity market.³⁸⁰ For example, former director of the Office of Compliance Inspections and Examinations Andrew Bowden stated that, "a private equity adviser is faced with temptations and conflicts with which most other advisers do not contend.... We have seen that these temptations and conflicts are real and significant."³⁸¹ In addition, the Commission has highlighted how the Investment Company Act "provides important protections that are not applicable to private funds or their investors. For example, the Investment Company Act includes limitations on self-dealing, affiliated transactions and leverage and requirements regarding independent board members, none of which apply to private funds..."³⁸² The Commission has also expressed concern that investors may get a "misimpression regarding the level of statutory and regulatory protections that apply to investors in a private fund," as a result.³⁸³ There is reason for concern that investors who are solicited to invest in a private fund will not understand these and other critical differences between private funds and registered investment companies.

Moreover, private funds' advertising practices have attracted heightened scrutiny for being misleading and deceptive, particularly around reporting of investment returns.³⁸⁴ This is partly because of the fact that there are no standards for reporting returns, which allows private funds to present returns in various ways. Given this flexibility, some do so in misleading and deceptive ways. The Commission has in the past acknowledged this concern, highlighting the fact that, "Based on enforcement and regulatory experience regarding private funds, we believe that the areas identified in Rule 156 as being vulnerable to misleading statements in investment

³⁷⁷ Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, SEC Rel. Nos. 33-8766 and IA-2576, December 27, 2006, <http://bit.ly/2lOtYfc>.

³⁷⁸ Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission (September 2003), <http://bit.ly/2niaIHA>.

³⁷⁹ *Id.* at 81.

³⁸⁰ See, e.g., Private Equity Conflicts of Interest, Consultation Report, IOSCO (November 2009), <http://bit.ly/2mZPa24>; Press Release, Institutional Limited Partners Association, "ILPA Urges Securities & Exchange Commission to Take Action to Ensure Robust Fiduciary Duties for Investors in the Private Equity Markets," (February 12, 2019), <http://bit.ly/2nxBbB4>.

³⁸¹ Andrew J. Bowden, SEC Director, Office of Compliance Inspections and Examinations, *Spreading Sunshine in Private Equity*, May 6, 2014, <http://bit.ly/2nzzAL5>.

³⁸² Proposed Amendments to Regulation D, Form D and Rule 156 at 67.

³⁸³ *Id.*

³⁸⁴ See, e.g., Mary Childs, *How Private-Equity Funds Can Artificially Boost Their Returns*, Barron's, August 22, 2019, <http://bit.ly/2l9lUph>; Don A. Steinbrugge, Agecroft Partners, *What aren't you telling me? Major discrepancies in hedge fund performance reporting*, hedgeweek, June 27, 2019, <http://bit.ly/2mJG7SM>.

company sales literature are similarly vulnerable with respect to private fund sales literature.”³⁸⁵ Retail investors are particularly vulnerable to being misled by such statements.

One troubling practice in the private equity fund market is the misleading use of internal rates of return (IRR). According to a McKinsey report, for example, even the most sophisticated investors don’t understand how IRR works.³⁸⁶ The report, based on “an informal survey of 30 executives at corporations, hedge funds, and venture capital firms ... found only 6 who were fully aware of IRR’s most critical deficiencies.”³⁸⁷ When the McKinsey researchers “reanalyzed some two dozen actual investments that one company made on the basis of attractive internal rates of return,” they concluded that, “If the IRR calculated to justify these investment decisions had been corrected for the measure’s natural flaws, management’s prioritization of its projects, as well as its view of their overall attractiveness, would have changed considerably.”³⁸⁸

Not just individual investment decisions, but also the assumption that private investments routinely outperform investments sold in the public markets rely on claims of investment returns that no investor actually received. Preston McSwain, a founder and managing partner of Fiduciary Wealth Partners, documented this when he reviewed multiple independent research reports, consultant reviews, and manager presentations, attended seminars and participated in private equity fundraising calls to try to determine why expectations of private equity returns were so high. What he found was “[c]onsistent evidence that the performance claims that seem to be driving funds into private investments are often based on the presentation of returns that ‘no client received’ (this is a direct quote from a recent private equity presentation).”³⁸⁹ McSwain noted that, “Their estimated net returns also didn’t include additional fees charged on their new offering” -- a topic he has dealt with in greater detail in a separate blog post.³⁹⁰ We understand there are additional ways private equity characterize their performance to depict enhanced returns, including through the use of bridge financing (also known as subscription lines of credit)³⁹¹ and return smoothing.³⁹²

This misleading presentation of private equity performance leads investors to over-invest in these assets. According to an article in *Harvard Business Review*, for example, “Overstated private equity performance may partially explain why investors continue to allocate substantial capital to this asset class, despite our finding (forthcoming in the Review of Financial Studies)

³⁸⁵ *Id.* at 81.

³⁸⁶ John C. Kelleher and Justin J. MacCormack, *Internal rate of return: A cautionary tale*, McKinsey Quarterly (August 2004), <https://mck.co/2mUpYKA>.

³⁸⁷ *Id.*

³⁸⁸ *Id.*

³⁸⁹ Preston McSwain, *Fake News?*, Provoking Posts, September 5, 2018, <https://bit.ly/2nbPdrK>.

³⁹⁰ *Id.* See also McSwain, *Enterprising Investor, Where Are Fees and Expenses Not Costs?*, CFA Institute, January 22, 2018, <https://cfa.is/2DylFfz> (discussing the issue in greater detail).

³⁹¹ See Paul J. Davies, *Private Equity’s Trick to Make Returns Look Bigger*, Wall Street Journal, March 9, 2018, <https://on.wsj.com/2lOOlsZ>; James F. Albertus and Matthew Denes, *Distorting Private Equity Performance: The Rise of Fund Debt* (June 2019), <http://bit.ly/2mWtwvT>; Alicia McElhaney, *The Private Equity Tool Distorting Returns*, Institutional Investor, August 20, 2019, <http://bit.ly/2lmSX9j>.

³⁹² See David Foulke, *Replicating Private Equity: the Impact of Return Smoothing*, Alpha Architect, March 7, 2016, <http://bit.ly/2nyyFuk>; Antti Ilmanen, Swati Chandra, and Nicholas McQuinn, *Demystifying Illiquid Assets: Expected Returns for Private Equity*, AQR, January 31, 2009, <http://bit.ly/2n0YuCM>.

that PE funds have historically underperformed broad public market indexes by about 3% per year on average.”³⁹³

Other concerns that have been highlighted -- including by former Director of the Office of Compliance Inspections and Examinations Andrew Bowden -- are a lack of transparency and limited investor rights,³⁹⁴ excessive expenses,³⁹⁵ misvaluation,³⁹⁶ inadequate policies and procedures, and inadequate disclosure.³⁹⁷ Based on over 150 exams that OCIE had conducted through 2014, Bowden found that, “By far, the most common observation our examiners have made when examining private equity firms has to do with the adviser’s collection of fees and allocation of expenses. When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50% of the time. This is a remarkable statistic...The flipside of expense-shifting is charging hidden fees that are not adequately disclosed to investors.”³⁹⁸ Here again, retail investors are likely to be particularly vulnerable to these practices.

Problem practices in the private fund market could undermine investor faith in the markets more generally. If, for example, investors were to invest in private funds without a proper understanding of the risks involved, and if they were to suffer harm as a result, it could affect their willingness to invest in public markets in the future. Indeed, as ICI has correctly pointed out with regard to hedge funds, “Trouble in the hedge fund area that bleeds over in the public’s mind to include mutual funds could shake public confidence in those regulated products, which serve as the primary investment vehicle for over half of all U.S. households.”³⁹⁹ The same could be said of investments in private funds more generally. That would be a terrible outcome for investors, market integrity, and capital formation.

³⁹³ Oliver F. Gottschalg and Ludovic Phalippou, *The Truth About Private Equity Performance*, Harvard Business Review (December 2007), <http://bit.ly/2nypUjV>; See also Martin Sorensen, Neng Wang, and Jinqiang Yang, *Valuing Private Equity*, NBER Working Paper No. 19612 (November 2013), <http://bit.ly/2lq7Ho3> (“Conventional interpretations of PE performance measures appear optimistic. On average, LPs may just break even, net of management fees, carry, risk, and costs of illiquidity.”).

³⁹⁴ Andrew J. Bowden, SEC Director, Office of Compliance Inspections and Examinations, *Spreading Sunshine in Private Equity*, May 6, 2014, <http://bit.ly/2nzzAL5> (“Lack of transparency and limited investor rights have been the norm in private equity for a very long time.”).

³⁹⁵ See also Eileen Appelbaum and Rosemary Batt, *Fees, Fees and More Fees: How Private Equity Abuses Its Limited Partners and U.S. Taxpayers*, Center for Economic and Policy Research (May 2016), <http://bit.ly/2IS0XzA>.

³⁹⁶ Andrew J. Bowden, SEC Director, Office of Compliance Inspections and Examinations, *Spreading Sunshine in Private Equity*, May 6, 2014, <http://bit.ly/2nzzAL5> (“A common valuation issue we have seen is advisers using a valuation methodology that is different from the one that has been disclosed to investors.” Also, highlighting one SEC enforcement action where a PE fund’s change in valuation methodology resulted in a quarterly change to the fund’s reported gross internal rate of return from roughly 3.8% to more than 38%.).

³⁹⁷ *Id.* (“Historically, the most frequently cited deficiencies in adviser exams involve inadequate policies and procedures or inadequate disclosure. This makes sense because virtually any primary deficiency can be coupled with a secondary deficiency for failing to maintain policies and procedures to prevent the primary deficiency or failing to disclose the primary deficiency to clients. And the deficiency rate for these two most commonly cited deficiencies usually runs between 40% and 60% of all adviser examinations conducted, depending on the year. So for private equity firms to be cited for deficiencies involving their treatment of fees and expenses more than half the time we look at the area is significant.”).

³⁹⁸ *Id.*

³⁹⁹ Letter from Paul Schott Stevens, ICI, to the SEC, October 9, 2007, <http://bit.ly/2ISkOi7>.

Because the risks far outweigh any purported benefits, the Commission should not move forward with a proposal to enable non-accredited retail investors to invest in private funds. On the contrary, as discussed further above, it should be looking at whether the existing accredited investor definition exposes retail investors to risks that they are ill-equipped to face.

D. Expanding Trading of Privately Issued Securities Would Further Undermine Public Markets and Increase the Risk that Investors Trading in these Markets will be Harmed.

In addition to soliciting comment on proposals to expand private offering exemptions, the Concept Release also solicits comment on whether the Commission should revise its exemptions governing the secondary trading of securities initially issued in exempt offerings. It suggests, without offering any evidence to support its assumption, that easing secondary trading restrictions would facilitate capital formation and promote investor protection. In reality, however, the proposal is bad for investors and bad for public markets, as the drafters of the original federal securities laws realized. As discussed above, the authors of the '33 Act intentionally restricted trading of privately issued securities in order to prevent the private offering exemption from being turned into a mechanism to evade the registration requirement for securities that would ultimately end up in the hands of the general public.

When companies can gain liquidity by trading privately issued securities in secondary markets, instead of by going public, investors lose all the benefits that are the hallmarks of our federal securities laws, including transparency, accountability, and a level playing field. In particular, increased secondary trading of privately issued securities threatens to deprive investors of the information needed to make informed investment decisions, create information asymmetries between purchasers and sellers as well as between retail investors and more sophisticated institutional investors, heighten the risk of undetected insider trading, and lead to pricing inefficiencies, all of which undermines market integrity and efficiency. It also further reduces the incentives companies have to go public, accelerating the decline in our public markets.

Since this proposal is being put forward as a means to facilitate capital formation, it bears mentioning at the outset that secondary trading does not provide new capital to companies directly. Any effects on capital formation from expanding secondary trading are likely to be indirect, insofar as the ability to exit their investments when they desire may make the securities more appealing to investors. Thus, the argument goes, expanding the liquidity of privately issued securities would decrease the premium that investors would otherwise demand for investing in these illiquid securities, thereby lowering the company's cost of capital.⁴⁰⁰ As discussed above, history has shown that past actions to ease secondary trading of private securities have indeed increased both issuers' ability to remain private for longer -- since they no longer need to go

⁴⁰⁰ See Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 *Hastings Law Journal* 445-502 (2017), <http://bit.ly/2mRoPmP> ("Greater liquidity at the back end ensures private companies cheaper capital at the front end."); Elizabeth Pollman *Information Issues on Wall Street 2.0*, 161 U. Pa. L. Rev. 179 (2012), <http://bit.ly/2mZKzxa> ("Increased liquidity for stockholders may in turn create ex ante benefits for start-up companies. With more exit opportunities, investors may be less inclined to price an 'illiquidity premium' into their potential investments. This may lead to more start-ups receiving funding than might otherwise occur without the secondary markets.").

public to enable founders, early investors, and employees to liquidate their holdings -- and investors' willingness to hold those securities. In fact, it is this very phenomenon that makes the current proposal so dangerous to the health of our public markets. Moreover, as discussed above, easing trading of private securities may promote capital raising -- and the churn and burn of small company job creation and destruction -- without promoting true, lasting capital formation. At the very least, the Commission has an obligation to study these issues before moving forward with proposals to further expand secondary market trading of privately issued securities.

Over the last several decades, Congress and the SEC have taken a series of steps to loosen restrictions on the resale of private securities, with the result that the secondary market for private securities transactions has expanded dramatically, both with regard to the types of securities being traded and the types of investors trading privately issued securities.⁴⁰¹ Until relatively recently, for example, resales were primarily limited to debt securities that were the result of privately negotiated deals between highly sophisticated counterparties who, at least in theory, had undertaken extensive due diligence and protected themselves through contractual representations and warranties.⁴⁰² Over the last decade or so, however, the use of online trading platforms for privately issued company stock has skyrocketed. For example, prominent online platforms, such as SharesPost, NASDAQ Private Market (formerly SecondMarket), and EquityZen, have expanded trading for a wide variety of private securities, including privately issued stock from companies that are not subject to the '34 Act reporting requirements.⁴⁰³

These platforms enable a variety of market participants to trade in privately issued stock of non-reporting companies. And evidence suggests that a wide variety of market participants currently avail themselves of this opportunity, including private company employees seeking to liquidate their shares, early-stage VCs, late stage VCs, hedge funds, private equity funds, other institutional investors, and individual investors who are accredited by virtue of meeting the applicable financial thresholds.⁴⁰⁴ In the absence of public market regulatory protections, playing in this arena poses special risks for retail investors, who are likely to operate at an extreme information disadvantage. For example, an early-stage VC investor with extensive inside knowledge about a company that is seeking an exit, or a company employee wishing to offload her company stock, can sell their stakes to unsophisticated accredited investors who have no connection to the company and no real opportunity to access critical information about the company.

Trading on these sites has exploded in recent years. For example, SharesPost reported an estimated \$2 billion in direct share trades from 2009 to 2014; SecondMarket reported \$1.5

⁴⁰¹ See discussion above regarding changes to the holding periods for 144 securities.

⁴⁰² Kellye Y. Testy, *The Capital Markets in Transition: A Response to New SEC Rule 144A*, 66 Indiana Law Journal 233 (1990), <https://bit.ly/2KE2ItK> (describing how private placements once occupied only a debt market where terms were individually negotiated. However the percentage of equity has grown considerably).

⁴⁰³ See Robert B. Thompson and Donald C. Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital-Raising*, 98 Cornell L. Rev. 1573 (2013), <https://bit.ly/2ljUq3>; Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 *Hastings Law Journal* 445-502 (2017), <http://bit.ly/2mRoPmP>.

⁴⁰⁴ Elisabeth Pollman *Information Issues on Wall Street 2.0*, 161 U. Pa. L. Rev. 179 (2012), <http://bit.ly/2mZKzxa> (stating that buyers in these markets typically include individuals, existing investors, late-stage VCs, hedge funds, private equity firms, and institutional investors.).

billion in 2013 alone.⁴⁰⁵ And, according to its 2019 Mid-Year Private Company Report, Nasdaq Private Market facilitated 35 private company-sponsored secondary transactions – a new record high for the period – with a total transaction value of \$2.3 billion.⁴⁰⁶ These transactions provided liquidity to approximately 4,500 sellers, comprising founders, management, employees, and investors, according to the report. Since its inception in 2013, Nasdaq Private Market has facilitated 287 programs for private companies, including 73 unicorns, accounting for \$22 billion in transaction value for 33,185 shareholders, according to the report. Meanwhile, EquityZen reports having closed over 9,000 deals, covering more than 150 companies with an estimated \$445 billion in total market cap.⁴⁰⁷

Indeed, according to three California State University professors writing in *The Journal of Entrepreneurial Finance*, “Today’s private secondary marketplace looks little like the obscure institutional market of two decades ago.”⁴⁰⁸ Moreover, as de Fontenay explained in her paper on the Deregulation of Private Capital, “The development of a full-fledged secondary market for private company stock is significant, given that the decline of IPOs has left private company investors such as founders, venture capital and private equity funds, and employees with only mergers and acquisitions as a ready means of exit ... While these fledgling secondary markets do not (and are unlikely to) offer anything like the liquidity afforded by the public markets, they reflect just how fundamentally the ‘private’ side of the securities-law divide has changed.”⁴⁰⁹ Before further expanding a trading market that puts retail investors at a distinct disadvantage, the Commission should first examine the effect such a change would have on both the health of our public markets and the well-being of investors.

1. Expanding Secondary Market Trading of Privately Issued Securities Harms the Vitality of Public Markets and Investors.

In determining whether to move forward with a proposal to expand secondary trading of privately issued securities, the Commission must not focus only on potential benefits that accrue to certain companies and certain investors. Rather, it must also seriously consider the much greater costs that will be imposed, both in terms of undermining public markets and in terms of exposing a large swath of investors to real harm. Specifically, expanding secondary trading and liquidity in privately issued securities would provide easier exit opportunities for private companies’ early-stage investors, replacing the liquidity these companies’ investors historically secured by going public. The Commission may consider this alternative source of liquidity a benefit, given the fact that start-ups typically have longer life-cycles today than they did in the recent past. The Commission may also view the potentially lower cost of capital that private companies pay when there is increased liquidity in their securities as a benefit. However, increased liquidity does not automatically produce increased price efficiency. In fact, given the

⁴⁰⁵ Robert Loveland, Eric Fricke, and Sinan Goktan, *Do Private Firms Benefit from Trading in the Private Securities Markets*, 19 *The Journal of Entrepreneurial Finance* 2 (2017), <http://bit.ly/2m2R4iu>.

⁴⁰⁶ Press Release, Nasdaq, “Nasdaq Private Markets Sets New Transaction Record in the First Half of 2019,” (July 23, 2019), <http://bit.ly/2mSXkjh>.

⁴⁰⁷ EquityZen, <http://bit.ly/2mXnhI3> (last visited September 26, 2019).

⁴⁰⁸ Robert Loveland, Eric Fricke, and Sinan Goktan, *Do Private Firms Benefit from Trading in the Private Securities Markets*, 19 *The Journal of Entrepreneurial Finance* 2 (2017) <http://bit.ly/2m2R4iu>.

⁴⁰⁹ Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 *Hastings Law Journal* 445-502 (2017), <http://bit.ly/2mRoPmP>.

absence of transparency that characterizes private markets, promoting increased secondary trading of privately issued securities increases the likelihood that pricing and valuation will be inefficient.

At the most basic level, creating parallel private markets that rival public markets undermines the purpose and policies underlying our securities laws. Loyola Law School of Los Angeles Professor Elizabeth Pollman has raised these policy concerns in her paper, *Do Private Firms Benefit from Trading in the Private Securities Market?* In it she states, “[T]here may be considerable downsides to robust private secondary markets that parallel public markets. Federal securities laws mandate registration, designed to protect investors and ensure confidence in the integrity of our capital markets. Expanding exemptions and loosening strictures on sales of restricted stock increases the scope of securities issued and traded without the safeguard of registration.”⁴¹⁰ In short, if the Commission were to further expand secondary market trading of privately issued securities, it would effectively be pushing an entire market into the dark, as it existed before 1933.

A primary consequence of expanding secondary trading of private securities is that, by providing an alternative liquidity source to going public, it further weakens the incentives companies have to go public. This appears to be a contributing factor to the growing number and size of so-called unicorns, enormous private companies that might have gone public earlier if their early-stage investors didn’t have the opportunity to exit via secondary trading of private securities. Some scholars have referred to the longer lifecycle for private start-up companies and the longer exit horizon for their early-stage investors as a “liquidity gap,” arguing that this liquidity gap has the potential to discourage investors from contributing capital if they can’t foresee a viable exit.⁴¹¹ According to these scholars, increasing secondary market liquidity for securities of private companies bridges the liquidity gap.⁴¹² However, a better alternative would be to restore incentives for companies to go public and eliminate the liquidity gap through that means.

Pollman sums it up this way: “[F]ostering the growth of private markets implicates an underlying tension with public markets and the policy rationales that undergird the divide between public and private companies. The new secondary markets have the potential to play an important role in the private company ecosystem, but their growth might also pose a threat to public markets or to the values that we aim to further by maintaining and regulating them.... a robust secondary market might lead companies to choose to stay private longer or to avoid the public realm altogether. The need for liquidity has been a key reason for companies to go public; if secondary markets can increase the liquidity of private company stock, that incentive loses

⁴¹⁰ Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. Pa. L. Rev. 179 (2012), <http://bit.ly/2mZKzxa>.

⁴¹¹ *Id.* (citing Jose Miguel Mendoza & Erik P.M. Vermeulen, *The “New” Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity* 14-15 (Lex Research Topics in Corp. Law & Econ., Working Paper No. 1, 2011); Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 9-10 (2012)).

⁴¹² *Id.* Relatedly, the JOBS Act provision that raised the maximum number of shareholders of record of a private company to become subject to the registration and reporting requirements under the ‘34 Act expanded the pool of potential investors in an individual private company and contributed to the increase in trading volumes on private secondary markets. Still, companies are very careful not to compromise their capital structure by expanding and diversifying the shareholder base too unduly and, as a result, still seek to maintain some control over the makeup of their shareholder base. However, maintaining this control does impose some costs on companies.

much of its force. Indeed, the secondary markets explicitly aim to help companies stay private.”⁴¹³

Those with a stake in private secondary markets admit as much. NASDAQ OMX Group’s Executive Vice President acknowledged in Congressional testimony that NASDAQ created Nasdaq Private Market based on “several provisions in the JOBS Act [that] allow companies to remain private longer.”⁴¹⁴ With many companies doing just that, he said, there is a “growing demand for liquidity in these companies’ shares, especially by their early investors and employees.”⁴¹⁵ Similarly, the CEO of SharesPost stated that, “Two of the biggest reasons to go public are to get liquidity for your existing shareholders and to gain efficient access to growth capital. We’ve stepped back and said, ‘Can we provide those two solutions for these companies?’ And if so, give the companies the opportunity to go public over their time frame as opposed to ‘I’ve got a gun to my head.’ Now the companies have much more control over the process and timing of if and when they do a public listing.”⁴¹⁶ The CEO of SecondMarket stated, “I think there’s an opportunity here to create an entirely new exchange, an entirely new marketplace that’s good for companies . . . I think over time what you’re going to see is more and more companies choosing to stay private and choosing to be a part of the new market structure that we’ve created.”⁴¹⁷ But what’s good for companies’ founders is not necessarily the same thing as what’s good for investors. Moreover, it is not the SEC’s mission to promote the interests of issuers over the interests of investors.

When investors buy and sell registered securities in secondary markets, they are afforded certain protections designed to ensure that they have equal access to high quality information about the issuer, that the prices at which they transact, by and large, reasonably reflect the value of the securities in which they are transacting, and that they will be protected against fraudulent activities, such as insider trading. These protections not only enhance transparency, they also foster market integrity and efficiency. Yet, in private secondary markets, investors are not guaranteed these protections in any meaningful way. Rather, increased trading in private secondary markets would deprive investors of the information necessary to make informed investment decisions, create information asymmetries between purchasers and sellers as well as between retail and institutional investors, heighten the risk of undetected insider trading, and lead to pricing inefficiencies, all of which undermine market integrity and efficiency.⁴¹⁸

Problems for investors in secondary markets start with the lack of complete and reliable information. According to Pollman, for example, “[C]oncern has been rising about the lack of

⁴¹³ Elizabeth Pollman *Information Issues on Wall Street 2.0*, 161 U. Pa. L. Rev. 179 (2012), <http://bit.ly/2mZKzxa>.

⁴¹⁴ Statement of Nelson Griggs, Executive Vice President, Listing Services, NASDAQ OMX Group, Hearing Before the Subcommittee on Securities, Insurance, and Investment of the Committee on Banking, Housing, and Urban Affairs, United States Senate, One Hundred Fourteenth Congress, First Session, On “Examining How Venture Exchanges Can Aid Capital Formation and Secondary Trading For Smaller Businesses and Companies, March 10, 2015, <http://bit.ly/2m3R9Cn>.

⁴¹⁵ *Id.*

⁴¹⁶ Elizabeth Pollman *Information Issues on Wall Street 2.0*, 161 U. Pa. L. Rev. 179 (2012), <http://bit.ly/2mZKzxa> (citing Jay Yarow, *Are We Headed for Disaster with Private Stock Markets? We Talk to SharesPost CEO David Weir*, BUS. INSIDER (Mar. 22, 2011)).

⁴¹⁷ *Id.* (citing *A New Vision for Capital Markets*, Stanford Tech. Ventures Program Entrepreneurship Corner (Apr. 13, 2011)).

⁴¹⁸ *Id.*

information and the information asymmetry between buyers and sellers in the secondary markets. This apprehension relates to both the quality and amount of information being disclosed. Underlying these concerns is the larger worry that without an adequate amount of accurate information, private company stock cannot be properly valued.”⁴¹⁹

First, retail investors in private secondary markets are likely to suffer from a lack of information about the issuer. Private companies often go to great lengths to avoid disclosing information about themselves, and the securities offering exemptions, such as Reg D, allow them to keep important information under wraps. They do so for a variety of reasons, both legitimate and problematic, including to avoid tipping their hand to competitors who might take advantage of that information, to avoid attracting increased scrutiny from regulators regarding their activities, or to avoid raising attention from existing or potential investors or employees regarding issues that are potentially problematic for the company.⁴²⁰ For these reasons, companies not only take advantage of the flexibility under private offering exemptions to limit their disclosures, some go so far as to ignore the requirement to file a Form D with the Commission, as discussed above. In light of the Commission’s lax approach to enforcement, the “benefits” of non-disclosure may outweigh the “risks” of noncompliance for these companies.

Another possibility is that, when trading in secondary markets, the seller may not possess all material information about the company. Or, a seller may possess the relevant information, but may have signed a confidentiality agreement with the company and therefore may be prohibited from disclosing material information. Therefore, according to Pollman, “unless the company or seller voluntarily discloses information or it is otherwise available—such as in a third-party analyst report or publicly available information—the buyer may possess little information when deciding whether to purchase stock at the offered price.”⁴²¹ As a result, “The buyer faces the risk that the stock will be valued at a lower price when the company eventually discloses information.”⁴²²

Moreover, as Pollman explains, “The amount and quality of publicly available information about private companies varies widely. Some companies are relatively early-stage or have not attracted much attention, and consequently very little information about them is available. By contrast, a fairly substantial amount of information may be available about mature, private companies in the public eye.”⁴²³ Therefore, to the extent an investor seeks to purchase shares in a company with which she has no relationship and which has not attracted much attention, that investor is at increased risk of buying without the information necessary to make an informed decision and doing so at a grossly inflated price that has no relationship to the company’s actual value. Even for companies that do attract considerable attention, there is no guarantee that the information, or the valuation based on available information, will be accurate or reliable, as WeWork and Uber have recently so vividly illustrated.

⁴¹⁹ *Id.*

⁴²⁰ See Elizabeth Pollman *Information Issues on Wall Street 2.0*, 161 U. Pa. L. Rev. 179 (2012), <http://bit.ly/2mZKzxa>. See also Renee M. Jones, *The Unicorn Governance Trap*, 66 U. Pa. L. Rev. Online 165 (2017), <http://bit.ly/2msD01w>.

⁴²¹ Elizabeth Pollman *Information Issues on Wall Street 2.0*, 161 U. Pa. L. Rev. 179 (2012), <http://bit.ly/2mZKzxa>.

⁴²² *Id.*

⁴²³ *Id.*

The information that's critical to properly valuing private company stock and therefore making an informed investment decision may not be publicly available, online or otherwise.⁴²⁴ Such information includes, for example, the company's recent capitalization table, corporate documents (charter, bylaws, and investment agreements), historical and projected financials, and recent board presentations and/or minutes.⁴²⁵ In addition, information from third-parties can vary significantly in quality and amount.⁴²⁶ For one reason, third parties themselves may not have ready access to high-quality, reliable and trustworthy information about an issuer. As Pollman explains, "Without comprehensive information from the company itself, third-party researchers likely have trouble providing robust valuation estimates."⁴²⁷ If, as a result, investors end up relying on third-party information that is not high-quality, reliable information, that creates further inefficiencies in the market, potentially causing investors to transact in securities at prices that bear no relationship to actual value. As Pullman puts it, "Market participants who buy and sell stock without knowledge of underlying fundamentals may propagate stock mispricing."⁴²⁸

The experience of a former technology executive illustrates this problem. Having learned about SharesPost and SecondMarket through a Google search, he decided to purchase Tesla when it was private, "going by gut."⁴²⁹ He reasoned, "I like the product. I think the company's doing well. The news that I read on TechCrunch or AllThingsD[igital] or any one of these technology blogs, it all looks good."⁴³⁰ However, when Tesla went public and this investor learned that the company had been losing money, he regretted his decision. "If I had actually known what the financials looked like, I would not have invested in Tesla," he stated.⁴³¹ Indeed, with experiences such as this on the rise, private secondary markets are getting the reputation among participants for facilitating transactions based on "public perception rather than investing fundamentals."⁴³²

Even those whom most would view as perfectly capable of "fending for themselves" may experience difficulties in accessing critical information to make an informed investment decision. For example, a managing director of an investment firm stated that, even with the information that platforms such as SecondMarket provide, "there's still not enough information available to help [investors] make prudent decisions."⁴³³ "It's hard enough to get information on Facebook [then private but very well-known]," he stated. "I'm an accredited [investor], I have an M.B.A. in finance, how do I know what these things should be valued at?"⁴³⁴

⁴²⁴ *Id.*

⁴²⁵ *Id.*

⁴²⁶ *Id.*

⁴²⁷ *Id.*

⁴²⁸ *Id.*

⁴²⁹ *Id.* (citing Ilya Marritz, *Hunting for Hot Stocks, Some Investors Head to Private Markets*, WNYC NEWS (Apr. 30, 2012)).

⁴³⁰ *Id.*

⁴³¹ *Id.*

⁴³² *Id.* (citing Ken Sawyer et al., *Saints Capital, A Guide to Secondary Transactions: Alternative Paths to Liquidity in Private Companies* (2010)).

⁴³³ *Id.* (citing Evelyn M. Rusli, *Beyond Facebook, SecondMarket Opens Its Doors to Thousands*, NYTimes DealBook, (March 10, 2011)).

⁴³⁴ *Id.*

His concern appears to be well justified, with many valuation experts reportedly questioning the prices that private securities trade at on electronic platforms. According to one such valuation expert, with almost a decade of experience as a VC and PE investor, “I believe that the majority of transactions taking place in today’s secondary markets are not reflective of Fair Value . . . I would say that a majority—if not an absolute union—of my peers [who attended a Fair Value Forum meeting] are in agreement with me on that.”⁴³⁵ The bottom line, according to Pollman, “is that market participants may have little to no information of the type typically considered necessary for accurate pricing. Varying amounts of other information may be available, but it may be inaccurate and misleading. Further, it would seem that investors cannot rely on efficiencies of the market for protection because stocks in these markets can be thinly traded and trades are not immediate.”⁴³⁶

In addition to the problems associated with insufficient or unreliable information, retail investors in private secondary markets are likely to suffer as a result of information asymmetries between them and other market participants.⁴³⁷ Specifically, unsophisticated investors who have no connection to the company whose stock they’re seeking to buy, and no real opportunity to access critical information about that company, may buy that company’s stock from highly sophisticated investors, such as VC investors or company employees, who have an extensive and intimate knowledge (inside information) about the company’s finances, operations, and future prospects. Because these employees and VC investors may actively participate in the development and governance of the company, they are likely to know better than anyone when it is best to cash out. Moreover, since they are under no obligation to do so, it is highly unlikely that they would provide the information that they have about the company to the investor to whom they are selling. Furthermore, according to Pollman, the information asymmetry may not be detectable to the retail investor participating in the transaction. That’s because, in contrast to the past, when private secondary markets were characterized by individually negotiated transactions where both sides of the transaction knew who they were dealing with and could gauge the other’s knowledge and motives, in today’s private secondary markets, the buyer may not know the identity of the seller until after signing the purchase agreement.

Electronic platforms may also have conflicts of interest, including an information advantage, that could lead them to place their own interests ahead of certain investors’ interests, and these conflicts may not always be fully transparent.⁴³⁸ According to SharePost’s website, for example, SharesPost is able to access key information from issuers and is an investor in many issuers on its site, but it does not provide that information to all investors using its site. It states, “Because of our strong working relationship with many issuers and the fact that we are also a shareholder in many cases, we typically have access to more information than other private market participants.”⁴³⁹ Elsewhere, SharePost discloses that, “any financial information provided

⁴³⁵ *Id.* (citing Bo Brustkern, *Response to Are Secondary Markets Helping to Overvalue Private Companies?*, QUORA (Dec. 18, 2010)). While Brustkern expresses faith that secondary markets can overcome these problems of opacity and inefficient pricing, the SEC cannot reasonably base its policies on the hope that conditions in secondary markets will one day improve. The more logical solution, as with so much else in this Concept Release, is to restore incentives for companies to enter the public markets, where these problems have already been effectively addressed.

⁴³⁶ *Id.*

⁴³⁷ *Id.*

⁴³⁸ *Id.*

⁴³⁹ SharesPost, Frequently Asked Questions, <http://bit.ly/2lqXg3B> (last visited September 26, 2019).

to us by an issuer is shared only with the consent of the issuer and on a need-to-know basis.”⁴⁴⁰ This is precisely the sort of information asymmetry that is prohibited in the public markets under Reg FD.

Even more troubling, given the fact that a significant amount of material information about private companies is nonpublic and that there are investors in the market who can trade private securities based on that inside information, there is increased risk in private secondary markets that insider trading will go undetected, according to Pollman. While Exchange Act liability, including insider trading laws, theoretically applies in private markets, the reality is that the key insider trading cases developed in the context of trading publicly traded securities. Given the inherent structure of private markets, moreover, “the concept of insider trading is a somewhat problematic fit in the context of secondary transactions in private company shares,” according to Pollman. Pollman cites two key reasons for this “problematic fit”: first, there are likely to be considerable amounts of material information about the private company that are non-public but that insiders have access to; and, second, existing shareholders, particularly current employees, may be subject to company confidentiality agreements that prohibit them from divulging material non-public information. As a result, “insider trading may be prevalent or difficult to avoid in secondary markets.”⁴⁴¹

In reality, insider trading is difficult to police in public markets. Former SEC Enforcement Director Linda Chatman Thomsen acknowledged how difficult it is to build an insider trading case. As she explained in Congressional testimony, “They are unquestionably among the most difficult cases we are called upon to prove, and despite careful and time-consuming investigations, we may not be able to establish all of the facts necessary to support an insider trading charge.”⁴⁴² Given how challenging these cases are to bring for publicly traded companies, even where the Commission dedicates considerable resources, it is highly unlikely that the Commission would be able to reliably detect, much less prove, insider trading cases involving privately traded securities. And given the lack of price transparency and valuations in private markets, even if the Commission had evidence of insider trading, it would be extremely difficult to figure out the damages that resulted.

Only when a company conducts an IPO do many of these problems associated with private markets, including unreliable valuations, become apparent. At that point, the harms that result can spread into and adversely affect investors in public markets. We saw how this can occur when Facebook went public. According to its registration statement, Facebook used several factors to value its common stock and set an IPO price, including the Market Transaction Method (MTM), which considers recent transactions in the equity securities of the business. Because Facebook was private, the method was based on “recent private stock sale transactions.”⁴⁴³ For three of the four quarters in 2011, Facebook “gave the greatest weight to

⁴⁴⁰ *Id.*

⁴⁴¹ Elizabeth Pollman *Information Issues on Wall Street 2.0*, 161 U. Pa. L. Rev. 179 (2012), <http://bit.ly/2mZKzxa>.

⁴⁴² Testimony of SEC Director of the Division of Enforcement Linda Chatman Thomsen, Before the U.S. Senate Committee on the Judiciary, Concerning Insider Trading, September 25, 2006 (as amended October 5, 2006), <http://bit.ly/2mXYkfa>.

⁴⁴³ Pollman (citing Facebook, Inc., Registration Statement (Form S-1), at 63 (Feb. 1, 2012). “The secondary markets may be encouraging reliance on their pricing data. SharesPost has made “real-time” pricing data for US-based private companies available on Bloomberg terminals.”)

the MTM due to the significant volume of third-party private stock sale transactions.” Facebook later amended its registration statement, increasing its valuation from the prior period, stating that this decision was “influenced in large part by third-party private stock sale activity that occurred in January 2012.”⁴⁴⁴ Thus, private secondary market trading of Facebook effectively drove Facebook’s IPO price.

When Facebook went public, retail investors constituted a significant percentage of purchasers of Facebook, and institutions that had invested early constituted a significant percentage of sellers of the stock.⁴⁴⁵ But upon IPO, it became clear that the company had been overvalued considerably. Thus, retail investors who bought in the IPO overpaid and lost money, while those who sold in the IPO, gained money.

More recently, concerns about WeWork’s valuation are being expressed in anticipation of its looming IPO, and indeed have placed that IPO in jeopardy. According to press reports, WeWork’s parent company is “exploring a dramatic reduction in its valuation as it aims to go public while facing widespread skepticism over its business model and corporate governance, according to people familiar with the company’s listing plans and its recent talks with major investors.”⁴⁴⁶ Initial reports were that WeWork might be valued somewhere in the \$20 billion range, which would be less than half of the \$47 billion valuation it received earlier this year. More recently, however, the company has reportedly been valued as low as \$10 billion, and the CEO has been forced to step down.⁴⁴⁷ Investors, many of whom are likely to include unsophisticated retail investors who purchased WeWork through a private transaction based on that fanciful \$47 billion valuation, are likely to lose considerable amounts of money when WeWork goes public and the company’s valuation meets reality.⁴⁴⁸

In addition to this anecdotal evidence, recent research also suggests that more liquid private secondary markets are not bringing anywhere near the type of pricing efficiency that exists in public markets. If secondary markets were working as claimed to increase pricing efficiency, one would expect that secondary market trading would lessen IPO underpricing and decrease post-IPO return volatility. However, one recent paper found no evidence that a pre-IPO listing on SharesPost lessens IPO underpricing.⁴⁴⁹ On the contrary, this paper found that post-IPO return volatility of SharesPost-listed firms is greater than that of non-SharesPost-listed firms.

⁴⁴⁴ *Id.*

⁴⁴⁵ Pollman (citing Jean Eaglesham & Telis Demos, *Lawmakers Push for Overhaul of IPO Process*, Wall Street Journal, June 21, 2012, (“Morgan Stanley [] allocated to retail investors 26% of shares, much higher than the 15% allocation in a typical IPO.”); Gretchen Morgenson, *Facebook Gold Rush: Fanfare vs. Realities*, N.Y. TIMES, May 20, 2012 (“Indications are that Facebook was bought primarily by individual investors, not institutions. Indeed, institutions that had invested early were big sellers in the I.P.O.”)).

⁴⁴⁶ Maureen Farrell and Eliot Brown, *WeWork Weighs Slashing Valuation by More Than Half Amid IPO Skepticism*, Wall Street Journal, September 5, 2019, <https://on.wsj.com/2nAVT37>.

⁴⁴⁷ Joshua Franklin and Anirban Sen, *WeWork is now considering an IPO valuation as low as \$10 billion, down from \$47 billion*, Reuters, September 13, 2019, <https://bit.ly/2ISmsjq>; David Gelles, Michael J. de la Merced, Peter Eavis and Andrew Ross Sorkin, *WeWork C.E.O. Adam Neumann Steps Down Under Pressure*, NYTimes DealBook, September 24, 2019, <https://nyti.ms/2mVJ4ju>.

⁴⁴⁸ See SharesPost, WeWork, <http://bit.ly/2n1m7Ly> (last visited September 26, 2019).

⁴⁴⁹ Robert Loveland, Eric Fricke, and Sinan Goktan, *Do Private Firms Benefit from Trading in the Private Securities Markets*, 19 The Journal of Entrepreneurial Finance 2 (2017) <http://bit.ly/2m2R4iu>.

In sum, expanding trading of private securities raises a whole host of problems for markets and investors. As Columbia Law School Professor John Coffee stated succinctly, “The market is less efficient with less transparency, and in the long run you are going to move to darkness, and bad things happen in darkness.”⁴⁵⁰ In light of these concerns, the Commission should not take steps, as contemplated in the Concept Release, to further ease restrictions on secondary market trading of privately issued securities. Instead, it should examine what additional protections are needed to reduce problems currently associated with secondary market trading.

E. The Commission Should Not Permit Exempt Securities to Trade on Venture Exchanges.

Another idea explored in the Concept Release is whether to allow secondary trading of exempt securities, such as Reg A securities, on so-called venture exchanges. It is all too typical of the Concept Release that the Commission asks what the effect might be on companies issuing securities through exempt offerings, but not what the effect on investors, particularly retail investors, might be.⁴⁵¹ In fact, venture exchanges present a host of issues for investors and market integrity. First, they would allow high-risk securities from unproven companies that are exempt from robust disclosure requirements to be freely resold to the public without having to meet listing requirements designed to ensure that the issuers meet basic standards appropriate for sales to the general public. In addition, venture exchanges are likely to suffer from adverse selection, where high-quality companies “graduate” to national exchanges and the lower-quality companies languish on the venture exchange. Given how small these companies are likely to be, they will not attract investment by large institutional investors, who help promote price efficiency. Rather, they are likely to be used almost exclusively by retail investors, who are all too likely to end up buying and selling at prices that don’t reflect the companies’ underlying values and suffering underperformance as a result. In short, retail investors are likely to be the most harmed by venture exchanges.

As an initial matter, it’s important to recognize that venture exchanges aren’t a novel idea. Rather, past efforts to develop venture exchanges have “fared poorly.”⁴⁵² For example, the Amex Emerging Company Marketplace (ECM) was launched in 1992, but it was plagued by scandal and quickly took on a reputation for listing unsuccessful companies.⁴⁵³ It closed in 1995.

⁴⁵⁰ Pollman (citing Ronald D. Orol, *SEC Hints at Easing of Rules for Non-Public Trades*, MARKETWATCH (May 10, 2011)).

⁴⁵¹ Concept Release at 210-211.

⁴⁵² SEC Commissioner Luis A. Aguilar, *The Need for Greater Secondary Market Liquidity for Small Businesses*, March 4, 2015, <http://bit.ly/2n32ym1>.

⁴⁵³ See, e.g., Reena Aggarwal and James Angel, *The Rise and Fall of the Amex Emerging Company Marketplace* (Apr. 1998), <http://bit.ly/2lsdYzy> (noting the “many failed attempts to launch public equity markets for small stocks in the United States and Europe” including ECM). See also Former SEC Chairman Arthur Levitt, *A Small-Cap Idea With Little to Recommend It: The SEC’s plan to create special exchanges sounds like a solution in search of a problem*, Wall Street Journal, March 2, 2015, <https://on.wsj.com/2ITSXhx> (“[ECM] suffered some notable scandals—an ECM-listed maker of flame retardants was a convicted arsonist, for example. The companies that proved themselves on ECM simply graduated to the regular exchange, thereby tainting ECM as a minor league market, mostly for unsuccessful enterprises.”).

Similarly, the SEC approved the Nasdaq OMX BX Venture Market in 2011; that venue never launched.⁴⁵⁴ Efforts in other countries to create venture markets have had similarly negative experiences, earning a reputation for allowing any company to list on the exchange, regardless of whether they meet minimum standards designed to ensure the companies are engaged in a legitimate business.⁴⁵⁵ The problems that venture exchanges have experienced in the past are the likely result of creating a largely retail market without meaningful protections. There is no reason to believe that the current effort would be exempt from such problems. Certainly, the Commission has presented no evidence to support that conclusion.

1. Lack of Robust Listing Standards Will Harm Investors and Market Integrity.

National exchanges for public securities impose quantitative and qualitative standards intended to ensure that only legitimate companies are listed and traded.⁴⁵⁶ These minimum quality safeguards protect investors and promote confidence in the integrity of markets. According to former SEC Chairman Arthur Levitt, for example, “Public markets enforce a level of rigor on management and increase investor expectations. The higher standards are appropriate, given the stakes: Public investors expect to evaluate companies that have been tested and gone through the process.”⁴⁵⁷ He added, “If companies are locked out of public markets because they can’t meet certain listing requirements, that may be a good thing. Perhaps they should wait, gain some seasoning and experience, and prepare for filing when they’re ready.”⁴⁵⁸

⁴⁵⁴ The Commission approved The BX Venture Market on May 6, 2011, but that market has yet to launch. See Self-Regulatory Organizations; NASDAQ OMX BX, Inc.; Order Granting Approval of Proposed Rule Change and Amendment No. 1 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 Thereto To Create a Listing Market on the Exchange, SEC Release No. 64437 (May 6, 2011), <http://bit.ly/2mTPGPf>.

⁴⁵⁵ See, e.g., Reena Aggarwal and James Angel, *The Rise and Fall of the Amex Emerging Company Marketplace* (Apr. 1998). See also Former SEC Chairman Arthur Levitt, *A Small-Cap Idea With Little to Recommend It: The SEC’s plan to create special exchanges sounds like a solution in search of a problem*, Wall Street Journal, March 2, 2015, <https://on.wsj.com/2ITSXhx> (“Small-cap, low-standards market efforts in Canada and the U.K. have had mixed-to-poor success. The U.K.’s Alternative Investment Market only recently began to recover losses from the 2007-08 financial crisis.”). See also SEC Commissioner Luis A. Aguilar, *The Need for Greater Secondary Market Liquidity for Small Businesses*, March 4, 2015, footnote 18, <http://bit.ly/2n32ym1> (citing to one article noting that “Canada’s junior stock market is in crisis” and that “liquidity on most [TSX] stocks is very poor, which makes it difficult for them to be bid anywhere but down.” Also citing to another article noting that Canada’s TSX has suffered “an unprecedented historical annihilation in shareholder value that has not been seen in this form on any other stock exchange in the world, followed by the worst fund raising crisis in history. The lack of funding has reached such a critical stage that the TSX-V in its current constitution appears to be in danger of becoming a memory in Canadian history books in the not so distant future.”).

⁴⁵⁶ See NYSE Listing Company Manual, 101.00, Introduction, <http://bit.ly/2ITqxnQ> (last visited September 26, 2019) (“A listing on the New York Stock Exchange is internationally recognized as signifying that a publicly owned corporation has achieved maturity and front-rank status in its industry---in terms of assets, earnings, and shareholder interest and acceptance. Indeed, the Exchange’s listing standards are designed to assure that every domestic or non-U.S. company whose shares are admitted to trading in the Exchange’s market merit that recognition.”). See also Nasdaq, Initial Listing Guide, August 2019, <http://bit.ly/2lokWPx> (“Companies listed on The Nasdaq Stock Market are required to meet high standards of corporate governance...”).

⁴⁵⁷ Former SEC Chairman Arthur Levitt, *A Small-Cap Idea With Little to Recommend It: The SEC’s plan to create special exchanges sounds like a solution in search of a problem*, Wall Street Journal, March 2, 2015, <https://on.wsj.com/2ITSXhx>.

⁴⁵⁸ *Id.*

By definition, venture exchanges would apply more lenient listing standards than those that apply to public companies that trade on the national securities exchanges. In fact, one of their selling points, in the eyes of issuers at least, is that securities that get delisted from national securities exchanges could list on a venture exchange. This is likely to result in lower quality securities being traded on venture exchanges, even before you take into consideration the added risks posed by trading of exempt securities (as discussed above).

The lack of robust vetting would be particularly troubling given that many of the companies that would be listed on venture exchanges would likely be very small, unestablished companies. Newer, unproven companies are more likely to fail or experience other problems in the market.⁴⁵⁹ For example, they may not have viable or legitimate business plan or may not be generating revenue, and in the case of exempt securities may not be required to provide the robust disclosures that would alert investors to those risks and allow a reliable valuation. In addition, small companies with limited available shares and low trading volume are more likely to be subject to manipulation (e.g., pump and dump schemes) as a result. In sum, without minimum standards, it is likely that venture exchanges will be saturated with lemons, and that “investors will be misled or invest in a firm with dubious prospects.”⁴⁶⁰

That harm could have spill-over effects, undermining investor confidence in the markets more generally.⁴⁶¹ NYSE recognized this risk, stating in 2015 congressional testimony that, “[C]ompanies available for trading on venture exchanges will have a higher rate of failure and could potentially shed a dark cloud over the rest of the U.S. public markets.”⁴⁶² At the same hearing, a former director of the SEC’s Division of Trading and Markets, Stephen Luparello, stated, “I am probably the only one here old enough to remember the AMEX EMC, and its failure was in part because of the quality of the issuers that were brought forward.”⁴⁶³

These concerns take on added weight when you consider that one effect of the proposal would be to allow more secondary trading in Reg A securities. As discussed above, since the

⁴⁵⁹ See James D. Cox, *Who Can’t Raise Capital?, The Scylla and Charybdis of Capital Formation*, Economic Research Initiatives at Duke (ERID) Working Paper (May 2014), <http://bit.ly/2m2sa2r> (“Smaller issuers not only present greater risks but also have less financial slack to withstand economic shocks, frequently depend on a single product, and are largely local”). See also Jeff Schwartz, *Venture Exchange Regulation: Listing Standards, Market Microstructure, and Investor Protection*, Forthcoming in the Handbook on Law and Entrepreneurship, Gordon Smith, Christine Hurt & Brian Broughman eds., Cambridge Univ. Press 2018, University of Utah College of Law Research Paper No. 179, <http://bit.ly/2tYknm>.

⁴⁶⁰ Jeff Schwartz, *Venture Exchange Regulation: Listing Standards, Market Microstructure, and Investor Protection*, Forthcoming in the Handbook on Law and Entrepreneurship, Gordon Smith, Christine Hurt & Brian Broughman eds., Cambridge Univ. Press 2018, University of Utah College of Law Research Paper No. 179, <http://bit.ly/2tYknm>.

⁴⁶¹ *Id.* (“Rather than try to separate the wheat from the chaff, many investors might throw up their hands and choose not to participate in the market at all.”)

⁴⁶² Statement of Thomas W. Farley, President, New York Stock Exchange Group, Hearing Before the Subcommittee on Securities, Insurance, and Investment of the Committee on Banking, Housing, and Urban Affairs, United States Senate, One Hundred Fourteenth Congress, First Session, on “Examining How Venture Exchanges Can Aid Capital Formation and Secondary Trading for Smaller Businesses and Companies,” March 10, 2015, <http://bit.ly/2m3R9Cn>.

⁴⁶³ Hearing Before the Subcommittee on Securities, Insurance, and Investment of the Committee on Banking, Housing, and Urban Affairs, United States Senate, One Hundred Fourteenth Congress, First Session, on “Examining How Venture Exchanges Can Aid Capital Formation and Secondary Trading for Smaller Businesses and Companies,” March 10, 2015, at 13, <http://bit.ly/2m3R9Cn>.

JOBs Act dramatically increased the amount of money that companies can raise each year through a Reg A offering, the experience has been an unmitigated disaster for investors, and companies have been “tainted by poor post-IPO performance and concerns about fraud.”⁴⁶⁴ The market has attracted obvious scams⁴⁶⁵ as well as “less mature companies with less developed business plans than other companies seeking to list.”⁴⁶⁶ And, the handful of Reg A+ companies that listed on a U.S. exchange in 2017 were trading about 40% below their offer price during a period in which the S&P 500 had risen 18% and the average IPO listed on a major U.S. exchange had climbed 22%.⁴⁶⁷ A *Barron’s* article described the “woeful performance” of the few dozen companies that are currently exchange-listed as well as the difficulty of trading or getting a price quote for the vast majority of companies that aren’t exchange listed. The one apparent exception to this rule, Longfin, turned out to be a total fraud that was subsequently shut down by the Commission.⁴⁶⁸

The major exchanges have learned from this experience. Rather than weaken requirements further, they have gone in the opposite direction, tightening requirements in order to better ensure that only legitimate businesses list.⁴⁶⁹ Nasdaq has compellingly laid out the case for doing so, stating: “The Exchange has observed problems with certain Regulation A companies. Most significantly, the Exchange believes that companies seeking to list in conjunction with a Regulation A offering are generally less mature companies with less developed business plans than other companies seeking to list. In addition, the Exchange believes that the Regulation A offering process may not adequately prepare companies for the

⁴⁶⁴ Alexander Osipovich, *Exchanges Shy Away From Mini-IPOs After Fraud Concerns*, Wall Street Journal, June 10, 2019, <https://on.wsj.com/2lrPWET>. See also Matthew Smith, *Reg A+ has failed both investors and startups: one founder’s experience*, Medium, April 9, 2018, <http://bit.ly/2lQFUNP>.

⁴⁶⁵ Samuel Guzik, *How (Not) to Market Your Regulation A+ Mini-IPO Offering*, Crowdfund Insider, November 14, 2018, <http://bit.ly/2mVrJaq> (describing a Reg A offering that resembled a “Virtual Boiler Room,” and which included a celebrity endorsement from a “tech pioneer” who happened to be a convicted felon.); Renaissance Capital, *Reg A+ is the wild west of IPOs and here’s the latest example*, July 10, 2019, <http://bit.ly/2m4WyJr> (describing a Chinese company that announced plans to raise \$700 million, despite Reg A’s offering limit of \$50 million, the company listed its auditor’s office in New York, CA, it listed George Soros as a cofounder, secretary and director, and much of it appeared to be “plagiarized whole cloth” from Ares Management Corp’s 2014 IPO prospectus.); Corrie Driebusch and Juliet Chung, *IPO Shortcuts Put Burden on Investors to Identify Risk*, Wall Street Journal, February 6, 2018, <http://on.wsj.com/2p4n8kf>.

⁴⁶⁶ Self-Regulatory Organizations; The Nasdaq Stock Market LLC; Notice of Filing of Proposed Rule Change to Adopt Additional Requirements for Listings in Connection with an Offering Under Regulation A of the Securities Act, Release No. 34-85687; File No. SR-NASDAQ-2019-017, April 18, 2019, at 4, <http://bit.ly/2lqI46q>.

⁴⁶⁷ Corrie Driebusch and Juliet Chung, *IPO Shortcuts Put Burden on Investors to Identify Risk*, Wall Street Journal, February 6, 2018, <http://on.wsj.com/2p4n8kf> (stating that the handful of Reg A companies that listed on U.S. exchanges in 2017 were trading about 40% below their offer price. Meanwhile, the S&P 500 had risen 18% since the start of 2017 and the average traditional IPO listed on the major U.S. exchanges in 2017 had climbed roughly 22%). See also Bill Alpert, Brett Arends, and Ben Walsh, *Most Mini-IPOs Fail the Market Test*, BARRON’S, February 13, 2018, <http://bit.ly/2FwKPw5> (describing the “woeful performance” of the few dozen companies that are currently exchange-listed and the difficulty trading or getting a price quote for the vast majority of companies that aren’t exchange listed. The Barron’s article further described how “[M]ost Reg A+ businesses haven’t gotten beyond the startup phase known as the pipedream.”).

⁴⁶⁸ Press Release, SEC, “SEC Obtains Emergency Freeze of \$27 Million in Stock Sales of Purported Cryptocurrency Company Longfin,” April 6, 2018, <http://bit.ly/2lp0bts>; Jean Eaglesham and Aaron Back, *Longfin Collapse Puts Focus on Lax IPO Rules*, Wall Street Journal, April 3, 2018, <https://on.wsj.com/2lnkKGE>.

⁴⁶⁹ Alexander Osipovich, *Exchanges Shy Away From Mini-IPOs After Fraud Concerns*, Wall Street Journal, June 10, 2019, <https://on.wsj.com/2lrPWET>.

rigors of operating a public company and satisfying the SEC and Exchange’s reporting and corporate governance requirements. The Exchange also notes that the financial press, Congress (prior to the adoption of Regulation A) and others have raised concerns about the potential for fraud by companies conducting offerings under Regulation A.”⁴⁷⁰

In response to these concerns, Nasdaq adopted “heightened review procedures” for companies seeking to list under Reg A.⁴⁷¹ In addition, Nasdaq instituted a requirement that these companies have a minimum operating history of two years. According to Nasdaq, “additional requirements for listing such companies are appropriate to help ensure that adequate safeguards are in place to better protect investors.”⁴⁷² Nasdaq stated that it specifically believed that the two-year operating history requirement “will help assure that companies have more established business plans and a history of operations upon which investors can rely.”⁴⁷³ We understand that NYSE has also become so concerned with the poor quality of Reg A securities that it has stopped accepting them for listing.

In sum, allowing Reg A companies to be listed and traded on venture exchanges would increase the risk that relatively opaque companies, with short to no operating histories, and no viable business models “swamp venture exchanges and thereby jeopardize their success,”⁴⁷⁴ injuring investors and damaging faith in our markets in the process. Instead of looking to expand secondary market trading of such securities, the Commission should be doing more to analyze whether Reg A+ has delivered the capital formation benefits attributed to it or whether the risks to investors and market integrity have outweighed the benefits.

2. Adverse Selection on Venture Exchanges is also Likely to be a Huge Problem.

Venture exchanges are likely to suffer from adverse selection. Specifically, if history is any guide, high-quality companies will either seek to quickly “graduate” to national exchanges or bypass the venture exchange altogether, while lower-quality companies that can’t meet the minimum listing standards at the national exchanges list and languish on the venture exchange.⁴⁷⁵ This has happened in the past. In a 1998 article, for example, Reena Aggarwal and James Angel described the rise and fall of the Amex Emerging Company Marketplace: “The ECM also suffered from the same adverse selection problem that has affected other junior markets. The successful firms graduated to the main Amex as soon as they could, leaving the unsuccessful firms on the ECM.”⁴⁷⁶ There is no reason to believe new venture exchanges that

⁴⁷⁰ Self-Regulatory Organizations; The Nasdaq Stock Market LLC; Notice of Filing of Proposed Rule Change to Adopt Additional Requirements for Listings in Connection with an Offering Under Regulation A of the Securities Act, Release No. 34-85687; File No. SR-NASDAQ-2019-017, April 18, 2019, at 4, <http://bit.ly/2lqI46q>.

⁴⁷¹ *Id.* at 5.

⁴⁷² *Id.*

⁴⁷³ *Id.*

⁴⁷⁴ Jeff Schwartz, *Venture Exchange Regulation: Listing Standards, Market Microstructure, and Investor Protection*, Forthcoming in the Handbook on Law and Entrepreneurship, Gordon Smith, Christine Hurt & Brian Broughman eds., Cambridge Univ. Press 2018, University of Utah College of Law Research Paper No. 179, <http://bit.ly/2ltYknm>.

⁴⁷⁵ See *United States Venture Market: Has the Time Come?*, CFA Institute (May 2016), <https://cfa.is/2IToXCs>.

⁴⁷⁶ Reena Aggarwal and James Angel, *The Rise and Fall of the Amex Emerging Company Marketplace* (Apr. 1998); See also Former SEC Chairman Arthur Levitt, *A Small-Cap Idea With Little to Recommend It: The SEC’s plan to create special exchanges sounds like a solution in search of a problem*, Wall Street Journal, March 2, 2015,

allow trading of exempt securities would be immune to this problem. As the NYSE's former president said in Congressional testimony: "My guess is your adverse selection concern is not—it is not theoretical. That is exactly what would happen. And Uber is not going to choose to list on a venture exchange, if you will."⁴⁷⁷

In short, attractive companies with ready access to capital and liquidity aren't going to want to risk sully their reputation and future prospects by being associated with a "junior" market full of companies that have a high likelihood of failure, or worse. Rather, these higher-quality companies will likely wait until they are ready for prime time, then conduct a full blown registration and listing on one of the national exchanges. Scott Kupor, Managing Partner of Andreessen and Horowitz, acknowledged this likely scenario in congressional testimony, stating: "The most attractive companies that can raise private capital through other means, as some are doing today, may simply continue to do so and, thus, only those who are in a weaker position may choose to list on the venture exchange."⁴⁷⁸ Relatedly, Kupor highlighted the risk that, rather than creating more liquidity in small company stocks, venture exchanges would result in less liquidity, because institutional investors, "may simply wait for venture exchange companies to graduate to the national market exchanges instead of investing in them as venture exchange issuers."⁴⁷⁹

In sum, venture exchanges are likely to attract and cater to the types of companies that can't meet the most basic standards for being publicly traded, putting investors and markets at risk.

3. Retail Investors are Likely To Be the Primary Victims of Venture Exchange Problems.

Venture exchanges are likely to be used primarily, if not exclusively, by retail investors. That's because large institutional investors are unlikely to invest in the kinds of companies that list and trade on venture exchanges. Micro and nano cap companies just don't attract institutional investor interest. There are a number of reasons for this.

- First, such small companies are unlikely to affect the overall performance of a large institutional investor's portfolio.⁴⁸⁰ As University of Utah S.J. Quinney College of Law Professor Jeff Schwartz explained in his article, *Venture Exchange Regulation: Listing*

<https://on.wsj.com/2ITSXhx> ("The companies that proved themselves on ECM simply graduated to the regular exchange, thereby tainting ECM as a minor league market, mostly for unsuccessful enterprises.").

⁴⁷⁷ Hearing Before the Subcommittee on Securities, Insurance, and Investment of the Committee on Banking, Housing, and Urban Affairs, United States Senate, One Hundred Fourteenth Congress, First Session, on "Examining How Venture Exchanges Can Aid Capital Formation and Secondary Trading for Smaller Businesses and Companies," March 10, 2015, at 17, <http://bit.ly/2m3R9Cn>.

⁴⁷⁸ *Id.* at 31.

⁴⁷⁹ *Id.* at 8.

⁴⁸⁰ Jeff Schwartz, *Venture Exchange Regulation: Listing Standards, Market Microstructure, and Investor Protection*, Forthcoming in the Handbook on Law and Entrepreneurship, Gordon Smith, Christine Hurt & Brian Broughman eds., Cambridge Univ. Press 2018, University of Utah College of Law Research Paper No. 179,

<http://bit.ly/2ltYknm> ("Even a well-performing investment in a smaller company would have little impact on the total returns of an institutional investor. Therefore, analyzing and investing in smaller companies is not worth the time and effort. This is particularly the case for larger institutions, where such investments would have the smallest impact.").

Standards, Market Microstructure, and Investor Protection, for institutional investors, “analyzing and investing in smaller companies is not worth the time and effort. This is particularly the case for larger institutions, where such investments would have the smallest impact.”⁴⁸¹

- Second, such small companies typically don’t have a significant amount of shares outstanding for institutions to buy and sell.⁴⁸² Rather, their shares are typically mostly owned by company management, which reduces the number of shares available to trade. Thus, according to the CFA Institute, “The limited float reduces the willingness and ability of institutional investors to invest, thus leaving this market largely to retail investors and brokers.”⁴⁸³
- Third, the lack of institutional investor interest in small company securities has resulted in a lack of research analyst coverage for these securities. According to Schwartz, “Coverage is typically provided for free to a brokerage firm’s institutional clients. There is little reason for these firms to assign analysts to cover companies in which their clients have muted interest.”⁴⁸⁴

As a result of all of these factors, institutional investors typically don’t trade in such small securities. That decreases liquidity, which in turn increases transaction costs, to the point where it can be more expensive to trade such small securities than the yield they produce.⁴⁸⁵ According to Schwartz, all of these challenges associated with investing in small company securities -- including “reduced institutional and analyst interest and increased trading costs—would exist on venture exchanges.”⁴⁸⁶

When institutional investors exit a market, retail investors may suffer. That’s because institutional investors help promote price efficiency in the securities in which they invest, which can provide an additional level of protection for other investors in the market.⁴⁸⁷ In other words, when markets are performing as intended, these sophisticated investors help to ensure that the companies they invest in exhibit prices that bear a close connection to their underlying values. According to Schwartz, for example, “[Institutional] investors absorb the available information about companies and this information is impounded into market prices through their trading decisions. Thus, retail investors trade at fair prices without reading and understanding all of the information that informs them. In a market where prices are set by sophisticated institutions, there is a smaller chance that retail investors will overpay for a company with dubious prospects or unsound business practices.”⁴⁸⁸ Because venture securities are unlikely to attract institutional investor interest, however, that additional layer of protection won’t be provided. Instead, it’s likely that a venture exchange will create a “less efficient market where share prices are less

⁴⁸¹ *Id.*

⁴⁸² *United States Venture Market: Has the Time Come?*, CFA Institute (May 2016), <https://cfa.is/2IToXCs>.

⁴⁸³ *Id.* at 12.

⁴⁸⁴ Jeff Schwartz, *Venture Exchange Regulation: Listing Standards, Market Microstructure, and Investor Protection*, Forthcoming in the Handbook on Law and Entrepreneurship, Gordon Smith, Christine Hurt & Brian Broughman eds., Cambridge Univ. Press 2018, University of Utah College of Law Research Paper No. 179, <http://bit.ly/2ltYknm>.

⁴⁸⁵ *Id.*

⁴⁸⁶ *Id.*

⁴⁸⁷ *Id.*

⁴⁸⁸ *Id.*

accurate.”⁴⁸⁹ As a result, the retail investors who are likely to be the primary users of venture exchanges will likely buy and sell at prices that don’t reflect the companies’ underlying values.

Moreover, the types of companies that would be listed on a venture exchange are likely to display the features -- i.e., relatively few available shares that are thinly traded -- that make it is easier for a fraudster to manipulate the price of the stock through pump and dump schemes.⁴⁹⁰ Indeed, the SEC has issued an Investor Bulletin raising these exact concerns with regard to microcap stocks.⁴⁹¹ It routinely suspends trading in microcap stocks,⁴⁹² and in 2013 it formed a Microcap Fraud Task Force “to target abusive trading and fraudulent conduct in securities issued by microcap companies, especially those that do not regularly publicly report their financial results.”⁴⁹³ And its website highlights the risks associated with these securities.⁴⁹⁴ Allowing such securities to trade on a venture exchange is likely to exacerbate these concerns.

In addition, the types of companies likely to trade on a venture exchange are usually terrible investments. According to an analysis by DERA of 1.8 million trades of OTC investments by over 200,000 individual investors, for example, “the typical OTC investment return is severely negative. Investor outcomes worsen for OTC stocks that experience a promotional campaign or have weaker disclosure-related eligibility requirements. Demographic analysis reveals that older, retired, low-income, and less educated investors experience significantly poorer outcomes in OTC stock markets.”⁴⁹⁵ It’s unlikely that putting these types of companies onto venture exchanges, or permitting other exempt securities to trade on such exchanges, would miraculously change these outcomes. It could actually result in the opposite effect if listing them onto a venture exchange creates a false sense among investors that they are investing in companies that are more liquid, more credible, and less susceptible to manipulation than OTC stocks. The end result, however, is likely to be that venture exchanges perpetuate the very problems that OTC stocks present, but they do so to a much greater magnitude, by proliferating the sales of the same types of companies to more retail investors who suffer similar harms as a result.

4. Venture Exchanges also Raise Monopoly and other Competition Concerns, Increasing the Risk that Investors will be Harmed.

Depending on how they are structured, venture exchanges may limit competition in some ways while simultaneously increasing other forms of competition on terms that hurt investors.⁴⁹⁶

⁴⁸⁹ *Id.*

⁴⁹⁰ See Written Statement of William Beatty, President, NASAA and Washington Securities Division Director, Before the Subcommittee on Securities Insurance, and Investment, of the Committee on Banking, Housing, and Urban Affairs, United States Senate, “Venture Exchanges and Small-Cap Companies,” March 10, 2015, <http://bit.ly/2lu5122>.

⁴⁹¹ See SEC, Investor Bulletin: Microcap Stock Basics (Part 3 of 3: Risk), Investor.gov, <http://bit.ly/2lsdz03> (last visited September 26, 2019).

⁴⁹² See SEC, Trading Suspensions, <http://bit.ly/2ntfMc2> (last visited September 26, 2019).

⁴⁹³ New Enforcement Initiatives by SEC Focus on Financial Reporting, MicroCap Fraud and Risk Analysis, Core Compliance Blog, <http://bit.ly/2m3vUk8>.

⁴⁹⁴ SEC, Spotlight on Microcap Fraud, <http://bit.ly/2nCKn7n> (last visited September 26, 2019).

⁴⁹⁵ Joshua T. White, *Outcomes of Investing in OTC Stocks*, DERA, December 16, 2016, <http://bit.ly/2ltyNus>.

⁴⁹⁶ Prepared Statement of Stephen Luparello, SEC Director of the Division of Trading and Markets, Before the Subcommittee on Securities, Insurance, and Investment of the Committee on Banking, Housing, and Urban Affairs,

First, recognizing that venture exchange securities would be at risk of suffering from illiquidity, one idea that venture exchange supporters have promoted is to suspend unlisted trading privileges (UTP).⁴⁹⁷ Suspending UTP would prohibit shares that are listed on the venture exchange from trading elsewhere, which would effectively consolidate trading. While that might promote more liquidity than if those same venture securities could trade across venues, it would also provide the listing venture exchange with a monopoly. According to CFA Institute, monopoly status, “limits competition and runs the risk of higher fees being charged to listed companies and investors.”⁴⁹⁸ Furthermore, according to CFA Institute “a monopolistic venture exchange could lead to an increase in trading costs for investors. Without competition, exchanges would have greater leeway to raise listing, trading, connectivity, and market data fees.”⁴⁹⁹

On the other hand, venture exchanges may, in some areas such as the competition for listings, increase competition, but on terms that hurt investors. Specifically, since venture exchanges will have a strong financial incentive to capture listings, it is likely that they will do whatever it takes to attract listings. This could include compromising whatever listing standards they might otherwise adopt.⁵⁰⁰ As discussed above, the applicable listing standards are not likely to be very rigorous in the first place. This incentive will only make them weaker.

In short, the issues relating to venture exchanges and how they affect competition are complex and varied. As Luparello stated, “The potential benefits and costs of various forms of competition in the secondary market for smaller companies is an issue that warrants close consideration by Congress, the SEC, and the public.”⁵⁰¹ We agree that the Commission should have a much better understanding of these issues before allowing them to play out in real time and under circumstances that harm our markets and investors.

F. Instead of Expanding Private Markets, the Commission Should Consider Scaling Back Existing Exemptions.

In this Concept Release, the Commission has attempted to divorce consideration of securities exemptions from their impact on the health of our public markets, but the issues cannot

United States Senate, One Hundred Fourteenth Congress, First Session, on “Examining How Venture Exchanges Can Aid Capital Formation and Secondary Trading for Smaller Businesses and Companies,” March 10, 2015, at 26, <http://bit.ly/2m3R9Cn> (“The Commission must also consider how efforts to protect a venture exchange’s liquidity pool would affect competition. While such efforts would restrict one form of competition—that is, competition among trading venues for order flow in a particular group of securities—it could potentially open up new forms of competition.”).

⁴⁹⁷ It is not clear the Commission has the legal authority to suspend UTP without further legislation.

⁴⁹⁸ See *United States Venture Market: Has the Time Come?*, CFA Institute (May 2016), <https://cfa.is/2IToXCc> (“The primary rationale for allowing unlisted trading is that failure to do so gives the listing exchange a trading monopoly, which allows it and its associated intermediaries to exploit investors on trading costs.”).

⁴⁹⁹ *Id.* See also Prepared Statement of Stephen Luparello at 26 (stating that “It is also possible...that high costs and other barriers to entry, such as network effects or cost-related economies of scale, may result in a more concentrated market with few active venture exchanges.”).

⁵⁰⁰ See Prepared Statement of Stephen Luparello at 26 (“The success or failure of the exchanges would largely depend on the extent to which the various venture exchanges were able to attract small companies and their investors.”).

⁵⁰¹ *Id.*

be separated. Four decades of deregulatory actions by Congress and the SEC have put our public markets at risk. The Commission cannot reasonably move forward with the proposals offered for consideration in this Concept Release, when the overwhelming weight of the available evidence suggests that doing so would further weaken the public markets that play such a crucial role in our nation's economy. Moreover, many of the proposals put forward in the Concept Release threaten to expose investors to significant new risks, and to do so without even offering a meaningful improvement to sustainable capital formation and job creation. Instead, the Commission should be considering actions to rein in existing exemptions in order to restore an appropriate balance between public and market markets and restore important investor protections.

While not a comprehensive list, the following are among the changes that should be at the top of the Commission's agenda:

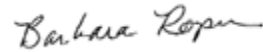
- Restoring incentives for large private companies with a dispersed shareholder base to go public by lowering the shareholder threshold under Section 12(g) of the Exchange Act that triggers the requirement to become a publicly reporting company. Specifically, we believe an approach based on beneficial owners, rather than holders of record, would better serve the intended regulatory purpose. While making this change would require Congressional action, the Commission should begin conducting the analysis that would support such a change and inform members of Congress, including members of the House Financial Services Committee and Senate Banking Committee, of its findings.
- Bringing added regulatory scrutiny to the Reg A market by reversing the Commission's definition of qualified purchaser, which ignored clear Congressional intent to broadly preempt state authority. Indeed, given the abysmal performance of Reg A+ securities since the JOBS Act was adopted, the Commission should give serious consideration to whether the exemption should be scaled back or eliminated entirely. While the latter would again require Congressional action, the Commission can rectify on its own the problem it created with its broadly preemptive qualified purchaser definition.
- Completely rethink the definition of accredited investor, abandoning the approach based on financial thresholds that are a poor proxy for all the markers of investors' ability to fend for themselves without the protections afforded in public markets (financial sophistication, ability to tolerate private market risks, or access to information). In order to begin collecting the data needed to better understand both the effectiveness of the existing definition and the potential impact of any changes, the Commission should start by strengthening its Form D filing requirements and enforcement in order to begin collecting the data needed for a thorough analysis.

Conclusion

The clear intent of the Concept Release is to begin building the record in support of proposals to further expand private markets and retail access to those markets. The Commission appears intent on pursuing this agenda despite the clear threat it poses to the health of public markets and investor protection, and despite the complete lack of compelling evidence that the proposed changes would promote sustainable capital formation. We urge the Commission in the

strongest possible terms to abandon this deregulatory agenda, which would be bad for investors and disastrous for the capital markets on which our nation's economy depends.

Respectfully submitted,



Barbara Roper
Director of Investor Protection



Micah Hauptman
Financial Services Counsel

cc: The Honorable Jay Clayton, Chairman
The Honorable Robert J. Jackson, Jr., Commissioner
The Honorable Hester M. Peirce, Commissioner
The Honorable Elad L. Roisman, Commissioner
The Honorable Allison Herren Lee, Commissioner
William Hinman, Director, Division of Corporation Finance